Client Update

Are Your Carry and Co-Invest Returns Safe from UK Income Tax? (Sadly Your Management Fee Probably Isn't.)

LONDON
Richard Ward
rward@debevoise.com

Ceinwen Rees
crees@debevoise.com

Salvador Dalí, the man who brought us Lobster Telephone, is famously quoted as saying that "what is important is to spread confusion, not eliminate it". It appears that the UK Government was taking lessons from this great master when they published the draft Finance Bill at the close of 2014. The Bill introduced a new taxing regime for, so called, disguised management fees the drafting of which was so wide in scope and jurisdictional breadth that it appeared to catch potentially all types of distributions made by a fund to its management team, wherever based, if even just marginal UK activity took place. After a period of consultation revised rules were published yesterday in the Finance Bill 2015.

AUTUMN DRAFT OF THE FINANCE BILL ("AUTUMN DRAFT")

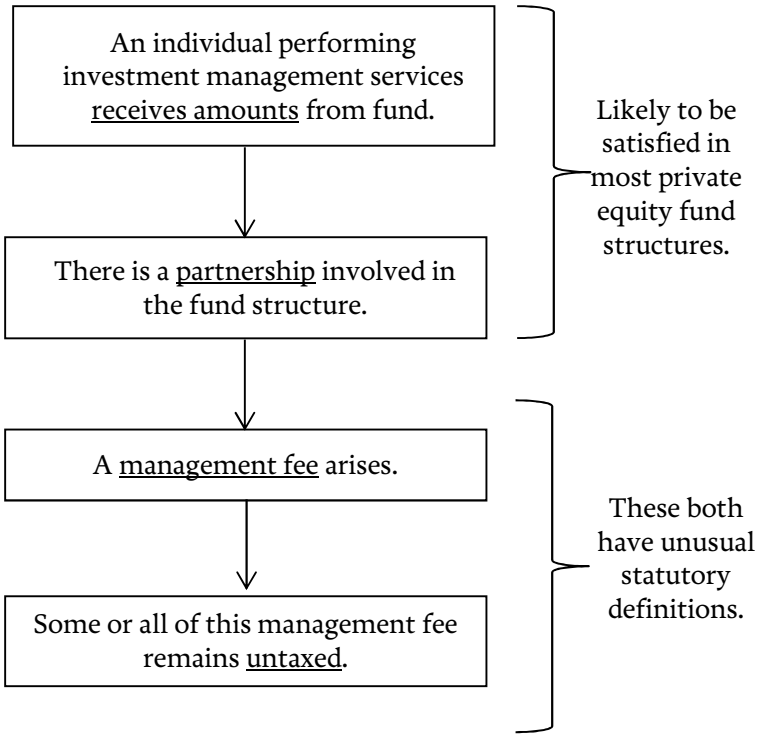
Tucked away in the UK Chancellor's Autumn Statement in November 2014 was a comment that the Government would be "taking measures to prevent [amongst other things] the disguising of fee income by investment managers". When the documents accompanying this statement were published later that week there were reassurances that this was not aimed at catching carried interest or co-invest returns. There followed a week of speculation about what this would mean in practice although not even the most pessimistic of speculators predicted a regime so broad in scope and so out of step with the industry that it had the potential to bring GP profit share as well as carry and co-invest returns within the UK income tax net, rather than the more favourable capital gains tax regime.[1]

[1] For a fuller discussion of the Autumn Draft see our Client Update "UK Tax on Management Fees, Co-Invest and Carry: Is Anything Safe?", 15 December 2014.

The industry response, spearheaded by the British Private Equity & Venture Capital Association, was quick and comprehensive; the rules as proposed did not satisfy the stated aims in the Autumn Statement, did not reflect the commercial reality of private equity and would make the UK uncompetitive in a global market. In last week's budget the UK Chancellor reassured the industry that "*Following consultation, the legislation has been revised to better reflect industry practice on performance related returns, to restrict the charge on non-UK residents to UK duties…*".

FINANCE BILL 2015

Since yesterday, the truth of this statement was open for review. Tucked in amidst nearly 350 pages of legislation are the new disguised investment management fee rules. Our first impression of the rules is that they are drastically different from the rules published in the Autumn Draft; the Treasury has clearly not been afraid to splash about the red ink (which can only be a good thing). Underlying these changes, the structure of the rules remains the same; there are still four requirements that need to be satisfied for the legislation to apply:

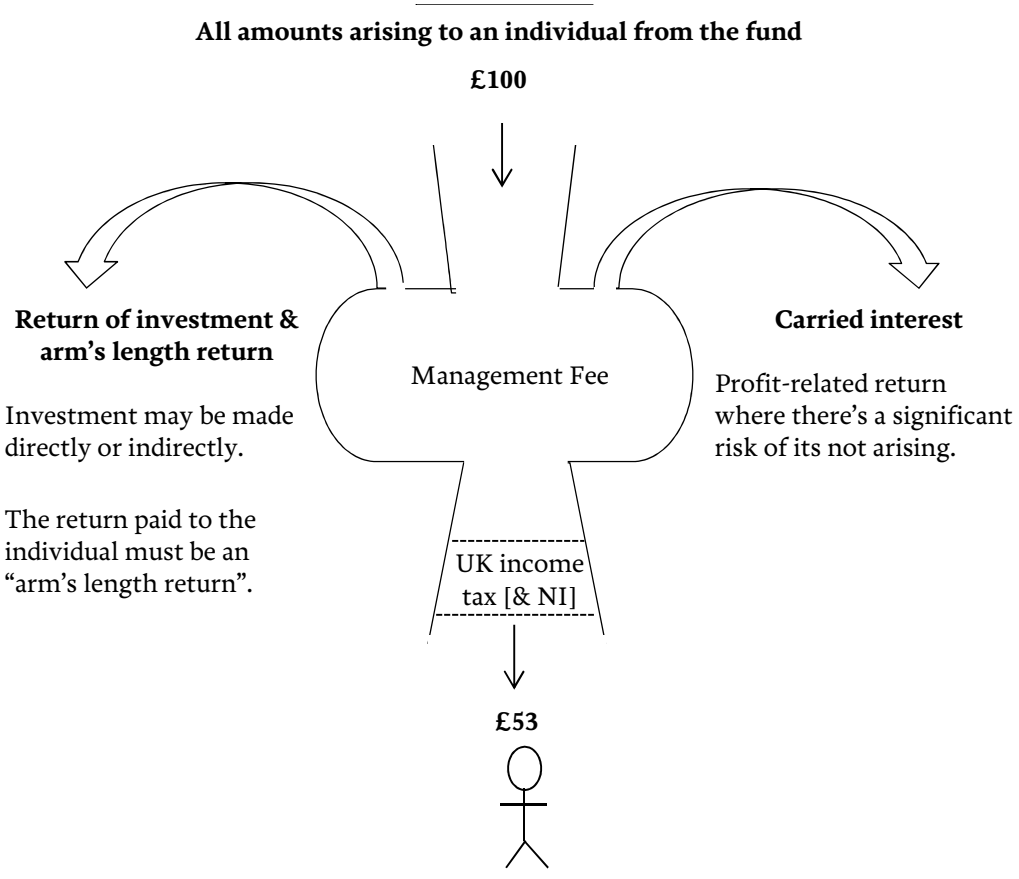


And, once within the regime, amounts will be subject to UK income tax (up to 45%) and possibly national insurance liabilities (2%) rather than UK capital gains tax (up to 28%).

WHAT IS A MANAGEMENT FEE UNDER THE REVISED LEGISLATION?

Under the new rules, any sum arising to an individual directly or indirectly from a fund under any arrangements is a management fee except so far as the sum constitutes:

- a repayment (in whole or part) of an investment made directly or indirectly by the individual;
- an arm's length return on an investment made directly or indirectly by an individual; or
- carried interest.



It is still not clear precisely what arising means and whether amounts held in a corporate entity will be treated as arising to an individual who is a shareholder. We expect HMRC to address this point in their guidance.

IS CARRIED INTEREST SAFE NOW?

The short answer: probably.

One of the most controversial parts of the Autumn Draft was the definition of carry, which required that it be amounts paid out of profit after participants had received back their capital plus a preferred return of 6% compound interest.

Although Parliament has stayed wedded to this definition of carry, it now forms a safe harbour rather than the only form of return that may constitute carry. The broader carried interest definition is "any sum which arises to the individual...by way of profit-related return" provided that such amount is not guaranteed but is at "significant risk of not arising". A return is a profit-related return if:

- the sum will arise only if there are profits;
- the amount of the sum varies in accordance with the profits; and
- returns to external investors are determined by reference to such profits.

We would therefore expect most standard carried interest structures to fall within this exclusion.

ARE CO-INVESTMENT RETURNS SAFE NOW?

The short answer: probably, although we await further clarification from HMRC.

Co-invest returns should not fall within this regime but the drafting presented in the Autumn Draft was fairly tortuous, relying on a return's being in respect of an investment made by an individual himself and that the return should not exceed a "commercial return" (which raised concerns in respect of any successful investment). Both of these concerns have been addressed in the new legislation.

Amounts representing the return of an investment made directly or indirectly by an individual fall outside of the regime and rather than a return's needing to be commercial it instead needs to be an arm's length return.

A return is an arm's length return if it:

- is a return on an investment which is the same kind of investment as external investors have made in the fund;
- the return on the investment is reasonably comparable to the return to external investors on those investments; and
- the terms governing the return on the investment are reasonably comparable to the terms governing the return to external investors on those investments.

The pause for thought in these conditions is the fact that the terms need to be "reasonably comparable". This is a phrase that has remained in the legislation from the original draft. We understand that HMRC has intimated that co-investment which is not subject to management fee or carry will nevertheless satisfy this condition and that guidance will be issued confirming the point. HMRC proposes publishing this guidance prior to 1 April but has not confirmed the exact date.

WHAT DOES "UNTAXED" MEAN UNDER THE NEW LEGISLATION?

The short answer: anything not subject to UK income tax.

Sadly the definition of untaxed remains relatively unchanged; in keeping with the very broad approach taken to defining management fees, "untaxed" doesn't actually mean that an amount has not been subject to tax but instead means, for the purposes of this legislation, that an amount has not been subject to income tax as employment income or trading income. Provision does not appear to have been made for foreign taxes paid and instead people will have to rely on double tax treaties, where they exist.

WHAT ABOUT THE INTERNATIONAL EFFECT?

Short answer: things are much better.

The exceptionally wide jurisdictional scope of the first draft of these rules caused much consternation. Thankfully, HMRC has reigned itself in somewhat and now the regime bites only to the extent that an individual performs investment management services in the UK.

The effect for non-UK-domiciled individuals will still be that all amounts falling within the legislation will have a UK source and therefore be taxed in the UK whether or not they are remitted into the country.

For a non-UK resident individual, who provides investment management services in the UK, the situation is still a little knotty. Technically, it looks like this person would be within the rules, although we would hope that double tax treaties should help most people. In terms of administration, though, it is not clear how an income tax liability arising to a non-UK tax resident would be assessed. We can but hope that HMRC provides some guidance on this point in its much anticipated guidance.

WHAT NEXT?

The Finance (No. 2) Bill 2015 was published yesterday, 24 March. It will pass through Parliament today. We expect the Bill to be passed in unamended (or insignificantly amended) form before Parliament dissolves on 30 March ready for May's election. The legislation will take effect from 6 April although, worryingly the Treasury has reserved itself a very broad right to amend the legislation by regulations.

Given this tight timescale, we suggest speaking with Richard Ward or Ceinwen Rees as soon as possible so that you can move quickly. We would also like to invite you to a webinar at 4pm UK time today in which we will be discussing these issues further. If you would like to attend (or receive a recording of the webinar), please email londonevents@debevoise.com.

Parliament may have played a clever hand; it delivered something incomprehensible and so now when presenting something, which 6 months ago would have caused horror, it is instead greeted with a feeling of deflated resignation and the mantra "it's not as bad as it could have been". We have moved from a lobster telephone to being served "Still Life with Two Lemons"[2].

* * *

Please do not hesitate to contact us with any questions.

[2] Dalí, c.1926.