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Carried interest taxes as income

Following HMRC's summer consultation on performance remuneration, draft rules were published yesterday which set out when carried interest will be taxed as trading income.

Unsurprisingly the rules are complex. They are summarised below, but we will be in touch with a briefing on the practical implications for funds in the next few days. In the meantime, please give us a call if you have any questions.

The new rules will not affect the taxation of the fund itself or external investors.

How do the new rules work?

Funds will have to calculate the average holding period of their investments to work out how their carried interest will be taxed. An average holding period of 4+ years means the new rules won't bite. A holding period of less than 3 years will turn all the carried interest into income.

How is the average holding period calculated?

Each time carried interest is paid, the fund must multiply the day-one value of their investments by its hold-period and then divide this by the total day-one value of investments. If the result of this sum is less than 4, then the new rules apply to that carry payment.

Doesn't that mean that any carry paid in the first four years is automatically taxed as income?

Yes, but if the fund is confident that – over a longer period – the average holding period will be longer, then the taxpayer can treat the carry as capital gain. If this turns out not to be the case, then the individual will have to adjust their tax return and pay tax at income tax rates. This concession only applies to carry arising up to year 4. These are complex rules and oddly you may get a worse result for carry that is received in years 5 or 6.

Our private equity fund invests additional amounts in portfolio companies all the time and doesn't always sell everything at once. How should it calculate its average hold period?

Special rules apply to funds which take majority, long-term stakes in trading companies. If they hold a 25% stake on day one, then any new capital injected is treated as having been invested at the outset. Partial disposals are ignored until the fund makes a disposal which takes them under the 25% threshold.

Are all funds treated the same?

No, the rules are harder on funds which carry out direct lending activities. Their carried interest is taxed as income unless the fund is a limited partnership and intends to make loans with terms of 4+ years. These rules are particularly complex. For funds which generally take minority positions, the rules around follow-on funding and part disposals are harsher. As a result the average hold period is likely to be treated as shorter under these rules for those funds.

When will the rules apply?

The new rules will come into force from 6 April 2016. HMRC is still talking to interested parties so there may be further changes before this becomes law.

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