Draft Finance Bill 2016—investment managers and performance-linked rewards

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Tax analysis: Stephen Pevsner, partner at King & Wood Mallesons, considers the potential impact of the draft Finance Bill 2016 provisions on investment managers who receive performance-linked rewards. In his view, the real issue is not the tax that will be raised from the new rules, but the burdens and uncertainty that the legislation will create.

Original news

Responses to consultation on taxation of performance-linked rewards paid to asset managers, LNB News 14/12/2015 92

Following consultation on the circumstances in which fund managers' performance-related returns are to benefit from capital gains tax treatment, the government has decided to proceed with an objective test based on the average length of time for which the underlying investments of the fund are held. Broadly, CGT treatment will apply when a fund's average holding period is four years or more. Income treatment will apply where the average holding period falls below three years. Draft legislation has been published for Finance Bill 2016 for consultation until 3 February 2016, and will apply to carried interest arising on or after 6 April 2016.

What is the background to the legislation?

This is the third piece of legislation announced in 2015 to establish a firm legislative basis for the taxation of amounts received by individuals involved in providing investment management services to collective investment schemes. The first piece of legislation, introduced by the Finance Act 2015, set out the landscape under which everything except carried interest, co-investment and an arm's length return on it (each as defined in the rules) is now taxed as trading income. The second piece introduced in the Finance (No 2) Act 2015 set out a statutory basis for taxing all carried interest at no less than the prevailing capital gains tax rate (removing the so-called base cost shift) and changed the source rules for non-domiciles. Then on 8 July 2015, HMRC announced a consultation titled 'Taxation of performance-linked rewards paid to asset managers' which will result in legislation to determine what carried interest should remain taxed as an investment return and what as trading income (LNB News 09/07/2015 4).

What concerns are the government trying to address and who is the legislation aimed at?

The government stated in the July consultation document that it is concerned that asset managers who have traditionally received a performance fee taxable as trading or employment income have sought to restructure their arrangements to receive performance rewards taxed in the same way as carried interest (ie as an investment return). The government wants to retain trading income treatment for performance-linked rewards that it considers relate to investment schemes which are themselves carrying out trading rather than long-term investment activities. The consultation document also states that the government does not anticipate that the treatment of performance-related rewards which have historically been subject to capital gains tax will change as a result of the new legislation. Having said that, it is unclear exactly what sort of activity the government wishes to cast as trading or how it intends to protect performance rewards that have historically been taxed as an investment return.

As drafted, when will performance-linked rewards be subject to income tax treatment?

In very broad terms, income tax treatment will apply to some degree to the extent that the average holding period of the investments of the investment scheme, and by reference to which the carried interest is calculated, is less than four years. If that period is between three and four years, a proportion of the carried interest is subject to trading income tax (as 'income-based carried interest' that is taxed as a disguised investment management fee under the rules in Chapter 5E of Part 13 of the Income Tax Act 2007) and a proportion is taxed as investment return under the existing (and recently amended) carried interest rules. The proportion taxed as income is:

- 100% if the average holding period is less than 36 months

- o 75% if less than 39 months
- o 50% if less than 45 months
- o 25% if less than 48 months, and
- o none if 48 months or more

How will the average holding period be determined?

The basic test requires a determination of when each investment made by the investment scheme (by reference to which the carried interest is calculated) is acquired, and when each is disposed of or part disposed of. There is a three step process:

- o multiply the value invested when the investment was made by the length of time for which the investment was held
- o add together the amounts from that step for all relevant investments
- o divide that amount by the total value invested by the investment scheme in all relevant investments

There is a requirement to assume that all relevant investments held at the time that the carried interest payment in question arises are disposed of in determining the holding periods. This latter requirement could considerably shorten the average holding period at the time that carried interest arises compared to if the average holding period were applied to the lifetime of the investment scheme (and see the discussion on conditional exempt carried interest in this regard).

The draft legislation also states that intermediate holdings or intermediate holding structures by or through which investments are made should be disregarded when determining the average holding period for investments. There is, however, no clarification on what constitutes an intermediate holding or intermediate holding structure and what an investment.

How does the draft legislation determine when an investment/disposal is made?

As stated, the basic rule is to look at the amount invested in each investment, the time that each investment was made and the time that each investment was disposed of or part disposed of. In respect of part disposals, there are two seemingly conflicting provisions--one which says use a first in, first out basis to determine when the part disposed of was acquired, and the other which says split the investment into two and treat both as made at the same time. The former seems to apply to cases where additional securities (or shares) of the same class are acquired at different times, and the latter when the whole investment was acquired at the same time, although this is not clear.

Whether or not a disposal has been made is determined using the disposal/no disposal rules in the Taxation of Chargeable Gains Act 1992 (TCGA 1992), with the addition that TCGA 1992, s 116 is disregarded, so that the no disposal treatment in TCGA 1992, ss 127-130 can apply to a reorganisation from or to a 'qualifying corporate bond' debt investment to or from an equity or 'non qualifying corporate bond' investment. There is also a disposal when the investment scheme in substance closes its position or ceases to be exposed to risks and rewards in respect of an investment.

Are there any exceptions to this basic rule?

There are two ways in which the basic test can be overridden.

Investments in trading companies

The first applies where the investment in question is a 'relevant interest' in a trading company or the holding company of a trading group. This means a 25% interest for a 'controlling equity stake fund' and a 50% interest otherwise (reduced to 40% when applying this treatment to disposals). The override states that once the investment scheme holds a relevant interest in a company, all future investments made into that company are treated as made when the relevant interest was acquired and all disposals are treated as made when the relevant interest ceases to be held. For periods when there is not a relevant interest held, the basic investment by investment rule applies. This is intended to simplify the average holding period calculation for what are considered more likely to be long-term investments rather than trading positions.

The 25%/40%/50% tests require the relevant percentage of ordinary share capital, voting rights, profits available for distribution to shareholders and assets available for distribution to shareholders in a winding up.

A controlling equity stake fund is an investment scheme in relation to which it is reasonable to assume that, when the scheme ceases to hold any investments, more than 50% of the total value of investments will have been in 50% or greater interests (controlling interests) in trading companies or trading groups and have been held for more than four years. It is unclear whether both conditions need to be satisfied for the same interests or whether the more than 50% is tested for the two conditions independently.

Conditionally exempt carried interest

The second relaxation applies where an amount of carried interest is 'conditionally exempt carried interest'. In that case the carried interest is originally treated as an investment return and the position is retested at the earliest of:

- when the investment scheme is wound up,
- four years after it is reasonable to assume that the scheme will not make any more investments,
- four years after the carried interest arose, and
- four years from the end of the period by reference to which the carried interest was determined.

If it turns out at that time that some or all of the original carried interest was income-based carried interest, then that amount is treated as having been subject to tax at trading income at the time that it arose with additional tax (and, presumably, interest but no penalties) to pay.

To be conditionally exempt carried interest:

- the carried interest must arise within four years of the investment scheme making its first investment,
- some of the carried interest would be income-based carried interest,
- it must be reasonable to suppose that were the carried interest to arise to the individual at the time when the status of the carried interest must be retested (as set out above) it would not be income-based carried interest to any extent, and
- the individual must make a claim for the carried interest to be treated as conditionally exempt carried interest.

Again, this relaxation is intended to significantly simplify the average holding period calculation for carried interest from investment schemes which, if looked at over their life, would be long-term investment and not trading. It has the merit of not requiring a deemed disposal of all of the scheme's investments at the time that each carried interest payment arises.

Derivatives

There are then some specific rules on investment value and disposals when derivatives are used, including provisions stating that no disposal is made when certain currency and interest rate contracts are entered into as hedges for investments.

Does the legislation go further than was proposed in the consultation document?

It is difficult to answer this, since it was entirely unclear what exactly was proposed in the consultation document. On the one hand, the document stated that the legislation was intended to catch only the small number of funds whose underlying activity would be treated as trading and was not expected to affect the treatment of carried interest traditionally taxed as an investment return. The draft legislation is not drafted with a focus only on trading funds by reference to their general activity. Rather it uses the complicated average holding period described above as a proxy for the trading/investment divide. On the other hand, the consultation document suggested two approaches, one fund activity based and the other based on holding periods. The draft legislation adopts the latter, albeit with the significant difference that the consultation suggested total investment return treatment if the average holding period was two years or more and the draft legislation has increased that to four years.

Do you think that the measures are proportionate to what the government is trying to achieve?

No, we think that the rules are hugely disproportionate given HMRC's statement in the consultation document that it wanted to retain the existing carried interest treatment for investment schemes that carried out investment activity (broadly, as that concept is recognised under the existing case law) and that the rules were intended to apply to investment schemes that had traditionally received their performance rewards as fees and were structuring to try to receive them as an investment return. It states specifically that it does not agree that this planning is effective as in the majority of cases the existing law will treat the underlying fund as trading, but that that law can be complex and difficult to apply to modern financial markets.

Essentially, the rules have been introduced simply to close what are perceived as relatively little used arrangements given the size of the investment management industry in the UK as a whole. However, the rules have been crafted in such broad terms (including the use of average holding periods as a crude proxy for trading) that they will create uncertainty and additional compliance costs for a large number of fund managers that HMRC would not consider to be within the scope of the rules. Even the relaxations to the hugely burdensome investment by investment acquisition and disposal calculation contain conditions which appear completely disproportionate and unnecessary to protect against any mischief--such as requiring four year holding periods for controlling equity stake funds, and that carried interest is only conditionally exempt if it is received within four years of the scheme making its first investment.

Additionally, notwithstanding statements by HMRC and the government that they do not want the rules to affect private equity or venture capital (and, presumably, similar activities such as growth capital) there is nothing in the draft legislation that will relax the rules for anything other than controlling stakes in trading companies or trading groups.

There is clearly still a lot of work to do to make the rules fit for purpose without discouraging investment managers from locating themselves in the UK because of the uncertainty, nor imposing considerable compliance requirements (and costs) on investment schemes which should simply not be within the scope of these rules.

Which funds will be most affected by the measures and how is the funds industry likely to respond?

It appears that the funds industry has not yet determined its response and is waiting in the hope that the rules will be simplified and more appropriately targeted by removing the uncertainty of treatment and reducing the compliance burdens before they come into law. If this does not happen, the industry will no doubt be reconsidering whether and to what degree the UK remains an attractive jurisdiction in which to locate its investment management activities.

As to which funds will actually pay increased tax on their carried interest, typical private equity and other long term investment funds will probably not be materially affected and the rules should catch the sort of traditional trading activity that they are aimed at. Having said this, the vast majority of investment schemes will be adversely affected by an increase to their compliance burdens, and the simplifications to the basic rules are currently not fit for purpose for sectors such as venture capital and growth capital which might take minority interests over a number of investment rounds. In addition, depending on how it is proposed the rules will apply to them, funds of funds might find it very difficult to obtain the information required to complete the average holding period calculations that are required. So it is sincerely hoped that HMRC take note that the real issue with how the rules have been crafted is not the tax that will be raised from them, but the burdens and uncertainty that they will place on investment schemes carrying out what would generally be considered to be bona fide investment activity and work to try to reduce these burdens by focusing on the precise activities that the rules are intended to prevent.

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