Client Update
More UK Tax? Additional Guidance on the Disguised Investment Management Fee Rules

LONDON
Richard Ward
rward@debevoise.com

Ceinwen Rees
crees@debevoise.com

The UK is showing its teeth when it comes to combating aggressive tax planning and it is not feeling constrained by our watery borders. In this year's budget the UK has introduced new and, potentially, far reaching rules which seek to:

- tax certain distributions from a fund to its management team as UK income instead of UK capital gains; and
- in some cases bring certain distributions to a management team into the UK's tax net.

A detailed discussion about the rules themselves is contained in our Client Update "Are Your Carry and Co-Invest Returns Safe from UK Income Tax? (Sadly Your Management Fee Probably Isn't.)", which is reproduced as an Annex to this note for your convenience.

This Client Update serves as a supplement to our more detailed note and has been written following the publication by HMRC of its guidance to accompany the new disguised management fee rules. The guidance can be accessed at https://www.gov.uk/government/publications/investment-managers-disguised-fees-income (the "Guidance").

As we had hoped, the Guidance provides clarification about many of the issues in the Finance Bill which were a little sparse on detail. We set out below a summary of the key points to note.

UK RESIDENT NON-DOMICILIARIES

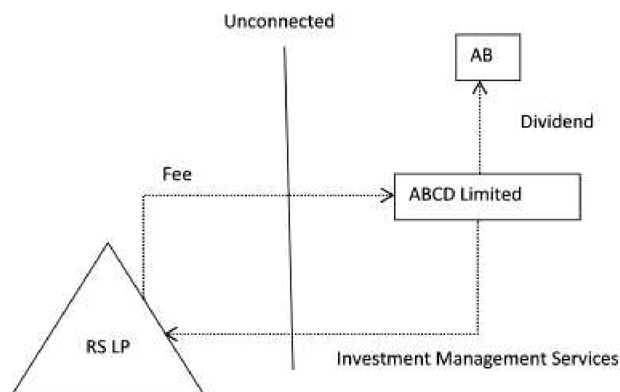
- The view that we expressed in our previous note – that for non-UK domiciled individuals all amounts falling within the legislation will have a UK source and therefore be taxed in the UK whether or not they are remitted to the UK – has been confirmed in the Guidance.

NON-UK RESIDENTS

- HMRC has provided a very helpful clarification that a tax charge should generally arise in respect of a non-UK resident that undertakes only minimal services in the UK only if their activities create a permanent establishment in the UK (which, for minimal activities, would be unusual). This view is based on the relevant person's benefiting from the business profits provision in an applicable double tax treaty.

WHEN DO AMOUNTS ARISE TO AN INDIVIDUAL?

- The Guidance clarifies that a sum "arises" to an individual when the individual actually has access to such amount. Sums allocated but inaccessible to an individual will not have arisen to them. However, sums advanced to an individual by way of loan, even if there has been no allocation to the individual, will be considered as "arising" to that individual.
- The legislation applies to fees arising on or after 6 April 2015, so amounts which accrue in a partnership prior to that date but which are made available to an individual on or after that date will be subject to a charge.
- Tucked away at the back of the Guidance are various examples. Example 8 is helpful for anyone planning to make pre-6 April distributions as it confirms that HMRC will respect these distributions even though the allocations to support such distributions are made post-6 April. In addition to being helpful in terms of short-term planning this also gives a useful insight into how HMRC views distributions and allocations, with cash coming out as king.
- Although not expressly stated in the Guidance, it appears that HMRC may respect genuine corporate blockers. Example 4 is as follows:



The key point to take away from this example is that HMRC's analysis rests on the dividend that is paid to AB and not on the amount that is paid into ABCD Limited. This looks like a genuine corporate blocker may work. That said,

HMRC do also state that where “sums are made available to an individual, who chooses to apply them in a particular way, for example by investing them in the fund, then they will arise at the point that they are made available, notwithstanding that they have been reinvested.” This brings into question the role of a corporate GP in facilitating co-investment on a pre-tax basis. In arrangements where amounts arising to the GP Co are automatically invested it may be possible for HMRC to say that the individual has chosen to apply amounts in a certain way. The specific facts in each case are therefore likely to be determinative.

CO-INVEST

- It has been clarified that the requirement that returns on a co-investment and the terms governing such returns must be reasonably comparable to those applicable to an external investor can accommodate co-investment that is paid free of management fee or carry. HMRC goes so far as to say that “the wording ‘reasonably comparable’ is intended to allow for this sort of difference, i.e. where there are genuine commercial reasons for the difference.”

CARRIED INTEREST

- An amount may constitute carried interest only to the extent that there is “no significant risk that a sum of at least a certain amount…would not arise to the individual” (s.809EZC). It appears that we were not alone in our confusion over the meaning of this phrase. HMRC dedicates a number of paragraphs to its explanation, which boils down to meaning “sums which are virtually certain to arise”.
- HMRC has further confirmed that the risk element relates to the arrangements in place between the management team and the fund rather than to the underlying investments or the track record of the fund manager.

NATIONAL INSURANCE

- The Guidance confirms that national insurance (2%) will be applicable to disguised management fees in the same way as it applies to other trading income.

We would be very happy to discuss the Guidance and related legislation with you further. Please contact Richard Ward or Ceinwen Rees to talk about both existing structures and future planning.

Annex

ARE YOUR CARRY AND CO-INVEST RETURNS SAFE FROM UK INCOME TAX? (SADLY YOUR MANAGEMENT FEE PROBABLY ISN'T.)

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")

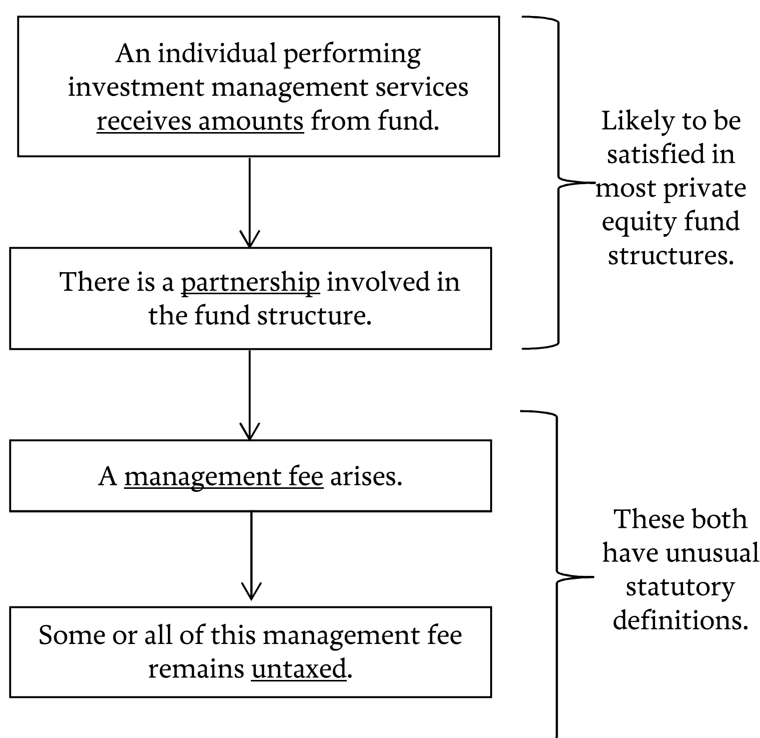
Tucked away in the UK Chancellor's Autumn Statement in November 2014 was a comment that the Government would be "taking measures to prevent [amongst other things] the disguising of fee income by investment managers". When the documents accompanying this statement were published later that week there 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]

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…*".

[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.

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:



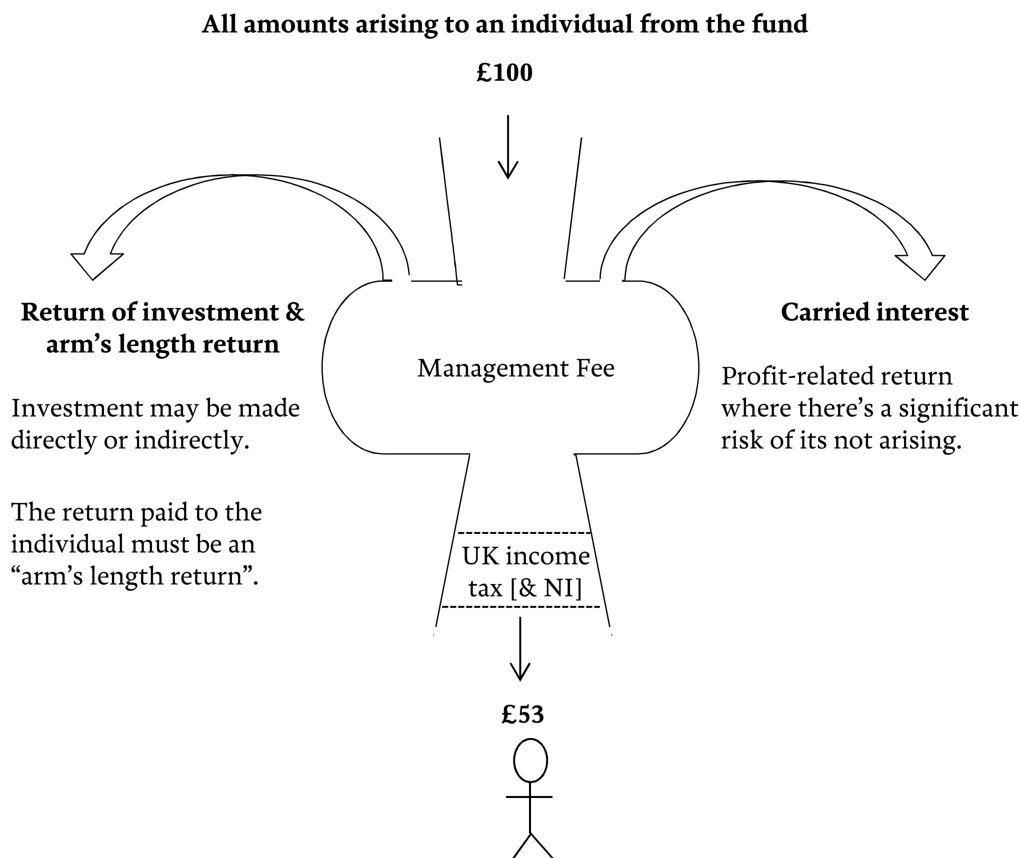
And, once within the regime, amounts will be subject to UK income tax (up to 45%) and possibly national insurance liabilities (2%) rather than UK capital gains tax (up to 28%).

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.