# Client Update
## HMRC's "Italian Job": The UK Finance Bill and Taxation of Funds

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"You're only supposed to blow the bloody doors off!"

Reading the draft legislation published today dealing with the taxation of carried interest in the United Kingdom feels reminiscent of the scene from the *Italian Job* where an excess of explosives results in an entire van's being blown up rather than neatly opening the doors, as had been planned.

In its consultation document on the future of carried interest, the UK government expressed its concern that "some asset managers who historically received a performance fee charged to tax as income, are seeking to restructure their performance linked rewards to reduce the rate of tax they pay… [by] arguing that the funds are investing for tax purposes rather than trading." It also made clear in the consultation document that carried interest awarded in a typical private equity context was not the primary target, even stating that the United Kingdom "is committed to maintaining the current tax treatment of some performance related rewards (for example, carried interest in private equity funds which should continue to be taxed as capital gains, as reflecting the underlying long term performance of a fund's investments)".

Rather than follow through on this promise, the UK government has used too much dynamite and has instead provided that all carried interest is income-based carried interest except where a fund satisfies a statutorily defined average holding period for its investments. The significance of this is that, when the rules enter into force on 6 April 2016, some distributions to UK resident carried interest recipients that are currently viewed as carried interest and therefore taxable as capital gains tax at a rate of 28%, will instead become taxable at a rate of 47%.

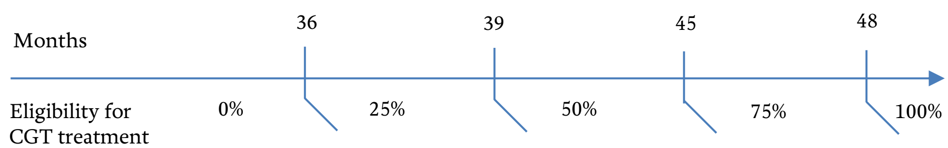
## WHAT IS CARRIED INTEREST?

The rules apply to carried interest as defined by the disguised management fee legislation published earlier this year. To fall within the carried interest exception, an amount needs to be made out of profits, needs to be variable by reference to those profits and, in relation to any amount of the return that is fixed, there needs to be some risk that the amount will not arise. If it is virtually certain that a fixed amount will arise, such amount will not be treated as carried interest.

This wide definition means that some returns distributed to a management team may be treated as carried interest (and within this legislation) for UK tax purposes when commercially they are not viewed as such.

## WHAT ARE THE AVERAGE HOLDING PERIOD RULES?

If a fund's average holding period for investments is between three and four years, carried interest payable by the fund will be eligible for between 25% and 100% capital gains tax treatment:




Calculating the average holding period is a three-stage process undertaken each time carried interest arises.

Step 1: for each investment, multiply the amount invested at the time the investment was made by the length of time held.

Step 2: add together all amounts from Step 1.

Step 3: divide the total from Step 2 by the total amount invested in all relevant investments.

For example, if a fund holds three investments:

| Investment | Invested capital | Holding period |
|---|---|---|
| A | 10,000 | 3 years |
| B | 8,000 | 4 years |

| Investment | Invested capital | Holding period |
|---|---|---|
| C | 6,000 | 5 years |

the calculation is as follows:

Step 1: 10,000 x 3 = 30,000

8,000 x 4 = 32,000

6,000 x 5 = 30,000

Step 2: 30,000 + 32,000 + 30,000 = 92,000

Step 3: 92,000/24,000 = 46 months

Therefore, in this example, 75% of carried interest is eligible to be taxed as capital gains tax.

Points to note when calculating an average holding period are:

- **follow-on investments** into an existing investment may not skew the average holding period calculation. If the initial investment is a “significant investment” in a trading company or the holding company of a trading group, any subsequent investments will be treated as having been made at the same time as the initial investment. An investment is significant if it is (a) a 25% interest (in the case of a fund which it is reasonable to suppose will hold more than 50% of its investments (by value) in controlling interests in trading companies or trading groups and will hold these interests for more than four years), and (b) in any other case, a controlling interest;
- **deal-by-deal v fund-as-a-whole carry** should be calculated on a similar basis given that deal-by-deal carry is typically drafted so that the overall effect is that carry recipients are no better off at the end of the fund’s life than if they had received whole-fund carry, thereby taking into consideration all investments; and
- **part disposals** – where an investment is partially disposed, the original investment will be treated as two investments, one which is retained and the other disposed of.

## WHAT ABOUT CARRIED INTEREST ARISING AT THE START OF A FUND'S LIFE?

Given that the average holding period for investments is calculated when carried interest arises, any carried interest arising in the first four years of a fund's life will be incapable of qualifying for capital gains tax treatment under the basic rule. Provision has been made for that in the draft legislation and any such carried interest may be treated as conditionally exempt carried interest. To be conditionally exempt carried interest it needs to be reasonable to suppose that were the carried interest to arise later in the life of the fund it would be fully eligible for capital gains tax treatment. The point at which this hypothetical calculation is undertaken is the earlier of:

- the time when it is reasonable to suppose that the investment scheme will be wound up;
- four years after the end of the fund's investment period;
- four years after the carried interest arises to an individual; and
- four years after the start of the period by which the relevant carried interest is calculated.

Significantly, an individual must claim that carried interest is conditionally exempt in their tax return as it does not apply automatically.

Conditionally exempt carried interest may cease to be conditionally exempt at the earliest of any of the dates set out in the bullets above or if it is no longer reasonable to suppose that were the carried interest to arise later in the life of the fund it would be fully eligible for carried interest treatment.

When carried interest ceases to be conditionally exempt it is treated as having been income-based carried interest from the moment that it arose, meaning that the tax is backdated by up to four years. A credit will be given against any income tax liability in respect of any capital gains tax paid.

## HOW DO THESE RULES IMPACT DEBT FUNDS?

Funds carrying on direct lending activities are automatically treated as distributing income-based carried interest unless it is reasonable to suppose that 75% of direct loans made by the fund will run for at least four years from the time when money is advanced to the time when at least 75% of the principal must be repaid, the fund is a limited partnership and carried interest meets the general carried interest definition set out above.

## HOW DO THESE RULES IMPACT FUNDS OF FUNDS?

It is not currently clear how a fund of funds will operate these rules. When determining the average holding period for investments, intermediate holding structures by or through which investments are made or held need to be ignored. In our view this should not include fund vehicles through which investments are held. Therefore, when calculating the average holding period, a fund of funds should be able to treat its investment in the other fund as the relevant investment rather than having to look through the fund into which it invests. Quite how this can be monitored in practice seems challenging, however.

## ANTI-AVOIDANCE PROVISIONS

Unsurprisingly there is a wide anti-avoidance rule which disregards any arrangements put in place to reduce the proportion of carried interest that is subject to income tax by altering the average holding period or determining whether a fund is a controlling equity stake fund (and therefore entitled to preferential follow-on investment treatment).

## IS THIS IT?

No, this is draft legislation and subject to consultation. Revised draft legislation will be published in the new year with the budget. We are aware that the BVCA is lobbying to have the average holding period changed to three years, to protect venture and capital growth funds where minority stakes are common and also to finesse the concept of controlling stakes to fit economic practice.

We also await HMRC's guidance on these rules which, in keeping with recent legislation, is likely to significantly impact the interpretation of the regime.

## WHAT ELSE DOES THE DRAFT FINANCE BILL CONTAIN?

### Hybrid Mismatch Arrangements

As announced at the Autumn Statement, draft legislation has been published dealing with hybrid mismatches. Taking its lead from the BEPS action plan on hybrids, the draft legislation aims to neutralise the effect of hybrid mismatch arrangements where either one party gets a tax deduction for a payment while the other party does not pay tax on the receipt, or where there is more than one deduction for the same expense. A detailed analysis of these rules will follow in a later note.

### Changes to Dividend Taxation

Currently, a recipient of dividend income will generally receive a tax credit of one-ninth of the dividend value, which they can set against their liability to income tax for dividends for that year.

The draft rules published today abolish the tax credit and replace it with a new "dividend allowance", which provides that the first £5,000 of dividend income for that year is taxed at 0%.

The changes will apply to dividends made on or after 1 April 2016. Their effect can be demonstrated as follows:

| **Recipient taxpayer's income tax band** | **Effective income tax rate for dividends** | |
|---|---|---|
| | *2015/16** | *2016/17* |
| *Basic rate* | 0% | 7.5%** |
| *Higher rate* | 25% | 32.5%** |
| *Additional rate* | 30.56% | 38.1%** |

*Based on 2015/16 income tax rates for dividends of 10%, 32.5% and 37.5%, respectively, with dividend tax credit applied.
**The first £5,000 of dividend income for that year will be taxed at 0%.

### Changes Affecting Non-UK-Domiciled, UK Resident Individuals

Today's draft Finance Bill has proposed changes relating to domicile and inheritance tax ("IHT"). The government's rationale for these reforms is to harmonise the IHT regime so that it is broadly in line with the new deeming rules which will apply to income and capital gains tax from 6 April 2017. In overview, the proposals are as follows:

- individuals that have been resident in the United Kingdom for at least 15 of the previous 20 tax years will be deemed UK-domiciled for IHT purposes;
- individuals born in the United Kingdom (with a UK domicile of origin at birth) who subsequently acquire a domicile of choice elsewhere will be deemed UK-domiciled for IHT purposes whilst they are resident in the United Kingdom, provided that they were resident in at least one of the previous two tax years; and

- overseas property settled into trust by returning UK domiciles while they were domiciled elsewhere will be liable to IHT once the relevant individual has been UK resident in at least one of the previous two tax years (as long as the individual meets the residence conditions).

No further announcements regarding the deemed domicile rules for income tax and capital gains tax have been made as yet. The UK government has indicated that draft legislation on these new rules will be published in early 2016.

**New 3% SDLT on Second Properties**

No draft legislation has been published regarding the new 3% SDLT charge on second homes and buy-to-let properties. We can only assume that the government baulked at the very real challenge of trying to encapsulate this policy in workable legislation.

## "HANG ON LADS, I HAVE A GOOD IDEA"

We're not quite there yet, especially on the new carried interest rules but give us some time to reflect on today's announcements and we look forward to discussing these changes in more detail. For now we will leave you with the silver lining – at least you're not in the *Italian Job*; stuck on a bus balanced precariously on a cliff edge.

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Please do not hesitate to contact us with any questions.