United Kingdom

Executive summary
On 8 July 2015 the UK’s Chancellor of the Exchequer (Finance Minister) announced changes to the taxation of carried interests held by individuals who provide investment management services in respect of collective investments schemes involving partnerships.

They are effective on amounts arising as of 8 July 2015 and apply to all carried interests held on that date (irrespective of date of grant) and to new grants of carry. Only pre 8 July 2015 carried interest rights that have been fully paid out before that date, are not caught.

It is expected the changes will have a significant impact on the personal tax treatment of those working in the asset management business in the UK with special changes in the proposals impacting non-UK domiciliaries who claim the remittance basis of taxation.

Background
The new law is part of a collection of rule changes and consultation exercises relating to remuneration and reward structures in the investment management services industry. This includes legislation on “Disguised Management Fees” introduced from April 2015 and a more wide ranging consultation into the taxation of performance linked rewards paid to asset managers to prevent capital gains tax treatment where the underlying activities are trading, rather than investment, in nature.

The intention behind this new law is to ensure that as a minimum a capital gains tax (CGT) rate of 28% applies to the economic gain realised from carried interest rights, for UK resident taxpayers. The changes achieve this by:

- Eliminating what has been known as the “base cost shift”, whereby partners can deduct the base cost of investors when computing the capital gain they have realised from their carried interest.
- Treating carried interest taxed as a capital gain as UK sourced if it relates to investment management services provided in the UK.

HMRC’s expectation is that the law will apply to any individual who has a carried interest right. If this right is excluded from the recent Disguised Management Fees legislation, as it is a carried interest right (as defined), then, due to the common definition used, it must be caught by these provisions.

There have been various discussions with HMRC in regards to the implementation and mechanics of these new rules and we expect them to issue further guidance in the autumn.

Detail
We outline below three changes to the treatment of carried interest that will have the most significant impact.
Base cost shifting

Previously, under formal UK Tax Office practice (known as SPD12), each partner in an investment management partnership was deemed to own a fractional interest in each of the partnership's assets. As such, when the partnership disposed of a chargeable asset each partner was deemed to dispose of their fraction of that asset.

Given the above, the total cost basis in a given asset was split between the partners based on their fractional share in the partnership at date of disposal of the asset. This does not necessarily correlate to the amount each partner may have actually invested. Often the holder of a carried interest will have very little of their own funds at stake, however, under SPD12 they are able to share in the amounts invested by external investors, when computing the chargeable gain. This is because the kicking in of the carried interest means that the carry percentage (typically 20%) of the base cost effectively moved to the carried interest holders. This is essentially a tax-free transfer of the investors tax base cost in a fund's asset to the carried interest-holder (the "base cost shift").

In the past this base cost shift could result in individuals who receive carried interest being charged to capital gains tax on amounts far lower than their actual economic return. The new legislation will no longer allow those that have carried interest to share in this cost basis and will see the taxable gain amount be more aligned to the economic return. This change will impact all individuals who are subject to capital gains tax (on arising or remittance bases) on their carried interest. The draft legislation is silent on whether taxing carried interest holders by reference to actual amounts they have contributed means other investors retain full basis in partnership assets and there is no base cost shift. Typically this may not matter to the other investors as they may be tax exempt or not UK resident.

Sourcing

For non-domiciled individuals taxed in the UK on the remittance basis, it will no longer be possible to treat carried interest as foreign source by reference to the situs of the assets disposed of by the partnership which gives rise to the carried interest amounts. Instead the new legislation states that gains will be treated as foreign only to the extent the duties performed managing the assets are performed outside the UK.

Those non-dom individuals with a carried interest who provide investment management services to the fund, entirely based in the UK, will no longer have the ability to protect this income from UK tax through claiming the remittance basis of taxation and maintaining the funds outside of the UK.

Instead, the full amount will be subject to UK capital gains tax (CGT) with only limited deductions allowed. This is irrespective of the jurisdiction in which the asset is located or whether the funds are brought to or used in the UK.

For those that provide investment management services partly in the UK and partly outside the UK there may be an ability to apportion some of the carried interest to being “foreign” – see below. If that is the case then this foreign element of the carry may still be protected from UK tax through claiming the remittance basis.

It is important to understand that the new law is a sort of default taxing charge. It may be necessary to do two computations, one under general law and one under the new law and see which gives rise to the greater chargeable amount. There is then a system of adjustments to try and remove any double taxation.

A number of areas remain unclear:

- How will the double taxation relief and capital losses interact?
- How will this characterisation as a UK chargeable gain interact with other jurisdictions where the carried interest may also be subject to tax (eg in the US)?
- When is carry deemed to arise and how is this impacted when held through a UK corporate or trust structure.

Apportionment

For non-dom taxpayers claiming the remittance basis the premise of how to apportion the carried interest between UK and foreign chargeable gains is vital.

For those who have a settled role throughout the life cycle of a fund, and whose duties are similar whether they perform them in the UK or overseas, it may be that a simple workday apportionment is appropriate.

However, many functions provide added value at particular points during a fund’s life cycle or in particular locations. As such there is argument that a greater weighting should be attached to time spent carrying out that role or in that particular place.

For example a fund raiser may provide much of their value at the early stages of a fund, or an individual with a supervisory role may add more value when on location at the site of the investment. Both of these scenarios may see individuals adding more value to their services when outside the UK.

We hope to see further guidance with regards to how to weight these duties and added value; however, it is possible that this will be determined on a case by case basis at the individual taxpayer level.

A key question for non domiciliaries paying tax on the remittance basis is how carried interest that is part UK and part foreign is considered for remittance purposes. Will this be subject to the so called “mixed fund” ordering rules which could leave taxed UK capital gains trapped behind foreign gains that would be taxed if remitted to the UK?
Next steps
It is clear that the practicalities of this new legislation will need detailed thought and careful action; which is unfortunate given these rules are to be applied as of now. In this respect:

▲ We can expect further guidance from HMRC on a number of the broad queries and concerns touched on in this alert as well as some very specific issues we foresee and which we have raised with them.
▲ It is worth noting that the law contains a mini GAAR (General Anti-Avoidance Rule) such that any planning or arrangements that are put in place to navigate around these new rules will be looked through.

Investment managers in structures which distribute carried interest will either be caught by the Disguised Management Fee legislation or these new rules, if they are not otherwise subject to income tax on carried interest distributions. As such, in many, if not most cases, the taxpayer will be exposed to a greater tax charge in the UK tax year ending 5 April 2016.

Non-domiciliaries who pay tax on the remittance basis will need to develop mechanisms for tracking where they perform duties as well as potentially what those duties are in order to apportion the carry between UK and foreign. They will also need to construct this information based on activities in the past if they are yet to receive carry distributions relating to past investment management duties.

In addition, absent clarity on the mixed fund rules we would advise that any carried interest distributions are deposited, where possible, in a separate non-UK situs bank account which has no other funds in it.

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