Analysis

Knocking on IRS's door: the new accruals framework for carried interest

Speed read

Carried interest holders (carryholders) who are US citizens or green card holders resident in the UK were left uncertain on the route to offsetting double taxation on carry when guidance was changed in early 2022 to close the door on offset against tax in this country. A new accruals basis election in the Spring Finance Bill should make it easier to claim double tax credits in the other direction, i.e. in the US. The proper administration of the elective basis may require significant liaison between the carryholder and the investment house.

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Firstly, a quick recap on carried interest, of a high-level nature. Private equity and certain other private capital fund structures have traditionally provided a special financial return to team members/carryholders in the form of an entitlement to the super-profits of the fund.

Under typical carried interest terms, once invested capital has been distributed back, and commonly a fixed or 'preferred' return, usually 8% cumulative per annum has been paid to the external investors, then (generally after a 'catch-up' to the carryholders) additional profits of the fund are distributed 20% to the carryholders, and the remainder is distributed to the external investors.

There are many variations of carried interest models and terms. With effect from 8 July 2015, a specific regime for UK taxation of carried interest was introduced in TCGA 1992 ss 103KA–103KH to broadly establish a minimum tax rate for carried interest and limit the types of deductions that could be applied. This is the usual UK carried interest regime, which is altered by the elective basis introduced in Finance (No. 2) Bill 2022/23 (the Spring Finance Bill).

Under UK taxation principles for carried interest, the taxation timing follows broadly when there is an entitlement to an allocation of profit, which typically will occur only once carried interest proceeds are distributable to the carryholders. The US tax timing rules can trigger a tax charge much earlier, when the potential entitlement to carry has value, but nothing may yet be distributable under the fund's terms.

Until recently, US citizen/US green card holder investment managers resident in the UK who are subject to both UK and US tax on their carried interest, to the extent they were not able to use the remittance basis of taxation would rely on the 'no double taxation provision' in TCGA 1992 s 103KE in the UK carried interest regime. This is instead of having to claim a US double tax credit for UK tax paid in their US tax returns.

This broadly worked for them, as the US taxation generally crystallised first, and then was applied against the UK carried interest tax liability. Doing this the other way round would have been far harder due to the timing differences between when the carried interest was recognised in the US and the UK for tax purposes. They may have been out of time to claim a UK tax credit against their US federal tax liability. It was not entirely clear whether HMRC fully endorsed use of s 103KE as a credit of last resort, in particular where alternative avenues of offset had not been exhausted.

In January 2022, HMRC changed its guidance to state that s 103KE in the UK carried interest rules only applied to UK tax and was not to be used to claim a credit for non-UK tax (see *Investment Funds Manual* at IFM37410).

In the absence of s 103KE, it would be very challenging to obtain an offset under a double tax treaty. The basic position in the US is that the foreign tax credit system permits no more than a one year carry back of the overseas tax (Internal Revenue Code section 904(c)).

Industry groups raised concerns with HMRC that the change to the guidance would result in significant extra cost in the form of double taxation for various categories of expatriate executives, and HMRC engaged with industry on a resolution, accepting the importance of the affected individuals to the UK economy, even if a relatively small group.

HMRC had consulted with the US Internal Revenue Service on potential solutions. The draft legislation contains a mechanism to make an irrevocable election to be taxed in the UK in a manner broadly similar to the US taxation basis, and at similar timing. This eases the facility to claim a double tax credit in the US.

Accruals election

The Spring Finance Bill introduces a mechanism (in TCGA 1992 new s 103KFA), which will enable a voluntary and irrevocable accruals basis election for UK taxation of carried interest and is based on a hypothetical realisation of the investments of the 'relevant scheme' at tax year-end. A 'relevant scheme' is the 'investment scheme', which takes its meaning imported from the disguised investment management fee legislation (found in ITA 2007 s 809EZA(6)), being a collective investment scheme or an investment trust, i.e. the fund vehicle.

This is expected to allow UK resident investment managers to seek to align their taxation timing with that of certain jurisdictions (principally the US) and assist the claiming of double taxation relief in those countries from UK taxation. For an individual to make the election in respect of a relevant scheme, a condition is that either the UK carried interest taxation provisions in s 103KA apply, or there is a reasonable expectation that these provisions will apply.

Once the election is made, a chargeable gain is deemed to arise to the individual at the end of the UK tax year, which by operation of the rules will be at the carried interest rate, currently 28%. The amount of the chargeable gain is the amount of the gain realised in the tax year on certain deemed facts, less any chargeable gains arising under these provisions in previous tax years. (This is important as the deemed facts gather events cumulatively.)

The deemed facts are as follows:

- Assume that all disposals of investments held within the investment scheme that have in fact been made to date (including disposals in previous tax years and in the 'relevant tax year' in question) have been made in the relevant tax year, for the consideration actually paid. To be included in the calculation, the investments need to be relevant to the entitlement to carried interest, thus gains on segregated assets that do not bear carry would be excluded.
- For those investments that have not actually been disposed of in any tax year (including the 'relevant tax year') i.e., investments still held at the end of the tax year, these are also deemed to be disposed of, but disposed of at cost.
- All income (e.g., dividends and interest) received by the investment scheme to date, including in the relevant tax year and previously, was received in the relevant tax year.
- All profits, whether gain or income were distributed to the investors. (The last two items are thought to provide certainty as to how certain elements in the calculation of carried interest under the fund's terms are applied in the hypothetical scenario, to be clarified in the guidance.)

See the example (overleaf) for a possible numerical illustration. Note, however, that until the HMRC guidance has been published, it cannot be guaranteed that this is precisely how HMRC intends the calculation to work. Since the publication of the Finance (No. 2) Bill 2022/2023, an amendment was tabled before the Public Bill Committee on 10 May 2023 to insert additional clauses to the calculation assumptions to ensure the methodology works as intended where the carried interest amount is affected by distributions to investors in a prior tax year.

Practical impact

The deemed facts on which the calculation must be made closely resemble the basis for valuing amounts that are recognised on a US Schedule K-1. A key feature of this is that unrealised investments are not recognised for US tax purposes at fair value or other market-based valuation, but instead at cost.

The result is that in many fact patterns, an element of what would otherwise be the UK carried interest charge under s 103KA is accelerated, potentially to match the overseas tax year in which the overseas tax crystallises, enabling a foreign tax credit to be claimed under the US or certain other countries' double tax relief regimes.

Further amounts are likely to fall into taxation on the accruals basis in successive UK tax years, with successive double tax relief claims to be made overseas for the UK tax that has been assessed under this basis.

There will be situations where value declines relative to the valuation brought into UK taxation under the accruals election. An adjustment mechanism is made available in the legislation, explained in more detail at 'Losses' below.

It is likely that the accruals basis election would help most in the case of European style 'whole-of-fund' carried interest models, where the carried interest crystallises for UK tax purposes only after the entire invested capital has been returned.

Administration

The accruals election must be made in writing to HMRC stating the first tax year in respect of which the election will take effect and must be made before 31 January following the end of the tax year. The election can be made in respect of UK tax year 2022/23 and later years.

Once made, the election will continue to apply to the relevant scheme (as well as associated schemes). Fortunately, it does not automatically include unrelated investment schemes in which the individual participates. This is helpful where the executive holds interests in other funds for which the cost outweighs the benefit.

Adjustment claims

The legislation enables an adjustment claim to be made to reduce other UK taxes that the individual is charged to on carried interest arising under the same investment scheme by the amount of any tax already paid under the new elective accruals basis.

This is a tax-against-tax offset rather than a credit of underlying taxed amounts. Elements taxed at higher rates, such as income amounts may incur additional tax, and there will be exposure to increases in tax rates.

Losses

The draft legislation contains a mechanism for claiming relief where the carried interest on which a UK tax charge has arisen under the new elective basis, does not ultimately arise to the extent assumed in the UK tax already paid. The conditions for this relief broadly require a wait and see approach until 'all, or substantially all, of the investments of the relevant scheme have been disposed of', which will generally be towards the end of the funds' life.

The legislation contains anti-avoidance provisions aimed at countering the artificial creation of a loss.

US alternative basis of double tax relief

US persons who claim relief for foreign taxes on 'the accrued basis' under US tax rules may still be exposed to double tax and/or timing issues in aligning credits. This US accrued basis for claiming foreign tax credits is entirely separate to the new UK accruals basis election.

This is typically because they can only claim UK tax credits related to the liability for the UK tax year ending in the calendar year, so the credit claimed on the calendar year 2023 US return will be determined from the UK tax year 2022/23 liability on the UK return. If carried interest arises in the second, third or fourth quarter of the year, there is still a potential mismatch in credits for those taxpayers on this basis for claiming foreign tax credits (Internal Revenue Code section 905).

Timing

The new election will only be available in respect of UK tax years from 2022/23 onwards (i.e. commencing on 6 April 2022 and after). Although the actual exposure for the 2022 stub period to 6 April 2022 may be limited, ideally the regime would have given some certainty on positions taken under s 103KE prior to January 2022.

Comment

Questions remain as to the detailed interpretation of all the limbs of the calculation basis. It is understood that HMRC

Simplified carried interest accrual comparison

For the purpose of this example, it is assumed that no income amounts have been paid impacting the amount of carried interest allocable.

Total invested capital: £1bn

Year 5		Year 6		Year 7 'into' carry and all sold	
	£m		£m		£m
Disposals to date		Disposals to date		Disposals to date	
Proceeds		Proceeds		Proceeds	
From year 4	500	From years 4-5	800	From years 4-6	1,500
This year 5	300	This year 6	700	This year 7	1,400
Total realised	800	Total realised	1,500	Total realised	2,900
Unrealised		Unrealised		Unrealised	
@ cost	800	@ cost	550	@ cost	0
Total disposals in calc	1,600	Total disposals in calc	2,050	Total disposals in calc	2,900
Pref return hurdle + costs	(1,489)	Pref return hurdle + costs	(1,607)	Pref return hurdle + costs	(1,734)
Excess over hurdle	111	Excess over hurdle	443	Excess over hurdle	1,166
Deemed taxable carry (20%)	22	Deemed taxable carry (20%)	89	Deemed taxable carry (20%)	233
Less carry taxed	(0)	Less carry taxed	(22)	Less carry taxed	(89)
Net	22	Net	66	Net	145
@ 28%	6	@ 28%	19	@ 28%	40

Pref return hurdle + costs

	£m						
	1,000						
Rate	8%						
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
	£m	£m	£m	£m	£m	£m	£m
Hurdle	1,080	1,166	1,260	1,360	1,469	1,587	1,714
Plus costs	20	20	20	20	20	20	20
Total	1,100	1,186	1,280	1,380	1,489	1,607	1,734

Summary

Carry tax with election	
Years 5-7	65
Carry taxation without election	
Total proceeds	2,900
Less year 7 hurdle	(1,734)
	1,166
20%	233
@ 28%	**65**

is working on draft guidance, which will help to clarify the manner in which the new elective basis is to work and the basis of calculation.

Will affected taxpayers wish to elect? It will depend upon the expected realisation profile of the fund and carry type and the individual's personal tax position. Where the extent of double taxation is of low materiality, affected taxpayers may think twice about the election, given the following areas of additional administration which the election is could attract:

- An annual calculation will need to be made, which would need to involve a fund level calculation. The individual and their tax adviser will likely require cooperation of the investment house. It is expected that HMRC would not simply accept US Schedule K-1 or overseas equivalents as evidence of the s 103KFA amounts, which means the underlying calculations may need to be re-performed in accordance with the s 103KFA methodology.
- It is also expected that some tracking will be needed of the amounts taxed in the UK year by year to ensure there is no over or under taxation, and the claiming of foreign tax credits in the US will typically be an annual exercise.
- Further calculations and apportionments may be needed in the case of individuals emigrating from the UK and remittance basis users.

The new regime is welcome and brings important clarity to an area that has been uncertain for some time. It is hoped that despite some of the additional administration associated with the election, there will be a strong take-up of the new regime to justify the significant investment of time by HMRC and industry in the process of consultation. ■