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Julian Nelberg explains the impact of new legislation which applies to executives working in the fund management industry

Key Points

What it the issue?

Sweeping changes have been introduced to the rules for individuals working in the fund management industry

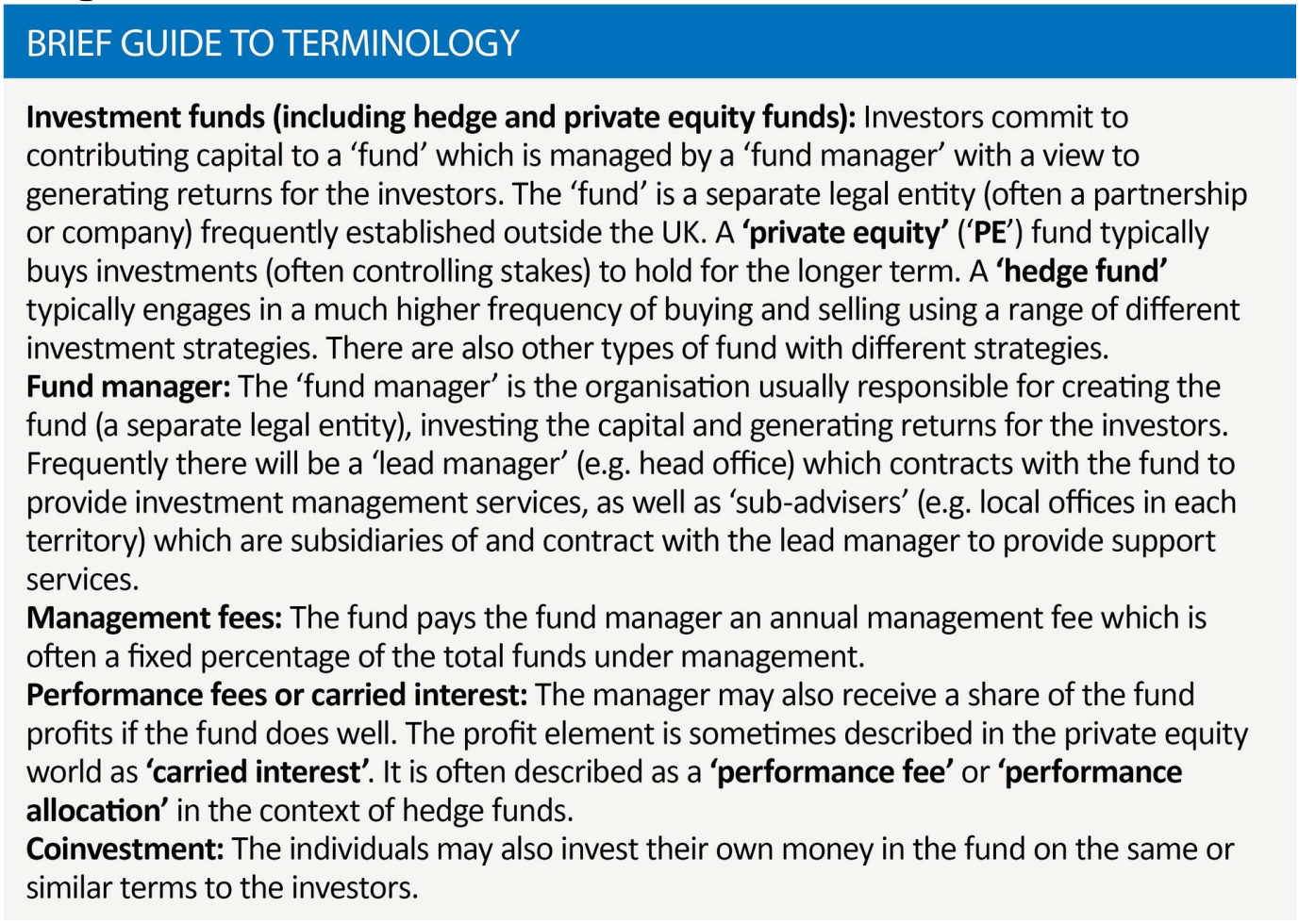
What does it mean to me?

Advisers with clients working for fund managers should review the legislation and guidance to determine the impact and advise their clients accordingly

What can I take away?

The rules could result in fund managers being subject to additional taxes but are generally unlikely to impact individuals whose remuneration is already subject in full to UK income tax and NICs

Image



This article seeks to explain the impact of the following legislation which applies to executives working in the fund management industry:

- Disguised Investment Management Fees (DIMF) in ITA 2007, Pt 13, ch 5E effective 6 April 2015 (see also the associated HMRC guidance note published 29 March 2015)
- Carried Interest in TCGA 1992, Pt III, ch 5 effective 8 July 2015 (See also the associated HMRC guidance note published 20 July 2015); and
- 'Income-Based Carried Interest' in ITA 2007, Pt 13, ch 5F, effective 6 April 2016.

The comments in this article are based on the legislation and guidance at the present date. Further guidance is expected at a future date with respect to all of the above legislation.

The thrust of the legislation is to ensure that (from 6 April 2015) individuals are subject to income tax and NICs on their share of management fee income, and that (from 8 July 2015) their share of fund profits is taxed at a minimum of CGT rates, or (from 6 April 2016) income tax rates when the fund investments fail to meet prescribed criteria. These rules apply to individuals who provide 'investment management services' (ITA 2007, s 809EZE(1)) for an 'investment scheme' (ITA 2007, s 809EZA(6)). It is understood that HMRC may interpret this as including all individuals who work for fund managers, irrespective of their actual role or job title.

Executives in the fund management industry are typically remunerated from the management fees paid by the fund to the fund manager. This compensation may take the form of salary and bonus or profit share, depending on whether the individual is an employee or partner. They may also be entitled to share in the profits of the investment funds they manage, if the fund performs well.

Historic treatment of carried interest

For private equity style funds (i.e. funds which acquire investments to hold for the long-term), the fund vehicle is usually a partnership. The executives often acquire an indirect interest in the actual fund through one or more other partnerships, so that for tax purposes they are considered to own a share of the underlying investments of the fund. This is referred to as a 'carried interest'. Where the fund profits take the form of capital gains, the carry holders are treated as receiving a share of those gains, taxable at CGT rates. A 2003 memorandum of understanding between the

British Venture Capital Association (‘BVCA’) and HMRC included safe harbour guidelines which if satisfied would typically support this tax treatment.

Hedge funds are typically more likely to be ‘trading’ than ‘investing’ for tax purposes, and therefore the returns are less likely to qualify for CGT treatment. The executives’ entitlement to share in the fund profits may either be structured as an allocation of fund profits (sometimes described as a ‘carried interest’ or ‘performance allocation’) or alternatively paid by the fund as an additional fee to the fund manager (a ‘performance fee’), and subsequently delivered to the individual executive as an additional cash bonus or in some other manner.

DIMF and carried interest legislation

The DIMF legislation is intended to ensure that from 6 April 2015, individuals are subject to income tax and NICs on the full amount of the fund management fees they are entitled to receive. These rules were intended to target private equity fund managers which, instead of receiving a management fee, would receive the first slice of future fund profits (which may be eligible for CGT rates). This was sometimes referred to as a ‘priority profit share’. In the early years of the fund, the fund manager would receive loans (initially non-taxable) which would be matched with future fund profits. The DIMF legislation rectifies this anomaly by taxing all ‘untaxed’ amounts (including loans) as income from a UK trade at up to 45% plus 2% NICs (ITA 2007, s 809EZA(4)). There are exceptions from DIMF for amounts meeting the definition of ‘carried interest’, a repayment of capital invested by the individual or an arm’s length return on investment on that capital on similar terms to external investors (e.g. coinvestment) (ITA 2007, s 809EZB and 809EZC). The DIMF exceptions are defined in detail in the DIMF legislation. Although the DIMF rules specifically target priority profit share arrangements, they potentially catch any situation where individuals are not paying full income tax on their share of management fees.

The Carried Interest legislation aims to ensure that from 8 July 2015, all amounts payable to an individual from fund profits (which meet the definition of carried interest) are taxed at a minimum of the CGT rates, irrespective of the nature of the underlying fund profit giving rise to the payment.

‘Carried interest’ is defined in the legislation as either a profit–related return from an investment scheme where there is significant risk that the individual will not receive

a payment, as well as arrangements which are reflective of a standard private equity type carry model (ITA 2007, s 809EZC and s 809EZD). See also the standard private equity carry model described in the 2003 BVCA/HMRC memorandum of understanding referred to above.

Any arrangements where an individual is remunerated from fund profits will potentially be caught by the carried interest rules, irrespective of whether or not the individual's entitlement is described as a carried interest.

Furthermore, any amount paid from an investment scheme which does not meet the definition of 'carried interest' will, by default, be DIMF income unless it meets one of the DIMF exceptions summarised above.

In addition to imposing a minimum tax rate of the CGT rates, the carried interest legislation removes a tax quirk commonly known as 'base cost shift'. In a typical private equity fund, the carry holders have no entitlement until the fund has generated sufficient profits to repay the investors' capital plus a preferred return, referred to as the 'hurdle'. When the hurdle is reached, the fund partnership profit sharing ratio changes in favour of the carry holders so that they own a share of the underlying investments – including a share of the tax base cost. This is treated as a 'no gain/no loss' transaction under Statement of Practice D12. Hence the capital gains attributed to the individuals could be lower than the amount of cash received. The Carried Interest legislation ensures that individuals are taxed on the economic profit, rather than the gain after applying the principles in D12.

The tax charge under both the DIMF and carried interest rules is triggered when an amount 'arises' to an individual or a connected person (trusts, family members etc), or (from 22 October 2015) if it 'arises' to anyone else but where the individual or a connected person could potentially benefit from the payment. Originally the legislation taxed amounts arising 'directly or indirectly' to the individual but on 22 October 2015 both the DIMF and carried interest legislation were amended to include the connected persons and power to enjoy provisions. The power to enjoy and connected persons provisions were introduced in an amendment to the legislation on 22 October 2015; prior to this the legislation taxed an individual on amounts arising 'directly or indirectly' from investment scheme, with no reference to connected persons.The term 'arise' is not defined but is understood to mean when received by the individual or another entity and earmarked for the benefit of the individual or a connected person. The carried interest tax charge is however

deferred where the individual is genuinely unable to access the cash due to a commercial deferral arrangement which has been agreed with the external investors in the fund (TCGA 1992, s 103KG(2) and s 103KG(13)).

The Carried Interest tax regimes replace any CGT charge which would have already arisen under pre-existing rules, but does not replace any pre-existing income tax charge. In the event that a double tax charge arises, the individual will be allowed an offsetting credit in order to avoid double taxation (ITA 2007, s 809EZG and TCGA 1992, s 103KE). So for example, if the carried interest payment is in fact a payment of UK income (e.g. a UK dividend received by the fund from a fund investment) then the individual will be taxed at the higher of the dividend and CGT rates.

Non-UK domiciliaries and non-UK residents

Both the carried interest and DIMF legislation override the remittance basis for non-UK domiciled individuals ('non-doms') who previously may have escaped paying UK tax altogether if the carry returns comprised only foreign income and gains. The DIMF legislation does this by deeming the income to be UK source trading income (ITA 2007, s 809EZA(1)). The Carried Interest legislation treats the carry payment as a UK capital gain but allows a remittance basis non-dom to treat a portion of each carry payment as a *foreign* capital gain, to the extent they have performed services for the fund *outside the UK* (TCGA 1992, s 103KC).

- HMRC suggest in their 20 July 2015 guidance that the determination of the foreign portion of the carry is based on the 'value' of the services provided outside the UK, rather than the ratio of foreign to UK days. This is clearly subjective, and clients and their advisers will need to consider an appropriate methodology for determining the UK and offshore split, in order to ensure consistency in tax return reporting. This needs to be balanced with the potential corporate exposures from claiming that activities are undertaken in other countries, such as the risk of creating a permanent establishment in another country.
- The carry must be paid into and retained in a non-UK bank account in order to be eligible for the remittance basis. If the carry is paid into a single non-UK bank account, then the individual will have a 'mixed fund' for the purpose of the remittance rules and remittances (for example to pay the tax on the UK portion of the carry) will be deemed to derive firstly from the non-UK carry,

which will trigger additional tax and could remove the benefit of being able to treat a part of the carry as foreign. HMRC have advised informally that the UK and offshore carry payments can be deposited by the fund manager into two separate bank accounts of the individual. This will hopefully be confirmed in guidance.

The DIMF legislation also applies to non-residents performing services in the UK. The tax charge is limited to the DIMF income which relates to UK services (ITA 2007, s 809EZA(2)(a)). It is assumed this requires a calculation similar to that for non-doms who wish to treat part of their carry as foreign. Individuals who are resident in a treaty country may be eligible to claim exemption from UK tax, if their UK activities do not constitute a permanent establishment.

By contrast, the current carried interest legislation would appear not to apply to non-residents, although it could apply to temporary non-residents (TCGA 1992, s 10A). However they could be taxed on payments received on/after 6 April 2016 which meet the definition of IBCI (see below) and hence are reclassified as DIMF income.

Income-based carried interest (‘IBCI’)

From 6 April 2016, carried interest will be taxed as UK source trading income rather than capital gains, if the fund investments by reference to which the carry is calculated fail to satisfy a weighted average holding period of 40 months or greater. Where the average holding period is 40 months, none of the carry will be IBCI. Where it is less than 36 months, 100% of the carry will be IBCI, and between 36 and 40 months there is a sliding scale.

The rules include detailed computational provisions to determine the average holding period, treating each injection of funds as a separate investment but with relaxations for certain types of funds, investments and strategies.

Non-UK domiciled individuals will be subject to UK tax on 100% of the IBCI carry–there is currently no apportionment for non-UK services (with the exception of a slight relaxation for certain individuals who were granted carry before becoming UK resident). Thus, from 6 April 2016, a non-UK domiciled individual’s UK tax rate could range from below 28% (if none of the carry is IBCI) to 47% (if all of the carry is IBCI).

Non-UK resident individuals will taxed on IBCI to the extent they have performed services in the UK but may be eligible to claim exemption under a tax treaty if their UK activities do not constitute a permanent establishment.

Carried interest which is an employment related security (‘ERS’) is currently exempt from being reclassified as IBCI. This appears quite generous on the part of HMRC, but of course where carry is already an ERS then the complexities arising from the ERS rules will need to be considered.

Practical challenges and next steps

Asset manger remuneration arrangements should be reviewed in order to determine the impact of the DIMF and carried interest rules on individual executives. This is unlikely to be straightforward given the complexity of the legislation. Here are some of the things their advisors will need to consider:

- Are the arrangements caught by the DIMF and carried interest rules?
- From 6 April 2016, will the carried interest be reclassified as income-based IBCI?
- Do they qualify for any of the exemptions or grandfathering provisions?
- When does the tax charge crystallise i.e. when does the carry or DIMF income ‘arise’ and for carry, does it meet the definition of ‘deferred carried interet’?
- Will the fund manager provide reporting to help the individuals complete their tax returns?
- For non-doms–apportionment of carry between UK and non-UK services, and bank account structuring for individuals who wish/need to remit their carry to the UK.

Special consideration is required for US citizens and US green card holders who will be subject to both UK and US tax on their carried interest and will therefore be keen to understand whether and how credits will be available to alleviate double taxation.

Given the complexity of the legislation, careful consideration of the rules is required to ensure that clients are appropriately advised. As ever, the devil is in the detail.