Saffery

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Private equity: the taxation of fund managers

This briefing outlines the UK tax treatment of private equity returns, including fees, carried interest and co-investment.

Management fees

An investment manager generally receives fees linked to the value of assets under management. In principle, annual fees have been subject to income tax but carried interest and co-investment returns have been taxed as a capital gain (at a lower rate of tax).

However, specific rules (the Disguised Investment Management Fee or DIMF rules) prevent fees being forfeited in exchange for increased carried interest or co-investment returns. Any fees caught by the DIMF rules are instead treated as trading or employment income, subject to income tax, regardless of the fund structure.

The scope of the legislation is broad, catching all management fees and other payments from a fund structure which do not fall within specific carved-out definitions of carried interest and co-investment.

For a co-investment return to fall within the carve-out, both the investment and the return must be on comparable terms to the external investment. The legislation takes account of the practicalities of coinvestment arrangements and does not go as far as to require the terms of the investment and the return to be completely identical.

Carried interest (the fund manager's share of profits once a certain hurdle has been met) is specifically – and relatively broadly – defined for these purposes, with the aim of ensuring that amounts genuinely arising as a profit-related return are not caught.

Amounts falling within one of the exemptions will remain within the capital gains tax (CGT) regime, unless they fall to be treated as 'incomebased' carried interest as described below. However, the rate of CGT applicable to carried interest remains at 28%, whereas a rate of 20% applies to most other types of capital gain.

'Income-based' carried interest

Historically, carried interest returns have been taxed as capital gains arising on the disposal of a fund's underlying investment – a treatment preserved by the DIMF rules. However, they are now instead taxed as income if certain conditions are met.

This legislation targets performance rewards seeking to convert an income return into a capital gain. Whether carried interest is taxed to income tax or CGT will now be determined by looking at the average holding period of all the fund's investments, weighted to the value of those investments.

For carried interest to be subject entirely to CGT, this weighted average holding period must be at least 40 months. A holding period of between 36 and 40 months leads to an apportionment between income tax and CGT, and for any average holding periods of less than 36 months the charge will be entirely to income tax.

The rules are complicated and look at a fund its entirety: it will be important to take professional advice to ensure that amounts are brought into tax correctly.

It is possible to make a deferral election if the minimum 36 month holding period is not met at the point the taxation of fund managersthe carried interest is realised, but where it may be at some point later in the fund's life.

Capital gains tax – the end of base cost shift

Until 2015, the rules around the general taxation of partnership capital gains allowed for certain partners to reduce their taxable capital gains to a lower level than their actual economic gains. This was achieved through a 'base cost shift' following a change in profit sharing ratios. This allowed non-UK resident partners to shift the base cost to the UK resident partners, reducing their taxable capital gain.

Finance Act 2015 included rules to counter this with effect from 8 July 2015 and to tax instead the economic carried interest returns. Where an amount of carried interest does (after considering both the DIMF and income-based carry rules), fall to be taxed under the CGT rules the holder may now only reduce the gain by 'permitted deductions'

(broadly any sums paid for carried interest, which tend to be negligible) in calculating their taxable gains. Essentially, the full economic gain is subject to CGT and the normal capital gains base cost rules do not apply. These changes also extend to gains on co-investments which are taxed under the CGT rules.

Who is taxable?

Individuals who provide investment management services are taxable on carried interest irrespective of the legal owner of that carried interest.

Historically, trust ownership of carried interest was popular amongst nondomiciled executives. The interaction of the specific tax rules applying to trusts and the DIMF rules means that a 'dry' tax charge may arise on the executive (where the trust actually received the economic return of the carried interest).

However, such gains are excluded from other anti-avoidance rules, which should mean no double taxation arises.

In addition, HMRC have confirmed that distributions from trusts to allow an individual to pay this 'dry' tax charge will be taxable, but this tax will reduce the tax on the carried interest.

Non-domiciled executives

For non-domiciled individuals, carried interest returns are only treated as having a non-UK source to the extent that the carried interest holder has performed investment management services outside the UK, and provided the carried interest is not incomebased carried interest.

For an individual providing investment management services exclusively in the UK, this will mean that they are liable to tax on all of their carried interest (it will be treated as having a UK source).

The remittance basis is not available for income-based carried interest, even if investment management services are performed outside the UK.

A non-UK domiciled individual providing investment management services both in the UK and overseas will be taxable on an appropriate portion of their carried interest. The precise calculation can be complex – the rules look at the value of work done in particular locations rather than pro-rata day counting – and professional advice should be sought.

Looking forward

Other changes to the taxation of nondomiciled individuals have also had an impact on the taxation of private equity executives.

Non-domiciled individuals who have been resident in the UK for 15 of the last 20 tax years, are 'deemed domiciled' in the UK for tax purposes. Where deemed domicile applies, the individual will be taxable on all worldwide income and gains in the UK, regardless of where they perform their investment management services.

Changes have also been made to the taxation of partnerships, which may affect the reporting and allocation of profit shares. Fund managers should take advice on the impact of these changes.

For more information regarding any of the issues raised here, please speak to your usual Saffery partner, or contact Robert Langston:

Robert Langston, National Tax Partner
T: +44 (0)20 7841 4129
E: robert.langston@saffery.com

This factsheet is based on law and HMRC practice at 1 October 2020.