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UK Tax Rules on Disguised Investment Management Fees: Final Legislation Published

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The UK's Finance Bill was published on 24 March 2015. It was subsequently enacted on 26 March 2015 without further amendment and became the Finance Act 2015. The "disguised investment management fee" provisions contained in this Act, summarised below, will be effective from 6 April 2015. These rules apply to managers of, and advisers to, private investment funds in relation to any fund structure that includes at least one partnership (the definition of which, according to guidance issued by HM Revenue & Customs (HMRC), includes a limited liability partnership). These new rules can affect existing fund structures as well as new structures; there will be no "grandfathering".

Certain amounts or value arising to investment professionals resident or working in the UK from these structures may be recharacterised as UK source trading income under the new rules and subjected to UK taxation, often at a higher rate than currently is the case. This can include carried interest in certain cases, despite not being the stated target of the legislation and despite the relaxation in the rules compared with the December 2014 draft. Returns from typical executive co-investment/GP commitment interests would be expected to fall outside the rules.

Although HMRC issued guidance on 25 March 2015 that clarified some of the questions raised in respect of the draft legislation, there remain some uncertainties.

UK managers and advisers to fund structures that include a partnership should look carefully at their structures to assess whether and to what extent these rules will affect them and their investment professionals. Non-UK managers and advisers to such structures also should consider the effect of the rules, if any, on their investment professionals that carry out investment management or advisory services in the UK.

What is the intention behind the rules?

Through these rules, the UK government intends to target structures which give investment professionals an interest in general partner's share (GPS), as well as interests relating to waived GPS or management fee (e.g., deemed contributions). This type of structuring has been used by some funds to pass a guaranteed profit share to individual executives before such profits are converted into trading income. In targeting such structures, the legislation adopts a broad "if it's not out, it's in" approach which may have unintended consequences.

There are exclusions for carried interest (as defined in the rules) and for executive co-investment/GP commitment interests. In addition, any amounts or value already charged to UK employment income tax or brought into the charge to UK income tax as trading profits are excluded. But all interests held by investment professionals in fund structures which include partnerships will need to be tested to establish whether they fall fully within these exclusions. This is particularly important for carried interest and performance allocations.

How could this change the UK taxation of carried interest and performance allocations?

Provided they are excluded from the scope of these rules, carried interest and performance allocations would continue (subject to the application of the employment income tax rules) to be taxed as capital gains at rates up to 28% or investment income at rates up to 45%, depending on the nature of the underlying profits. Any sums caught by the new rules will be recharacterised as trading income, subject to UK income tax and national insurance contributions at the highest rates (up to a combined rate of 47%). As a result, where the rules apply, the biggest impact will be felt by those who currently would pay capital gains tax (for example, on carried interest gains).

Broadly, under the carried interest exclusion, proceeds from carried interest/performance allocations should be outside the rules if either:

- the fund has a "fund as a whole" or a "deal by deal" carried interest model that includes a preferred return equivalent to at least a 6% compounded annual interest rate (the "6% preferred return safe harbour"); or

the carried interest/performance allocation is determined by reference to either the overall profits of the fund or the profits on the specific investments (and investors' returns also are determined in this way) and variable to a substantial extent; however, if at the time the interest in the carried interest/performance allocation was acquired by the executive there was no significant risk that all or part of the carried interest/performance allocation would not arise, this second exclusion will not be available to that individual to that extent.

Funds that operate carried interest/performance allocations that do not meet the 6% preferred return safe harbour will need to be assessed case-by-case to determine whether the second, broader exclusion applies.

Among other points, HMRC guidance has suggested that the "no significant risk" test only applies to sums which are, in substance, virtually certain to arise and that the test is not intended to apply to normal diversification arrangements by funds. However, careful consideration should still be given before relying on this test.

Hedge fund performance allocations, as well as private equity-style carried interest that does not fall within the 6% preferred return safe harbour in the first exclusion, may be able to benefit from the second exclusion. In particular, NAV-based arrangements may be within the second exclusion, but each arrangement should be considered on its own facts.

What is the effect on executive co-investment/GP commitment interests?

Those who have been following the progress of this legislation will be pleased to learn that, compared to the previous draft of this legislation, the position for executive co-investment/GP commitment interests has improved. Arm's-length returns on investments are excluded from the scope of the rules. Essentially, arm's-length returns are those which are reasonably comparable to the returns made by external investors. HMRC guidance confirms that the inclusion of "reasonably comparable" is intended to allow for differences arising for genuine commercial reasons. The guidance also suggests that HMRC sees co-investment by investment professionals on a no fee / no carry basis as falling within this safe harbour. Returns from typical executive co-investment/GP commitment interests (including those where executive co-investors pay no fee or carry) are therefore expected to fall outside the rules.

How are arrangements under which investment professionals receive a share of GPS affected? How are fee or GPS waiver structures affected?

We anticipate that most arrangements where investment professionals receive such interests will result in recharactisation of the amounts and/or value received on or after 6 April 2015 as trading income. Such arrangements should be analysed on a case-by-case basis.

Is it just UK resident investment professionals who are affected?

These rules also apply to non-UK resident investment professionals to the extent they carry out investment management or advisory services to any extent in the UK and the disguised investment management fees they receive (e.g., carried interest, performance allocations, interests in GPS, fee or GPS waiver interests) arise by virtue of these UK services.

For non-UK resident investment professionals who perform investment management or advisory services in the UK, the application of these rules and any possible double tax treaty relief should be reviewed on an individual basis. In particular, HMRC guidance suggests that treaty relief is likely to apply to non-UK residents who are treaty resident where they perform very limited services in the UK (for example, coming to the UK for a small number of business meetings every year), but care should be taken to ensure they have no UK permanent establishment.

If interests such as carried interest, performance allocations, interests in GPS, fee or GPS waiver interests are held by non-individuals, are these interests within the scope of the new rules?

While there has been no movement on this point in the legislation compared to the previously published draft, HMRC's guidance does provide some additional detail on this issue. The key clarification is that HMRC accepts that genuine corporate management vehicles which have sufficient substance and which carry on management activities will be able to "break the link" between the scheme and the individuals for the purposes of these rules. However, it will not be sufficient to use more contrived structures, passive corporate entities and/or trust entities. As a result, we anticipate that many of the structures used by investment professionals to hold their carried interest, performance allocations, interests in GPS, fee or GPS waiver interests may fail to prevent these rules from applying. Such arrangements should therefore be reviewed on a case-by-case basis.

If you think you are or may be affected by these new rules, please contact Robert Gaut or Catherine Sear or your usual Proskauer contact and we would be pleased to work with you to analyse the impact on your fund structures.

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