Wednesday, 28th October 2015

Summer Finance Bill: progress through Parliament – amendments to the DIMF and carried interest rules

Last week the government published detailed amendments to the disguised investment management fee rules ("DIMF") and the draft carried interest rules which remove the base cost shift.

RECAP

Our earlier briefings on these topics can be found here and here, but – by way of a recap:

- From 6 April 2015, "disguised investment management fees" have been taxable as trading profits. All amounts which (i) arise from a collective investment scheme; (ii) to a person involved in investment management activities; (iii) under arrangements which involve a partnership, are caught by these rules, unless (a) they fall into the exceptions for carried interest and co-invest or (b) the amounts have already been taxed as employment income or fed into the calculation of the individual's trading profits.

- Under the new carried interest rules, carried interest arising to an individual involved in investment management is taxed as capital gain (with only very limited deductions). This effectively means the end of the base cost shift. This new rule applies as well as (rather than instead of) the taxation of carry under general principles. This means that – if a portfolio company pays a dividend to a private equity fund, for example – any resulting carried interest is still taxed at the dividend rates under general principles and as capital gain under the new rule. A credit must be actively claimed to avoid double taxation.

CHANGES: NEW DEFINITION OF "ARISING"

The first cut of the rules described above applied to amounts "arising directly or indirectly" to an individual. The meaning of "directly or indirectly" was uncertain (HMRC took the view that it allowed them to look through intervening vehicles in some cases but not others). This phrase has been removed.

Instead, detailed rules have been added which apply to determine the meaning of "arise" when someone other than the individual receives carried interest or DIMF.

We set out the new rules below and then apply them to three scenarios:

- Management fees received by a UK regulated company manager, owned by the senior management team;
- As above, but where the fund manager is a non-UK company; and
- Carried interest held by an individual via a personal company.

What do the new rules say?

An amount which arises to (a) a connected company; or (b) any unconnected person is deemed to arise to the individual if any "enjoyment condition" (see below) is met.

The references to "A" below are to the individual and his or her connected persons. Helpfully the connection test is modified so that individuals are not automatically connected with other partners in a partnership.

Enjoyment conditions

The enjoyment conditions are:

- Enjoyment condition (a): the sum is dealt with by a person to "enure for the benefit" of A;
- Enjoyment condition (b): the sum increases the value of assets held by or for the benefit of A;
- Enjoyment condition (c): A receives or is entitled to receive a benefit from the sum;
- Enjoyment condition (d): A may become entitled to the beneficial enjoyment of the sum if one of more powers are exercised;
- Enjoyment condition (e): A can control (directly or indirectly) the application of the sum.

Exclusions

These are broad tests, but there are some exclusions:

- Enjoyment conditions (b), (c) and (d) are not met just because the individual holds shares in the company in question. We refer to this exclusion as the "Shareholder Exemption";
- Enjoyment conditions (a) and (e) are not met where a sum arises to a company which is connected with the individual and either:
  - the amount has been taken into account in calculating the company's liability to corporation tax; or
  - the company is a controlled foreign company and the exemption for CFCs which pay tax at a rate equal to at least 75% of the UK corporation tax rate applies (or, if the company is not a CFC, would apply if it was).

  We refer to this exclusion as the "Corporation Tax Exemption".

An individual cannot rely on these exemptions if it is reasonable to assume that:

- in the absence of the arrangements, the sum would have arisen to the individual (or a connected person); AND

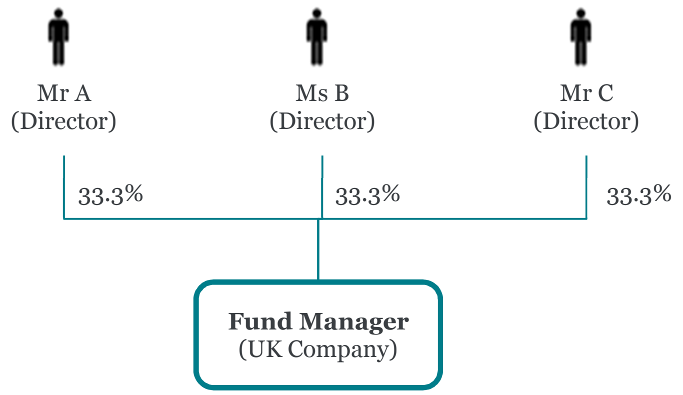
- the arrangements have the avoidance of income tax, capital gains tax, inheritance tax or corporation tax as a main purpose. This condition is deemed to be met where the sum is invested in the fund.

There is also a separate rule which applies where a sum arises to a connected person which is not a company (for example, a trust in relation to which the individual is the settlor). If an amount arises to such a person and is not taxed in their hands under the disguised investment management fee rules or the carried interest rules, the amount is deemed to arise to the connected individual.

Effective Date

The changes have effect from 22 October 2015, although there are transitional rules for carried interest funded by disposals of fund assets prior to 22 October.

EXAMPLE ONE



Mr A, Ms B and Mr C each own 1/3 of a UK company which acts as a fund manager and pays corporation tax on its profits. All three are on the company's board of directors. Can the company's income be treated as arising to them and taxed in their hands under the revised DIMF rules?

The answer to this question ought to be 'no', but the circumstances are critical to the answer. Although the receipt of management fees by the company is likely to increase the value of A, B or C's shares (enjoyment condition (b)) and the team will receive a benefit if the board decides to pay a dividend (enjoyment condition (d)), the rules will not apply if these kind of benefits *only* arise from A, B or C's rights as shareholder i.e. the team can rely on the Shareholder Exemption. The suggestion on the face of the legislation is that there must be additional steps which confer or could confer a further benefit.

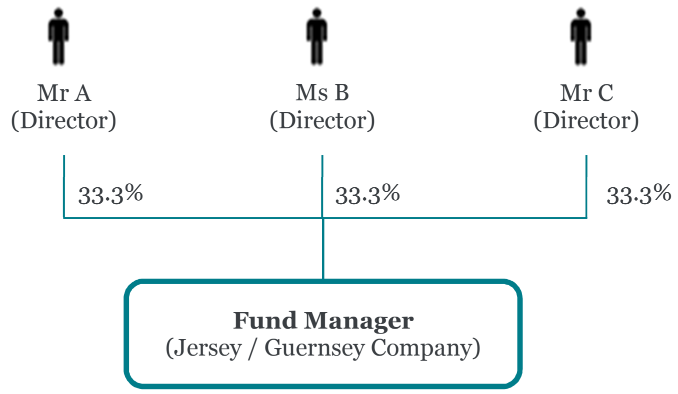
In this example, the individuals have power over the company's profits in their capacity as directors too. This means consideration also has to be given to enjoyment condition (a) where the amounts are "calculated to enure" for their benefit or enjoyment condition (e) where they "control" the application of the company's income. It is a question of fact whether any one team member controls the company. Individually, they do not – each only owns 1/3 and no single person can force their views onto the rest of the board. However, if there is a shareholders' agreement (or similar arrangement) then consideration must be given as to whether they act together to secure this control.

In this case, the team can rely on the exclusion from enjoyment conditions (a) and (e) because the company pays corporation tax. However, neither the Shareholder Exemption nor the Corporation Tax Exemption are available to a fund management team if:

- it is reasonable to assume that, in the absence of the arrangements under which the sum arises to the company, the sum would have arisen to the individuals; and
- there is a UK tax avoidance motive. A tax avoidance motive is treated as existing if the company uses the amounts arising to acquire fund interests (that is, interests in a collective investment scheme). Teams who traditionally have warehoused some carried interest or who have an element of "house" co-invest (as opposed to co-invest held directly by the team) will have to think hard about the application of these rules.

In relation to the first condition, if the individuals are the driving force behind the business, there must always be a risk that HMRC might argue that the sums would otherwise have arisen to them. However, there must be a counter-argument to this which is that the company is authorised by the FCA to manage and operate the fund and the individuals are not: the management fees could not have been paid to them directly.

EXAMPLE TWO



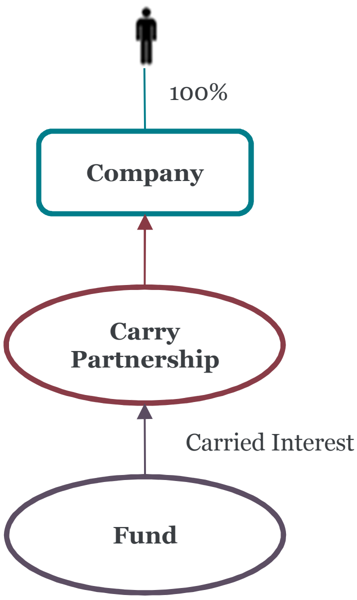
This is the same set of facts as the first example, except that the manager is based in and regulated by a Channel Islands jurisdiction.

To the extent that the receipt of the management fee increases the value of the shares in the fund manager or might enable the fund manager to pay a dividend, Mr A, Ms B and Mr C can – in their capacity as shareholders - rely on the Shareholder Exemption in relation to enjoyment conditions (b), (c) and (d). However, the Shareholder Exemption will not be available if sums received by the fund manager are used (directly or indirectly) to acquire an interest in the fund AND, but for the "arrangements", the sums would have arisen to the team directly. This latter limb is unclear: what is meant by arrangements? Are the arrangements the use of a Jersey/Guernsey company as the manager? If yes, then the team may be able to argue that the amounts could not have arisen to them directly because the fund needs a manager regulated by the relevant Channel Islands authority. An individual might be on a stickier wicket if – for example – Mr A owned his interest in the fund manager through a personal company. The amounts arising to such a company might be deemed to arise to Mr A personally.

Where the manager is offshore, the team will also have to look harder at enjoyment conditions (a) and (e). This is because they cannot rely on the Corporation Tax Exemption. In this case, the team will have to look carefully at the meaning of "calculated to enure" (enjoyment condition (a)) and "able to control directly or indirectly" (enjoyment condition (e)). There is a significant body of case law around similarly worded enjoyment conditions because they are borrowed from the transfer of assets abroad rules which have been around since 1936.

In one sense, all amounts arising to a company will eventually "enure" for the benefit of its shareholders. Case law suggests something more is needed here: "calculate" means "likely to, estimated to, intended to…" all phrases which suggest that a considered plan is in place. In one case, the company reinvested its income (rather than paying it out), not because there was a pressing business need to do so, but because there was an acknowledged intention that the purpose of the arrangements was to roll up profit until the (real) beneficiaries eventually left the UK. In that case, the income was "calculated to enure" for those beneficiaries.

EXAMPLE THREE



The final example looks at where carried interest is held through a personal vehicle such as a company.

If the company is wholly owned by the individual in question, then it is hard to say that the individual in question does not have the power to enjoy the amounts arising to the company. It is likely that the individual can choose who is appointed to the board and – in this way – controls, directly or indirectly – the application of the amounts arising.

Where a non-domiciled individual holds his or her carried interest through a corporate vehicle which they control, amounts received by their vehicle are likely to be treated as arising to them. The individual is unlikely to be able to rely on the safe harbours of the Shareholder Exemption or the Corporation Tax Exemption. Even if the arrangement is long-standing and may not have been established for tax reasons, the individual is likely to be caught by enjoyment conditions (a) and (e). Such a non-dom will have to consider the extent to which his or her investment management services have been performed in the UK to work out how much of this carried interest can be taxed on the remittance basis.

TWO OTHER (HELPFUL) CHANGES

As explained above, the carried interest rules are designed to sit alongside the existing tax rules so that some double taxation is inevitable unless a credit is claimed. Under the first draft of the rules, a claim for credit could be made if the individual in question had suffered double tax. The amendments allow credit to be claimed where another person has paid tax in respect of the carried interest which is then deemed to arise to the individual under – for example – an example three scenario.

In addition, under the first draft of the rules, the team entitled to carried interest lost the advantage of the base cost shift, but – under ordinary SP D12 principles – the investors also lost a proportion of their case cost. The revised draft includes a mechanism to reinstate the investors' base cost, but only if a claim for relief is actively made.

EFFECTIVE DATE

These changes have an effective date of 8 July 2015, like the rest of the new carried interest rules.

HOW TO FIND OUT MORE

If you have any questions or would like to know more about how these issues may be relevant to you, please contact any of the contacts below.

FOR FURTHER INFORMATION, PLEASE CONTACT

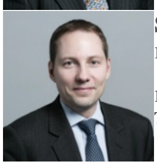
10 Snow Hill
London EC1A 2AL
T: +44 (0)20 7295 3000
F: +44 (0)20 7295 3500
www.traverssmith.com

Richard Stratton
Tax partner

E: richard.stratton@traverssmith.com
T: +44 (0)20 7295 3219

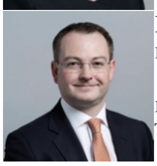
Emily Clark
Tax partner

E: Emily.clark@traverssmith.com
T: +44 (0)20 7295 3393



Sam Kay
Head of Investment Funds

E: sam.kay@traverssmith.com
T: +44 (0)20 7295 3334



Phil Bartram
Financial Services and Markets partner

E: phil.bartram@traverssmith.com
T: +44 (0)20 7295 3437