Investment Funds: Summer Budget Update

The key points for the asset management industry from today's Budget are:

Carried Interest

As from today, base cost shift will no longer be effective in relation to carried interest. The rules apply to all carried interest arising on or after today's date.

The draft legislation has just been published and the headline points are:

- Carried interest will have the same meaning as it does in the disguised investment management fee rules (i.e. BVCA style carry with a hurdle of 6%+ and other "profit related returns" provided that there is "no significant risk" that the returns will not arise). Co-invest will not be caught, provided it satisfies a newly revised (potentially stricter) definition included in the disguised investment management fee rules.

- Any amount received in respect of carried interest is to be treated as chargeable gain subject to capital gains tax accruing at the time the carried interest arises (which is of course a different time from when the underlying gains accrue to the fund).

- There are some permitted deductions such as amounts paid for the carried interest, and where charges have arisen under the Employment Related Securities Rules on the carry.

- Non-doms, who would currently be able to claim the remittance basis to keep non-UK gains outside the UK tax net, can now only keep such gains outside the scope of UK capital gains tax to the extent that the individual performs investment management services **outside the UK** in respect of a scheme giving rise to the carry. To the extent the services are performed in the UK the gains become UK gains. This is an unrelated change and has nothing to do with imposing capital gains tax on carry returns. It is also not obvious how to work out the "extent" to which the services are provided within or outside the UK as the carry arises at a point in time, whereas the services are provided over a period.

- There is a provision avoiding double taxation but this does not reduce other taxes which might be payable. So for example, to the extent the carry return constitutes interest, it will be charged at income tax rates and it would appear that, to that extent, the carry will not be taxed at the capital gains tax rate.

- The charge is lopsided in that, while the carried interest holders are charged to capital gains tax without the benefit of any base cost shifted to them under D12, the base cost shift still appears to apply to investors (as D12 still applies to them) who must draw up their tax computations accordingly.

Consultation on Performance Related Rewards

There is a consultation (running from today to 30 September) into how performance related rewards should be taxed. HMRC is concerned that some fund managers may exploit the complexity around the investment vs. trading rules and try to argue that their fund is investing to get capital gains tax treatment on their performance-related fund returns. Significantly, HMRC states that "*it is not anticipated that the treatment of performance related rewards which have historically been subject to capital gains tax will change as a result of this consultation*". The proposals do not give much confidence that this will be the case although they are early stage. The consultation is overseen by Richard Rogers who was in charge of the salaried members and DIMF consultations.

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In summary, HMRC proposes to define the circumstances in which performance related fund returns can be taxed as capital gains. They state that, whatever the outcome of the consultation, this will not affect the fundamental analysis of whether the fund is investing or trading for tax purposes, the treatment of other investors, the white list for authorised funds and investment trusts or the investment manager exemption.

HMRC invites responses to two alternative tests which could be adopted to ascertain whether performance rewards should be income or capital in nature. The first looks at the asset classes of the fund. The second is a “holding period” test.

Asset classes: the list of classes which HMRC proposes should be eligible for capital gains tax treatment are:

- controlling equity stakes in trading companies intended to be held for 3 years;
- holding real property for rental income and capital growth where it is reasonable to assume it will be held for 5 years;
- purchase of debt on a secondary market where the debt will be held for 3 years; and
- equity and debt investments in venture capital companies (not yet defined) provided they are intended to be held for a set period (not yet specified).

HMRC asks whether other classes should be included. Notable by omission are minority holdings and debt funds which focus on direct lending (unless, potentially, to venture capital companies).

The alternative test proposes a graduated system depending on the holding period of the asset as follows:

Average period investments held	**Proportion of return eligible for taxation as chargeable gain**
Less than six months	0%
At least six months but less than one year	25%
Between one year and 18 months	50%
Between 18 months and two years	75%

Our comments: the new rules create a disparity between general tax principles and the rules applying to fund managers. Just as the disguised investment management fee rule introduced earlier this year deemed certain investment returns to be trading returns, the outcome of the changes to carry and the consultation means that some investors in funds will calculate their tax by reference to one set of tax principles (D12, trading vs. investment) while asset managers will have to apply a separate statutory overlay. This may mean that investors and fund managers are no longer neatly aligned (particular if, for example, asset managers are incentivised to hold assets for longer, even if this is not in the wider best interests of the fund). The Option 1 proposal creates a number of issues, for example:

- It is stated that there is no desire to change the treatment of carry for PE. But in a selling market, would a PE fund want to hold assets more than three years (which is what HMRC seem to think is the badge of being a PE fund)?

- Why do you need 5 years holding period for property but only 3 for shares? There is no conceptual justification for this.

- Why distinguish between controlling equity stakes and others? Many PE funds take minority stakes.

- Why limit to stakes in trading companies? Surely if the group as a whole is not trading that should make it more justifiable that returns are capital not income.

- Finally, what does the definition of a venture capital company include?

The Option 2 proposal is uncertain in its application and potentially very complicated. The proposed charge operates by reference to the **average** period for which investments are held, but how is this to be calculated? For instance if a fund has bought five investments and sells 1 of them after 6 months but retains the others, what is the "average" holding period? Do you judge it at the point of sale or later? If you judge it at the end of the fund when you know what it is how do you complete a tax return for a prior year? No indication is given as to how this type of issue will be dealt with.

Other changes

Non-doms who have been in the UK for more than 15 of the previous 20 years will no longer be treated as non-domiciled (for any UK tax purposes, so the current 17 year IHT threshold is reduced) and cannot claim the remittance basis. This reform will make redundant the £90,000 remittance basis charge payable by those resident for 17 of the last 20 years. Individuals who have a UK domicile at the date of their birth, will revert to having a UK domicile for tax purposes whenever they are resident in the UK (even if under general law they have acquired a foreign domicile). These changes are likely to affect a number of fund managers, particularly those with global reach. The new rules will be effective from 6 April 2017.

Corporation tax will, by 2020 be at the historically low level of 18% (and will be reduced to 19% in 2017); but…

The dividend tax credit will be abolished from April 2016, and a new yearly Dividend Tax Allowance of £5,000 is to be introduced. The new rates of tax above the allowance are to be 7.5%, 32.5% and 38.1% for basic, higher and additional rate income tax payers respectively (i.e. a 7.5% increase above the threshold).

Limited Partnerships: the government will publish a consultation on technical changes to limited partnership legislation to enable private equity and venture capital investment funds to more effectively use the limited partnership structure.

SDLT seeding relief: As previously announced, the government intends to introduce a seeding relief for Property Authorised Investment Funds (PAIFs) and Co-ownership Authorised Contractual Schemes (CoACSs) and intends to make changes to the SDLT treatment of CoACSs investing in property so that SDLT does not arise on the transactions in units, subject to the resolution of potential avoidance issues (to be included in Finance Bill 2016).

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.

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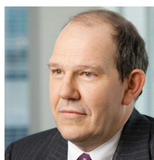

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