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Client Alert
Commentary

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Draft UK Income-based Carried Interest Legislation Published

Proposed new UK rules will tax carried interest in certain funds as income, with only specified funds entitled to capital gains treatment

The UK government published draft legislation on 9 December 2015 amending the tax treatment of carried interest. The final legislation is expected to be enacted in a substantially similar form to the published draft, although further changes are possible. The new rules restrict the ability of UK tax-resident individuals to treat carried interest as a capital gain (the headline rate of tax on capital gains is 28%, whereas an individual's income can be taxed at a rate of up to 45%). All returns realised on or after 6 April 2016 will fall within the scope of the new rules, even if the underlying arrangements were established before that date. These changes follow the Disguised Investment Management Fee rules introduced on 6 April 2015 and the rules that impact "base cost shift" that apply from 8 July 2015, and form part of the UK government's ongoing efforts to ensure that rewards which asset managers receive are subject to UK income tax, except if those rewards are a return in respect of an genuine investment made by the asset manager.

The draft "income-based carried interest" rules consist of a "general rule" governing the extent to which carried interest is income-based carried interest and a specific rule for "direct lending funds". Each is considered separately below. The new rules sit alongside existing rules applicable to carried interest, including the offshore fund rules.

General Rule

For most investment schemes, income-based carried interest will arise where the "average holding period" for investments made by the investment scheme is less than four years. All carried interest will be income-based carried interest if the average holding period is less than three years. For average holding periods of between three and four years, the proportion of carried interest that will be income-based carried interest is tapered depending on the average holding period (36-39 months: 75%, 39-45 months: 50% and 45-48 months: 25%). The relevant amount of income-based carried interest is then chargeable to UK income tax rather than UK capital gains tax.

An investment scheme's average holding period is the weighted average length of time for which the scheme has held investments by reference to which carried interest is calculated. Investments are "held" for these purposes until the earlier of: (a) the time they are disposed of; or (b) the point at which the carried interest arises.

The average holding period is calculated by:

(a) Multiplying the value of each investment at the time it was made by the length of time for which the investment has been held

(b) Adding together the amounts produced in (a) above

(c) Dividing the amount in (b) by the total value invested in all relevant investments

If part of an investment is disposed of, the part disposed of and the part not disposed of are treated as two separate investments, and the value of each is the appropriate proportion of the original investment. If the investment scheme disposes of part of a holding of a class of shares in a company, the investment scheme is assumed to have disposed of the shares in the same order in which the shares were acquired.

The income-based carried interest rules contain specific additional provisions clarifying the application of the rules to derivative contracts and hedging of exchange and interest rates.

Conditional Exemption

The fund may claim a "conditional exemption" for carried interest arising in the first four years of the fund's existence so that the carried interest is subject to capital gains treatment at that time. Notably, the conditional exemption is only available if the carried interest arises in the first four years of the fund's life and if it is reasonable to suppose that were the carried interest to have arisen at a later time in the fund's life (the relevant time), it would not be income-based carried interest. The relevant time is the earliest of:

(a) The time when it is reasonable to suppose that the investment scheme will be wound up

(b) Four years after the fund is reasonably expected to cease investing

(c) Four years after the carried interest arose to the individual

(d) Four years from the end of the period by reference to which the carried interest was determined

The carried interest will cease to be conditionally exempt when the relevant time (as described above) actually occurs, or, if earlier, any time at which it is no longer reasonable to suppose that at the relevant time, the carried interest would not be income-based carried interest.

The rules require the fund to review the carried interest when the relevant time occurs to determine whether the carried interest is income-based. If the carried interest would be income-based had it arisen after the conditional exemption ceases, then the carried interest is assumed to have been income-based carried interest when it arose, triggering any necessary tax adjustments. Any capital gains tax previously paid is set off against income tax due.

The conditional exemption's scope is narrow. The exemption is designed to prevent carried interest being charged to income tax in the early years of an investment scheme's existence, when the average holding period will inevitably be less than four years.

Additional Provisions

Investment schemes holding significant interests in certain companies are entitled to more favourable treatment. If an investment scheme holds a "controlling interest" in a trading company or the holding company of a trading group, any subsequent additional investment will be deemed made at the same time as the original investment. For these purposes a fund will generally have a "controlling interest" if the fund holds at least 50% of the company's ordinary share capital and is entitled to at least 50% of: (a) the voting rights; (b) the profits available for distribution to shareholders; and (c) the assets available for distribution to shareholders on a winding up. Controlling equity stake funds, for which it is reasonable to suppose that more than 50% of the total value of all the fund's investments will be controlling interests held for more than four years, may benefit from this rule if the fund holds a 25% interest in a company.

A similar rule applies to disposals. An investment scheme's disposal of interests in a company in which the investment scheme has a "relevant interest", is not considered completed until the total interest the fund holds in that company ceases to be a "relevant interest". For these purposes, a fund will generally have a "relevant interest" if it holds at least 40% of the company's ordinary share capital and carries an entitlement to at least 40% of: (a) the voting rights; (b) the profits available for distribution to shareholders; and (c) the assets available for distribution to shareholders on a winding up. Controlling equity stake funds may benefit if the fund holds a 25% interest in a company.

Direct Lending Funds

Carried interest arising from a direct lending fund will be deemed income-based carried interest in its entirety and will be taxed in the UK as income regardless of the application of the general rule.

Direct lending funds are investment schemes that make the majority of their investments by way of direct loans. An investment scheme makes a direct loan if it advances money at interest to an unconnected company under a genuine commercial loan agreement negotiated at arm's length with fixed repayments and a fixed maturity. The investment scheme must have the intention and ability to hold the loan to maturity. Third-party loans acquired by the investment scheme within 120 days of the first advance of funds will also be direct loans.

An exception is available for certain direct lending funds if it is reasonable to suppose that, when the fund stops investing, at least 75% of all the fund's direct loans will have had a relevant term of at least four years. Broadly, the exemption should apply if the term of at least 75% of loans is more than four years. Provided that the underlying borrower in question is unconnected to the fund, and the borrower's decision to repay any money is not connected to the exemption's application, it should not matter if, in fact, the borrower repays early. This exception is only available to limited partnerships, and relates only to carried interest paid after participants have received repayment of their investment and external investors have received a preferred return.

Anti-avoidance

The draft legislation unsurprisingly contains an anti-avoidance rule to prevent manipulation of the average holding period. In determining the average holding period (and whether the investment scheme holds controlling interests in a company), no regard is given to any arrangements that have as one of their main purposes the reduction of the proportion of carried interest that is income-based carried interest.

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