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Finance (No. 2) Bill 2016

Income-based carried interest

The legislation has been subject to significant changes since the previously published draft. The weighted average holding period which would attract capital gains tax for carried interest recipients has been reduced from 48 months to 40 months. A number of special provisions relating to several different types of funds have also been added to the legislation.

Summary of legislation

Background

Over the past year we have seen a number of changes affecting the taxation of investment management executives' reward. The cumulative effect of these changes is that the taxation of these executives has become incredibly complicated. The Finance Bill legislation represents the third and hopefully final instalment of the new regime for investment executive taxation. Briefly, the previous two provisions were the disguised investment management fee rules and the carried interest rules. The disguised investment management fee rules were effective from 6 April 2015. The objective of those rules was to tax sums arising to an investment manager as income unless they were either: (i) already subject to income tax; (ii) a return on a qualifying coinvestment; or (iii) carried interest. The carried interest rules were introduced in July 2015 to ensure that carried interest is subject to tax as a capital gain as a minimum.

The Finance Bill change effectively restricts the amount which is excluded from being taxed as income under the disguised investment management fee rules by virtue of being carried interest. In relation to carried interest arising on or after 6 April 2016, carried interest which is 'income based carried interest' will be deemed to be income under the disguised investment management fee rules (therefore 'income based carried interest' will be subject to income tax and NI as if it is income from self-employment).

Draft legislation was published in December 2015 and has been subject to a number of representations to HMRC by advisers and industry. The latest rules see a number of changes to the previously published draft legislation.

In addition, the Finance Bill also reduces the main capital gains tax rate from 28% to 20% (for higher and additional rate tax payers), with the exception that gains from carried interest (and residential property) will continue to be taxed at a new 'upper rate' of 28%.

Outline

The basic rules seek to consider the weighted average holding period of the investments to which carried interest relates to determine what proportion of the carry should be subject to income tax.

Where the average holding period is less than 36 months all of the carried interest arising will be subject to income tax. Should the average holding period be 40 months or more then the carried interest will continue to be fully exempt from the disguised investment management fee rules (and will therefore be taxed per the underlying nature of the funds income or gains and the July 2015 carried interest rules).

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Where the average holding period is between 36 and 40 months, then a proportion will be deemed to be income as follows:

Average holding period	Relevant proportion
Less than 36 months	100%
At least 36 months but less than 37 months	80%
At least 37 months but less than 38 months	60%
At least 38 months but less than 39 months	40%
At least 39 months but less than 40 months	20%
40 months or more	0%

Carried interest arising in respect of employment related securities is not currently affected by these rules. Therefore carried interest holders who are employees should not be affected at this time, but it is interesting the legislation specifically permits the Treasury to amend this aspect of the rules by regulation – a clear sign that HMRC will be sensitive to abuse in this area (and perhaps an indication that this exemption from the rules may be removed in the future).

Calculation of average holding periods

It is necessary to calculate the weighted average holding period of investments in order to determine how much of the carried interest should be subject to income tax. There are however a number of provisions that are relevant to this calculation.

Timing of the calculation and conditionally exempt carried interest

The calculation should be made at the point when carried interest arises, based on the amounts invested in each investment. Investments still held at the point the carried interest arises are initially deemed to have been disposed of at that point. Clearly this calculation would result in artificially low average holding periods when initial carry payments are made early in the life of a fund. There are therefore provisions to conditionally exempt carried interest from the income based carry rules for a temporary period where certain conditions are met. For carry to be conditionally exempt it needs to meet certain conditions. It would then be assessed at a 'relevant time'.

The conditions to conditionally exempt carried interest are broadly:

- it either needs to arise within four years from the commencement of the scheme, or within ten years where the carry is calculated on a realisation model; and
- it is reasonable that the carry would 'at the relevant time' not be income based carry.

The 'relevant time' is broadly the earliest of:

- when the fund will be wound up;
- at the end of four years from when the fund will cease to invest;
- either four years beginning when the carried interest arises, or ten years if the carry was calculated on a realisation model; and
- four years after the period to which the carried interest was determined.

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A 'realisation model' is broadly one which repays its investors the investment they made in the scheme to acquire the assets which generate the carried interest before any carry can arise.

This position then needs to be reassessed at the earliest of:

- when the scheme is wound up;
- four years from when the scheme actually ceases to invest;
- either four years from when the carried interest arises, or ten years from when the carry arises based on a realisation model;
- four years after the period by reference to which the carry was calculated; and
- when the carry is no longer expected not to be income based carry at the 'relevant time'.

The reference to ten years for carry calculated on a realisation model is an extension to the previous draft and would be welcomed by funds which operate these models.

Part disposals and follow on investments

The basic rule is that, where a follow on investment, or a part disposal is made, then the investment is effectively treated as two investments for the purpose of calculating the average holding period. Where there are several tranches of investment made in the same class of asset, then the assets are identified on a FIFO basis.

Special calculation methodologies

There are a number of exceptions to this basic rule for different type of funds. The qualification criteria varies depending on the type of fund as outlined below.

Unwanted short-term investments

Where an investment is made that is 'unwanted' for the purpose of the rules, then (subject to certain provisions) it is ignored for the purpose of calculating the average period. This is a welcome extension to the rules for funds who make investments with the intention of quickly syndicating part of them.

Venture capital funds

For these purposes a venture capital fund is a fund which expects to:

- invest at least two-thirds of its value in qualifying venture capital investments; and
- at least two thirds of its value will be invested in investments which will be held for at least 40 months.

A venture capital investment is broadly:

- an investment in an unlisted company;
- which has been trading for less than 7 years;
- where at least 75 percent of the value invested is in either newly issued shares or newly issued securities which are convertible into shares;
- the investment is used to support growth or development; and
- the fund has certain rights regarding appointing a director.

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Where a qualifying venture capital fund has a qualifying interest in a trading company, then any follow on investment is to be regarded as having been made when the relevant interest was originally acquired. Any disposal is also ignored until either it has disposed of more than 80 percent of the largest amount invested or until certain rights regarding appointing a director cease.

Significant equity stake funds

There are similar provisions for qualifying 'significant equity stake funds'. This provision affects funds which:

- do not qualify as venture capital funds; and
- which expect to invest more than 50 percent of value in companies that qualify, and at least 50 percent of that value will be invested in investments which are held for at least 40 months.

In order for an investment to qualify for the purpose of this provision, they need to:

- be in an investment in an unlisted company which is likely to remain so;
- hold an interest of at least 20 percent interest in the company; and
- have qualifying rights regarding appointing a director.

This category of fund is able to deem follow on investments in qualifying investments to be made when the original qualifying investment was made. Disposals are deemed to have been made when the fund ceases to have a 15 percent stake in the company, or until it ceases to have appropriate rights in relation to appointing a director.

Controlling equity stake funds

A controlling equity stake fund is a fund which does not qualify in either of the above exceptions, expects to invest more than 50 percent of its value in controlling interests in trading companies, and expects that more than 50 percent of its value invested will be held for at least 40 months. For funds which meet this definition, where they have an interest of at least 25 percent in a trading company, then further investments are considered as being made when the original 25 percent investment was made. Any disposals are deemed to occur at the point the fund ceases to have a 25 percent interest in the company.

Real estate funds

A fund qualifies as a real estate fund if it does not qualify for any of the above exceptions, and when it commences it expects that both, 50 percent of the value invested will be invested in land, and at least 50 percent of its investments by value will be held for at least 40 months. Where a qualifying real estate fund has a major interest in land (as defined for VAT purposes) any follow on investment in that land is deemed to have been acquired when the major interest was acquired. Any disposal is deemed to occur when the fund has disposed of more than 50 percent of the largest value that it has had invested in the land. In addition, where a real estate fund acquired land adjacent to land in which it has a major interest, the original acquisition and the adjacent land is deemed to be one holding for calculating the holding period of the investments.

Funds of funds

There are also special rules for funds of funds. For a fund to qualify as a fund of funds the following conditions need to be met:

- substantially all their investments in collective investment schemes need to represent less than 50 percent of the value of that fund;

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- more than 50 percent of the value of the fund of funds' investments needs to be held for at least 40 months; and
- 75 percent of the value invested in the fund of funds needs to be invested by external investors.

Qualifying fund of funds essentially treat their investment in each investee fund as the relevant investment for the purpose of the rules. In addition, where a fund of funds has a significant investment (an investment of at least £1million in a fund, or an investment which equates to at least 5 percent of the amount raised by the underlying fund) then any follow on investments can be deemed to have been made when the significant investment was first made, and any disposal is treated as being made either when the fund has disposed of at least 50 percent of the largest amount that it invested in that investment, or the value drops below the greater of £1million or 5 percent of the total value of all the fund of funds' investments.

Secondary funds

There are similar rules for qualifying secondary funds. These are funds where:

- substantially all their investments are in the acquisition of investments in unconnected funds;
- more than 50 percent of its investments by value are expected to have a holding period of at least 40 months; and
- more than 75 percent of the amount invested in the fund will be by external investors.

Secondary funds also do not need to disregard holding companies, and can deem qualifying follow on investments in a significant investment to have been made when the significant investment was first made. A significant interest is an investment of at least £1 million or of at least 5 percent interest in the underlying fund. It can also deem any disposals to occur when the fund has either disposed of at least 50 percent of its largest investment in that fund, or the value invested falls below the greater of £1 million and 5 percent of the total value of all the secondary funds' investments.

Direct lending funds

These special rules are broadly similar to those in the original draft legislation. They effectively deem any carried interest from a direct lending fund to be income based carry unless the exemption is met.

A direct lending fund is a fund which is not a venture capital, significant equity stake, controlling equity stake or real estate fund, and it is expected that the majority of its investments will have been through making direct loans (a loan which is advanced at interest or a return determined by reference to the time value of money). The acquisition of a direct loan is deemed to be a direct loan if it is acquired within 120 days from when it was advanced).

The exemption is available if:

- the fund is a limited partnership;
- carried interest only arises when (broadly) the investors receive their investment and a preferred return of at least 4 percent; and
- at least 75 percent of the direct loans would have been qualifying loans (broadly unconnected loans which have fixed and determined repayments with a fixed maturity where the scheme intends to hold the loans until maturity and the period from lending to having 75 percent of the principal repaid will be at least 4 years).

The reduction of the required preferred return from the original 6 percent to 4 percent will be welcomed by many direct lending funds.

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Where a qualifying loan is repaid before the end of 40 months, it is treated as being held for 40 months for the purpose of calculating the funds average holding period.

Timing

The measures will apply to sums of carried interest arising on or after 6 April 2016.

Our view

The application of these rules is going to be complicated. Funds will firstly need to determine which (if any) of the special categories they may qualify for so that they can determine which calculation methodology they should adopt in order to calculate their average holding period. They will then potentially need to calculate the average holding period several times during each fund's life in order to determine the correct tax treatment for their executives.

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