# Summer Budget 2015: implications for private equity

George Osborne had promised a "big" budget for the first of the new Conservative Government, but few in the private equity industry will have expected the significant changes to the tax regime for carried interest. This note summarises this change and the others of greatest importance to the industry

## Carried interest

### *Abolition of base cost shift*

The Chancellor announced changes which will put an end to what is commonly known as 'base cost shift', with the effect that more tax will be paid on carried interest. Whilst the notion of taxing carried interest at capital gains rates may not seem particularly controversial, the proposals overturn long-standing practice agreed and accepted by the Government and HMRC and are therefore unexpected.

Draft legislation implementing these changes has been published, and it is clear that the legislation works in conjunction with the "disguised investment management fee" (DIMF) rules, which came into effect earlier this year. The rules affect individuals who perform investment management services for a collective investment scheme, through an arrangement involving one or more partnerships.

Specifically, the new carried interest rules operate to ensure that amounts which were exempted from the DIMF rules because they fell within the definition of carried interest are at least charged to tax at full rates of capital gains tax. There is relief for the amount paid for carried interest, as well as amounts charged to tax under the Employment Related Security rules. There are also measures to avoid double taxation (although these ensure that the highest applicable tax rate is paid, and so income allocated in respect of carried interest will still be taxed at 45%).

Importantly, the rules provide that such gains should only be treated as a foreign chargeable gain where the carry recipient performs his/her services outside of the UK – this is likely to be a significant change for some carry recipients who are currently taxable on the remittance basis.

The notes published alongside the Budget refer to Statement of Practice D12, which is the HMRC guidance which states how capital gains should be treated within a partnership, and gives rise to base cost shift. HMRC state that this can result in "fund managers being charged to capital gains tax on amounts significantly lower than their actual economic returns". It is for this reason that the Statement of Practice is now being overridden for investment managers. It is relevant to note that this long-standing treatment was agreed by the then Inland Revenue and Department for Trade and Industry in 1987 and so the changes will come as a surprise for many.

As we digest the new rules, a number of questions arise. More will be known as we seek clarification from HMRC, and following the publication of the full draft Finance Bill next Wednesday (15 July).

## Consultation on performance linked rewards

HMRC has today launched a consultation on the taxation of performance fees. This is aimed at managers of, typically, hedge funds who although historically receiving a performance fee charged to tax as income have sought to restructure so as to receive performance-linked receipts from the fund they managed which are taxable as capital. Two options are proposed for a statutory test to distinguish such arrangements from the carried interest arrangements in private equity and similar funds. The main area of focus for the industry will be to ensure that bone fide private equity arrangements are not inadvertently caught by the proposals.

## Changes for non-UK domiciled residents

The Budget announced significant changes to the tax regime for UK resident but non-domiciled individuals ('non-doms'). A detailed consultation document will be published after Parliament's summer recess with changes effective from 6 April 2017.

The key proposed change is that non-doms who have been resident in the UK for more than 15 out of the preceding 20 tax years will be deemed UK domiciled for all tax purposes. This means that the remittance basis of taxation will no longer be available and they will also be deemed domiciled for inheritance tax purposes. The Government's objective is to equalise the treatment of long term UK residents who are not UK domiciled with those who are. Furthermore, any individual who had a UK domicile at birth will also be deemed UK domiciled whenever they are UK resident.

Clearly the consultation document will be key in understanding the impact of these changes, and representations are likely to be made to HMRC regarding the impact of the changes.

In addition, the Government announced measures to bring the value of all UK residential property held through offshore companies of non-doms or their trusts into the scope of IHT in the same way as if the property were owned personally. This will apply regardless of the value of the property and whether the property is occupied or let.

## Changes to taxation of dividends

From April 2016, the dividend tax credit system is being abolished, to be replaced with a £5,000 tax free dividend allowance and revised dividend tax rates (7.5% for basic rate, 32.5% for higher rate taxpayers, and 38.1% for additional rate taxpayers). HMRC anticipate that taxpayers receiving dividends of up to £140,000 will not pay additional tax, albeit that does not account for the impact on taxpayers already in the higher or additional rate band when dividends are received whose effective rate is likely to increase at a much lower level of dividend receipts.

## Changes to tax rates

In a bid to further increase UK competitiveness, the corporation tax rate will be cut to 19% in 2017 and 18% in 2020. In respect to personal taxation, for 2016/17 the personal allowance is being increased to £11,000 and the higher rate threshold increased to £43,000.

The Government has also committed to consulting this Autumn on abolishing Class 2 NICs and reforming Class 4 NICs. Given the recent changes to the HMRC approach to Class 2 NICs and investment partnerships, the abolition of Class 2 NIC will be a welcome change for many, but we will need to wait and see whether one objective of 'reforming' Class 4 is to increase the tax take, perhaps by aligning it to Class 1 which applies to employment.

## Corporation tax changes

The Government have changed the rules so that purchased goodwill will not be deductible when amortised through a company's accounts, where the acquisition was made on or after 8 July 2015. This is a significant change that may affect acquisition structuring when looking at share or asset purchases.

The Annual Investment Allowance will be fixed at £200,000 for all qualifying investment in plant and machinery from 1 January 2016, in order to encourage capital investment by SMEs.

## Other points of interest

A consultation will be published on technical changes to limited partnership legislation to enable private equity and venture capital investment funds to more effectively use the limited partnership structure. There is no further information as to what is meant to be covered by this consultation, and so we will need to wait for further detail before we can assess the potential impact of the Government proposals.

There are a number of changes in respect of inheritance tax in the Budget, including provision for a new transferable nil rate band in respect of residential property of £100,000 in 2017/18 (increasing in stages to £175,000 in 2020/21) which applies when a main residence is passed to a child or grandchild on death.

There are also additional pension changes, specifically a tapering down of tax relief on pension contributions for those earning more than £150,000 per year and a consultation on wider reforms to pension tax relief.

There are measures to increase HMRC's resources to tackle wealthy individuals and corporations who avoid tax, and a consultation on introducing a General Anti Abuse Rule penalty.

Mortgage interest relief on buy to let homes is being restricted to the basic rate, phased in over 4 years from April 2017. Furthermore, wear and tear allowance is being abolished from April 2016.

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