



HM Revenue  
& Customs

# Taxation of performance linked rewards paid to asset managers

**Summary of Responses**  
9 December 2015

# Contents

1	Executive Summary	3
2	Overview and summary of responses	5
3	Option 1	7
4	Option 2	12
5	Employees	19
6	Summary of proposals and next steps	20
Annex A	List of respondents	21

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# 1. Executive Summary

## Background

- 1.1 The government announced at Summer Budget 2015 that it would consult on the circumstances in which fund managers' performance-related returns are to benefit from capital gains tax treatment.
- 1.2 The consultation "Taxation of performance linked rewards paid to asset managers"<sup>1</sup> was published on 8 July 2015 and closed on 30 September 2015. The consultation document set out proposals for introducing statutory criteria to determine when performance-linked rewards arising to investment fund managers are to be taxed as income or as capital gains.
- 1.3 HMRC received 23 responses from a range of businesses and representative bodies. These responses are captured in this document. Annex A contains a list of stakeholders consulted.
- 1.4 Chapter 2 summarises the responses and sets out some overarching and general comments made in response to the proposals. Chapters 3, 4 and 5 provide more detail about the replies to the specific questions and the Government's response.
- 1.5 Chapter 6 sets out next steps, including draft legislation for inclusion in the 2016 Finance Bill. Comments are invited on the draft clauses by 3 February 2016.

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<sup>1</sup> *Taxation of performance linked rewards paid to asset managers*, 8 July 2015: [consultation document](#)

## Headline summary of responses

- Most respondents understood the government's aim to establish a clear legislative test in place of the existing case law, and to ensure that capital gains tax was limited to performance-linked rewards arising from long-term investment activity.
- However, some respondents questioned the need for action in this area and stated that, in their experience, only funds which were carrying on long-term investment activity used the carried interest model. These respondents argued that any shift by funds that had historically treated themselves as trading (and used a fee structure to reward their managers) into a carried interest model which sought to access capital gains treatment was still at an early stage and that action should not be taken at this stage. Respondents were concerned that the asset management industry has had to deal with significant legislative changes in a number of recent Finance Acts. Respondents also criticised aspects of the proposed approach including its general nature in place of targeted rules and the potential compliance burden that could result.
- A majority of respondents were opposed to Option 1 on the basis that looking to a fund's intended investment strategy would retain the uncertainty in the existing law which causes concern for the government and taxpayers. Respondents also queried whether the government listing some assets and not others as being able to access CGT treatment is appropriate and argued that this could affect the ability of the asset management sector to innovate and respond to wider changes in the economy.
- The objective test established by Option 2 was the preferred option (although many stakeholders commented that neither proposal was attractive). Many respondents were concerned, however, by the prospect of an unexpectedly swift disposal dictated purely by market forces or commercial considerations impacting on the treatment of a performance-linked reward.
- While Option 1 represented the government's preferred approach when the consultation was started, having considered the responses received over the summer and the valid criticisms made of that proposal, the government has decided to proceed with Option 2. To ensure that this represents a robust regime which achieves the government's policy aim, the holding periods which were included in the original consultation document have been reviewed in the light of further analysis and longer holding periods are now proposed.

## 2. Overview and summary of responses

This chapter summarises the responses received during the consultation in relation to the overall merits of each of the two proposals, together with general comments about the proposals as a whole.

1. Respondents' views are sought on the two proposals which are explained in more detail below and their respective merits.

2. Do respondents believe that the above proposals will successfully prevent fund managers adopting carried interest planning in respect of funds which the government considers to be trading?

- 2.1 The consultation document set out two alternative proposals for determining the vehicles in which performance linked interests may give rise to capital gains rather than income:
- Option 1 would list particular activities which are, in the government's view, clearly investment activity such that a performance linked interest in a fund vehicle performing such activities may be charged to tax as chargeable gains provided certain conditions are met;
  - Option 2 would focus on the length of time for which the underlying investments are held.
- 2.2 The majority of respondents supported the Government's aim to prevent abusive tax planning in relation to performance linked rewards within the asset management sector. However, many expressed concerns that a further set of regulations within the industry would put an additional administrative burden on asset managers and could have an impact on the UK's status as Europe's leading centre for fund management. The respondents queried whether the scope of the proposals was proportionate to the perceived level of tax planning which they seek to address.
- 2.3 Almost half of the respondents expressed a preference for option 2 over option 1, as the 'time held' test was considered simpler to undertake and provided a greater degree of certainty.
- 2.4 A much smaller number of respondents expressed a preference for option 1, as it was based on the intended holding period of the investments at the time of acquisition, and therefore allowed for situations where investments are sold earlier than anticipated due to external factors. Possible practical difficulties with Option 2 were also highlighted.

Some respondents felt that neither option was particularly attractive and that a completely different approach is called for in any implementing legislation.

- 2.5 Most respondents agreed that either of the two proposals would successfully prevent fund managers adopting carried interest planning to achieve an inappropriate tax outcome. However, many also expressed concerns that the proposals may unintentionally disadvantage managers of certain funds.
- 2.6 Some respondents suggested that, if implemented, option 1 may be less successful than option 2, as funds may seek to structure their activities so that the investments made will fall within the defined categories of long-term investment activities.
- 2.7 Many respondents expressed concerns that either proposal would create a misalignment of the interests of the fund manager and the investors in the fund, which could cause tension or damage the reputation of the industry.
- 2.8 Several respondents suggested alternative proposals which would seek to define the activities which would not be eligible for capital gains tax treatment.

### ***Proposals and next steps***

- 2.9 The Government recognises the benefit of an option which is simpler, more objective and easier to apply in a way that provides clarity to the industry. The government therefore proposes to implement a set of rules based on option 2, involving a test to determine the average length of time for which the underlying investments of the fund are held.

## 3. Responses to questions relating to Option 1

This chapter summarises the responses received regarding the proposal set out in the consultation as Option 1. As the government has concluded that it wishes to proceed on the basis of Option 2, a specific government comment or proposal is not recorded against the responses to every question. Nonetheless, the government welcomes the responses received, which have helped to provide valuable background to the industry and its activities.

### 3.1 List of long-term investment activities

3. Respondents' views are sought on the above activities. In particular, comments are sought on whether there are any further long-term investment activities which should be considered for inclusion and whether the definitions above are sufficient to cover the intended activities.

3.1.1 The consultation document proposed that the list of activities to be considered long-term investment activities should include:

- controlling equity stakes in trading companies intended to be held for a period of at least 3 years;
- the holding of real property for rental income and capital growth where, at the point of acquisition, it is reasonable to suppose that the property will be held for at least 5 years;
- the purchase of debt instruments on a secondary market where, at the point of acquisition, it is reasonable to suppose that the debt will be held for at least 3 years; and
- equity and debt investments in venture capital companies, provided they are intended to be held for a specified period of time.

3.1.2 Respondents suggested a number of additions to the list as follows:

- primary market debt investments;
- non-controlling interests in unquoted trading companies;
- debt and equity investments in holding companies and non-trading entities;
- short-term bridging finance where this is made to secure a long-term investment;
- life insurance contracts;
- derivative contracts; and

- miscellaneous investment instruments if held in the course of and to facilitate a long-term investment activity.

3.1.3 Many respondents felt that the list was overly prescriptive, and that if this approach was adopted the list would need to be regularly updated in order to respond to innovation in the industry. Stakeholders also queried whether listing some assets and not others is justifiable and argued that this could adversely affect the ability of the asset management sector to innovate and respond to wider changes in the economy.

3.1.4 Some respondents queried the differences in the specified minimum hold period of the listed activities, and suggested that a single timescale should be applied to all types of investment.

### *Proposals and next steps*

3.1.5 The government recognises the difficulties in creating a legislative list of asset classes that can give rise to capital gains tax treatment. One of the attractions of Option 2 is that it avoids the need to specify any particular asset classes, and so does not come with a risk of failing to keep pace with developments in the asset management sector or wider financial markets.

## **3.2 Definition of “venture capital company”**

4. Comments are sought, in particular, in relation to how “venture capital company” should be defined, what investments in venture capital companies should be included and what further conditions should be met.
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3.2.1 Many respondents suggested that if option 1 were adopted the list of specified activities should be significantly expanded to reflect the broad spectrum of activities which funds engaging in long-term investment undertake, such that it would be unnecessary to define the term “venture capital company” specifically.

3.2.2 Some respondents suggested using the existing definition of “venture capital company” found within the FCA’s guidelines.



### 3.3 Provision for funds making mixed long-term and short-term investments

5. Comments are sought on whether provision should be made for funds carrying on different activities, not all of which will qualify as long-term investment. If so, would a series of bands representing different levels of long-term investment activity be workable?

3.3.1 The consultation document considered whether the approach needed to be modified to cater for funds which invest in multiple asset classes, and particularly sought to avoid the problems which would arise from specifying a “cliff edge” level of activities, which would alter the tax treatment of any performance linked interest. The document suggested introducing a number of bands of specified activity to determine the proportion of the performance linked reward which would be eligible for capital treatment.

3.3.2 More than half of the respondents felt that this approach would introduce a large degree of complexity to the calculation, and that there would be significant practical difficulties in implementing it. Several respondents felt that such an approach would be unnecessary given the rarity of funds which undertake several different types of asset management activity, while others suggested that it would be beneficial.

#### *Proposals and next steps*

3.3.3 The government recognises the complexity that could result from the approach originally proposed, especially given the rarity of funds that may face this problem in practice. This will not be an issue in the case of the government’s preferred option (Option 2) as it looks to all the assets held by a fund.

### 3.4 Potential for market distortion under option 1

6. Could a test which listed particular activities distort commercial decisions by fund managers around what investments a fund should make and how those investments should be structured?

3.4.1 Responses were mixed on this question. Many respondents felt that option 1 had the potential to distort commercial behaviours by incentivising fund managers to make investments which conform to the

list of specified activities and for new joiners to the industry to gravitate towards strategies which could give rise to CGT treatment.

- 3.4.2 Many respondents suggested that there may be a limited impact on existing funds but that there may be a significant impact on the structure of funds set up in the future, as these may seek to ensure that their activities fall within the scope of the list of specified activities.
- 3.4.3 In terms of specific investment decisions, respondents pointed to the strict regulatory regime that applies to asset managers and requires them to transact on a “best price” basis. Respondents also highlighted the commercial pressures in a highly competitive industry which would punish any decisions made on the basis of the asset manager’s tax treatment rather than securing the best return for investors. The “intention” based test under Option 1 also provided a considerable degree of comfort around unexpectedly quick disposals driven by market or commercial considerations. However, respondents did highlight the perception risks the approach could have for the UK’s asset management industry amongst overseas investors.

### *Proposals and next steps*

- 3.4.4 The government has decided in favour of Option 2, and the responses around the distortion of investment decisions in the context of an objective holding period test are discussed below.

## **3.5 Rewards paid to individuals managing mixed funds**

<p>7. Is it common for funds to carry on more than one of the activities listed above? If so, and different individuals are responsible for managing different assets, how is their performance linked reward determined and in what form is it paid?</p>
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- 3.5.1 Responses to this question were mixed. Some stakeholders suggested this situation is rare in practice, while others commented that it is not unusual for funds to carry on more than one of the listed activities.
- 3.5.2 Where different individuals are responsible for managing different assets their performance linked reward is most commonly determined according to the performance of the fund as a whole, but may be determined on a deal-by-deal or strategy-by-strategy basis.

3.5.3 The performance linked reward may be paid at the end of the fund, or as gains are realised throughout the life of the fund.

### *Proposals and next steps*

3.5.4 The government has decided to proceed with a version of Option 2. This looks to how long, on average, the underlying fund holds investments. This means the difficulties of catering for funds which carried on different specified activities will not arise.

## **3.6 Apportionment of rewards based on activity**

8. Comments are sought on how the proportion attributable to each activity could be determined.
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3.6.1 The consultation document sought views on how to determine the proportion of any performance linked reward attributable to each of the fund's activities and therefore the proportion eligible for capital treatment.

3.6.2 Respondents suggested a number of factors to consider in making such a calculation, including the amount of capital invested in each activity, the amount of time for which each investment is held, the value of each investment at the time of calculation, the amount of capital returned to investors in relation to each activity, and the profit attributable in relation to each activity.

3.6.3 Respondents expressed concern that such a calculation would present practical difficulties.

## 4. Responses to questions relating to Option 2

This chapter summarises the responses received regarding the proposal set out in the consultation as “option 2”.

### 4.1 Option 2 and the graduated system

9. Comments are sought on whether this proposal would be practical, and the proposed graduated system above.

4.1.1 The consultation document sought views on option 2, which would focus on the average length of time for which the fund holds investments. A graduated system was proposed, whereby the proportion of any performance linked-return eligible for taxation as a chargeable gain would increase incrementally from 0% to 100%. The consultation document included the following illustration of how the graduated system might operate.

<b>Average period investments held</b>	<b>Proportion of return eligible for taxation as chargeable gain</b>
Less than six months	0%
At least six months but less than one year	25%
Between one year and 18 months	50%
Between 18 months and two years	75%
Over two years	100%

4.1.2 Most respondents agreed that this proposal appeared simpler and would provide more clarity to the industry than option 1. However, some respondents expressed concern that calculating the average holding period for which the fund holds investments may present significant practical difficulties, and that the result would be arbitrary, as it does not take into account the intention of the fund’s investment strategy.

4.1.3 A number of respondents queried whether the holding periods required to access capital gains treatment (which were shorter than those outlined under Option 1) set out in the consultation document would be sufficient to achieve the government’s policy aim of restricting the carried interest model to funds carrying on long-term investment activity. During consultation meetings, it was suggested that some investment managers would be able to use the relatively short holding periods specified to

reduce the amount of tax that they pay as compared with their current treatment. These periods would not, therefore, have achieved the government's objectives of limiting the circumstances in which managers should be able to access capital gains treatment to situations where the fund is carrying on long-term investment activity. There would have been a significant risk that funds which undertook much shorter-term trading strategies would have been able to restructure their performance-linked rewards to access (at least partial) CGT treatment.

- 4.1.4 Several respondents stated that many funds make investments in a series of tranches for commercial reasons, and expressed concern over how the average holding period test would apply in this situation. These respondents argued that the test ought to operate on a portfolio company by portfolio company basis, such that the "start date" for all investments relating to a particular asset would be determined by the date of the initial investment. This would reflect the fact that the asset is being held in the long term, although the final tranche of investment may be made not long before the asset is sold. Such considerations would also apply where investments are rolled-over: it would be necessary to disregard the disposal and re-acquisition for the purposes of considering the length of time for which the investment is held.
- 4.1.5 Similarly, respondents indicated that investments were sometimes exited early for reasons outside the fund manager's control, and in such cases it would be inequitable for the activity to be considered to have a trading nature if the original intention had been to hold the asset as a long-term investment.
- 4.1.6 The key concern raised was that the method of calculation should be made clear, to ensure that the compliance burden is minimised as far as possible, and to provide certainty to the industry.

### ***Proposals and next steps***

- 4.1.7 The government has concluded that the required holding periods should be longer than the illustrative scheme set out in the consultation document. To ensure that the government's policy aim is achieved, capital treatment will apply when a fund's average holding period is four years or more. Income treatment will apply – however the performance linked reward is structured – where the average holding period falls below three years, while a graduated system will operate where the average falls between these two thresholds as set out below.

:

<b>Average Holding period</b>	<b>Proportion of any performance-linked charged to income tax</b>
Less than 36 months	100%
At least 36 months but less than 39 months	75%
At least 39 months but less than 45 months	50%
At least 45 months but less than 48 months	25%
48 months or more	0%

4.1.8 More detail about how average holding periods will be calculated is provided in the next section.

4.1.9 The government believes that with an average holding period test, isolated and unrepresentative transactions where a fund exits an investment unexpectedly quickly will not distort the tax treatment. Even where a fund holds a relatively small number of individual investments, one or two unexpectedly swift disposals should not materially alter the tax treatment of any performance linked rewards provided the activity of the fund as a whole represents genuine long-term investment.

4.1.10As outlined in more detail below, the approach adopted will generally mean a fund is not treated as ceasing to hold an investment where a restructuring or reorganisation takes place. The draft legislation also includes provision designed to ensure that debt and equity investments are, in certain situations, aggregated to avoid the need to track further investments, partial debt repayments or other disposals. HMRC is also willing to discuss other situations where the provisions could be said to misrepresent the average holding period of a particular type of fund and to explore any unintended consequences.

4.1.11In particular, the government understands that the investment model used by many venture capital funds may result in the above test producing a shorter average holding period and income tax treatment even where the fund is undertaking long-term investment activity. HMRC is keen to engage with industry representatives so as to ensure the average holding period test accurately reflects the activity undertaken by venture capital funds.

## **4.2 Calculation of the average holding period**

10. Respondents' views are sought on how the average holding period for a fund should be determined and whether this would be difficult to calculate in practice or likely to produce a misleading result.

- 4.2.1 Respondents largely agreed that the average holding period would need to be calculated as a weighted average based on either the proportions of investor debt, capital and debt, or investor proceeds attributable to the investments. Several respondents suggested that the calculation should be based on the whole fund, and not just the particular investments which contribute to the performance linked reward.
- 4.2.2 Many respondents raised the concern that it would be difficult to calculate the average holding period where a performance linked reward was paid before the fund ends, as it would not yet be known how long the assets would be held for, and therefore what the average holding period would be. For example, if a performance linked reward were paid at the end of the first year of a seven-year fund, the fund manager would either have to estimate the average holding period, which may not produce the correct result, or calculate the average holding period up to that date, which would result in the performance linked reward not being eligible for capital gains treatment. Either way the fund manager may subsequently need to amend their return once the average holding period can be accurately calculated at the end of the fund. Provision would need to be made for this in the legislation.
- 4.2.3 Several respondents indicated that in most cases the calculation could be made using information which was already being collected for other purposes. Some respondents suggested that in certain scenarios, for instance where a UK based investment manager is managing an overseas fund, there may not be sufficient information available to make the calculation.
- 4.2.4 Some respondents suggested that since this test would not take into account the intention of the fund the calculation may produce misleading results.

### ***Proposals and next steps***

- 4.2.5 The government proposes that the average holding period should be a weighted mean calculated by reference to the amounts originally invested by the fund in each relevant investment.
- 4.2.6 The test will look to the value originally invested by the fund. This will prevent subsequent fluctuations in value of investments distorting the calculation. Using the value invested also avoids the need for costly and subjective valuations where a fund invests in illiquid assets where there is no easily ascertainable market price.
- 4.2.7 Provision will be made for circumstances where some carried interest is paid out early in a fund's life, but the average hold period is expected to

bring the manager within capital gains tax treatment. This is intended to deal with the situation raised by many respondents during the consultation and summarised above (that the average holding period calculated at that point may not reflect the length of time for which assets will be held over the life of the fund), and to minimise the compliance and administrative difficulties that could result where a performance-linked reward is paid out early in the life of a fund which intends to hold assets for the long term.

4.2.8 There will also be provision to allow debt and equity investments to be aggregated and treated as a single investment (with further injections of funding or partial debt repayments being, in effect, ignored) in certain circumstances (for example, where the fund has a controlling stake in a company)

4.2.9 Whether a disposal has taken place for the purposes of calculating the average holding period will be determined by reference to the capital gains legislation. The government believes that this represents a comprehensive legislative framework, familiar to advisers, which already sets out when a disposal takes place (or is not treated as taking place). For example, the capital gains legislation contains extensive provisions around corporate reorganisations and restructurings and when they will not be treated as giving rise to a disposal. However, these rules will be modified where they do not work appropriately in this context (for example, the operation of the share-pooling rules will be changed). HMRC officials are willing to engage with stakeholders if they consider that any other provisions of the capital gains tax rules need to be amended for the purpose of this test.

4.2.10 Additional conditions will apply to direct-lending funds to ensure that capital gains tax treatment in respect of lending activity is limited to investment schemes which provide long-term committed finance and to ensure that other lenders do not try to move to a carried interest remuneration structure. The government believes that the above holding periods will cater for situations where some loans advanced by such a fund are repaid in advance of their contractual maturity date. However, HMRC is willing to discuss any cases where direct lending funds can evidence that returns from what is intended to be long-term investment activity may be re-characterised as income by events which are outside the fund's control and which are not catered for in the draft legislation.



## 4.3 Potential for market distortion under “option 2”

11. Could the use of a “time held” test distort commercial decisions around when an investment should be sold?

4.3.1 Over half of the respondents were of the opinion that the “time held” test could distort commercial decisions around when an investment should be sold, as it would create a conflict of interest between the fund managers and the investors. Several respondents considered that this depended on how the average holding period would be calculated, and indicated that if a straight line pro-rata percentage were applied rather than bands with “cliff edge” boundaries this effect may be mitigated.

4.3.2 Over a quarter of the respondents suggested that commercial decisions were unlikely to be affected, as fund managers are held responsible by the investors to make decisions conforming to the fund’s strategy, there are regulatory rules in place which govern this, and the fund managers would benefit from an increased return on the investment through sale at the most profitable time.

### *Proposals and next steps*

4.3.3 For most funds the government believes that their investment strategy will very clearly fall on the income or capital side of the average holding period test (which should also reduce any compliance burden in many cases). It will not, therefore, be practically possible for such funds to distort their investment decisions to an extent which will impact their tax treatment under the proposed rules.

4.3.4 Even where a fund is closer to one of the thresholds under the test, the government believes that the pre-existing regulatory regime and market forces will significantly mitigate this risk. Furthermore, with a weighted average approach, a fund would need to consistently (and potentially by a significant margin) distort investment decisions to affect the tax treatment of any performance-linked reward. This will compound the restraining effect of the surrounding regulatory and commercial constraints.

4.3.5 The government acknowledges, however, the potential for a perception risk amongst overseas investors in UK managed funds. The government believes the above factors, together with the holding periods specified in the test, should limit this risk. However, if any stakeholders believe there are other routes to help respond to concerns within the legislative

framework set out in the accompanying draft legislation, the government is willing to give them consideration.

## 5. Employees

### 5.1 Interaction with employment related securities rules

12. Comments are invited on how this proposal should interact with the employment related securities rules and whether the employment related securities rules are effective in preventing performance linked interests being granted to employees where the investment vehicle is not carrying on long-term investment activity?

- 5.1.1 Several respondents indicated that care would need to be taken to ensure that this proposal interacts effectively with the employment related securities rules and the disguised investment management fee rules to ensure that no double taxation is caused as a result.
- 5.1.2 A small number suggested that there could be a level of risk if the government relied on the employment related securities rules to prevent fund managers who are employees from accessing capital gains tax treatment where the underlying fund is not carrying on long-term investment activity.

#### *Proposals and next steps*

- 5.1.3 The government remains of the view set out in the consultation document, and does not envisage that the average holding period test will be applied to interests which come within the employment related securities rules. These rules establish a comprehensive regime for the taxation of securities (including interests in funds) received by reason of an individual's employment.

## 6. Summary of proposals and next steps

- 6.1 The government proposes to introduce legislation in the 2016 Finance Bill based on Option 2 looking to the average holding period of the fund's investments.
- 6.2 Draft clauses and explanatory notes are attached to this document. Comments on these draft clauses should be sent to HMRC by 3 February 2016.
- 6.3 Any Comments should be sent to CTIS – Specialist Policy Team, 3C/04, 100 Parliament Street, London SW1A 2BQ (or by email to [fundmanager.consultation@hmrc.gsi.gov.uk](mailto:fundmanager.consultation@hmrc.gsi.gov.uk))

## Annexe A: List of stakeholders consulted

Alcentra Ltd  
Alternative Investment Management Association (AIMA)  
Ashurst LLP  
BlackRock  
BlueBay Asset Management LLP  
British Private Equity and Venture Capital Association (BVCA)  
British Property Federation (BPF)  
Business Growth Fund plc  
Clifford Chance LLP  
Deloitte LLP  
Endless LLP  
Ernst & Young LLP  
Eversheds LLP  
Intermediate Capital Group plc (ICG)  
Kinetic Partners  
Macfarlanes LLP  
PricewaterhouseCoopers LLP  
Simmons & Simmons LLP  
Smith & Williamson LLP  
The Institute of Chartered Accountants in England and Wales (ICAEW)  
The Investment Association  
The Law Society  
Travers Smith LLP