MACFARLANES

FUND MANAGERS' PERFORMANCE INTERESTS

INTRODUCTION

- On 9 December HMRC published responses to their consultation document issued in the summer on the taxation of performance linked rewards paid to asset managers alongside a first draft of the legislation which will be introduced (with effect from 6 April next year) to give effect to their policy decisions.

- This consultation and the draft legislation are the third (and hopefully final) piece of reform to the UK tax treatment of fund managers. The first change was the introduction of the disguised investment management fee (or DIMF) rules at the beginning of the year. The DIMF rules charge to tax as income everything obtained by an individual who is providing investment management services to a collective investment scheme in the context of arrangements which involve a partnership. These changes are focused on planning techniques designed to "stream" part of what was in effect the regular management fee from a fund so that it was received by individuals as a profit share from the underlying fund. Excluded from the DIMF regime are carried interest payments and amounts received in respect of co-investment arrangements (where, broadly speaking, an individual manager co-invests in his fund on essentially the same terms as third party investors).

- The second change came in the summer in the form of a rule which effectively takes away the "base cost shift" for carried interest by providing in essence that all elements of carried interest payments will be subject to CGT in the hands of the recipient if they are not otherwise taxable at a higher rate (which they might if, for example, they constitute a share of interest or dividend flowing through the carried interest). The new carried interest rules also introduced rules which "look through" holding structures in order to catch carried interest and amounts within the DIMF legislation arising otherwise than to individual fund managers. The new carry (but not DIMF) rules give a measure of relief for a remittance basis user if some of the individual's duties are performed abroad.

- The third piece of the jigsaw sits on top of the two earlier changes. Where it applies, it will tax as income all or part of what an individual receives from a performance (or carried) interest in the fund he manages. If the individual already receives income (because the fund pays a performance fee to the manager) he will be unaffected by these changes, but to the extent he holds a capital interest in the fund itself, these rules can turn some or all of his return on that interest into income. The rules which deprive him of the base cost shift apply to the portion of his carried interest which survives this test.

- The draft legislation and response document follow from a consultation begun earlier in the year where the Government explained its policy intention, that capital gains tax should be restricted to performance linked rewards arising from long term investment activity; in other words, fund managers should only be able to access CGT treatment for their carried interest if the fund they manage pursues a long term investment strategy. In particular, the Government was concerned that managers of actively managed, trading funds were seeking to structure their funds so that they too could receive a performance linked reward with CGT treatment.

- The Government suggested two ways of differentiating between long and short term investment funds. One was to look at a fund's intended investment strategy. It would list particular activities which are in the Government's view clearly investment activities and a performance linked interest in a fund vehicle which adopts such a strategy would be subject to CGT provided certain conditions were met. The second option would simply be to focus on the length of time for which the underlying investments were held, with the suggestion in the original consultation being that after a two year average holding period all of the performance interests in the fund could qualify for CGT treatment.

THE CURRENT PROPOSAL

- In the light of responses received, the Government has chosen the second option but has also extended the length of the average holding period required to qualify for CGT treatment. The response document described this as "simpler, more objective and easier to apply in a way that provides clarity to the industry". Not everyone will agree with that description.

- Under the current proposal, capital treatment will be available where a fund's average investment holding period is four years or more. Income treatment will apply (however the performance linked reward is structured) where the average holding period falls below three years, with a proportion of any performance linked return being charged to income tax where the averages holding period falls between those two points. It is important to note that references to "capital treatment" and paying CGT refer to the part of the carried interest not turned into income by these new rules. It will remain important to structure the performance interest so that, as far as possible, it produces capital rather than income on general principles.

HOW WILL THE NEW TEST WORK?

- The legislation will operate by taking out of the carried interest exception from the DIMF regime all or part of an individual's return from his carried interest. This is very important for remittance basis users, as DIMF income is charged in full on UK residents in the year of receipt, with no form of relief for remittance basis users if all or part of their duties are performed abroad. In addition, non-residents who are involved in running UK funds may find themselves caught by these rules.

- To make sure that their coverage is wide enough, the DIMF rules are themselves being changed in two important respects. First, the requirement for the arrangements under which an individual supplies investment management services to involve a partnership will be removed. This means that the DIMF legislation (and the rules charging carried interest returns as income) can apply in entirely corporate arrangements (where an individual is involved with a corporate structure providing services to a fund structured in entirely corporate form). The exception to this is the "carve out" for employment-related securities (discussed below). Also the DIMF legislation would at the moment appear to catch an amount received by an individual only if he is involved in providing investment management services in the tax year in which he receives that amount. This timing link will be removed.

- As just mentioned, the new regime will not apply to employment-related securities. So, if an individual receives a carried interest by reason of his employment, he will not be affected by these rules. This is a deliberate policy decision by the Government, which has concluded that the employment-related securities rules (which impose a tax charge on the acquisition of carried interest to the extent an individual does not pay a full price for it) provide a sufficient and comprehensive code in this area. As far as private equity carried interest is concerned, the 2003 Memorandum of Understanding between HMRC and the BVCA provides helpful guidance around the operation of the employment-related securities rules in this area and in particular indicates how the valuation of carried interest awarded early in the life of a fund is to be approached.

WHEN AND HOW DO I MEASURE AVERAGE HOLDING PERIODS?

- The basic premise of the legislation is that the tax treatment of carried interest received from a fund depends on its average investment holding period. In principle, this would appear to be a simple and straightforward rule. However, the times at which and the way in which average holding periods are measured mean that what is being measured is not the real average holding period of investments but an average of selected artificially foreshortened holding periods.

- The test for average holding periods is run every time a carried interest payment arises, not just at the end of the life of the fund. So, the steps described below need to be followed each time a carry payment is made.

- The first step is to identify what the "relevant investments" are. These are the investments that are made for the purposes of the fund and by reference to which the carried interest is calculated. This last phrase (the investments by reference to which the carry is calculated) is a little ambiguous. It would seem that it must refer to the investments which form part of the pool, the overall return on which counts towards the carried interest, not just the investments the sale of which funds the carry payment. Although this possibility is not discussed widely, it would seem to be implicit in the idea that some investments may be relevant and some not, and that there could be more than one carried interest arrangement in respect of a particular fund each with its own pool of relevant investments. The legislation directs that intermediate holdings and structures should be ignored. The search, therefore, is for "real" investments made for the purposes of the fund (what it is really investing in), ignoring any intermediate holding structures.

- Subject to a special rule for controlling equity stake funds (discussed below), each cashflow into an investment is treated as an investment and looked at separately. So, the first step in calculating the average holding period is to look at each value invested and then multiply it by the time it was held. The next step is to add up these amounts and the final step to divide the result by the total value invested in all relevant investments. This will give an average holding period for the fund's investments.

- The catch here is not just when this calculation is run but also the way the time an investment is held is calculated. If an investment has been disposed of before a particular carried interest payment arises, then the time for which the investment was held runs from when it was made until when it was disposed of. Otherwise, if the investment is still held at the time the carried interest payment arises, it is treated as if it had been disposed of at that time.

- For these purposes, a fund disposes of an investment if it makes a disposal (in whole or part) for CGT purposes. The CGT rules contain some complex reorganisation rules which are designed to prevent a disposal arising in the context of securities where an investment has been merged or otherwise reorganised but not effectively realised. These rules will not help a fund which invests in non-UK assets where a merger or other reorganisation cannot be restructured in a way that the UK CGT rules would recognise or assets other than securities. In addition, an asset will be disposed of if a fund enters arrangements under which it in substance closes out its position (in whole or part) or ceases to be exposed to risk/reward in the investment. This rule is designed to catch arrangements which amount to an economic disposal of an asset without amounting to one in legal form.

- Where there is a part disposal, only a part of the original investment is treated as being realised and that part is calculated by multiplying the value of the investment made by A/B where A is the value (at the time of disposal) of the part disposed of and B is the value of the whole at the time of disposal. This is designed to make sure that if a fund makes a profit on a part disposal this does not result in a disproportionate amount of the original investment being treated as returned. Basing the part disposal formula on values will potentially create a significant compliance cost. Where some securities of a class are disposed of they are identified on a FIFO (first in first out) basis.

- This need to look at each inflow separately will complicate calculations significantly and increase the compliance burden. It will also artificially shorten the average investment holding period. A fund which is looking to syndicate part of an investment would need to treat the entire investment as just that and then its part disposal would mean that a significant amount invested would be treated as held for a very short period. Similarly, a private equity fund following a buy and build strategy for a particular investment or a real estate fund incurring a significant amount of capital expenditure will find its average investment holding period shortening every time it puts more money in to fund a new investment. These new rules have potential to create a real tension between the interests of managers and investors.

WHAT IF I FAIL THE TEST AND MY CARRY IS TREATED AS INCOME?

- In certain circumstances, a carried interest payment which is treated as income (in whole or in part) as a result of this calculation can be treated as "conditionally exempt". Where this is the case, the individual pays CGT on his carry on receipt and revisits the calculation at a later date. This is particularly important because of the way the calculation we have just discussed shortens the holding periods for assets which are still on hand at the point carried interest is received. To benefit from this conditional exemption the carried interest payment in question must arise within four years of the time the fund first makes an investment. For many funds, this condition is unlikely to be met. It is not immediately clear why this requirement was introduced, but its practical effect will be to shut the door on conditional exemption for many people who might otherwise benefit from it. Also it must be reasonable to suppose (looking at all relevant factors including fund offering documents) that, were the carried interest to arise at the "relevant time", the holder would be entitled to full CGT treatment.

- For these purposes "the "relevant time" is the earliest of (i) the time when it is reasonable to suppose the fund will be wound up, (ii) four years from the time when it is reasonable to suppose that the fund will not make any more investments, (iii) four years from the time the carried interest in question arises and (iv) (where relevant) four years from the end of the period by reference to which the carried interest payment was calculated.

- The conditional exemption regime ceases to apply on the earliest of when the scheme is wound up, four years from when the fund stops making investments, four years from the time the carried interest arises, (where relevant) four years from the end of the period by reference to which the carry was calculated and finally at any time if it becomes apparent that the carried interest payment will ultimately not benefit from full CGT treatment.

- Because this conditional exemption applies on a carry payment by carry payment basis, there is a high level of monitoring required here. In respect of each separate payment (not the fund overall) the fund manager needs to know at all times whether, if the carried interest payment had been made at the relevant time for that payment (and the relevant time for each payment may well be different), it would be entirely outside the income based carry regime.

- When a carried interest payment ceases to be conditionally exempt, its tax treatment is definitively determined. If, in the light of what is known at that time, all or part of the payment is income based, then there will need to be a payment of tax to HMRC (with credit given for CGT already paid) together with interest.

- This "conditionally exempt carry" regime does not simply allow certain funds (where you might expect that the fund would produce an entirely capital carry by the end of its life) to wait until the end of the life of the fund and have a reckoning up. The idea that conditional exemption provides a regime which will be simpler administratively for a fund to apply and produce a right/fair result over all of the fund's investments is misleading.

FUNDS HOLDING LARGE EQUITY STAKES

- The requirement to look at each inflow and outflow/ part realisation separately is relaxed where a fund has a "relevant interest" in a trading company or group. Where a fund has a "relevant interest" it can treat all of its investments as made at the time when it acquired its relevant interest and all its disposals as not being made until it ceases to have a "relevant interest".

- Whether a fund is a controlling equity stake fund (or CESF) or not, it will acquire a "relevant interest" if it acquires a controlling interest (broadly speaking, 50 per cent+ of the ordinary share capital that carries an entitlement to at least 50 per cent of the voting rights in the company, the profits available for distribution to shareholders and the assets available for distribution to shareholders in a winding up) and it will cease to have a "relevant interest" when its interest (measured in the same way) falls below 40 per cent. For a CESF a "relevant interest" is also acquired when the fund obtains a 25 per cent+ (measured in the same way as a controlling interest) interest and disposed of when its stake falls below a 25 per cent interest.

- A CESF is one where it is reasonable to suppose that, over the life of the fund, more than 50 per cent of the total value invested will have been invested in controlling interests in trading companies/groups which are held for more than four years. The draft legislation is not clear as to when this test is applied or what happens if you get different answers depending when you apply it. This rule will benefit funds whose investment strategy is focused around taking control of trading enterprises (because it should be reasonable to suppose that more than half of their funds will be invested in this way), but that is not enough; it must also be "reasonable to suppose" that controlling stakes representing more than half of the funds available for investment will be held for more than four years.

- The advantage of being a CESF, of course, is that the special rule (which treats all money invested when a relevant interest is acquired and all money realised when a relevant interest is lost) will extend to 25 per cent+ stakes as well as controlling interests. This should make it easier for a fund to enter a club deal without adversely affecting its average holding period, but it will be necessary for the fund to acquire a 25 per cent+ stake not just to be a member of a club which has control.

- This special timing rule helps with the time at which an investment is made or disposed of, but it does not help with the foreshortening of the investment holding period if the investment stake is still held in the fund at the time the average hold period calculation needs to be carried out. Nevertheless, being a CESF should make it easier for carry holders to claim conditional exemption for their carried interests, because it should be more likely that average investment holding periods will be four years or more.

- While this rule will be welcomed by funds which regularly take controlling stakes, and in particular by CESFs, it is of no help to funds which do not invest in securities. It will, for example, be of no help at all to a real estate fund which incurs capital expenditure on a building. It is of little help (as the response document itself acknowledges) to venture capital funds, which invest in numerous funding rounds of unquoted companies but normally without taking control. HMRC indicated in the response document that they are aware of this shortcoming and are anxious to find a way of helping venture capital.

DERIVATIVES AND HEDGING

- A derivative strategy is one way in which a fund could effectively dispose of its economic exposure to an investment. If the fund takes out a derivative position with this effect, that will end the holding period in relation to the underlying investment. If the fund enters into such a position, the derivative is not an investment for the purposes of these rules. If, however, the derivative is subsequently disposed of without a disposal of the underlying investment, then the fund is treated as making a new investment to the extent it is now materially exposed to risks and rewards.

- Other than that, a derivative contract can be an investment just as much as anything else. The value invested depends on the nature of the derivative. In the case of an option it would be the cost of acquiring the option, with a future it will be the price specified in the contract for the underlying subject matter and in the case of a contract for differences it would be the notional principal of the contract.

- Where a fund enters into a forex or interest rate hedge, this is not treated as an investment (or a deemed disposal of the hedged investment), but ending the hedging relationship could amount to the making of a new investment in the hedging instrument if it is allowed to run on.

DIRECT LENDING FUNDS

- The legislation seeks to help direct lending funds, but it does so in a rather curious way. The opening position is that carried interest arising from a direct lending fund is to be taxed in its entirety as income.

- A fund is a direct lending fund if it is reasonable to suppose that over the life of the fund the majority of the investments (by value invested) would be direct loans made by the fund. A direct loan is one which is made to an unconnected borrower, under a genuine commercial loan negotiated on arm's length terms, where repayments are fixed and determinable, maturity is fixed and the fund has a positive intention and ability to hold the loan to maturity. If the fund purchases a direct loan within 120 days of its being made, that is regarded as the fund making a direct loan.

- However, this rule does not apply to carried interest arising from a direct lending fund if:
  - the fund is a limited partnership;
  - the carried interest is payable after all relevant investments have been repaid with a 6 per cent (or greater) hurdle; and
  - it is reasonable to suppose that over the life of the fund at least 75 per cent (by amount advanced) of the direct loans made by the fund will have had a "relevant term" of at least four years. For these purposes, "relevant term" means the period which begins when the money is advanced and ends at the time by which, under the terms of the loan, at least 75 per cent of the principal must have been repaid. In addition, if the direct loan has a relevant term of at least four years and the loan is repaid early by the borrower, then as long as the borrower is not connected with the fund and it is reasonable to suppose that the borrower's decision to repay early is not affected by tax considerations, the loan can be treated as one held for four years.

- The upshot of these provisions is that a fund which makes direct loans to unconnected third parties which would normally be expected to stay outstanding for four years or more should be capable of generating a carried interest with capital treatment. However, even for these funds issues remain:
  - 6 per cent is a high hurdle for a direct lending fund.
  - There are constraints around underwriting/ syndication. To qualify as a "direct loan" a fund must intend to retain it to maturity.
  - A high level of secondary activity could be problematic. A loan is not a "direct loan" if it is acquired more than 120 days after inception.

CONCLUSIONS

- Although we have described the draft legislation in some detail, it is exactly that. The Revenue are inviting comments on the draft legislation, and we will be inputting into the consultation directly as well as through participation in representative bodies. Anyone with concerns around how this legislation might apply to a fund he is interested in should raise those concerns with HMRC or someone who can lobby on his behalf.

- The main negative feature of the draft legislation is the need to have an average holding period of four years to access full capital treatment. That is significantly longer than the two year period in the original consultation. To that extent, HMRC have moved the goalposts in the middle of the consultation and the near universal support for the second option might be thought to have been achieved on a false premise.

- Clearly, the rules will impose a significant compliance burden on all fund managers, other than those who conclude at an early stage that there is no way in which their carried interest will not be fully taxed as income. Anyone else, who wants to try to preserve capital treatment for at least part of the carried interest, will need to monitor investments very carefully and carry out a number of calculations over the life of the fund.

- A fund which would expect to make most of its investments in controlling stakes of unquoted trading businesses (a CESF) will find its compliance burden reduced and the legislation will tend to produce less artificially shortened holding periods. If that fund can also access the conditionally exempt carry regime, its managers may be further helped. However, to be a CESF, a fund needs to expect to hold its controlling stakes for at least four years and the conditionally exempt carry regime is only available in the first four years after an investment is first made. Both of these regimes are too hedged about to be anything approaching a complete answer.

- The legislation would be much improved if a simplified conditional exemption (or just an ability to review the final position at the end of the life of the fund) were available to all carry holders in all types of funds regardless of asset class and if subsequent investments in the same situation (so all further investments of all sizes of stake in debt or equity securities in the same corporate by all funds, capex programmes in a real estate fund etc) were all treated as made when the first investment is made and realised on final disposal (with a targeted anti-avoidance rule to address artificial manipulation). This would not address the concerns of funds which hold investments for periods short of three or four years, but which are clearly not trading funds. It would, however, be a more honest way of measuring real average holding periods and be more likely to justify the government's description of the new regime as being "simpler, more objective and easier to apply in a way that provides clarity to the industry".

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