A Guide to the UK Disguised Investment Management Fee Rules

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Overview

New rules effective from today in the U.K. are likely to have material impact on the tax treatment of payments by a fund to its U.K.-based management executives and service providers. The rules cover many areas of fund manager taxation that previously have not been specifically legislated for in the U.K. Given the haste with which the new rules were constructed and passed into law, it is not surprising that many situations are now being analyzed with a degree of concern, in particular where the rules have had some unexpected, and in some cases, potentially negative effects.

The stated target of the new rules is colloquially known as GP LP planning. However, there is also a view that the new rules will be a useful tool for HM Revenue & Customs (HMRC) to attack planning within the fund management sector that would otherwise be technically sound but does not comply (in HMRC's view) with the spirit of the U.K. tax code.

While the enacted form of the rules and accompanying guidance is much better than the original announced regime in December 2014, that merely marks the level of improvement wrought by heavy lobbying and much listening by HMRC, rather than the intrinsic soundness of the final rules. There remains a conceptual difficulty at the heart of the regime, namely how HMRC should look to treat amounts that are received by a manager from a fund, when some of those amounts are a percentage of AUM and some are profits-related, yet both reflect services performed. The policy intention within the private equity industry at least has always been that only the former should be taxed to income, and the new rules look to make sure that remains the case by trying to define all instances of the latter, with mixed success.

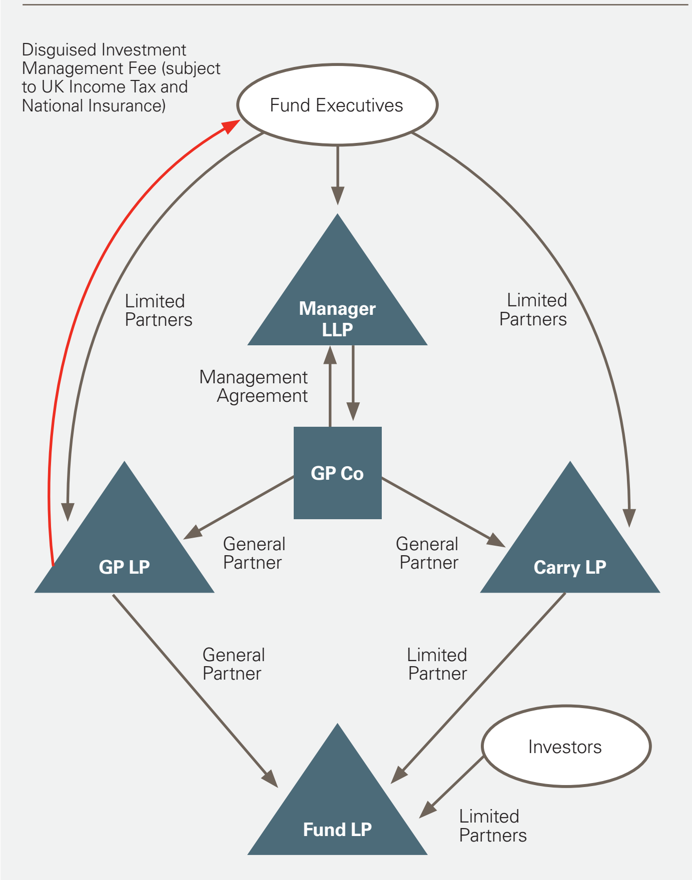
Application of the Rules

The new rules apply to individuals performing investment management services in the U.K. in relation to a fund structure containing at least one partnership. Subject to certain exclusions, management fees that "arise" to such individuals in respect of a fund (whether directly or indirectly through a passive blocker such as an offshore management company), will be subject to U.K. income tax (current top rate of 45 percent) and national insurance liabilities (2 percent) unless they have already been taxed as employment income or trading profits. HMRC's recent guidance on the new rules provides that a sum will arise to an individual when he has actual access to it, not necessarily when the sums are allocated to him.

Provided certain statutory conditions are satisfied, carried interest and returns from GP commitment or executive co-investment will generally be excluded from the new rules, and will remain taxed at the lower capital gains rate (currently up to 28 percent). As the new rules apply to any management fee that is "made available" to individuals on or after April 6, 2015, both new and existing fund structures are likely to be affected. The "grandfathering in" of existing structures was not offered. The legislation also includes targeted anti-avoidance rules that effectively look to negate any tax planning arrangements put into place on or after April 6.

The new rules are primarily aimed at structures that stream a portion of the AUM-based management fees to fund executives before such fees are passed on to a management entity and converted into taxable trading income (see Fig 1).

Fig 1. Typical Fund Structure and Flow of Disguised Investment Management Fee



Source: HM Revenue & Customs

Notably, the legislation grants HM Treasury broad regulation-making powers to amend, *inter alia*, the definition of fund structures to which the rules apply and the definition of carried interest, which is carved out of the application of the rules. The stated purpose of such powers is to allow the government to respond quickly to changes in the types of arrangements used by funds, but this could potentially disrupt genuine tax mitigation efforts by investment funds. Key terms used in the statute, such as sums "arising," have also been left undefined statutorily, providing HMRC with the opportunity to adjust their published attitude to such terms through updates of guidance that need no parliamentary or ministerial scrutiny.

Summary of Key Changes

(1) Are Executive Co-Investment and Carried Interest Taxed to Income?

Under the new rules, any sum "arising" to an individual from a fund (whether in the form of a loan, advance or allocation of profits) that otherwise passes through the initial gateway mentioned above, will not be subject to U.K. income tax if it is: (i) a repayment of the co-investment, (ii) an arm's length return on the co-investment, or (iii) carried interest.

Co-Investment

A return on executive co-investment is considered arm's length if the return is reasonably comparable (both in quantum and on the substantive terms) to the return to investors. Helpfully, HMRC has acknowledged that co-investment vehicles that are not liable for management fee or carried interest in respect of their investment will nonetheless fall within the reasonably comparable test, as long as there are genuine commercial reasons for the difference in treatment. On this basis, co-investment returns on a no-fee, no-carry basis will likely fall outside the new rules.

Carried Interest

As well as a generic and conceptual description of carried interest, the legislation also includes a specific safe harbor exclusion for carry (whether under the "whole of fund" or "deal by deal" model), provided the preferred return is equal to at least 6 percent compounded annual interest. Given that most European private equity funds include a typical preferred return of 6 percent to 8 percent, the new rules are not expected to affect the U.K. tax treatment of carried interest in the majority of such funds. Even if the safe harbor does not apply, the generic carve-out for carried interest applies if the performance allocation to the individual (and returns to the investors) are determined by reference to the overall profits of the fund or the profits of specific investments, and are variable to a substantial extent. Hedge funds that are subject to NAV-based performance fees, or venture funds with no hurdle, could potentially fall within this generic carve-out for carried interest.

(2) Territorial Application

The new rules contain a deeming provision to treat any disguised management fees received by a U.K. resident or non-U.K. resident as U.K. trading income, to the extent the individual performs investment management services in the U.K.

Non-UK Residents

Technically, this means that non-U.K. residents who come to the U.K. for a small number of business meetings may be deemed to be carrying on a trade in the U.K., and accordingly subject to U.K. income tax in relation to the portion of disguised management fees attributable to services conducted in the U.K. To the extent such individuals can avail themselves of the protection of any double tax treaties, a U.K. tax charge will arise only if a U.K. permanent establishment exists in relation to that trade. Adverse U.K. tax consequences can usually be avoided with proper planning (*e.g.*, by avoiding a taxable presence which could otherwise arise through a fixed place of business in the U.K.).

Non-Domiciled UK Residents

Non-domiciled U.K. residents claiming the remittance basis on amounts paid indirectly from the fund could similarly be affected by the new rules, as the deeming provision will treat disguised fees for investment management services carried out in the U.K. as having a U.K. source, and those amounts would therefore be subject to U.K. income tax (whether or not remitted). If, however, as a matter of fundamental U.K. tax law, such amounts have a non-U.K. source (*e.g.*, from a partnership controlled and managed outside the U.K.) and the relevant services for that partnership are actually performed either outside the U.K. or within the U.K. but without creating a U.K. permanent establishment, it may be that those amounts could remain subject to the remittance basis and not be taxed by the new rules. This could be either because the amounts are treated as already brought into charge to tax for U.K. purposes or because the carried interest or co-investment carve-outs apply.

Some Practical Implications of the New Rules

(1) Timing of Distributions, Clawback and Deferral

According to the HMRC guidance, the new rules only apply to distributions of disguised management fee that were "made available" to an individual on or after April 6, 2015. Notably, the rules do not apply if the individual had access to the relevant amounts before April 6, but the allocations of profit to match such advances occurred after this date. Similarly, the fact that the individual may be subject to clawback obligations after April 6 should not affect the analysis, as the fees were available to the individual when they were paid to him prior to that date (subject to a separate clawback obligation, usually net of tax, under the limited partnership agreement).

Conversely, the new rules will likely apply to fees that were allocated to the individual before April 6 but remained inaccessible until after that date due to deferral arrangements (with the tax charge arising only when the individual has access to it). This is particularly relevant to full-scope U.K. alternative investment fund managers whose executives are subject to the pay-out process rules of the Financial Conduct Authority's Remuneration Code (SYSC 19B). These rules require, *inter alia*, that the variable remuneration of executives be deferred over a period of time and be subject to certain performance adjustments. The tax charge will therefore arise when the performance hurdles are met and the sums are made available to the executives. To the extent that any sums received by the executives are already taxed in their hands, consequential adjustments may be made on a just and reasonable basis to avoid double taxation. There remains doubt over the treatment of an individual member of an LLP who receives a capital allocation which reflects an amount that was originally allocated to another member but whose interest in the relevant amount subsequently failed to vest due to performance or departure.

Although steps may be taken before the new rules come into force to mitigate concern about the applicability of the rules (such as acceleration of entitlements), any arrangements specifically made after that date with the main purpose of avoiding the rules are disregarded for U.K. tax purposes. It remains to be seen if HMRC will consider arrangements to have been changed after that date if payments are different because of restructuring done prior to April 6.

(2) Management Fee Offset Against GP Commitment

The new rules may also apply to management fee offset arrangements, where the individual's "skin in the game" is funded (on a pre-tax basis) by a reduction in the management fee. In the absence of HMRC guidance, there is some uncertainty as to when the tax charge arises. If the fees are recycled by the individual voluntarily into GP commitment, the individual could be said to have had access to the fees, resulting in a tax charge at that point. Existing fund structures where the management fees were voluntary recycled into GP commitment before April 6 will therefore fall outside the scope of the new rules. The situation is less clear where the individual's investment in the GP commitment is mandatory, as one could conceivably argue that the cash is made available to the individual only when the investments are realized (resulting in a deferral of the tax charge). The precise tax treatment will likely turn on the specific facts of the case.

(3) Loans to Fund Executives

HMRC's guidance acknowledges that individuals who fund their co-investment through loans extended to them on "arm's length terms" will generally not be subject to the new rules. However, it is unclear if this requires the loans to be extended on entirely commercial terms. Junior members of the management team who receive "soft loans" or limited recourse loans from the manager to finance their co-investment may fall foul of the arm's length test, resulting in an income tax charge on their co-investment return. On the other hand, the arrangements may not have passed through the initial gateway if the grant of the loan was already taken into consideration under the employment benefits code.

(4) Reallocation of Carried Interest Between Joiners and Leavers

The generic carve-out for carried interest includes a requirement that the sums in question be at "significant risk." This is tested when the individual becomes party to the LPA or performs the investment management services, or if later, when "material changes" are made to the allocations. In the context of an early stage fund, this test is likely to be fulfilled, as the fund's investments may not be successful. Nonetheless, individuals who join the management team at a later stage (when investment returns are more certain) may still qualify under the carve-out, provided there is significant risk the carried interest will not arise.

When a member of the management team leaves and his share of the carried interest is reallocated among the remaining executives, HMRC has confirmed that this will generally not constitute a "material change" to the carried interest arrangement (requiring satisfaction of the significant risk test again), provided the reallocation does not distort the proportions in which the remaining executives share in the carried interest.

(5) Corporate Blockers

In certain circumstances, placing a genuine corporate management vehicle between the individuals and the flow of management fee may be effective in "breaking" the link with the fund, provided the company carries on the trade of investment management services on a commercial basis with a view to profit, and the individual receives an arm's length remuneration from his employment by that company. Any dividends received by the individuals on shares in the corporate vehicle will fall outside the new rules. However, HMRC has expressly warned it would scrutinize the substance behind any corporate vehicle based in an offshore low- or no-tax jurisdiction, and may inquire into transfer pricing arrangements where management fees are streamed through such corporate blockers.

Conversely, simply interposing a "passive" blocker between the flow of management fee and the individuals may not be sufficient to prevent the fees from being subject to the tax charge, as HMRC considers such fees to have arisen to the individual indirectly. According to HMRC, this would include structures where the company is owned directly or indirectly by a trust, from which the individuals may benefit. The status of companies that might invest post-tax proceeds from an LLP in the fund is unclear. (HMRC do not state whether they are active or passive.)

(6) Amendments to Fund Documents

Some fund agreements give the GP a unilateral right to amend these agreements to address adverse tax changes. Any legal costs associated with amending fund documents to address the application of the new rules will need to be examined in light of the existing language in the LPA. Limited partners are unlikely to accept restructuring costs as reasonable operating expenses of the fund, especially if the restructuring is undertaken solely for the benefit of the management team. It is anticipated that there are unlikely to be any relevant tax gross-up clauses relating to the management fee, but these should be considered carefully.

(7) Impact on Hedge Funds

Whereas the management fee and carried interest for private equity funds are generally streamed through separate vehicles, the management fee and incentive fee for hedge funds are typically co-mingled at the vehicle level. This may give rise to practical issues for non-U.K. resident managers carrying out investment management services in the U.K., particularly if there is a need to apply the carried interest exemption provisions to the sums received. It is not clear whether it would be possible to argue that the management fee has largely been absorbed as running costs of the manager, with mainly the carried interest/incentive fee left to allocate to members at the end of the financial year.

(8) Impact on Limited Partners

Limited partners are not expected to be affected by the new rules as long as they do not carry out investment management services (which may prejudice their limited liability status in any event). The term "investment management services" is defined in the legislation to include fundraising, researching potential investments, acquiring, managing or disposing of property, and assisting an investee entity to raise funds.

However, investors who provide seed funding and receive a seat on the board of the manager may be caught by the new rules, to the extent the individual's activities on the board constitutes investment management services, and if the individual receives any economic return not otherwise available to other investors.

(9) Impact on Law Firms, Accountancy Firms and Other Third-Party Service Providers

The definition of investment management services includes the conduct of diligence on potential investments. Fees that law firms and accounting firms receive from work carried out for an investment fund are considered by HMRC potentially to be disguised management fees under the new rules. Presumably, this also applies to placement agents, should their compensation be anything other than taxable fee income, and considerations should be given to any nonstandard engagements of service providers by private equity funds and their managers.