HM Revenue & Customs

Investment Managers: Disguised Fee Income

Technical Note

29 March 2015

Contents

Summary of Legislation: Investment Managers: Disguised Fee Income

Chapter 5E, Part 13, Income Tax Act 2007

The legislation sets out the tax treatment of the management fees arising to managers of investment funds in some circumstances. It is intended to ensure that these fees are correctly charged to income tax, as the amounts in question are in substance income, paid in return for providing investment management services.

It contains a number of exclusions, in particular for fees which have already been charged to tax as trading income, or as employment income. Carried interest, the performance linked return to managers, is also excluded.

The measure was announced on 3 December 2014, and the draft legislation was published on 10 December 2014. Following representations made on the draft legislation, a number of changes have been made. The legislation comes into effect on 6 April 2015.

Chapter 1 of this guidance sets out the background to the legislation, Chapter 2 runs through the main provisions of the legislation, with examples, and Chapter 3 contains further examples.

This note is intended to give guidance to the investment industry and their advisors, and uses terms specific to that industry.

Chapter 1

Background to Legislation

1. The measure is intended to restore the correct treatment of annual fees of fund managers, in particular where general partner/limited partner (GP LP) or general partner/limited liability partner (GP LLP) planning is used. However, this measure is not restricted to these particular structures or the private equity fund managers where they are most commonly used. This measure will apply to any attempt to disguise what is, in substance, an investment management fee such that it is not properly charged to tax as income.

2. A typical private equity fund pays, broadly speaking, two types of return to the fund managers.

    a. a fee based on funds under management (generally at a rate of 1.5 – 2%), that is typically routed via a priority profit share paid to the general partner of the fund[1]; and
    b. a return linked to performance of investments above a certain hurdle rate, often described as the carried interest (typically 20% of profits above a hurdle rate equivalent to an annualised rate of approximately 8%).

3. The general tax treatment of carried interest is set out in a Statement issued by the British Venture Capital Association (BVCA) with the approval of the then Inland Revenue and Department of Trade and Industry in 1987[2]. In parts, this was superseded and supplemented in 2003 by a further Memorandum of Understanding (MOU) agreed between the BVCA and the Inland Revenue.[3]

4. The treatment of the fees based on funds under management is not covered by the MOU. Historically, these fees were paid via a management company, and gave rise to a charge to income tax when received by the managers. Many private equity houses now use limited liability partnerships as their management vehicles, but the fees are still charged to income tax in such a structure. However, HMRC has become aware that some funds are adopting planning in which some or all of these fees avoid an income tax charge.

GP LP and GP LLP planning

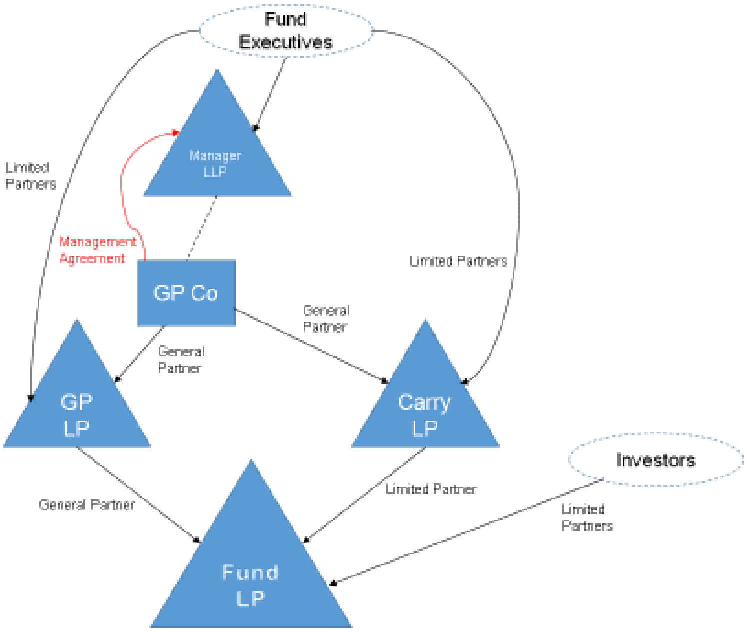
[1] Please note that this note uses the term "fee" to include sums paid as a priority profit share to the general partner of a fund vehicle that are then (or, in the absence of GP LP or GP LLP planning, would be) on-paid by that general partner as a fee to a management entity. This will also include sums paid to the general partner by way of loan when there are insufficient partnership profits to meet that priority profit share, as explained in more detail below.

[2] Statement and issued by the British Venture Capital Association (BVCA) on 26 May 1987of which a copy is available at HMRC Manual CTM36580.

[3] Memorandum of Understanding between the BVCA and Inland Revenue agreed on 25 July 2003 on the income tax treatment of Venture Capital and Private Equity Limited Partnerships and Carried Interest of which a copy is available at HMRC Manual ERSM30530

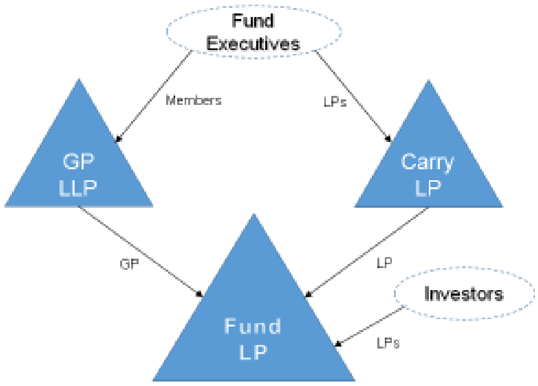
5. The effects of the measure are not limited to any one avoidance structure or category of asset manager. However the types of planning at which they are aimed are sometimes described as GP LP and GP LLP planning.

6. In both cases, the investments of the fund are held in a limited partnership (LP), the fund partnership. In GP LP planning, the general partner of this LP is itself a limited partnership (GP LP) (See Fig 1).



7. The annual fee[4] is paid as a priority profit share by the fund LP to the GP LP. Some of the fee may be paid on to a management company or limited liability partnership, i.e. the traditional structure. However the individual partners in the GP LP may allocate some of the annual fee to themselves without passing it via the management company. GP LLP planning (Fig 2) is broadly similar.

[4] The fee based on assets under management is referred to for convenience in this document as the annual fee, although in practice the fee may be paid at different intervals, for example quarterly or semi-annually. In most private equity funds the fee will strictly be calculated by reference to the sums committed by investors to the fund, even before those sums have been drawn down.



8. The effect of this planning is that annual fees for investment management are not being taxed in full. Since the annual fees are clearly a return for services provided, they should be charged to income tax. Chapter 5E has therefore been introduced to ensure that these fees are charged to income tax.

9. It is not clear that the planning actually has the effect that the fees escape an income tax charge, and HMRC are considering the position.

Summary of effects of legislation

10. Where a fee is paid for investment management services, via a structure involving partnerships, then it is potentially a target for the legislation. The partnership or partnerships may be involved in the investment structure or management function of the arrangements in question.

11. However, the clause will not affect sums which are carried interest; this is to ensure that the current treatment of carried interest does not change.

12. If a manager has been required to invest some of his or her own capital, then a return of that capital will not be taxed under the measure, nor will an investment return on that capital, as long as the return is reasonably comparable to the return arising on external investments in the scheme.

13. A third exclusion applies if the fee has already been brought into charge to income tax as employment income or where the fee has been brought into account when calculating trading profits for the purposes of income tax.

14. The legislation will apply to fees, whatever the legal form of the fee, including cases where the annual fee is paid in the form of a loan or advance.

15. The overall intention of the legislation is that fees for investment management services, particularly those based on a percentage of assets under management, but not limited to those fees, will always be charged to income tax in full.

16. If funds are restructured in an unacceptable way to avoid the effects of the charge, then they will be caught by the anti-avoidance provisions in the legislation.

17. HMRC will keep the situation in review in future to ensure that all aspects of the tax treatment of private equity funds (and any other funds using similar structures) continue to deliver an equitable result.

Chapter 2: Details of Legislation

General points

18. The provisions are in a new Chapter 5E of the Income Tax Act 2007.

19. The main aim of the legislation is to ensure that sums calculated by reference to funds under management (e.g. 2% of the funds committed or invested) are charged to income tax where they arise to individuals.

20. The structure of the legislation is that if sums arise from a fund to an individual providing investment management services, and are not carried interest, a return of capital, or a return on sums invested, they are subject to income tax, unless they are already charged to income tax as profits from a trade or earnings from employment.

21. This raises the possibility of a double charge to tax, so section 809EZG gives relief where this is the case.

Deemed trade

22. The first section of the legislation, s809EZA(1), provides that where a disguised fee arises to an individual from an investment scheme, or schemes, then the individual is to be charged to income tax in respect of the disguised fees.

23. The legislation only applies where an investment scheme is involved. For the purposes of Chapter 5E, this includes collective investment schemes as defined using the meaning in section 235 of the Financial Services and Markets Act 2000 (FSMA 2000).

24. Corporate bodies are generally not collective investment schemes, as a result of the exclusion in Statutory Instrument 2001/No.1062. However Open Ended Investment Companies (OEICs) are collective investment schemes.

25. Investment trusts, whether approved or non-approved, are also defined as investment schemes, by Section 809EZA (6) and so are in the scope of Chapter 5E.

26. The disguised fee is to be taxed as the profits of a trade, which means that such fees are brought into account for the purposes of income tax and Class 4 National Insurance contributions (NICs).

27. One single trade exists, whether the individual performs the activities for one or more collective investment schemes.

28. Any disguised fees are treated as the profits of the deemed trade, not as receipts. This means that losses or expenses cannot be set against the disguised fees. The deemed trade cannot give rise to a loss, as it only applies to fees arising.

Territoriality

29. S809EZA(2) provides that the deemed trade is treated as carried on in the UK to the extent that the individual performs the services in the UK, and outside the UK, to the extent that the services are performed outside the UK

30. This rule applies alongside section 6 ITTOIA 2005, and so will have the effect that if the investment management services are carried out by a UK resident, then the trade is regarded as carried on wholly in the UK.

31. If they are carried out by a non-resident, then the trade is regarded as carried on in the UK when the services are performed in the UK and as carried on outside the UK where the services are performed outside the UK.

32. Some individuals may perform only very limited services in the UK, for example, coming to the UK for a small number of business meetings during the course of the year. The effect of the legislation is to provide that a deemed trade exists for the individual.

33. This means that the business profits article of most double taxation treaties will apply, and so a tax charge will only arise if a permanent establishment exists.

34. The usual conditions for determining whether a permanent establishment exists will apply, in particular, a few brief visits would not normally give rise to a permanent establishment.

35. NIC treatment will follow that of other trades.

Disguised Fee

36. To be a disguised fee, the four conditions in s809EZA (3) must apply.

Investment management services.

37. The first condition is that the individuals must perform investment management services. The phrase will take its normal everyday meaning, but some examples of services included are given in section 809EZE(1). Investment management services will include:

- seeking funds for scheme purposes from participants or potential participants;
- researching potential investments for the scheme;
- acquiring, managing or disposing of property on behalf of the scheme; and
- acting on behalf of the scheme for the purposes of assisting a body in which the scheme has made an investment to raise funds.

38. The list is not exhaustive, so other activities which fall within investment management may be included.

39. It is expected that “investment management services” will cover the activities of all managers in a private equity fund who are involved in the GP LP and GP LLP structures targeted by the legislation.

Involvement of partnership

40. The second condition is that the legislation will only apply when the arrangements involve at least one partnership. “Arrangements” has a broad meaning, and so would include a fund with a partnership anywhere in the structure, for example, the investment partnership which actually holds the scheme investments, or the GP LP, GP LLP, or other entity involved in managing the scheme. It also includes any foreign partnership or other foreign structure which has the same characteristics as a UK partnership.

Fee arising to individual

41. The third condition is that a management fee must arise to the individual directly or indirectly from the scheme.

42. A management fee is defined in more detail in s809EZB but broadly the intention is to include any sum arising from the scheme which is not carried interest, or a return of capital invested by the individual, or profits on that investment.

43. Sums “arising” are not defined, so the word will take its usual meaning in legislation. Sums will arise when the individual actually has access to them. This will be when they are allocated to the individual, and the individual can access them.

44. If the sums are allocated, but not accessible to the individual, for example, they are deferred for a period of time, then they will not arise to the individual until he or she can actually access them.

45. On the other hand, if the sums are made available to an individual, who chooses to apply them in a particular way, for example by investing them in the fund, then they will arise at the point that they are made available, notwithstanding that they have been reinvested.

46. The section also catches loans, so that if, as is usual in the early years of a fund, the annual fee is advanced by way of a loan, it will be subject to income tax under this measure.

Loans and disguised fees

47. In the early years of a private equity fund, it is likely that no profits or gains will be available to pay the annual fee, so it will be met instead from loans from the fund to the GP LP, which will be repaid from later profits or gains, or in cases where the fund is unprofitable, may not be repaid at all.

48. These payments, even where they may take the form of loans, arise to managers in return for investment management services, and should be taxed accordingly.

49. Section 809EZB (1) makes it clear that loans and advances are included in the sums subject to s809EZA.

Directly or indirectly

50. A management fee can arise directly or indirectly from a scheme. Since it can arise indirectly, simply interposing another structure, or structures, between the scheme and the individual will not prevent the sum from being a disguised fee.

51. However there are some circumstances where a sum will not be regarded as arising from the scheme. This is covered in paragraph 141 below.

Sums which are untaxed

52. S809EZA (3) only catches sums which are "untaxed". The term "untaxed" is defined in section 809EZA (4). It has the meaning that any sum not charged to tax as employment income, or brought into account in calculating the profits of a trade for income tax purposes, is untaxed.

53. So overall the effect is that if a sum is already charged as trading income or as income from employment, the new measure will not impose any additional charge.

54. The intention is that if a fund already ensures that all fees arising to individuals for investment management services are charged to income tax and NIC, then there will be no additional charge.

55. The effect of the definition is that sums arising to employees which are taxed as benefits or under the employment related securities legislation will not be untaxed for the purposes of Chapter 5E.

56. If the sum is only partly taxed, then Chapter 5E applies to the untaxed part

Management Fee

57. The term management fee for the purposes of s809EZA (3) (c), is defined in s809EZB. It is broadly defined: any sum arising to an individual from a collective investment scheme is a management fee if it is not a repayment of an actual

investment made by the individual in the scheme (or in investments made for the purposes of the scheme), an arm's length return on such an investment, or carried interest.

SUMS WHICH ARE NOT DISGUISED FEES: COINVEST AND CARRIED INTEREST

Coinvest: Investments made by managers, and arm's length return for managers

58. Returns of coinvestments by managers in funds, or returns on those investments, are excluded from being disguised fees, provided that they are on arm's length terms.

59. Section 809EZB (2) defines an arm's length return. The investments made by managers must be of the same kind as investments which are made in the scheme by external investors, (or reasonably comparable to those investments); the return must be reasonably comparable to the return realised by external investors on those investments, and the terms governing the return must be reasonably comparable to the terms governing the return to external investors.

60. The aim behind these conditions is to ensure that genuine coinvest and returns on coinvestments, are excluded, but to rule out any attempt to provide management fees by way of investments available only to managers.

61. For example, arrangements could be made for the managers' capital to receive an excessive return, and to pay the annual fee in that way.

62. If these terms are not met, then sums arising will be treated entirely as disguised fees, and subject to income tax.

63. It is accepted that the return to internal and external investors will not be identical. In particular, where a private equity fund manager invests in a fund on the same terms as external investors but is not liable to the management fee or carried interest in respect of that investment, HMRC accept that it will still meet the reasonably comparable tests above

64. The wording "reasonably comparable" is intended to allow for this sort of difference, i.e. where there are genuine commercial reasons for the difference.

65. While it is not set out as such in the legislation, HMRC would accept that where an individual invests capital in a scheme which has been lent to the individual on arm's length terms, it can still meet the above requirements.

No comparable funds

66. Where an investment fund is entirely “in house” it may have no external investors. In these situations, the comparison to be made for the purposes of s809EZB (2) is with a fund of a similar nature which does have external investors, taking all factors into account.

Carried interest and profit related returns

67. Sums which are carried interest are excluded from a charge under Chapter 5E. Carried interest is generally used to mean a share of the profits of the fund which arises to managers if performance targets are met by the fund.

68. This legislation contains two different definitions of carried interest. Section 809EZD sets out the definition of carried interest which follows the description of typical carried interest arrangements in the Memorandum of Understanding (MOU) agreed between the BVCA and the Inland Revenue in 2003 and BVCA Statement and Guidelines approved by the then Inland Revenue and Department for Trade and Industry in 1987.

69. However, some investment funds use models of carried interest which do not fit within the description in the MOU. For example, venture capital funds may have a lower hurdle rate, and some funds will pay carried interest out of unrealised profits.

70. Since genuine carried interest is intended to be exempted from the charge, an alternative definition of carried interest is also used in the legislation.

71. The legislation is set out in this way so that funds which are using the model set out in the MOU can be satisfied that the carried interest will be exempt without needing to study the broader definition in s809EZC. (The BVCA model of carried interest is defined as meeting the requirements of s809EZC).

72. The wider definition of carried interest used in s809EZC should not be taken as an indication that any particular arrangement necessarily falls within the definition of carried interest in the Memorandum of Understanding; that is a separate issue which must be considered on the facts of the case.

Carried interest – definition in s809EZC

73. Section 809EZC sets out the definition of carried interest. It is intended that the definition will apply to all carried interest used in normal commercial arrangements, but rule out sums which are essentially fixed or largely fixed.

74. Section 809EZC (1) says that a sum is carried interest if it is a profit-related return, subject to various other conditions.

75. A profit-related return is defined in section 809EZC (2). That section applies three conditions.

76. The first condition is that the sum must arise only if the fund is making profits. Where deal-by-deal carry is used, the individual investments giving rise to the carried interest must be profitable.

77. Profits are defined in section 809EZE (1), and include realised and unrealised profits, and capital and income receipts.

78. A calculation of whether the fund is making profits is to be based on the period set out in the arrangements. So for example if a fund draws up annual accounts, and a decision on whether to pay carry is based on those accounts, (for example by comparing the net asset value with the net asset value at the start of the accounts period), then the period in question would be the year used for the test.

79. In some cases, it is possible that carried interest may be paid where the fund has made a loss. This might arise, for example, if a substantial profit is made in year 1, then a loss in year 2. The arrangements might provide that carry is still to be paid in year 2, provided that over the two year period profits are made at a sufficiently high level. In this case, the period provided by the arrangements would be two years, and the condition would be met.

80. The second condition is that the sum which may arise must vary substantially by reference to profits. The intention here is to reflect a standard arrangement in which, provided the hurdle rate has been met, the carried interest is a percentage of profits. In these circumstances, the carried interest paid would vary substantially by reference to profits.

81. The third condition is that the investments used for these tests must be the same ones by which returns to external investors are measured. For example, if a pool of investments was set up with a safe and steady return, and used just for the purposes of determining payments to managers, those payments would not qualify as carried interest under this condition.

No significant risk condition

82. As well as meeting the conditions in section 809EZC (2), the sums arising must also meet the condition that there is no significant risk that the sum will not arise.

83. The intention is that any attempt to apply a notional profit link to a fee which is really fixed in substance will be ineffective.

What is a significant risk?

84. This is not defined in the legislation, but the intention is only intended to catch disguised management fees, i.e. sums which are in substance virtually certain to arise.

85. Whether this is the case is a matter of fact, and will depend on all of the circumstances, taking a realistic view of the facts.

Test applies to arrangements

86. The test as to whether there is a significant risk that a sum will not arise applies to the arrangements, and not to the investments made by the fund.

87. For example, it is possible that a fund could invest in risky investments, but put arrangements in place which provided a certain payment every year to managers. Equally, a fund might invest in relatively safe investments, but set a high hurdle rate such that it was not by any means guaranteed that a manager would ever receive any carried interest.

88. If fund managers have a good record, such that 5 out of their previous 6 funds have delivered high returns, this does not in itself mean that there is no significant risk attached to the sums arising to the managers. If funds have to deliver a high enough performance to repay loans to external investors and meet the hurdle rate before any carry is paid it is unlikely that at the outset there would be no significant risk that any carry would not be paid, based on these facts.

Test to be carried out

89. In deciding whether there is a significant risk, the legislation requires two different tests to be carried out, one at the level of an individual sum, and the other taking sums together over the tax year.

90. In the simplest case, if one sum is paid during a tax year, then only that sum needs to be examined. If there was a significant risk that it would not arise, then the sum is carried interest (assuming the other conditions in the legislation are met).

91. The second test required is that all of the sums received in the tax year should be considered together, and an assessment made of whether taken together there is no significant risk that a sum would not arise.

92. This would only have any effect in the exceptional circumstances that a fund had invested in a series of investments which taken together deliver a certain return to the managers.

93. This test is not intended to catch normal "diversification" arrangements by funds. It is of course not unusual for funds to invest in a spread of investments to give a safer return overall.

94. The "taken together" condition would only apply if avoidance arrangements were in place to give investment managers disguised fees where there was no significant risk, and this would be applied after considering the chance of providing a return

which exceeded the hurdle rate and resulted in carried interest payments to managers.

95. Sections 809EZC (5) and (6) set out the test to be carried out.

96. For each sum which arises, compare the amount which did arise and any other sum which might have arisen. If there was a sum which was certain to arise, (i.e no significant risk that it would not) that is called the minimum amount.

97. Starting with the test at the individual level, compare that amount with the sum that actually did arise. The amount which is certain to arise is not carried interest, and is therefore a disguised fee. The remainder of this sum is carried interest (assuming the other conditions are met).

98. Example: the managers are to receive in a tax year £1m if there are no profits, and 20% of any profits above £50m. There is only about a 30% chance that the profits will exceed £50m.

99. In the event, the profits are £60m, so the managers receive a total of £3m. The minimum amount is therefore £1m. The additional amount that might have arisen, (and in this case did in fact) arise, is £2m, and this £2m is carried interest. The £1m is a disguised fee.

100. If the profits were £45m, then no additional sum arises. The carried interest is nil, and the disguised fee is £1m.

Allocation of sums treated as disguised fees, following the test

101. In circumstances where part of the sums arising to managers are disqualified under the test, i.e. some of the return is certain to arise, and is therefore a disguised fee, then subsections 809EZC (7) and (8) set out how the disguised fee is apportioned to sums.

102. Where it arises from one asset, then the disqualified part is assigned to that asset. Where it is assigned to a range of assets (and it is not possible to apply it to any particular asset), then it should be assigned on a just and reasonable basis.

Example

103. A fund invests in a fixed rate deposit with a guaranteed return, some corporate bonds, and a number of start-up companies.

104. The guaranteed returns to an individual manager are: £10, £1, and nil, respectively. (That is, there is no significant risk that these sum will not be received). The actual amounts received are £10, £5 and £100. The sums which are not carried interest are: £10, £1 and nil.

105. In this case, the returns can be attributed to individual assets, so the sums which are disguised fees are: £10 on the deposit, £1 on the bonds, and nil on the start-up companies.

106. If the fund had invested instead in a large number (say 100) of small investments, each individually risky, then it could be estimated that overall 50 of these would produce a profit and 50 a loss. Taken together, a return of 50 is 90% likely to arise, and actually 75 arises. From this 75, 25 will be carried interest, and 50 will not. The 50 is to be attributed between the investments on a just and reasonable basis.

When is the test applied?

107. Section 809EZC (5) sets out when the tests (of whether there is a significant risk that a sum will not arise) is to be assessed.

The time is the latest of:

- When the individual becomes party to the arrangements
- When the individual begins to perform investment management services under the arrangements
- A time when a material change is made to the arrangements which relates to the sums arising to the individual

108. Generally speaking, this would mean, for a closed ended fund, that the test is likely to be applied at an early stage in the life of the fund. Later in the life of the fund, if it has been successful, it may be certain that sums will arise to the managers under the carried interest arrangements, if the hurdle rate has been passed. However, this does not mean that sum does not qualify as carried interest, provided that there was a significant risk that the sum would not arise when the arrangements were entered into.

109. The “material change” condition only applies where there is a possibility that the change affects the amount of carry which the individual might receive – there may be other material changes which do not affect that amount.

110. Where an individual leaves a management team and his entitlement to carry is wholly or partly re-allocated amongst the remaining managers, this will generally not amount to a “material change” provided that (i) those individuals were previously entitled to a portion of the carried interest in respect of the scheme in question and (ii) the re-allocation does not materially distort the proportions in which those individuals will share the carried interest between themselves.

Insolvency condition

111. When applying the test, s809EZC (6) provides that a risk that the sum will not arise due to insolvency or otherwise is to be ignored. This means, for example, that an argument that none of the return is certain, since the fund may lose all its money, will not succeed.

112. It does not mean that a risk of insolvency in the underlying investments of the fund must be ignored; rather this is one of the elements which is taken into account in assessing whether a payment is carried interest or not. It is understood that investment funds may invest in risky ventures where insolvency of an investee company is a real risk.

Carried interest – BVCA MOU definition

113. The MOU and 1987 Statement is an interpretation of the law which sets out the tax treatment that will follow when venture capital/private equity funds are structured in a certain way. It is assumed that private equity firms in the UK will very often be structured in this way to ensure that they benefit from the tax treatment set out in the MOU and 1987 Statement.

114. Broadly, s809EZD provides that carried interest is a sum which arises to the individual out of profits on investments made by the scheme, but only after all or substantially all of the investments made by investors have been repaid, together with the preferred return on those investments.

115. This is to match a standard structure in which the fund managers do not get any share in profits by virtue of their carried interest until external investors have had their investments in the fund (apart from partnership capital) repaid, together with a fixed rate of return, often referred to as the hurdle rate.

116. The reference to investments being repaid includes loans from external investors being repaid, as well as other investments. The reference in s809EZD (2) to "… substantially all" of the investments being repaid is to acknowledge that capital contributions to the partnership (rather than loan commitments to the partnership, which will comprise the vast majority of the investment made by the managers and third party investors) will rarely be repaid until the partnership is wound up, i.e. the carried interest may be paid when the capital investment is still outstanding.

117. Section 809EZD (3) covers the situation where profits are repaid on a deal by deal basis, rather than an overall fund basis. The same principle will apply, that carried interest will only be regarded as being paid when in accordance with partnership agreements, investments to partners and the hurdle rate have been paid to external investors after disposal of particular investments.

118. It will essentially be a matter of fact what sums are paid to managers; if a sum of 2% of funds under management (for example) is paid annually to managers,

as provided in the partnership agreements or elsewhere, then this will not be regarded as carried interest.

119. Subsection (3) defines the preferred return, setting this as a minimum of an annual rate of 6% compound interest. The intention here is to reflect the wording of the MOU (which refers to higher hurdle rates), and to ensure that sums described as carried interest do match the usual commercial arrangements.

Definitions of terms used in the legislation

120. Section 809EZE contains definition of various terms used in the legislation. Most of these should be self-explanatory, and are intended to reflect the normal operation of investment funds. S809EZE(2) is intended to give more background to the exclusion of coinvestment, setting out when a sum is intended to be regarded as invested in a fund. For investment trusts, this will include a purchase of shares in the trust.

Anti-avoidance clause

121. Section 809EZF is an anti-avoidance clause. It provides that if any steps are taken to avoid the effects of Chapter 5E, they will not be effective. This is to be interpreted widely, for example, if a payment which was an annual fee in substance was paid in a different form, this planning would be ineffective for tax purposes.

122. For example, if arrangements were amended so that a sum which was in substance an annual fee based on 2% of sums under management was alleged to be carried interest arising from disposals, s809EZF would apply.

123. However, if steps are taken to ensure that the arrangements fall within the legislation, this will not in itself mean that the anti-avoidance clause will be invoked. For example, if the hurdle rate for a fund was increased from 5% to 6% so that the carried interest fell within the definition in s809EZD, this would not be a reason for the anti-avoidance provision to be applied.

Avoidance of double taxation

124. It is possible that payments could be charged to income tax as a result of section 809EZA, and another tax charge could arise, at the same time or later, on a payment which in effect arose from the same sum. This charge could either be to income tax or to a different tax.

125. Section 809EZG provides for avoidance of double taxation. It contains two separate provisions.

126. S809EZG(1) provides for tax relief where a charge is made under s809EZA, and a second possible tax charge arises on the same amount.

127. For example, a fund disposes of an asset such as an investee company and an individual's share of the proceeds is £2m. The proceeds from the disposal are, as a matter of fact, allocated to the individual at the level of a GP LP entity and used to meet an annual fee; this gives rise to a charge under s809EZA.

128. The individual is liable to capital gains tax on his share of the disposal, but can make a claim under section 809EZG (3) for a consequential adjustment.

129. If the claim is allowed, then an adjustment can be made, limited to the lower of the tax charge under s809EZA and the other tax involved. (In this case, this is likely to be the lower of income tax at 45%, or capital gains tax at 28%).

130. S809EZG (2) applies in circumstances where two charges under Chapter 5E could otherwise apply.

131. For example, in the early years of a fund before any profits have arisen, a loan is made to an investment manager to meet the 2% annual fee. Three years later profits arise in the fund and this profit is required to be used to discharge the outstanding loan.

132. A charge under s809EZA arises at the time when the loan is made, and could arise again when profits arise and are used to repay the individual's loan. S809EZG(2) provides for relief in these circumstances.

Regulation-making Power

133. Section 809EZH contains a regulation making power. It allows regulations to be made to amend the definitions of schemes to which the legislation applies, the persons who are participants in such scheme, and the definition of carried interest.

134. The aim is to allow changes to be made to the legislation to respond quickly to changes in the types of arrangements used by funds, which may be useful in this rapidly changing area.

Commencement and sums arising

135. The new legislation will apply to all fees arising on or after 6 April 2015, whenever the arrangements were entered into.

136. Arising in this legislation will take the meaning of "made available" to an individual. This means that profits which accrue in a partnership but have not been made available to an individual do not give rise to a charge until they are available.

137. Where sums accrue before 6 April 2015, but arise after that date, they will be subject to a charge, whenever they accrued.

138. Where a loan was made before 6 April 2015, it would not have been subject to a charge. If sums arise after that date, and must be used to repay that loan on or after 6 April 2015, then they will not be available to the individual at that stage, and so no charge will arise on sums used to repay the loans.

139. More generally, if a sum is allocated, and the partner has access to the sum so that he or she can withdraw it from the partnership, it will arise at that stage for the purposes of the legislation. If the partner then draws the sum, this will be regarded as withdrawing money which already belongs to him or her, and will not be regarded as a further sum arising, whether in the same or another tax year.

140. HMRC would expect the principle of sums arising to be addressed consistently so that a sum will give rise to a charge once when it arises, but not more than once on what is demonstrably the same amount.

Sums arising directly or indirectly

141. The measure applies to sums which arise directly or indirectly to an individual from a scheme. It is intended to catch any sum which is in effect a management fee paid for providing investment management services.

142. Where an individual acts as an investment manager, and holds shares in the company for which he or she works, they may receive dividends from those shares. These dividends would arise from the shares, and reach the individual in their capacity of shareholder, and so would not be regarded as arising from the scheme provided that (i) the company carries on a trade of providing investment management or advisory services on a commercial basis with a view to profit and (ii) the individual receives an arm's length rate of remuneration from his or her employment by that company.

143. In short, genuine corporate management vehicles (i.e those with sufficient substance to carry on the management activity and who actually do so with their own employees, contracts and other assets) will generally be sufficient to "break" the link with the scheme such that dividends paid on shares held in those vehicles or their parent are not caught by this measure (provided the individual is receiving an arm's length rate of remuneration from the company and this is not part of a wider structure which seeks to avoid the application of this measure). However, HMRC consider that more contrived structures will be caught.

144. For example, merely interposing a passive company between an individual manager or group of individual managers and the GP LP or GP LLP vehicles referred to above would not break the link and sums allocated to that company will

be treated as directly or indirectly arising to the individuals. This would also be the case where such a company was owned directly or indirectly by a trust from which the individual manager could benefit (whether that is a personal trust or a trust used as part of an avoidance structure such as a "Members Benefit Trust" which could benefit members of a partnership which carries on investment management activity).

145. In addition, HMRC will pay particular attention to structures which rely on claiming that investment management activities are partially performed by a vehicle outside the UK in a low (or no) tax jurisdiction. HMRC will closely examine the substance of the purported offshore activity, the transfer pricing of the transactions in place and also consider the potential application of other anti-avoidance provisions, including the "split contracts" rules and the other provisions in Part 13 of ITA 2007 as appropriate.

Dividends on scheme investments

146. If shares in companies held by the investment scheme as investments give rise to dividends, which are used to pay the annual management fee to the investment managers, those sums would be regarded as disguised management fees. The individuals would be subject to a charge under s809EZA. (Double taxation relief may be available under s809EZG if a tax charge also arises on the dividends.)

Allocation of shares or partnership interests

147. Where shares in the fund management company, or a partnership interest are allocated to an individual, these would generally not be regarded as arising from the scheme itself, so will not give rise to a disguised fee charge.

148. In all of these situations, HMRC may critically examine the facts to decide whether an allocation of shares or partnership interest is in fact a device to ensure that management fees are not being charged to income tax, and may apply the anti-avoidance test in section 809EZF if appropriate.

Sums retained under AIFMD

149. To comply with requirements under AIFMD (the Alternative Investment Fund Managers Directive), an investment partnership may retain funds which have been allocated to a partner.

150. The partnership itself may pay tax on these sums, under the provisions in sections 863H – 863K ITTOIA 2005. The sums may be forfeited by the partner, for example because performance hurdles have not been met.

151. Under these circumstances HMRC would regard the initial allocation as not giving rise to a charge under Chapter 5E, as although the sums are allocated to a

partner, the partner does not have access to them, so they do not arise for the purpose of the legislation.

152. If the performance hurdles are met and so the sums are made available to the partner, the sums will arise at that point. However, any sums which are taxed would not be untaxed income within the meaning of s809EZB.

VAT

153. Although the measure provides that a deemed trade exists for income tax purposes, it does not have any effect for VAT purposes, so it does not change the VAT treatment of any sums.

Chapter 3: Examples

Territorial scope

Example 1

ABC LLP is a US limited liability partnership. DE is one of three partners who live and work in the US and has not been to the UK in the tax year. FG is a fourth partner who lives and works in the US but has visited the UK for three days in relation to the acquisition of a UK business by a collective investment scheme that ABC LLP provides investment management services to. Neither DE nor FG is a UK resident for tax purposes. Each of the four partners received £10,000 that would, if the individuals had lived and worked in the UK, be treated as a disguised fee.

DE has not performed any services in the UK, so is not brought into charge under this measure. FG has performed services in the UK, so is potentially within the charge. However, it is unlikely that a few days in the UK will have the effect of creating a UK PE, depending on the facts. If there is no PE, then a charge will not arise under this measure.

Sums arising directly or indirectly

Example 2

MNO LP is the general partner of YZA LP which is an investment fund. MNO LP receives a profit share from the fund. O provides investment management services for YZA LP fund. O is a member of MNO LP. Under the terms of the LP agreement O receives a share of the profits of the MNO LP.

The profits share allocated to O is the disguised fee.

Untaxed income

Example 3 - accountancy partnership

AB is a partner in CD LLP, a large accountancy firm. AB carries out due diligence on a potential acquisition by RS LP, an unconnected private equity fund. CD receives a fee for doing so and this increases CD's profits. AB receives a share of those profits.

Due diligence falls within (b) of the "investment management services" definition.

The fee is included in the calculation of the profits of CD and so is not "untaxed". This sum falls within s809EZA(4)(b) – "profits of the trade of the individual".

Example 4 - company

AB is a director and 50% shareholder in ABCD Limited, an accountancy firm. AB provides corporate finance advice on a potential acquisition by RS LP, an unconnected private equity fund. ABCD receives a fee for doing so and this increases ABCD's profits. ABCD's profits are subject to corporation tax. AB receives a dividend from ABCD. CD has not provided any services to RS LP and also receives a 50% dividend.

Corporate finance services fall within the "investment management services" definition. The fee is included in the calculation of the profits of ABCD and not AB and so is "untaxed". However the dividend is not regarded as arising from the collective investment scheme, and so does not fall within the scope of this charge.

Collective investment schemes

Example 5

ABC plc is in the process of seeking a listing of its shares on a stock exchange. The company is seeking to raise £1bn of new money on the listing. The money raised on the listing is intended to be used to purchase a number of private businesses. DE is the Finance Director of ABC plc and is currently spending a significant amount of time meeting potential investors and researching potential investors.

While DE's role may include "investment management services", it is in relation to ABC plc which is not a collective investment scheme.

Carried Interest

Example 6 - Conditional management fees.

A manager is entitled to 2% of the value of a fund, deferred until the fund has positive profits or return.

The fee would not be carried interest within Chapter 5E, as the amount paid does not vary by reference to profits.

Example 7 - Sums partly linked to profits.

A manager is paid £1m, or £1m plus 20% of profits if the profits of the fund are above a certain level.

The £1m would not be carried interest, as it does not vary by reference to profits, and there is no significant risk that it will not arise. The second component would be *treated as carried interest, unless it was set at a level that meant that there was no significant risk that it was not going to arise.*

Commencement

Example 8

AB is a partner in CD LLP which receives, on 1 December 2014, an advance on account of profit share from a collective investment scheme structured as a limited partnership. On 31 December 2014 CD LLP distributes to AB £10,000 sourced from the advance received by CD LLP from the collective investment scheme.

This would have been treated as a disguised fee under the new legislation if it had been in place. On 31 December 2015, the collective investment scheme receives interest income that is allocated, via CD LLP, to AB.

The legislation does not apply to pre-6 April 2015 sums, and the interest income will be taxed as interest, rather than as trading income.

Example 9

AB is a partner in CD LLP. On 30 June 2015 he is advanced £10,000; this was in relation to arrangements when a new collective investment scheme was established on 1 July 2014. Profits arise which satisfy this cash drawing in 2017/18.

The legislation does apply, as the sum is received after 5 April 2015 and it does not matter that arrangements were set up pre-6 April 2015. The tax point for the disguised investment management fee is 30 June 2015 and so it is taxed as income of 2015/16.

Practical implications

Example 10

AB is a partner in CD LLP. AB pays income tax and class 4 NIC on her share of CD LLP's profits. In addition, £10,000 is treated as a disguised fee under the new legislation.

AB will need to report the fees as a separate trade on her tax return.