Thursday, 17th December 2015

Carried interest taxed as income

Fundamental changes are being made to the way in which carried interest is taxed. Following on from the consultation on the taxation of "performance linked rewards" paid to asset managers, the government has published draft legislation which introduces a new test which could restrict the capital gains tax treatment of carried interest paid to fund managers. The new test looks to the average period for which a fund holds its investments. Any carried interest not qualifying for capital gains tax treatment under the new rules will be taxed as trading income.

CALCULATION OF INCOME BASED CARRIED INTEREST

Percentage of carry taxed as income

To work out the percentage of carry taxed as income, fund managers will need to calculate the "average holding period" for which the fund holds "relevant investments" (being those investments made by the fund and by reference to which carry is calculated (ignoring intermediate holdings or holding structures)). The average holding period then determines the percentage of carry taxed as income.

Average holding period	% taxed as income
< 36 months	100%
≥ 36 months but < 39 months	75%
≥39 months but < 45 months	50%
≥45 months < 48 months	25%
48 months +	0%

How is the "average holding period" calculated?

The average holding period is calculated by reference to the time the carry arises using the following steps:

Step 1	Multiply the acquisition cost of each "relevant investment" by the length of time it has been held. The length of time to be used is: **A.** for those investments disposed of before carry arises, the time the investment was held before disposal; and **B.** where the investment has not been disposed of, the time it was held up to the time carry arises.
Step 2	Add together all amounts calculated under Step 1.
Step 3	Divide the amount at Step 2 by the total value invested by the fund in "relevant investments".

In a "fund-as-a-whole" carried interest model, all fund investments are "relevant investments" because they are all taken into account in calculating carried interest. In a deal-by-deal model the position is less clear. The "deal-by-deal" tag may be misleading because the model may take into account previous losses, written-down investments and impose claw-back arrangements.

Conditionally exempt carried interest

The average holding period test means that carried interest arising in the first four years of the fund is automatically trading income.

This could be unfair, so carried interest which arises in the first four years is "conditionally exempt" from being taxed as trading income provided that:

- The individual makes a claim (because they believe that the average holding period of the fund is likely to be over 4 years); and
- It is reasonable to suppose that the carried interest would not have been taxed as trading income if it had arisen at a later date.

The later date is the earliest of:

- The time when the fund will be wound-up;
- Four years after the time the fund will stop making investments;
- Four years after the carried interest in question arises (or, if carried interest is calculated by reference to a specific period, four years after the end of that period).

We call these dates the "long-stop dates". All of the long-stop dates are tested by reference to what it is "reasonable to suppose" will happen (see inset).

The carried interest ceases to be conditionally exempt at the first long-stop date (or earlier if it becomes apparent that the average holding period will be less than 4 years). At this point, the average holding period must be calculated and the result applied to the previously "conditionally exempt" carry. This may mean that the individual has to make an adjustment to their earlier tax return and pay income tax on some or all of their earlier carried interest receipt.

"REASONABLE TO SUPPOSE"

This takes into account all the circumstances, in particular any prospectus or other document:

- which is made available to external investors, and
- on which external investors may reasonably be supposed to have relied.

How is conditionally exempt carried interest taxed?

Carried interest which is conditionally exempt will be subject to tax on ordinary principles (likely to be capital gains tax or taxed as investment income).

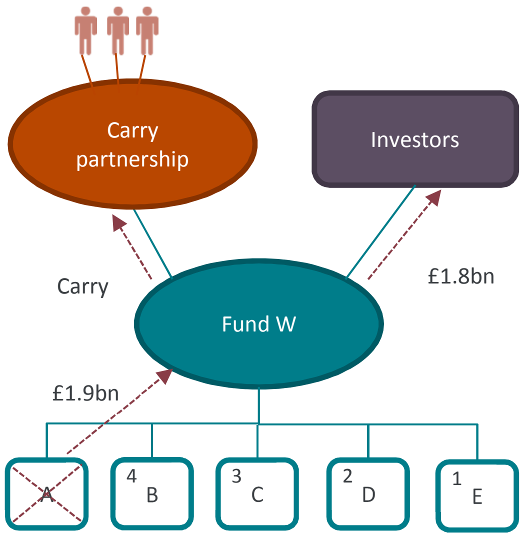
EXAMPLE 1 - WHOLE FUND CARRY MODEL

Fund W holds five investments, A, B, C, D and E, acquired for £200m each (total cost £1bn).

There is no entitlement to carry until each fund investor recoups its capital contribution plus a preferred return of 8% in relation to all investments. The "relevant investments" are A, B, C, D, and E.

Investment A is sold for £1.9bn and carry kicks in. At the time carry arises investments B, C, D and E have been held by the fund for 4, 3, 2 and 1 years and none have been sold other than A.

The tax treatment differs depending on whether investment A is sold in Year 5 or Year 4.



CALCULATION: Investment A is sold in Year 5 for £1.9bn and carry kicks in	
Step 1: Relevant investment x time held	(E: 1 x £200m) + (D: 2 x £200m) + (C: 3 x £200m) + (B: 4 x £200m) + (A: 5 x £200m)
Step 2: Add investments held under Step 1	£200m + £400m + £600m + £800m + £1bn = £3bn
Step 3: Divide Step 2 amount by invested amount	£3bn/£1bn = 3 3 x 12 months = 36 months
Result:	**75% of carry taxed as income** • Not conditionally exempt because carry arises in year 5 • No true-up at the end of the fund if average holding period is 4 years or more

CALCULATION: Investment A is sold in Year 4 for £1.9bn and carry kicks in	
Step 1: Relevant investment x time held	(E: 1 x £200m) + (D: 2 x £200m) + (C: 3 x £200m) + (B: 4 x £200m) + (A: 4 x £200m)
Step 2: Add investments held under Step 1	£200m + £400m + £600m + £800m + £800m = £2.8bn
Step 3: Divide Step 2 amount by invested amount	£2.8bn/£1bn = 2.8 2.8 x 12 months = 33.5 months
Result:	Starting position: 100% of carry taxed as income but carry arises in year 4 and "conditionally exempt" conditions satisfied. Individual makes claim for carry to be conditionally exempt so **100% taxed as capital gain**

CALCULATING THE HOLDING PERIOD OF THE ASSET

How are follow on funding and part disposals treated?

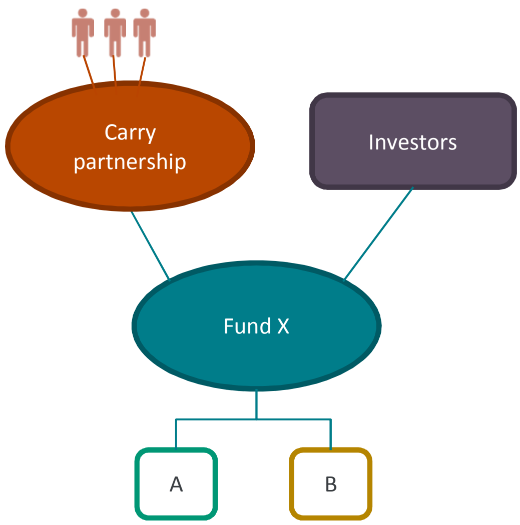
Under the basic rules, follow on funding is treated as a new investment made at the time of the funding. Injecting further cash into an investment shortly before a sale would therefore result in a very short holding period for that investment.

The legislation also contains a specific rule for part disposals of an investment. Where part of an investment is disposed of, the investment is treated as being split into two separate investments on a pro rata basis.

EXAMPLE 2

Fund X makes two investments in trading companies **A** and **B** at the beginning of year 1. **A** and **B** are acquired for £100m each and Fund X acquires a 40% interest in each company.

At the beginning of year 2 Fund X invests an extra £100m into **company A**. At the beginning of year 3 Fund X disposes of 20% of the shares in **company B**. At the end of year 4 Fund X disposes of both investments. The carry operates on a whole fund basis and is triggered by the disposals at the end of year 4.



What are the relevant investments and holding periods?

The initial investment of £100m in **company A** is held for four years.

The additional funding provided to **company A** counts as a new investment of £100m held for 3 years.

The part disposal of **company B** splits the **company B** investment into two separate investments:

- **B1** £50m held for 2 years
- **B2** £50m held for 4 years

CALCULATION:	
Step 1: Relevant investment x time held	(A: 4 x £100m) + (additional funding: 3 x £100m) + (B1: 2 x £50m) + (B2: 4 x £50m)
Step 2: Add investments held under Step 1	£400m + £300m + £100m + £200m = £1bn
Step 3: Divide Step 2 amount by invested amount	£1bn/£300m = 3.33 3.33 x 12 months = 39.96 months
Result:	**50% of carry taxed as income**

Special rules where the fund holds a significant interest

The new rules are more generous in relation to follow-on funding and part-disposals where the fund holds:

- A "relevant interest";
- In a trading company or a holding company of a trading group.

The definition of a relevant interest is complex. If the fund is a "controlling equity stake fund" (see inset) then the threshold for a relevant interest is 25%. For other funds it is 40% or 50%. A relevant interest looks at ordinary share capital, voting rights *and* economics.

CONTROLLED EQUITY STAKE FUND

It is "reasonable to suppose" that once the fund has disposed of all of its investments, more than 50% of the total value invested by the fund will have been invested in:

- controlling interests in trading companies, or holding companies of trading groups; and
- which are held for at least four years.

How do the rules operate?

	Rule	"Relevant interest" required for "controlling equity stake funds"	"Relevant interest" required for other funds
Further investments	Any further investment in that company is treated as made at the time of the original investment into that company	25%	Controlling interest, which is defined as a 50% interest
Part disposals	Part-disposals are ignored, provided the fund still retains a relevant interest. No disposal is treated as made until the fund makes a disposal which means it no longer holds a relevant interest.	25%	40%

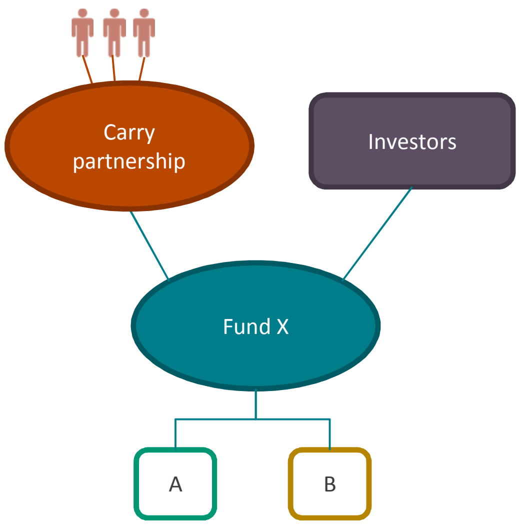
EXAMPLE 3

The facts are as set out in example 2 but, Fund X holds 70% in each company and so is a controlling equity stake fund.

What are the relevant investments and holding periods?

The additional funding in **company A** is treated as if it was made at the time of the initial investment. **Company A** is treated as one investment of £200m held for 4 years.

The part disposal of **company B** is ignored as after the disposal Fund X retains a relevant interest in **company B**. **Company B** is treated as one investment of £100m held for 4 years.



CALCULATION:	
Step 1: Relevant investment x time held	(A: 4 x £200m) + (B: 4 x £100m)
Step 2: Add investments held under Step 1	£800m + £400m = £1.2bn
Step 3: Divide Step 2 amount by invested amount	£1,200m/£300m = 4 4 x 12 months = 48 months
Result:	**0% of carry taxed as income**

For private equity funds who tend to invest in majority stakes in trading companies these special rules will be welcome. They should be able to inject further funding into investments or make small part disposals, for example refinancing out any bridge financing, without skewing the averaging holding period of the fund.

DIRECT LENDING FUNDS

Under the draft rules, all carried interest arising from a "direct lending fund" will be taxed as trading income. A fund is a "direct lending fund" if the majority of its investments are "direct loans", meaning a loan at interest made by the fund to a company and where:

- the company is unconnected with the fund;
- the loan is a genuine loan agreement negotiated on arm's length terms;
- repayments are fixed and determinable;
- maturity is fixed; and
- it is intended that the loan will be held by the fund to maturity.

DIRECT LENDING FUND EXEMPTION

Fund not treated as a direct lending fund if:

- the fund is as a partnership;
- it is reasonable to suppose that when the fund's investment period ends, the "relevant term" of at least 75% of direct loans made by the fund will be 4 years; and
- the carry qualifies as "carried interest" under the disguised investment management fee rules

The "direct loan" definition catches loans which meet the conditions above and which are acquired within 120 days of lending.

The special rules for direct lending funds will have an impact on many debt funds. Managers will need to review fund assets to determine whether the majority of them fall within the definition of "direct loans" set out above and if so, whether the exemption could apply.

Private equity funds making minority investments will also need to consider whether loan note funding could be direct loans thereby risking the fund being a direct lending fund (unless the exemption applies). We would not expect loan note funding provided by private equity funds making majority investments to be caught (because the fund is then likely to be connected with the borrowing company).

WHAT ABOUT INFRASTRUCTURE FUNDS AND REAL ESTATE FUNDS?

Although infrastructure funds typically hold assets for long periods, carry may be calculated on a net asset value basis. Carry arising in the first four years may be conditionally exempt but any carry arising after year 4 is likely to be caught. Managers of infrastructure funds should, therefore, review their carry arrangements (whilst carry may be in the form of income (interest or dividends), under these new rules, it would be taxed as trading income which could impact UK resident non-UK domiciled fund managers).

For real estate funds, it is unclear from the rules which asset is the "investment" for the purposes of the average holding period. Rather than acquiring direct interests in land, real estate funds may invest in companies trading in land. As such, the special rules on funds holding "significant interests" set out above may be beneficial. It is unclear, however, whether the company holding the land would be ignored under the draft rules.

Comment

There are considerable complexities in the draft legislation and even where funds do have a long term holding strategy, carried interest structures will need to be reviewed. The rules may have a significant impact on funds managers who are UK resident but not UK domiciled – since carried interest caught by these rules would be taxed as trading income, the remittance basis would not be available to the extent they conduct any of their investment management activities in the UK. Consideration should also be given to whether the carried interest is acquired by reason of employment and, therefore, subject to the employment related security rules - the draft rules do not apply to carried interest which arises in respect of an employment related security.

The new rules will apply to carried interest arising from 6 April 2016. The draft rules will undergo a further period of consultation up to 3 February 2016 before a final version is published after the UK Budget (16 March 2016).

Please contact us if you would like to discuss the implications of these changes further or if there are any particular points you would like raised at our January workshop.

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