August 2017

Reforms to Corporation Tax Loss Relief – Impact on UK General Partners

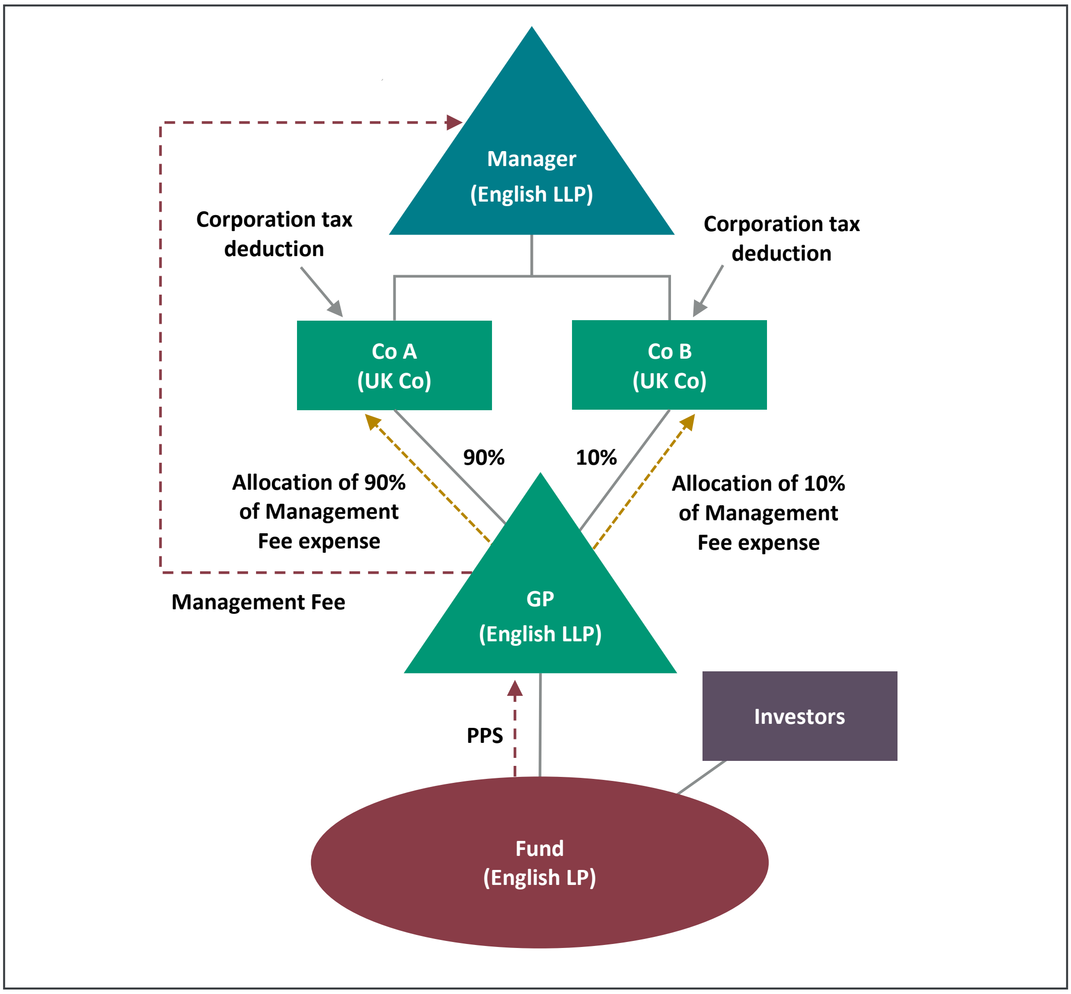
On 13 July 2017, HMRC released revised legislation for its reforms to the corporation tax loss relief regime which the Government has now confirmed will have effect for accounting periods beginning on or after 1 April 2017.

In short, the new regime gives greater flexibility in using prior year losses and carrying losses forward within a group, but this increased flexibility is balanced with a restriction on the amount of profits which can be relieved by carried forward losses (whether incurred before or after 1 April 2017). Broadly, groups will only be able to use carried forward losses to offset 50% of their profits over a £5 million deductions allowance (to be shared between group members) in any one accounting period.

The implications of these changes will likely be significant for many of our clients who manage limited partnership funds with UK general partners, and may have a direct economic impact on fund managers. A simple example demonstrating the impact of these changes is provided below. There are possible solutions to mitigate the impact of the changes which we can assist you with, and so if you need guidance on this issue, please do get in touch - our contact details are at the end.

HOW DO THESE REFORMS IMPACT UK FUNDS?

The example below addresses the potential tax implications of these reforms for a typical English limited partnership fund structure with an English general partner LLP whose members are two UK resident companies (as illustrated below).



HERE'S HOW IT WORKS:

- The GP is entitled to a priority profit share (PPS) from the Fund – in the early years of the Fund (i.e. before it is profitable), the PPS is funded through investor draw downs and treated as a (non-taxable) advance in the hands of the GP.

- The GP uses the PPS to pay the management fee to the Manager – the expense of the management fee is allocated to the GP's two UK corporate members – Companies A and B. They are deemed to carry on the investment business of the GP and so claim a deduction for the expense of the management fee. This means that in the early years of the Fund, Companies A and B will incur losses (i.e. because there are no profits against which the management fee expenses can be offset).

- Later on, when the Fund becomes profitable, the advances made to the GP in the early years are reversed out: profits are allocated to the GP (and ultimately allocated by the GP to Companies A and B) in respect of the earlier years but the cash is distributed to investors to repay commitments drawn down in earlier (non-profitable) periods.

- Prior to the rule changes, the two UK corporate members would have carried forward their management expense losses from previous years to reduce or eliminate profits allocated to them when the Fund is profitable. For accounting periods beginning on or after 1 April 2017, it will only be possible to set such losses off against 50% of each of Company A and Company B's total profits (subject to certain adjustments) – Companies A and B will each have an annual deductions allowance of £5 million (provided they are not companies within a group).

HERE IS A SIMPLE EXAMPLE TO SHOW THE IMPACT OF THE CHANGES

Assume the following:

- Fund has £500 million of commitments
- PPS is 2% (so £10 million each year)
- Management fee is £9.8 million (assume this is the GP's only expense)
- Companies A and B share in the profits and losses of the GP in the ratio 90:10
- In Years 1 to 3, the PPS is funded by an advance from the fund partnership, not by fund profits, so Companies A and B incur losses from paying the management fee
- In Year 4, there is a spike in fund profits and the GP is allocated £40 million by the fund. It uses £9.8 million to pay the Year 4 management fee, leaving it with £30.2 million to allocate to Companies A and B in the ratio 90:10.

Company A position in year 4	
PRE 1 APRIL 2017 RULES	**POSITION FROM 1 APRIL 2017**
Profit of £27,180,000 (i.e. 90% of £30.2 million)	Profit of £27,180,000
Losses of £8,820,000 in each of Years 1 to 3 (i.e. 90% of the £9.8 million management expense each year), so carried forward losses of £26,460,000	Carried forward losses from Years 1 to 3 of £26,460,000
No cap on amount of carried forward losses which can be used to relieve profit	Maximum amount of profit in excess of £5 million deductions allowance which can be relieved with carried forward losses is £11,090,000 (i.e. profit of £27,180,000 less £5 million deductions allowance, then 50% of this) So maximum amount of carried forward losses which can be used is £16,090,000 (i.e. £11,090,000 plus £5 million deductions allowance)
Carried forward losses offset against profit to reduce taxable profit from £27,180,000 to **£720,000**	Carried forward losses offset against profit to reduce taxable profit from £27,180,000 to **£11,090,000**
No carried forward losses remaining to use in future years	Carried forward losses remaining to use in future years: £10,370,000

Company B position in year 4	
PRE 1 APRIL 2017 POSITION	**POSITION FROM 1 APRIL 2017**
Profit of £3,020,000 (i.e. 10% of £30.2 million)	Profit of £3,020,000
Losses of £980,000 in each of Years 1 to 3 (i.e. 10% of the £9.8 million management expense each year), so carried forward losses of £2,940,000	Carried forward losses from Years 1 to 3 of £2,940,000
No cap on amount of carried forward losses which can be used to relieve profit	Profit can be completely relieved by £5 million deductions allowance
Carried forward losses offset against profit to reduce taxable profit from £3,020,000 to **£80,000**	Carried forward losses offset against profit to reduce taxable profit from £3,020,000 to **£80,000**

WHAT NEXT?

We anticipate that these rules will have significant implications for many of our clients who manage UK funds with UK general partners but the level of impact will depend on a variety of factors, including the amount of the management fee and PPS, how great an interest each UK corporate member holds in the GP LLP, the amount of management fee expense allocated to each UK corporate member of the LLP, and of course the performance of the fund both in the early years and later on.

There are ways to mitigate the impact of the changes both for existing and new fund structures. What is appropriate and effective will need to be considered in detail and will depend on your specific circumstances and the appetite for making changes.

The following points will also need to be considered:

- Unsurprisingly, there is a targeted anti-avoidance rule (this is likely to be more of an issue for existing funds rather than new funds at the formation stage).
- Depending on timings and the potential solutions, engagement from third party investors may be required particularly where the solutions involve changes to the fund structure – third party investors may not agree to changes being made. There will also likely be commercial and other non-tax issues in play.

If you would like to discuss the implications of these reforms for your business, or anything else, please do get in touch.

FOR FURTHER INFORMATION, PLEASE CONTACT

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