

Explanatory Note

Clause 40: Carried interest

Summary

1. These amendments make a number of technical changes to ensure that Clause 40 operates as intended.

Details of the amendments

2. Amendment 71 amends section 103KA(2)(a) of TCGA 1992, introduced by Clause 40. The amendment ensures that only the correct amount of carried interest is charged to capital gains tax, (and that no other chargeable gain or allowable loss arises in respect of that carried interest).
3. Amendment 72 amends section 103KA(6)(c) of TCGA 1992, introduced by Clause 40. The intention of the legislation is that any returns in respect of amounts contributed by a fund manager from their own resources so that they are an investor on their own behalf (termed: 'co-investment') are disregarded for the purposes of this legislation. Section 103KA(6) lists the deductions permitted in calculating chargeable gains which arise in respect of carried interest. This amendment ensures that certain employment income tax charges that could arise in relation to co-investment are not included in those deductions.
4. Amendment 73 amends section 103KA(7) of TCGA 1992, introduced by Clause 40. The amendment expands the coverage of the section to encompass acquisitions of rights to carried interest from all persons, including companies, not solely acquisitions from individuals.
5. Amendments 74 and 75 amend section 103KB(1) of TCGA 1992, introduced by clause 40. The amendment ensures that consideration received for variations of rights to carried interest is taxed as carried interest for the purposes of this legislation, in the same way as consideration received for disposals, cancellations and loss of rights to carried interest.
6. Amendment 76 deletes section 103KB(3) to (8) of TCGA 1992, introduced by clause 40. These provisions introduced a 'market value rule' that was intended to apply in certain circumstances where a fund manager no longer had entitlement to carried interest.
7. Amendments 77 and 78 amend section 103KE of TCGA 1992, introduced by clause 40. The amendments expand the coverage of this provision to ensure that any tax borne by any person in respect of the carried interest can be credited against tax charged under these provisions, and not solely the tax borne by the person charged to tax under these provisions.
8. Amendment 79 inserts new subsection (6) into section 103KE of TCGA 1992, introduced by clause 40. The amendment deals with circumstances where the person being charged to

capital gains tax has allowable losses brought forward. Section 2 of TCGA 1992 provides that such losses are set off automatically against chargeable gains arising in later years, at the earliest opportunity. This could work to the disadvantage of a person in receipt of carried interest where that carried interest is also chargeable to income tax or is charged to tax in the hands of another person such that the manager can claim relief from double taxation under section 103KE. The amendment permits some flexibility such that the person can reduce the amount of allowable losses brought forward that are to be set against capital gains arising from carried interest in those situations.

9. Amendment 80 inserts new section 103KEA into Chapter 5 of Part [X] of TCGA 1992. This addresses the position of external investors in the fund who may be affected by what is known as 'base cost shift'.
10. The legislation prevents a fund manager benefitting from 'base cost shift' when computing the chargeable gain which arises in respect of carried interest. In this context, 'base cost' means the consideration given to acquire an asset which is then deducted when calculating the chargeable gain, or allowable loss, that accrues to a taxpayer when that asset is disposed of. 'Base cost shift' involves some investors transferring some of their allowable cost of acquiring investments in the fund to the fund manager, thus reducing the manager's chargeable gains. This will increase the investor's chargeable gains by a corresponding amount. Many investors in funds affected by this measure are exempt from UK taxation (such as pension funds) so they will not be adversely affected by an increase in their gain. However, some investors are chargeable to UK tax and will have paid tax on a gain increased by shifting base cost to the fund manager. This amendment ensures that where the increase in base cost has been disallowed in the tax computation of the fund manager, then the amount of the increase is effectively allowed as a deduction in the hands of the investor who originally transferred that base cost to the fund manager.
11. Amendment 81 inserts new section 103KEB Into Chapter 5 of Part 3 of TCGA 1992. It deals with the question of when carried interest arises for the purposes of the chargeable gains legislation.
12. Section 103KEB(1) aligns the meaning of 'arises' with that in Chapter 5E of Part 13 of ITA 2007, which deals with the taxation of disguised investment management fees. Section 103KEB(2) makes this general rule subject to certain exceptions concerning 'deferred carried interest'.
13. Section 103KEB(3) defines what is meant by 'deferred carried interest'. Typically this involves carried interest that has been allocated to a fund manager but cannot be released to the manager at that time because further conditions need to be met, for example for regulatory purposes or to better align incentives for managers with the interests of investors.
14. Section 103KEB(4) provides that a sum arises for tax purposes when it ceases to be 'deferred carried interest' (typically, when the necessary conditions have been met). This is subject to section 103KEB(5), which provides that a sum does not arise if the 'enjoyment' conditions are not met, and there is no reasonable likelihood that they will be met.
15. Section 103KEB(6) sets out the 'enjoyment conditions'. These are broadly similar to those which apply for income tax relating to investment management fees. Section 103KEB(7) to (9)

provide further rules as to when the enjoyment conditions are or are not met.

16. Section 103KEB(10) and (11) introduce an anti-avoidance rule to ensure that arrangements with a main purpose of avoiding tax cannot be used to ensure that the 'enjoyment conditions' are not met.
17. Section 103KEB(12) to (14) introduce an anti-avoidance rule to ensure that arrangements are not put in place to take advantage of the deferral conditions.
18. Section 103KEB(15) imports the definition of 'connected' from section 993 of ITA 2007, with certain necessary adaptations. This definition applies rather than the definition at section 286 of TCGA 1992.
19. Amendment 82 deletes section 103KF(1) of TCGA 1992, introduced by clause 40. This provision is replaced by section 103KEB, introduced by amendment 81.
20. Amendment 83 inserts the definition of 'external investor' into section 103KF(2) of TCGA 1992. This is needed to provide a definition for section 103KEA, inserted by amendment 80.
21. Amendments 84 and 85 set out the commencement dates for these changes. The amendment to sections 103KB(1) and the whole of section 103KEB take effect from 22 October 2015. The other changes have effect from 8 July 2015, the original commencement date for these provisions.
22. Amendment 86 makes a small consequential amendment to section 103KF(4) to reflect the revised commencement provisions.

Background note

23. This legislation concerns the taxation of rewards paid to fund managers. The Government introduced legislation in Finance Act 2015 to ensure that disguised investment management fees are properly charged to tax as income.
24. The Government subsequently introduced legislation in the Summer Finance Bill 2015 to ensure that where 'carried interest' is charged to tax under the capital gains tax code, the full economic gain is brought into charge to tax. That legislation took effect from 8th July 2015.