Client Update
The UK Becomes a Tax Haven. (Unless You're an Asset Manager)

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It can only be supposed that the UK Chancellor is taking his inspiration from Winston Churchill (also a Conservative party chancellor for a time) in his dealings with the private equity industry over the past years. Churchill is quoted as saying that "*to improve is to change; to be perfect is to change often*" and change has certainly been the watchword of the UK Government's approach to taxing private equity executives of late. In just two years, the industry has been subjected to the disguised salary rules for limited liability partnership members, the "mixed members" rules applicable to partnerships and, more recently, the disguised management fee rules. The 2015 summer budget heralded two more major changes specifically targeted at the investment management industry and a third which will have a significant impact on many of its participants.

Despite these changes, the Government claims that it "*continues to support the asset management industry in the UK…*". They have an interesting way of showing this support and a flawed view of perfection (if that's what they are aiming for).

WHAT ARE THE BIG ANNOUNCEMENTS?

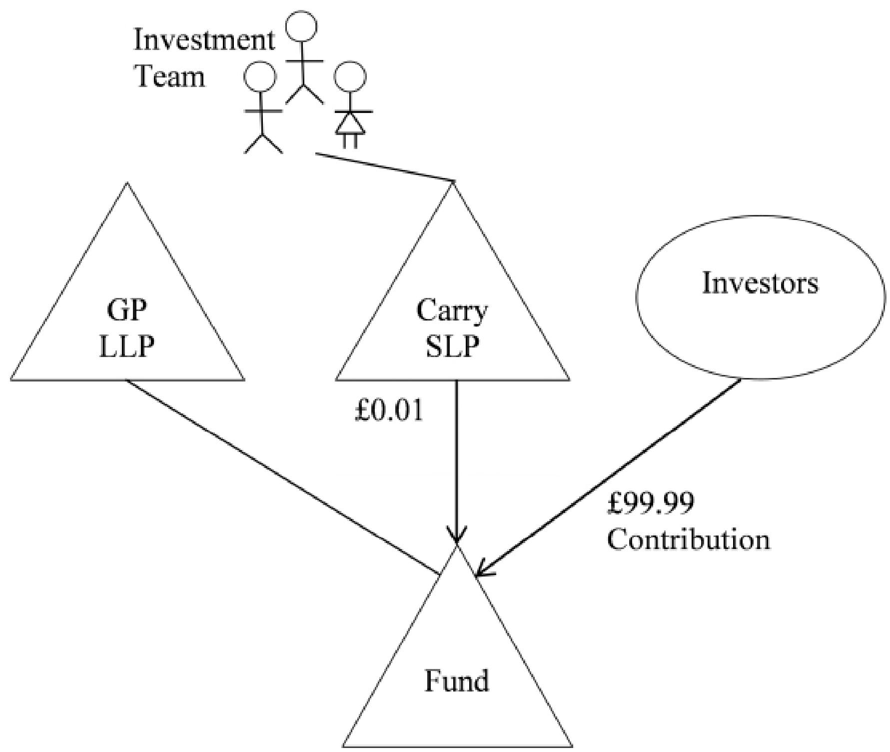
On 8 July, the UK Chancellor presented the Government's Summer Budget, which, after the recent General Election, follows hot on the heels of the scheduled budget earlier this year. This briefing concentrates on the three main announcements that are likely to impact the investment management industry:

- changes to the way that carried interest is taxed (which, in technical terms, results in the abolition of "base cost shift");
- changes to the tax treatment of individuals who are resident but not domiciled in the UK ("non-doms"); and
- potential changes to the way that performance returns are taxed in the hands of executives.

CAPITAL GAINS TAX TREATMENT OF CARRIED INTEREST

A quirk of the UK tax rules on partnerships (by long-standing practice of the UK's tax authorities) means that in a fund scenario, such as outlined below, the investment team is taxed on an amount which is less than the distribution which they actually receive.

The simple way to think about this is that some of the investors' base cost in the fund is transferred to the investment team. Technically, what actually happens is that there is a profit shift from the investors to the investment team when a fund moves into carry. This profit shift is commonly referred to as a base cost shift as, conceptually, it is easier to think of it this way. By way of example:



- if a £1,000 distribution is made from the fund shown above to investors and the Carry SLP on a 80:20 split, the Carry SLP (and therefore, due to the tax transparent nature of a partnership, the investment team) is treated as if it had made 20% of the contributions to the fund;
- this means that, for UK tax purposes, the investment team is treated as receiving a distribution of £200 which is reduced by £20 representing "their" base cost;
- assuming that the fund operates a typical buyout strategy, the investment team will be liable to UK capital gains tax at 28% on £180 rather than on

£199.99. This brings the effective rate of tax down, in this example, to just over 25%. The rate would decrease further if the return was lower, to around 18% on a 3x return deal. Given that the highest rate of UK income tax is currently 45%, this treatment makes an already attractive rate even more desirable.

In response to a number of PE houses using enhanced base cost shift to essentially obtain tax-free carried interest, from 8 July 2015, the investment team will be eligible to deduct only amounts which they have actually given in consideration for acquiring a right to carried interest. In the example above, this would mean that the investment team is taxed at 28% on £199.99.

The draft legislation applies the definition of carried interest used in the disguised management rules for its scope. This definition is broadly in line with a commercial understanding of carried interest and therefore this new legislation is likely to pick up most carried interest arrangements, although we note that some co-invest arrangements may also get picked up in the definition due to the restrictive definition of co-invest in the disguised management rules.

For UK taxpayers who receive carried interest, this change in law will almost certainly result in an increased tax burden.

Areas of Uncertainty

Interaction with Statement of Practice D12 (“D12”)

A major area of uncertainty, which was created by HMRC publishing its guidance on 20 July 2015, is exactly how the rules apply: in some places HMRC refer to the new regime’s applying “instead of D12,” whereas elsewhere in the guidance HMRC provides a worked example of the new legislation which shows D12’s being applied but capital gains tax being charged on the amount of base cost shift. The result is, obviously, quite different for investors; if there is no base cost shift the entire base cost is still available to investors, whereas if there is base cost which is then taxed, the investors are in the same position as prior to 8 July. We are hopeful that this area will be further clarified by HMRC following discussions with the BVCA.

Application to Carry Derived from Income

It is not clear on the face of the legislation whether all carried interest, irrespective of its source, is caught within the regime. The rules state that they apply to carried interest which arises on the disposal of an asset owned by the partnership and “in other circumstances”. The draft legislation is framed by reference to capital gains and will be contained in the Capital Gains Tax Act 1992; however, it is unclear within the legislation how the inclusion of carried interest which arises "in other circumstances" interacts with this capital gains tax background. HMRC is pretty clear on its view that the "legislation establishes a minimum level of tax on carried interest". This view, set out in HMRC's guidance, suggests that all carry, however characterised, falls within the new regime; this is supported by a worked example in the guidance which anticipates carried interest derived from interest income falling within the regime.

When Does Carried Interest Arise?

In addition to general questions about the scope of the rules, one of the questions to which we have been giving a considerable amount of thought is when exactly an amount arises for the purpose of the legislation. We are aware that a number of funds hold carried interest in escrow or subject to other similar arrangements prior to distribution. For these amounts it is important to determine whether the amount has already arisen and is taxed under the old regime or has yet to arise, thereby falling within the new rules. HMRC directs the taxpayer to its guidance in respect of the Disguised Management Fee Rules regarding their interpretation of arising. In brief, HMRC state that:

- the word needs to take its usual meaning in the legislation;
- an amount arises when an individual actually has access to it;
- if an amount is allocated but not accessible it has not arisen;
- if an amount is made available to an individual but that individual chooses to use the amount in a certain way (for example, investing in the fund), the amount has arisen; and
- it will not be possible to prevent or delay a charge arising by inserting an entity between the manager and the right to carried interest (this is contained in HMRC's guidance on the new rules).

HMRC's guidance is a reasonable summary of the position, but given that there is a considerable amount of case law in this area, it is necessarily incomplete, and also somewhat favorable towards HMRC. As a result, each arrangement will need to be considered on its facts and analysed against the case law available in addition to HMRC guidance.

Disposal, Loss or Cancellation of Carried Interest

Finally, the draft legislation contains a provision which holds that on the loss, disposal or cancellation of the right to carried interest the individual will be charged tax on the market value of the carried interest. This clause was updated on 15 July to provide that when calculating market value, any restrictions on the right to carry are disregarded. In practical terms, this means that an individual cannot claim that his carried interest is worthless because it is subject to good leaver/bad leaver provisions. This additional wording will stop people gifting their carried interest entitlements into trusts for no gain. The (we hope unexpected) result of the amendments is that an executive whose carried interest rights are cancelled when they leave the fund may be liable to taxation at the full market rate of the carried interest rights, which could be significant. We hope that this will be clarified in the next version of the legislation or through a revised version of HMRC's guidance.

UK sourcing rule

When the legislation relating to carried interest was published there was a further, unexpected, twist; carried interest arising from 8 July 2015 will be deemed to have a UK source to the extent that investment management services are performed in the UK. This impacts UK resident non-domiciled individuals as it means that such people will be taxable in the UK irrespective of whether they remit their carried interest returns to the UK in relation to non-UK investments. In addition to the general uncertainties around this legislation, there is also a lack of clarity surrounding this clause, in particular how HMRC will determine the extent to which an individual performs investment management services in the UK. There has been some indication from HMRC that a simple day count is not appropriate; however, no alternative has yet been put forward. In its guidance, HMRC rather enigmatically states that the split will be made "on a just and reasonable basis… [which] will depend on the facts or circumstances of each particular instance." The small amount of guidance on what this may mean seems only to create more questions; HMRC accept that carry paid in a particular year doesn't always relate to services provided in that same year and that it may be necessary to look back over a longer period.

This amendment will have a significant impact on investment professionals working in the UK who currently benefit from non-dom status. In particular, the interaction of these rules with foreign tax credits needs to be developed. As currently drafted, UK non-doms who pay, for example, US tax on carry on a deal-by-deal basis may not be eligible for credit against the UK tax paid at a later point. Given the potentially high rate of UK tax, the economic impact could be significant.

Next steps

The BVCA has already made and will continue to make representations to HMRC and the Treasury regarding the impact of these changes.

We expect that further drafts of the legislation and/or HMRC guidance will be published before we reach the final landing place. Although the regime is operational now, exactly what that regime will look like is still evolving.

CHANGES TO THE TREATMENT OF UK NON-DOMS

As widely predicted, and to some extent previewed during the General Election campaign, the Government is proposing to restrict further the tax advantages afforded to individuals who are non-doms. The concept of domicile is somewhat arcane and is akin in some ways to permanent residence, except that an individual's domicile is in the first instance derived from the domicile of a parent (the domicile of origin), which can be substituted only if the individual decides to reside permanently elsewhere. For an individual with a domicile of origin outside the UK, it is therefore comparatively straightforward not to acquire a UK domicile in the UK. This issue was addressed many years ago in an inheritance tax context by a "deemed domicile" rule, under which a person resident for not less than 17 out of the last 20 years in the UK is deemed to have acquired a UK domicile. This approach is now going to be adopted for all tax purposes with effect from 6 April 2017, but with the additional sting that instead of 17 years, domicile will be acquired after more than 15 years of UK residence in a 20-year period.

The main tax benefit which this proposal will curtail is the remittance basis of taxation for non-doms. This allows non-doms to pay UK tax on foreign source income and gains only when remitted or deemed remitted to the UK (the rules on remittances and deemed remittances are extremely complex, although well-advised non-doms are usually able to manage these complexities). Over the past few years, the remittance basis has attracted a toll charge for longer term residents wishing to take advantage of its benefits, but the proposal will remove it altogether for those who meet the new "deemed domicile" rule.

Although the new rule is easy to state, there are complicated knock-on effects, for example, in relation to trusts. This in part explains why the Government is entering into a consultation exercise after the summer recess with a view to legislation's being incorporated into next year's Finance Act. As mentioned, however, the rules will not take effect until the beginning of the 2017/18 tax year. Watch this space for further detail.

TAXATION OF PERFORMANCE LINKED REWARDS PAID TO ASSET MANAGERS

A consultation document was also published on 8 July which seeks opinions on how the Government should determine "*when rewards arising to investment fund managers are to be taxed as income*" and has arisen due to the Government's desire that "*everyone in the industry should pay a fair and correct amount of tax on the rewards they receive, accepting that the type of tax chargeable will depend on the type of reward received*".

The mischief which this consultation seeks to fix is that of asset managers' taking a liberal view of the activities of their fund and treating the fund's activities as investment activities rather than trading activities. This classification makes a significant difference to the taxation levied on returns from the fund to the investment team; a trading partnership returns income which is taxed at 45% whereas an investment partnership is capable of returning capital which is taxed at 28%.

There is no statutory definition of trading in the UK, therefore the categorisation of a fund as trading or investment is very nuanced. The consultation seeks to determine the circumstances in which it is legitimate for a fund manager's performance linked reward to benefit from capital gains tax treatment with a view to introducing a new regime for taxing such performance linked rewards to "*ensure that individuals are taxed appropriately in light of the underlying activity of the investment vehicle*".

The Government has proposed two approaches to the new regime.

<u>Option 1</u>: would list particular activities which are, in the Government's view, clearly investment activity and therefore eligible for capital gains tax treatment provided certain conditions are met. The following asset classes are currently under consideration as being investment activities and the Government has asked if there are any further activities that should be included:

- controlling equity stakes in trading companies intended to be held for a period of at least three years;
- the holding of real estate property for rental income and capital growth where it is reasonable to suppose that property will be held for at least five years;
- the purchase of debt instruments on a secondary market where, at the point of acquisition, it is reasonable to suppose that the debt will be held for at least three years; and

- equity and debt instruments in venture capital companies, provided that they are held for a specified period of time.

Option 2: would focus on the length of time for which the underlying investments are held and a graduated approach would be taken to tax, so that an asset held for less than six months would be 0% eligible to be taxed as chargeable gain moving to an asset held for over two years, which would be 100% eligible.

The consultation document provides assurances that the following categories of return/people are not intended to be caught by this legislation:

Type of returns	Type of people
Genuine co-investment (we await further details as to what this is)	The investment vehicle
Carried interest from private equity funds (although this will apparently be subject to the investment strategy of the fund)	External investors
	Employees taxed under the employment securities rules

The carve outs for the investment vehicle and for investors mean that a fund may be treated as an investment fund for one category of person but as a trading fund for another. The Government recognises and accepts this potential disparity and does not appear to be overly concerned about it.

A further positive that comes out of the consultation document is a statement that the treatment of performance related rewards which have historically been subject to capital gains tax should not change as a result of the consultation, which suggests that comprehensive grandfathering rules will be included in the legislation.

The consultation document invites comments until the end of September and the plan is to introduce legislation in Finance Bill 2016 to take effect from April 2016.

OTHER INTERESTING ANNOUNCEMENTS

Aside from these three main proposals, it is worth noting that there were a number of other interesting announcements made. We outline the announcements that may be of interest below and are, of course, happy to discuss them in more detail with you if you so wish.

Changes to Dividend Taxation

The current tax credit system will be replaced with effect from April 2016 by a new dividend allowance of £5,000 and will be introduced together with new tax rates, the highest being 38.1% (up from the current effective tax rate of 30.6%).

Corporation Tax

The rate of corporation tax will be reduced from 20% to 19% in April 2017 and 18% in April 2020.

WHAT'S NEXT?

Parliament has broken for the summer recess; however, we are aware of a number of meetings being held between HMRC, The Treasury, BVCA and other interested parties. We anticipate revised legislation and/or revised guidance in September.

An on-demand webinar discussing these issues is available to view on our website at http://www.debevoise.com/insights/publications/2015/07/taxation-of-carried-interest.

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Please do not hesitate to contact us with any questions.