Client Update

UK Tax on Management Fees, Co-Invest and Carry: Is Anything Safe?

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"*If I had a world of my own, everything would be nonsense. Nothing would be what it is, because everything would be what it isn't. And contrary wise, what is, it wouldn't be. And what it wouldn't be, it would. You see?*" said Alice in Lewis Carroll's *Alice's Adventures in Wonderland & Through the Looking-Glass*. This is, perhaps, the guiding principle behind the UK Government's draft legislation regarding the taxation of the newly coined, disguised investment management fees.

On Wednesday, 3 December 2014, the UK Government announced that it was going to ensure that amounts arising to investment fund managers for their services would be taxed as income rather than under the more favourable capital gains regime. The draft legislation published to support this announcement was released on Wednesday, 10 December 2014. We would like to be able to say that the whirl of speculation that followed the announcement has now ended. Unfortunately, the legislation has raised as many questions as it has answered and, although perhaps not everything is nonsense, much is not what it purports to be.

HOW THE DRAFT LEGISLATION WORKS

As with many recent legislative regimes, the taxation of disguised management fee rules are drafted incredibly broadly and are then subject to a small number of, limited, exceptions.

The main charging provision, which will be inserted into the Income Tax Act 2007, provides that "*where one or more disguised fees arise to an individual in a tax year from one or more collective investment schemes…the individual is liable for income tax…as if (a) the individual were carrying on a trade for the tax year, (b) the disguised fees were the profits of the trade of the tax year, and (c) the individual were the person receiving or entitled to receive those profits.*" The key to understanding the legislation is therefore what constitutes a disguised fee.

A disguised fee has four component parts:

- the individual receiving the amount performs investment management services in respect of the fund;
- there is a partnership involved in the fund arrangements;
- under these arrangements, a management fee arises (whether in the form of a loan or advance, by way of allocation of profits or otherwise); and
- some or all of this management fee is untaxed.

The first and second of these requirements are fairly straightforward and likely to be satisfied by most private equity fund arrangements. Conditions three and four require a bit more investigation.

What Is a Management Fee?

Current Status

Until Wednesday, what constituted a management fee would have elicited fairly uniform responses throughout the industry; that it is the fixed amount, normally in the region of 1-2%, which the fund manager receives regardless of the success, or otherwise, of investments. In the UK, such amount is commonly structured as a priority profit share paid up to the general partner, who is:

- a limited partnership (a "GPLP");
- a limited liability partnership (a "GPLLP"); or
- a limited company (a "GPCo").

Some of this priority profit share is used to pay the manager its fee and the remainder is paid up to the management team.

For individuals receiving returns through the GPLP or GPLLP, the transparent nature of the structures means that the priority profit share retains its capital characteristics and so is chargeable to capital gains tax in the hands of the recipient. For non-UK-domiciled individuals claiming the remittance basis, gains arising from offshore investments will retain their non-UK source status and therefore fall within the UK tax net only to the extent that they are remitted to the UK.

For those who are shareholders in a GPCo, returns will be paid up as dividends and individuals will benefit from dividend rates (which although higher than capital gains tax rates are still lower than income tax rates). If the GPCo is offshore, non-UK-domiciled individuals should be able to treat dividends as non-

UK source income and therefore subject to UK tax only to the extent that amounts are remitted to the UK.

Proposed Law

Unfortunately, the legislation has not adopted this accepted concept of management fee, unlike in the US where there is a tax on guaranteed payments which is designed to catch management fee type arrangements. Instead, 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 carried interest – which is given a statutory definition in this draft legislation as amounts paid out of profits after investors have received back all or substantially all of their investment together with a preferred return at least equal to compound interest of 6% on their investment (there is a whole fund and a deal–by–deal formulation, but both rely on this 6% concept); or
- arises by way of a repayment of an investment or constitutes a commercial return on an investment – in both cases, the investment has to be made by the individual receiving the relevant sum.

What Does "Untaxed" Mean?

Interestingly, 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. Meaning, the returns obtained in the form of dividends and subject to tax at the UK dividend rate (which is lower than the general UK income tax rate) would be treated as untaxed.

Anti-Avoidance

Unsurprisingly, there is a wide ranging anti-avoidance provision included in the draft legislation. Under this provision, any arrangements put in place, the main purpose, or with one of the main purposes, of which is to secure that the disguised management fee rules do not apply will be disregarded.

WHAT DOES THIS MEAN?

At a basic level, as drafted, the legislation will mean that any individual performing investment management services in the UK (which, for the purposes of the legislation includes fundraising and researching potential deals) will be subject to UK income tax unless it can be shown that such sum is either carried interest pursuant to the narrow definition discussed above or, is a return of an invested amount or a commercial return on such invested amount. Therefore, individuals benefiting from capital treatment on excess management fee derived through a GPLP or GPLLP structure should expect an increased tax bill from 6 April 2015.

Beyond this, the exact scope of these rules is not clear from the draft legislation. Work needs to be done with HMRC to establish the boundaries of the rules and their interaction with existing legislation. We understand that the BVCA will be having detailed discussions with HMRC in the new year with a view to clarifying many of the anomalies.

Discussing all of the potential issues arising under the draft legislation is beyond the scope of this note, but instead we focus on some of the key areas of concern.

Co-Invest

When introducing this legislation, the UK Government specified that it did not intend to catch returns made on investments. It is therefore with surprise that we note that co-investment returns are not specifically excluded but, on the contrary, may be included within the definition of disguised investment management fees for two reasons.

- Investments have to be made by the individual receiving the sum. In cash based co-investment arrangements this requirement may be satisfied but it is more difficult to be certain of this position for leveraged co-investment arrangements where the GP takes on third-party debt with which to fund the co-investment.
- Profits on an investment are excluded only to the extent that they represent a "commercial return". Although this return is not quantified (unlike the investors' preferred return), it has to be at a rate comparable to a commercial rate of interest and have terms reasonably comparable to those of external investors. This appears to mean that individuals who have managed or advised a fund with a successful investment will get penalised with a higher tax rate unless the excess over a commercial return can be treated as carried interest within the draft legislation. For these purposes, it is necessary for co-invest to be paid out only after other investors have received back their invested amount and their 6% compound interest preferred return (although we note that the individuals may count as investors with respect to their co-invest piece, which will negate the need for the 6% preferred return).

Carried Interest

As stated above, the definition of carried interest requires that investors first receive all, or substantially all, of their investment back and also benefit from a return of at least 6% of their investment compounded annually. This is odd, in our experience; not all funds use compound interest as a calculation of return, instead favouring IRR. Also, the definition ignores a whole gamut of distribution arrangements, such as those where there is a reduced priority return but no catch-up or no management fee but an immediate 80:20 split. Such arrangements are particularly common in the venture capital and debt fund markets.

Further, having a legislative definition of carried interest is of concern because not only could it give rise to market distortion but it also gives the UK Government a very easy way to punitively tax the industry in the future by simply upping the return required by investors.

Non-UK-Domiciled Individuals

The effect for non-UK-domiciled individuals will 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.

Non-UK Resident Individuals

There are questions over the jurisdictional scope of the legislation. The legislation looks to investment management services which "*are to any extent performed in the United Kingdom*". This suggests that, for example, a US individual working for the New York-based manager but who spends a month in the UK assisting the UK advisor with a particular deal and a month in the UK meeting with potential investors may have 1/6th of his income treated as having a UK source. It is likely that, in our example, the UK/US double tax treaty would kick in to prevent the UK from actually taxing the US individual but for individuals in jurisdictions not benefiting from a double tax treaty with the UK they may suffer double taxation.

Even more concerning, it is possible that individuals managing an offshore fund with neither a UK manager nor a UK advisor may be caught by these rules to the extent that they perform any investment management services in the UK – given that this includes meeting with investors and researching potential deals, this is a genuine risk.

NEXT STEPS

Unfortunately, there is no one-size-fits-all solution to these rules and the answer to “what now?” will differ from fund to fund. What is clear is that any fund manager with any kind of UK presence should be considering its position. We would be very happy to work with you in determining what your current exposure to these rules is and developing a plan with which to move forward.

As Alice would say, “curiouser and curiouser.”

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Please do not hesitate to contact us with any questions.