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DISGUISED MANAGEMENT FEES - FINAL DRAFT RULES PUBLISHED

BACKGROUND

- In the Autumn Statement in December 2014, the Government announced plans to introduce legislation to ensure that guaranteed amounts received by individuals from UK fund management activities were liable to income tax and NICs. The proposed effect of the rules was that, to the extent an individual performs any investment management services in the UK, all amounts received by that person directly or indirectly from the fund are subject to UK income tax unless excluded by being carried interest or an acceptable return on investment.
- The December draft legislation is summarised here.
- The final draft rules were published with the Finance Bill on 24 March and we do not expect these rules to change before coming into force on 6 April 2015. The rules will, however, be supplemented by HMRC guidance which is yet to be published.
- This note summarises the changes from the original draft rules and our view on the answers to the key questions raised by the new rules.
- The main concern with the rules as originally drafted was that disguised investment management fee (i.e. the cashflows caught by the rules) was drafted to include all cash flows to an executive from a fund not taxed as earned income unless specifically excluded. However, the original exclusions for carried interest and co-investment return were incredibly narrow such that cash flows from a fund which were not management fee in any commercial sense were caught by the new rules.
- Thankfully, the final draft rules address many of these concerns, albeit they leave a number of questions unanswered.

GPS STREAMING

- The main target for the new legislation is so-called "GPS streaming", planning which involves streaming guaranteed profit share arising from a limited partnership fund directly (for tax purposes) to individuals before it is converted into trading income. This was successfully targeted by the original draft rules and there are no changes in the final legislation. GPS arising directly (for tax purposes) to fund executives will be caught by these rules (subject to the limits on territorial scope explained below). Amounts distributed before 6 April and subsequent allocations against those amounts should not be caught by the new rules.

GPS OFFSET

- Another technique which these rules will counter is GPS offset, whereby an executive's co-investment in the fund is treated as made by reducing the fund GPS. The question here is when the rules bite - on the offset occurring or on the deemed investment being realised. This comes down to the meaning of "money or money's worth" and is likely to depend on the facts and will hopefully be clarified in guidance.

CARRIED INTEREST

- The main change with the final draft legislation is a significant extension of the definition of carried interest, increasing the types of performance awards taken outside the new rules.
- Previously, carried interest was defined narrowly as sums arising after repaying investors their investment plus a minimum 6 per cent preferred return on either a whole fund or deal by deal basis. This definition has survived as a safe harbour but the definition has been materially broadened with a generic carve out.
- This carve out will take most fund promote arrangements outside of the new rules.
- The new definition of carried interest includes sums arising to an individual if:
  - the sum only arises if there are profits, including unrealised and income profits, relating to the relevant investments within the scheme;
  - the sum is variable, to a substantial extent, by reference to those profits; and
  - returns to external investors are also determined by reference to those profits.

This definition should include carried interests with no hurdles (e.g. venture funds) and carried interests which are based on NAV (for example, in long dated closed ended infrastructure funds or open ended more hedge fund like funds).
There is an exclusion for amounts where there was no significant risk that the promote would not arise however this should not impact genuine performance awards.

CO-INVESTMENT

The original draft rules excluded the repayment of a funded co-investment from the new rules however it only excluded profits on a co-investment up to a commercial rate of interest. This had the effect of punishing successful funds. The exclusion has been extended to include an arm's length return. An arm's length return is a return on a co-investment where the terms of, and return on, investment are reasonably comparable to those of external investors. We would expect this to cover most funded co-investments, even where on a no-fee, no-carry basis. However, it will not apply to GPS offset arrangements.

TERRITORIAL SCOPE

The new rules provide for disguised management fee to be treated as arising from a UK trade to the extent the individual performs services in the UK and as arising from a trade carried on outside the UK to the extent the individual performs services outside the UK. While this (together with tax treaties) will assist non-UK resident executives, it is not clear whether this will give scope for UK resident non-domiciled fund executives to take amounts outside these rules to the extent they perform their duties outside the UK.

CORPORATE BLOCKERS

The rules only apply to amounts arising to an individual directly and, subject to the two points below, do not apply to amounts arising to a vehicle in which the individual has an interest. However, there are two issues with this:

- The rules apply where amounts arise directly or indirectly to individuals and so could apply when amounts are subsequently extracted from a blocker structure. We are expecting HMRC guidance to clarify when a blocker structure might cleanse cash flows (for example, we would expect dividends from the management company of a multi-fund manager to be outside these rules but a dividend from a personal company likely to be caught).
- There is a targeted anti-avoidance rule (TAAR) whereby any arrangements which have a main purpose of avoiding these provisions are ignored in determining their application. While the TAAR could apply to stop GPS streaming into a specially created corporate blocker when the law comes into force, HMRC accept that a TAAR cannot apply to steps taken before the law comes into effect. Therefore, it may be possible to take such steps now.

CONTACT DETAILS

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