Carried interest

A changing landscape – UK tax developments

8 April 2016

A changing landscape

Initial changes that came into effect as of 6 April 2015 were the first step towards a major shift in how individuals working in the asset management industry will be taxed. Since that date we have seen a number of further proposed changes and consultations leading to periods which govern how individuals receiving carried interest will be taxed in the UK.

There have been significant changes relating to remuneration and reward structures for individuals performing investment management functions, including legislation on disguised management fees, a substantial limitation of the circumstances where capital gains treatment will apply and new rules on when a taxing point will occur. These rules may apply differently depending on a number of factors including the type of fund giving rise to carried interest and whether the individual is UK or non-UK domiciled.

The most recent carried interest legislation in Finance Bill 2016 took effect from 6 April 2016, though there are still uncertainties regarding the implementation and mechanics of the rules. There have been various discussions with HMRC in this regard and we are expecting further guidance to be issued. Further changes regarding the taxation of non-UK domiciled individuals will be introduced in Finance Bill 2017 and draft legislation is expected later this year.

Here we address the timeline of developments and the interaction of the various sets of rules.

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Timeline of developments

The carried interest path since 6 April 2015, when the Disguised Management Fee (DMF) legislation was implemented, to 6 April 2017 when the new deemed domicile rules come into force sees many obstacles for the fund and those receiving carried interest to navigate.

6 April 2015
Disguised Management Fee rules

The DMF legislation taxes disguised fees where the amounts have not previously been subject to tax. Sums arising to individuals are treated as trading or employment income subject to tax at up to 47%.

Qualifying co-investment and carried interest returns are excluded from the scope of the DMF legislation.

8 July 2015
New carried interest regime

Legislation is introduced to ensure that carried interest arising to individuals is effectively taxed at a minimum rate of 28%. This is achieved by removing base cost shift whereby individuals set investors' base cost of the underlying asset against the capital gain realised from their carried interest.

From 8 July 2015, non-UK domiciled individuals (non-doms) can only treat their carried interest as a foreign gain eligible for the remittance basis to the extent that the services relating to the carried interest are performed outside the UK.

The reduced UK capital gains tax rate of 20% effective 6 April 2016 does not apply to carried interest.

22 October 2015
Amendments to the meaning of arising

The carried interest legislation is amended to ensure that - where the benefit of the carried interest is available for the benefit of connected persons, such as family members, trusts and beneficiaries - it is deemed to arise to the individual.

6 April 2016
Income-based carried interest legislation

Carried interest arising after 6 April 2016 will be income-based carried interest (IBCI) and subject to tax at up to 47% unless the carried interest is an employment-related security or the underlying assets of the fund have been held for an average weighted holding period of at least 40 months.

For non-doms, there is no ability to apportion IBCI between foreign and UK sourced to enable remittance basis protection. An exception may apply in certain cases where individuals arrive in the UK and received payments relating to services performed when non-resident.

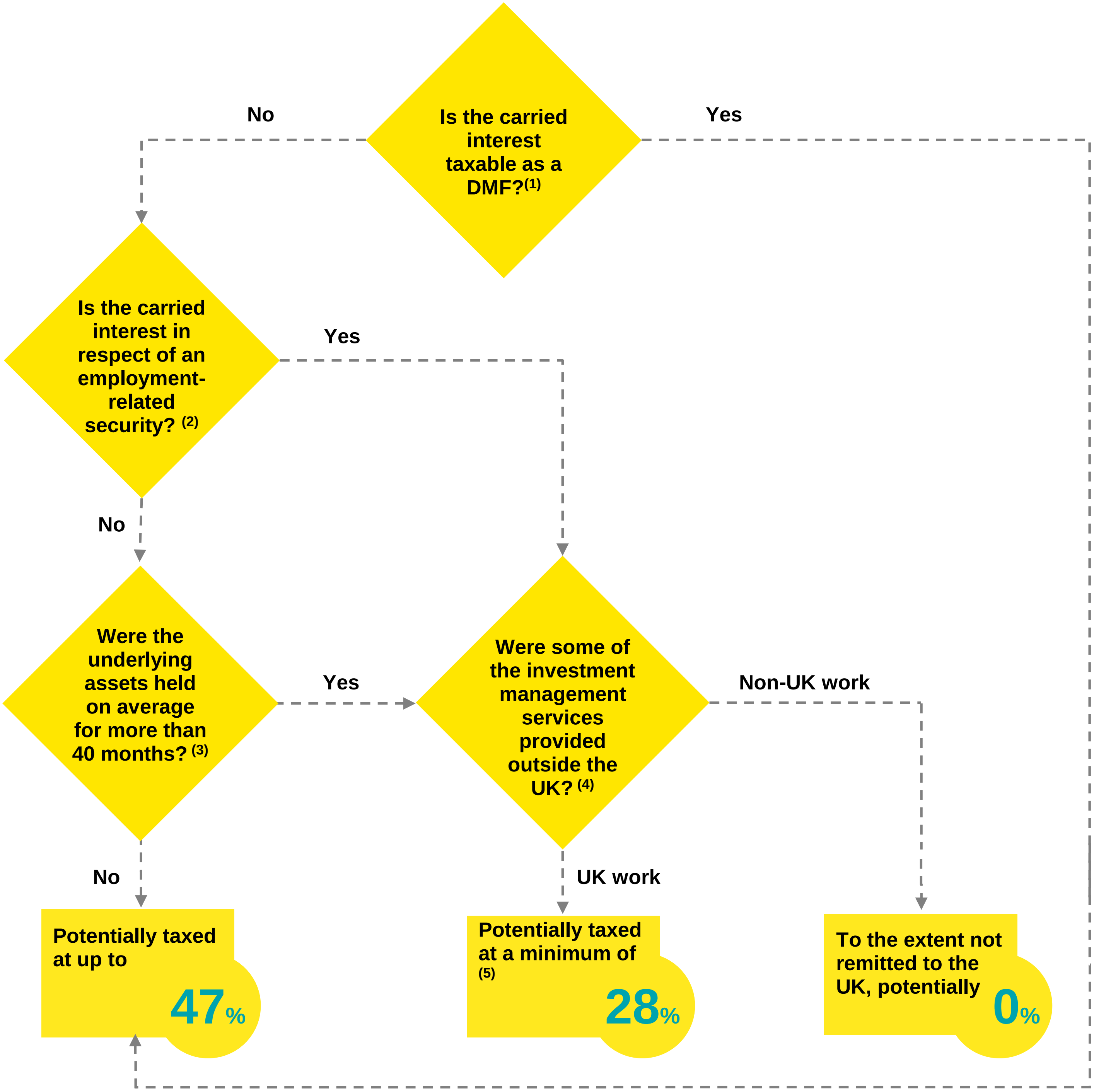
6 April 2017
Deemed UK domicile rules

From 6 April 2017 non-doms will become deemed domiciled in the UK after they have been UK tax resident for 15 of the previous 20 years.

Deemed-UK domiciled individuals will no longer be able to claim the remittance basis to protect their non-UK source carried interest from UK tax and therefore be subject to UK taxation on their worldwide income and gains.

Carried interest flowchart

The applicable UK tax rate will depend on the rules that are relevant to each particular event that generates carried interest arising to an individual. This may differ each time carried interest arises as various factors need to be considered and can range from 0% to 47%. The following flowchart provides an overview of the process to determine which rules apply and the subsequent tax that may be due.



Footnotes and Assumptions

1. Answer NO if the sum meets the definition of carried interest in the DMF legislation. At this point, do not consider whether the sum is DMF income under the IBCI rules.
2. Employment-related security as defined in Part 7 of the Income Tax (Earnings and Pensions) Act 2003.
3. Tapered capital gains tax rates apply to carried interest arising from funds where the underlying assets were held on average for between 36 and 40 months.
4. Apportionment of carried interest between UK-sourced and non-UK sourced assumes that the underlying assets giving rise to carried interest are non-UK situs assets and assumes the individual is a non-dom.
5. 28% capital gains tax will apply as a minimum. Where carried interest is satisfied through an allocation of income (e.g. interest or dividends), this will be taxed at up to 45%.

Further questions and how we can help

Certain aspects of the rules require further guidance. We are in regular and direct communication with HMRC on these areas. We are well placed to provide guidance to both the fund and the individuals on the impact of these rules, including but not limited to:

- Determining which of the rules apply when the carried interest arises along with the rate of UK tax that may be suffered.
- Advising on how to apportion the investment management services between those performed inside and outside the UK.
- Providing tax reporting for the fund, carried interest vehicle and carried interest recipients.
- Assisting with the preparation of UK tax returns.

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DLC_2016_0036 (eDTP160308) Carried Interest - A Changing Landscape (UK)