Analysis

Carried interest: funds of funds and the IBCI rules

Speed read

The income-based carried interest rules in Finance Act 2016 are based on an average holding period test. Favourable bespoke rules for calculating that average apply for a fund of funds, as defined. As a technical matter, certain funds of funds investing in closed-ended private investment funds may fall outside that definition, although this does not appear to be intended. Even for those funds which are within the definition, applying the rules is not straightforward. Managers of such funds of funds should look closely at whether and how the rules will apply and keep an eye on developments, in particular any future guidance from HMRC.

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Alongside other private fund managers, 'fund of funds' managers must consider the application of the new income-based carried interest (IBCI) rules. A fund of funds, as the name suggests, is a fund investing in a portfolio of unrelated funds, exposing investors to a range of funds to which they might not otherwise have access. This article focuses on those funds of funds investing in closed-ended private investment funds, typically structured as limited partnerships. For simplicity, these are referred to below as 'private equity fund of funds'.

IBCI rules recap

In brief, the IBCI rules can turn carried interest from funds with an average holding period of less than 40 months, which would otherwise be taxable as capital gain, into a trading income receipt.

The rules were introduced by FA 2016 (as ITA 2007 Part 13 Chapter 5F) with effect from 6 April 2016. Previously, carried interest, as defined in the disguised investment management fee (DIMF) rules in ITA 2007 Part 13 Chapter 5E, was:

- excluded from the DIMF trading income tax charge; and
- taxed under the F(No. 2)A 2015 regime, in short subject to minimum 28% capital gains tax with additional tax if underlying returns are income.

Under the IBCI rules, to the extent that carried interest is 'income-based' – either pursuant to the average holding period test or because it arises from a direct lending fund, the carried interest from which is automatically income-based – it will be subject to tax as DIMF. (For more background, see the article 'FB 2016: Carried interest — the latest changes' (Kevin Ashman and Suzanne Hill), *Tax Journal,* 6 May 2016.)

Some fund managers may be outside the scope of the new rules because of the exclusion for employment-related securities (ITA 2007 s 809FZU). For most others, though, a key question is how to calculate the average holding period, bearing in mind any bespoke rules which may apply. Private equity fund of funds managers are no exception.

Bespoke fund of funds rules

For a fund of funds, defined in ITA 2007 s 809FZO, two bespoke rules may apply.

The first rule relates to defining those investments of which the holding period goes towards the average. The default position is that intermediate holding structures are disregarded (ITA 2007 s 809FZC(5)). The Finance Bill explanatory notes indicate that, under this default rule, a fund of funds investing in private equity funds would regard the holding company of each trading group held by each underlying private equity fund as a separate investment. The fund of funds manager is unlikely to have rights to sufficiently detailed information about ultimate portfolio investments to determine the average on this basis. The bespoke rule in ITA 2007 s 809FZO(1) is intended to switch off this default rule, so that a fund of funds' investments are the underlying fund interests.

A key question is how to calculate the average holding period, bearing in mind any bespoke rules

Where that bespoke rule applies, the second bespoke rule may also apply. If certain detailed conditions are met, the fund of funds can essentially treat subsequent investments in an underlying fund as having been made simultaneously with the original investment; and can ignore partial disposals until it is treated as having made a 'relevant disposal' (ITA 2007 s 809FZO(3)). This single investment treatment mirrors similar rules for staged acquisitions and exits for other kinds of funds, as described in Kevin Ashman and Suzanne Hill's article.

On the face of it, these rules seem helpful for carried interest holders in a typical private equity fund of funds, particularly given that underlying fund interests are generally likely to be held for longer than 40 months. However, private equity fund of funds managers may struggle to meet the prescriptive conditions.

Fund of funds definition

To be within the fund of funds definition, it must be reasonable to suppose that, in summary, 'substantially all' of the fund's investments by value will be in 'collective investment schemes', of which the fund holds less than 50% by value (ITA 2007 s 809FZO(5), (6)).

The term 'collective investment scheme' is essentially borrowed from regulatory law (Financial Services and Markets Act (FSMA) 2000 s 235). It might therefore be expected to include structures typically used for closed-ended private investment funds. A detailed analysis of its meaning is the preserve of regulatory specialists and beyond the scope of this article. Suffice it to say that a closed-ended investment fund formed as a non-UK law limited partnership may not be capable of being a 'collective investment scheme' if it has characteristics suggestive of a body corporate (Financial Services and Markets Act 2000 (Collective Investment Schemes) Order, SI 2001/1062, art 21).

As such, it is possible that certain underlying funds may fall outside the 'collective investment scheme' definition. From a regulatory standpoint, if there is uncertainty the more conservative view may be to regard such a fund as a 'collective investment scheme'. However, from the perspective of a fund of funds and IBCI, it may be more prudent to assume that it is not. In addition, care should be taken not to inadvertently take a position for IBCI purposes which is inconsistent with any regulatory position taken.

Delaware limited partnerships may be capable of being regarded as being outside the 'collective investment scheme' definition, as a result of having some corporate characteristics. A significant proportion of closed-ended private investment funds raised globally are structured as Delaware limited partnerships. Consequently, many genuine private equity fund of funds may have doubts as to whether 'substantially all' of their investments are in 'collective investment schemes'; and, as such, whether they can take advantage of these bespoke rules. This uncertainty would seem to be an unintended consequence of the use of the term 'collective investment scheme' in this specific context, given the prevalence of structures like the Delaware limited partnership in the global market in which private equity fund of funds invest.

Where a private equity fund of funds meets the fund of funds definition, the two bespoke fund of funds rules will only apply to 'collective investment scheme' investments.

Single investment treatment

The bespoke rule enabling a fund of funds to backdate subsequent investments and ignore staged exits is only available if *inter alia* there is a 'significant investment' in the underlying fund. (See Kevin Ashman and Suzanne Hill's article, referred to above, for an outline of the other requirements.) In summary, this is an investment of at least £1m or at least 5% of the amounts raised by the underlying fund (ITA 2007 s 809FZO(8)).

At first glance, this appears an easy threshold for a private equity fund of funds to reach; investments of less than £1m are uncommon in this industry. However, often an investment by a particular fund of funds manager may be spread across funds of different vintages or strategies, or across different parallel funds within the same vintage and strategy. Significantly, the interests of these funds cannot be aggregated when applying these thresholds. This contrasts with other thresholds in the IBCI rules, where interests of 'associated investment schemes' can be aggregated (see the rules on significant interests, venture capital funds, significant equity stake funds and controlling equity stake funds in ITA 2007 ss 809FZJ–809FZM). It also contrasts with one of the other requirements for single investment treatment; namely, that the fund of funds, together with any connected funds (based on a control test), must not hold more than 30% of the underlying fund (ITA 2007 s 809FZO(9)(b)).

In addition, it is not clear what an 'investment' is for the purposes of this test. Is it the amount committed by a fund of funds upon subscription? Is it an amount actually drawn down and paid over to the underlying fund? If it is the latter, can amounts drawn down be aggregated to satisfy the £1m threshold? Notably, the first draw down may be for costs, so could be for less than £1m even if the commitment is significantly more.

Turning first to whether investment means commitment or drawn down amount, the explanatory notes indicate that 'investment' takes its normal, commercial meaning in the context of fund investment strategies. The *OED* definition of investment focuses on money employed or laid out, rather than committed or promised. That being said, ITA 2007 s 809FZO(8)(b) refers to an investment in terms of amounts raised by an underlying fund. On that basis, it may be possible to build the argument that investment means the commitment of money towards the total funds raised, particularly if the fund managers themselves commonly use the term 'investment' to refer to making a commitment to the underlying fund, rather than (or perhaps as well as) amounts actually drawn down.

The next question is whether amounts can be aggregated to reach the £1m threshold. The legislation refers both to a significant investment being 'made', suggesting that it may be a one-off event, and to it being 'held', perhaps indicating that the investment can be built up over time. The latter references give a basis for aggregating drawdowns to reach the £1m threshold, but it would be prudent for a fund of funds manager to run the modelling on the alternative basis to establish the level of risk in taking this approach. On this issue, as well as the commitment vs. drawdown issue, it would be helpful to have HMRC guidance.

Secondary funds and funds with a secondary strategy

The IBCI legislation contains separate bespoke rules for secondary funds (ITA 2007 s 809FZP). While it is beyond the scope of this article to address the requirements of those rules in detail, some of the points raised above may be relevant for those rules too. In practice, a private equity fund of funds may combine a primary investing strategy with a secondary investing strategy, possibly also making direct co-investments.

Subject to the points raised above, the fund of funds definition would appear to be wide enough in principle to encompass such a fund, provided that any direct co-investments are expected to be made through pooled vehicles. In particular, the fund of funds definition refers to investing in underlying funds without specifying whether that is an investment by acquisition or by subscribing for interests. This raises the question of whether a pure secondary fund might fall into the fund of funds definition as well as the secondary fund definition, so those advising secondary funds may wish to consider both sets of rules.

Conclusions

The fund of funds rules illustrate some of the challenges of the IBCI legislation more generally. First, the rules are prescriptive and can produce seemingly anomalous results. Second, many of the concepts are difficult to apply to complex investment fund structures and further guidance would be welcome. On that note, it is understood that HMRC intends to publish guidance on these rules, although the timing is unclear.

Those advising managers of private equity fund of funds on the IBCI rules should be aware that the fund of funds definition as it currently stands may give unexpected, and probably unintended, results. For funds which are or may be within the definition, running the average holding period modelling on the basis of various different interpretations of the rules may be useful in cases of real uncertainty, such as the meaning of significant investment. Advisers should keep an eye on developments, for example if and when HMRC guidance is published. ■

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- FB 2016: Carried interest – the latest changes (Kevin Ashman & Suzanne Hill, 28.4.16)
- Carried interest: the new landscape (Laura Charkin & Stephen Pevsner, 17.2.16)
- Summer Finance Bill: Carried interest (Damien Crossley, 30.7.15)
- FA 2015: Disguised investment management fee rules (Laura Charkin & Stephen Pevsner, 23.4.15)