Explanatory Note

Clause 22: Carried Interest

Summary

1. This measure introduces a new test to determine whether performance-based rewards (or 'carried interest') paid to asset managers should be taxed as income or as chargeable gains. The new legislative test replaces the case law tests based around the 'badges of trade'.

Details of the clause

2. Clause 22 amends Chapter 5E of Part 13 of the Income Tax Act 2007 (ITA), which contains the Disguised Investment Management Fee Rules ("DMF Rules").

3. Subsection (1) amends section 809EZB(1) of ITA, so that the exclusion from the DMF Rules for carried interest does not apply where the carried interest is "income-based carried interest", as defined in new Chapter 5F of Part 13. This has the effect of ensuring that carried interest which does not arise from long-term investment activity will be charged to income tax under the DMF Rules (where it is not already charged to tax as trading or employment Income of the relevant individual).

4. Subsection (2) inserts new Chapter 5F into Part 13 of ITA. Chapter 5F consists of new sections 809FZA to 809FZS inclusive.

5. New section 809FZA provides an overview of the provisions in Chapter 5F.

6. Section 809FZA(7) provides that these rules do not apply to carried interest which arises in respect of an employment-related security within Part 7 of the Income Tax (Earnings and Pensions) Act 2003.

7. Section 809FZA(8) puts beyond doubt that these rules do not affect the taxation of either the investment scheme itself or external investors in the scheme.

8. New section 809FZB introduces the concept of the 'relevant proportion' of a sum of carried interest being classified as "income-based carried interest". The 'relevant proportion' is determined by the average time for which the fund giving rise to the carried interest holds its investments. It is then applied to the carried interest to determine what proportion is taxable as income.

9. New section 809FZC explains how to calculate the average holding period for the purposes of the Chapter. Only those investments by reference to which the carried interest arises are included when determining the average holding period (see subsection (2)(b)). Where carried interest is calculated by reference to the "fund as a whole", this will include all investments made by the fund. Where carried interest is calculated by reference to the performance of a

portfolio over a given period, the relevant investments will be those disposed of during that period and those which remain held at the close of the period.

10. Section 809FZC(3) explains that the calculation is made when the carried interest arises.

11. Section 809FZC(4) sets out the detail of the calculation of the average holding period. A weighted arithmetic mean is calculated, taking the sum total of all relevant investments multiplied by the length of time held, and dividing that total by the total value invested. The value of the investment is determined as at the time it was made, and not at the time the carried interest is calculated.

12. For example. A fund holds three investments of £10,000, £8,000 and £6,000 and it holds them for 3, 4 and 5 years respectively. The calculation is (10,000x3)+(8000x4)+(6000x5), equals 92,000 which is then divided by £24,000 to give an average of 46 months.

13. Section 809FZC(5) directs that any intermediate holding structures are to be disregarded for the purposes of determining the average holding period.

14. Section 809FZC(6) explains how to determine the length of time for which an investment is held. If the investment is disposed of before the carried interest arises, the investment is treated as held for the time period it was owned by the fund. Otherwise the time period is taken as the time from which the investment is acquired to the time the carried interest arises.

15. Section 809FZC(7) makes clear that, in calculating the average holding period, any deferral of the carried interest is to be disregarded.

16. New Section 809FZD determines when an investment is disposed of. The starting point is that there will be a disposal of an investment if there is a disposal for the purposes of the Taxation of Chargeable Gains Act 1992 (TCGA) (see subsection (1)), or a deemed disposal (see subsection (2)).

17. Section 809FZD(2) explains what is meant by a deemed disposal. In essence, it involves a fund entering into arrangements to either (i) in substance, close its position in relation to an investment or (ii) no longer have any genuine economic exposure to the investment. There will only be a deemed disposal where it is reasonable to suppose that the arrangements in question were put in place to achieve that result. There will not be a deemed disposal, therefore, where a fund accidentally closes out a position by taking a reciprocal position. Regard must be had to all the circumstances in determining what it is reasonable to suppose (see section 809FZQ).

18. Section 809FZD(3) directs that, when a fund holds investments which comprise shares or securities in a company of the same class, a 'first in first out' basis is to be used in deciding which investments have been disposed of.

19. Section 809FZD(4) directs that section 116 of TCGA is to be disregarded for the purposes of this section. This means that sections127 to 130 of TCGA will be able to apply to transactions involving qualifying corporate bonds.

20. New section 809FZE sets out the rules governing part disposals. The part disposed of and the part retained are treated as two separate assets (subsection (1)). The value of each part is calculated in accordance with subsections (2) and (3).

21. New section 809FZF sets out the treatment of derivative contracts. The value invested for the

purposes of the weighted average holding period is determined by subsection (2) depending on the type of derivative contract in question. A substantial alteration to the terms of a derivative is treated as a disposal and new acquisition at the time of the alteration (subsection (5)).

22. New Section 809FZG sets out the treatment of instruments that hedge exchange gains and losses, defined in subsection (2). Such instruments are not treated as investments for the purpose of this legislation (subsection (4)), and entering into such an instrument is not treated as a deemed disposal of the hedged asset(s) for these purposes (subsection (3)).

23. New Section 809FZH sets out the treatment of instruments that hedge interest rates, defined in subsection (2). Such instruments are not treated as investments for the purpose of this legislation (subsection (4)), and entering into such an instrument is not treated as a deemed disposal of the hedged asset(s) for these purposes (subsection (3)).

24. New Section 809FZI applies where an investment scheme holds a relevant interest in a company and makes a further investment in that company. Where the conditions apply, any further investment by the scheme in the company is treated as made at the time that it met the conditions for holding a 'relevant interest' (subsection (1)).

25. Section 809FZI(2) to (4) sets out the definition of 'relevant interest'. Where the scheme is a 'controlling equity stake fund'), then a relevant interest will comprise a 25% interest in the company. Otherwise, it must hold a controlling interest in the company. This means that any fund will be able to able to aggregate further investments into trading companies or groups where it holds a majority stake, and that where the fund is a 'controlling equity stake fund' this treatment will apply even where the fund owns a minority interest in the company (provided the fund holds at least a 25% stake). A 'controlling equity stake fund' is one where it is reasonable to assume that when the fund ceases to hold investments, more than half of the total value of investments will have been controlling stakes held for more than four years.

26. New Section 809FZJ sets out when a disposal of a 'relevant interest' is made. Any disposals are treated as not being made until such time as the fund no longer has a relevant interest (subsection(1)), which for this purpose is defined as a 25% interest for a 'controlling equity stake fund' and a 40% interest otherwise (subsection (2)).

27. New section 809FZK sets out the treatment of 'conditionally exempt carried interest'. Where certain conditions are met, that carried interest is conditionally taxed under the chargeable gains rules and not as income (subsection (1)). This prevents carried interest being charged to income tax under these rules in the early years of a fund's existence (when the calculation required by new section 809FZC will necessarily produce an average holding period of below four years) when the fund expects to hold the relevant investments for a period which would exceed four years.

28. Section 809FZK(2) to (5) sets out the required conditions. These are that: (i) the carried interest arises no later than four years after the fund first makes an investment, (ii) the carried interest would be taxed as income by applying the new rules at the time the carried interest arises, but (iii) it is reasonable to suppose that, if the carried interest had arisen at a later time in the fund's life, it would be treated by the legislation as derived from assets that meet the test for being treated as long term investments.

29. Section 809FZK(6) and (7) set out the relevant time at which the carried interest is assumed to

arise for the purposes of the test in subsections (2) to (5). This is the earliest of: (i) the period of four years after the fund is expected to cease to make investments; (ii) the period of four years after the carried interest arose to the individual; and (iii) the end of the period of four years from the end of the period by reference to which the carried interest was determined.

30. New section 809FZL sets out how 'conditionally exempt carried interest' is subsequently to be treated.

31. Section 809FZL(1) provides that conditionally exempt carried interest ceases to be exempt at the earliest of: (a) the time the scheme is wound up; (b) four years after the firm ceases to make investments; (c) four years from the day the carried interest arose to the individual; (d) four years from the end of the period by reference to which the carried interest was calculated and (e) any time at which it is no longer to reasonable to suppose that the carried interest would not be income-based carried interest if it arose at the relevant time (i.e. if it becomes apparent at any time that the carried interest will be chargeable to tax as income under these rules)..

32. Section 809FZL(2) to (4) sets out the consequences. The carried interest is reviewed at that time to determine whether it should be taxed as income or capital. Any necessary tax adjustments are made, and where there is now to be a charge to income tax any capital gains tax paid in respect of the same carried interest is set off against that income tax.

33. New Section 809FZM treats carried interest arising from direct lending funds as chargeable to income tax, unless new section 809FZN applies.

34. New section 809FZN exempts certain direct lending funds from the scope of section 809FZM. . Where those conditions apply, the general rules of Chapter 5F will apply to the carried interest instead of section 809FZM, although certain loans repaid before maturity will be treated as held for four years. .

35. New Section 809FZO puts in place an anti-avoidance rule to prevent manipulation of average holding periods or whether a scheme is a 'controlling equity stake fund'.

36. New section 809FZP provides a regulation making power to vary how the average holding period is calculated.

37. New section 809FZQ defines what is meant by 'reasonable to suppose' for the purposes of Chapter 5F.

38. New Section 809FZR defines 'controlling interest', '40% interest', and '25% interest' for the purposes of Chapter 5F.

39. New section 809FZS provides definitions of various terms used in Chapter 5F.

40. Sub-section (3) amends section 809EZA of ITA to (i) make clear that the DMF Rules apply to an individual who has performed or will, in the future, perform investment management services; (ii) to remove the requirement that the arrangements involve a partnership; and (iii) to make clear that the rules apply to sums arising to an investment manager from any investment scheme.

41. Sub-section (5) provides that these provisions will apply to all sums of carried interest arising on or after 6 April 2016.

Background note

42. Managers of investment funds are rewarded in a variety of ways. Management Fees are charged to tax as income, and legislation in FA 2015 ensured that fee income could not be disguised as a form of capital receipt.

43. Managers also receive performance-based rewards, sometimes known as 'carried interest'. This is based on the performance of the funds that they manage and can take the form of a share in the fund's total return. Legislation in Finance (no 2) Act 2015 ensured that where carried interest is taxable as a chargeable gain, the full amount would be taxable without reduction through arrangements such as 'base cost shift'.

44. In the 2015 Summer Budget the government also announced that it would consult on a new legislative test to determine when carried interest should be taxed as income or as chargeable gains. The intention is that this test should replace the current test, which is based on case law and is centred around the so-called 'badges of trade'. The case law underlying the test has mainly considered trades connected with areas such as manufacturing and retail. The test is more difficult to apply to a business such as asset management. The government has therefore decided to put in place a legislative test.

45. If you have any questions about this change, or comments on the legislation, please contact James Coward on 03000 579560 (email: james.coward@hmrc.gsi.gov.uk).