MACFARLANES BUDGET UPDATE – CHANGES TO THE TAXATION OF CARRIED INTEREST

The Chancellor has announced changes affecting individuals working in the asset management industry and, in particular, the tax treatment of carried interest. These changes are:

- All proceeds from carried interest to be taxed at at least 28 per cent. This change came into effect on 8 July 2015.
- A consultation on the types of funds whose carried interest should benefit from capital gains tax treatment (and which funds the carried interest in which should be taxed as income). These changes will come into effect from 6 April 2016.
- Changes to the domicile rule including individuals being deemed to be domiciled in the UK for income and capital gains tax purposes when they have been resident for 15 out of 20 tax years. These changes will come into effect from 6 April 2017.

IMMEDIATE CHANGE - TAXATION OF CARRIED INTEREST

Under current law, carried interest holders in partnerships do not pay tax based on their economic profit (i.e. the amount of cash they receive) but instead based on the underlying profits allocated to them by the fund. This has a number of consequences.

First, a distribution of cash to carried interest holders following the disposal of an investment by the fund will not be matched by an allocation of the same amount of profit as part of the cash amount will represent the cost of the relevant investment to the fund. For example, if a fund bought an investment for 100 and then sold it for 200 at a time the carried interest holders participate in proceeds, only 50 per cent of the cash received by the carried interest holders would be taxable and the remainder would be tax free. This is known as the “base cost shift”.

Second, to the extent cash received by a carried interest holder is matched by profits, the tax payable depends on the nature of those profits. If the profit is capital gain, the tax rate is 28 per cent but if the profit is income (for example, interest income, discount or offshore income gains), the profit is taxed at up to 45 per cent. This second fact of course means that the base cost shift is more valuable in funds which produce more profit in income form than in capital form as base cost shift saves them 45 per cent tax, not 28 per cent.

From 8 July 2015, the taxation of carried interest will not be solely dependent on the underlying nature of the profits arising to the fund.

Instead, all carried interest arising to an individual (less certain permitted deductions such as acquisition cost) is treated as capital gain, accruing at the time the carried interest arises to the individual.

Furthermore, that gain is treated as UK source to the extent the individual performs his or her investment management services for the relevant fund in the UK meaning that, to the extent of their UK activities for the fund in question, UK resident non-domiciled individuals will be subject to 28 per cent tax on carried interest whether or not remitted. The impact on carried interest held by non-doms through trusts will need to be considered. Finally, it should be noted that there are anti-avoidance rules which counteract arrangements to avoid the rules.

One issue is that the new rules seem to overlay rather than replace the existing rules. So, if the event giving rise to the carried interest produces a higher (income) tax liability for the individual under the existing rules, the individual would still be liable for that tax, albeit able to make a claim to reduce the capital gains tax arising under the new rules on a just and reasonable basis to avoid double taxation. It is not clear how these rules will operate in practice.

It will also become more difficult for US citizens caught by these rules to manage their tax credit position to avoid double tax.

For these purposes, carried interest is defined using the definition introduced this year under the disguised investment management fee rules and includes almost all types of performance award structured in equity form. The rules do not impact co-investment returns.

CONSULTATION ON GOOD VS BAD CARRIED INTEREST

HMRC have also issued a consultation (open until 30 September 2015) on the types of funds that should be able to issue carried interest which benefits from the capital gains tax treatment outlined above with a view to changing the law with effect from 6 April 2016 and limiting this to funds with a longer term investment strategy. HMRC are targeting hedge funds converting their annual performance fees to carried interest. However, the consultation would also seem to impact other, longer term, carried interest in funds which HMRC do not regard as being sufficiently investment in nature.

The effect of this change, as currently proposed, will be to tax carried interest in certain funds as income with only specified funds being entitled to issue carried interest benefitting from the

capital gains treatment outlined above. Quite how and where HMRC will draw the line is not clear and HMRC are consulting on whether to define the line by reference to the assets held by the fund and/or the length of time they are held for.

If the first approach were adopted, HMRC's initial proposal is for the funds investing in the following asset classes to be "good" funds:

- Controlling equity stakes in trading companies intended to be held for a period of at least three years.
- The holding of real property for rental income and capital growth where, at the point of acquisition, it is reasonable to suppose that the 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.
- Equity and debt investments in venture capital companies, provided they are intended to be held for a specified period of time.

This would make direct lending funds, mezzanine funds, minority funds, many cross-over funds and most hedge funds "bad" funds. Quite why HMRC draw some of the distinctions they do is not entirely clear to us and this will be the focus of a number of responses to the consultation.

HMRC also suggest that funds which do a combination of good and bad activity might have their carried interest pro rated between capital gain and income.

If the second approach were adopted, HMRC say they would look to the average hold period of the investments of the fund, with only funds whose average hold is over two years being entitled to full capital gains tax treatment for carried interest. Under the initial proposal here, there would be some pro rating of income and capital treatment for funds with shorter average holds down to six months below which all carried interest would be income.

We will be participating in the consultation and look forward to the observations of our clients and contacts for this purpose. Draft legislation will be published in the autumn.

CHANGES FOR NON-DOMS

Many carried interest holders are non-UK domiciled with the result that they often pay UK tax on carried interest only if remitted to the UK. As stated above, where the new rules apply to an individual, the carried interest gain is treated as UK source and so taxable on an arising basis to the extent the individual performs his or her investment management services in relation to the relevant fund in the UK. For wholly UK based non-doms holding carried interest directly, this effectively abolishes the remittance basis for carried interest. The impact of the new rules on individuals holding carried interest through trusts is not clear.

However, from April 2017, the source of the gain will be irrelevant for long term UK residents with a proposal that individuals will be deemed to be domiciled in the UK for income and capital gains tax purposes when they have been resident for 15 out of 20 tax years. Further details on the proposed changes to the domicile rules can be found here.

CONTACT DETAILS

If you would like further information or specific advice please contact:

MARK BALDWIN
PARTNER
TAX
DD: +44 (0)20 7849 2603
mark.baldwin@macfarlanes.com

DAMIEN CROSSLEY
PARTNER
TAX
DD: +44 (0)20 7849 2728
damien.crossley@macfarlanes.com

JAMES MCCREDIE
PARTNER
TAX
DD: +44 (0)20 7849 2129
james.mccredie@macfarlanes.com

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MACFARLANES LLP
20 CURSITOR STREET LONDON EC4A 1LT
T: +44 (0)20 7831 9222 F: +44 (0)20 7831 9607 DX 138 Chancery Lane www.macfarlanes.com

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