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United Kingdom Income Tax on Disguised Fund Management Fees

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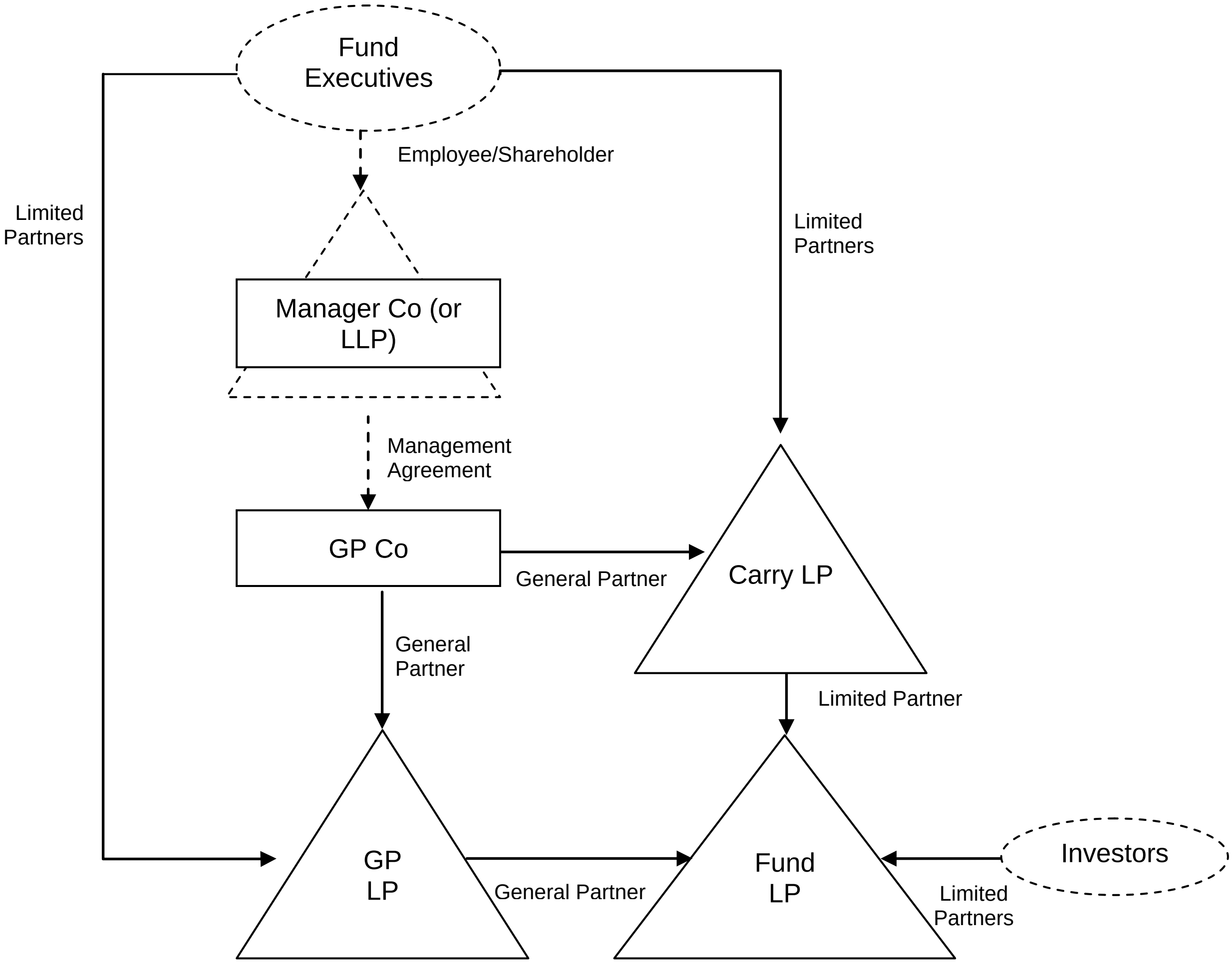
A new UK tax anti-avoidance measure has been introduced to prevent what are, in essence, fixed fees paid to individuals for investment management services being disguised as a share of the fund profits. From 6 April 2015, such amounts will be taxed as trading income. The new rule applies to all sums arising on or after that date, regardless of when the arrangements were made. The final version of the legislation responds to concerns on the part of the asset management industry about the commercial need to protect legitimate carried interest and co-investment arrangements.

Background

The measure targets certain arrangements whereby the typical annual fixed fee, based on funds under management (e.g., 2% of the funds committed or invested), is paid in such a way as to avoid an income tax charge on the individual recipients; for example, under so-called GP LP and GP LLP planning.

GP LP planning can be illustrated as follows:



In the illustrated structure, the fund is formed as a limited partnership (**Fund LP**) and the general partner of that limited partnership is itself a limited partnership (**GP LP**). The fixed fee is paid as a priority profit share by the Fund LP to the GP LP. To the extent that the GP LP allocates its profits to a general partner company, which in turn delegates the asset management function to a manager, the priority profit share should effectively be taxed as trading income and/or employment income, depending on the form of the manager entity. However, in some cases, the individual fund managers, as well as being members and/or employees of the manager entity, are also limited partners in the GP LP, and part of the priority profit share received by the GP LP is allocated directly to those individuals.

If the planning is successful, the individuals are taxed on their direct allocation of the priority profit share based on the nature of the underlying profits of the Fund LP, which will usually be capital gains (or investment income), rather than trading or employment income.

A GP LLP structure is similar, using an LLP, instead of a limited partnership, as the general partner of the Fund LP.

New measure

Under the new rule, if sums arise from a fund to an individual who is providing investment management services, and such sums are not carried interest, or a return of capital, or a return on sums invested, they are subject to income tax and national insurance contributions (at up to 47% in total), as deemed UK source trading profit, unless they are already charged to tax as profits from a trade or earnings from employment.

The remittance basis of taxation is not available to protect non-domiciled individuals from the tax charge.

Fund

The tax charge can only apply if the fund constitutes an "investment scheme". This is defined to include a "collective investment scheme" within the meaning of the Financial Services and Markets Act 2000.

However, most companies are not a collective investment scheme, so many hedge fund arrangements should not be affected.

Investment management services

The rule only applies where the individual performs "investment management services". These include (but are not limited to):

- Seeking investors;
- Researching potential investments;
- Acquiring, managing or disposing of assets on behalf of the fund; and
- Acting on behalf of the fund for the purposes of assisting a portfolio company to raise capital.

Her Majesty's Revenue and Customs (**HMRC**) say that the activities of all managers in a private equity fund should be covered.

Partnership

The legislation only applies when the arrangements involve at least one partnership. This might be a limited partnership or an LLP and includes any foreign entity which has the same characteristics as a UK partnership. It does not matter what role the partnership plays in the overall structure.

Sums arising

The rule applies to all sums arising to the individual, directly or indirectly, from the fund, including by way of a loan.

This includes situations where sums are routed via one or more other entities. For example, HMRC say that the rule would still apply if a passive company were interposed between the individual and the GP LP as shown by the dotted structure in the illustration above.

On the other hand, a genuine corporate asset management vehicle, such as the management company in the illustration above, does break the link, where it has sufficient substance to carry on the asset management activity, and actually does so with its own employees, contracts and other assets, and the individual receives an arm's-length rate of remuneration from the company. In that situation, if the individual is also a shareholder in the company, the dividends paid on his/her shares will not be caught.

In principle, this is equally the case where a UK resident, but non-domiciled, individual is claiming the favourable remittance basis of taxation in respect of his/her employee remuneration for services performed solely outside the UK for a non-UK resident management company (or his/her member's share of the profits of the non-UK business of an investment manager formed as an LLP).

However, HMRC say in their published guidance that particular attention will be paid to structures that rely on an argument 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 off-shore activity and the transfer-pricing of the transactions and also consider the potential application of other anti-avoidance provisions aimed at the diversion by individuals of income offshore.

HMRC takes the view that a sum "arises" when it is put at the disposal of the individual. It remains to be seen how this test will apply to arrangements for automatic re-investment of profits by the GP LP in the fund on behalf of the individual.

Where a partnership retains monies that have been allocated to a partner but which may be forfeited if performance hurdles are not met, in compliance with AIFMD requirements, sums will not be regarded as arising for the purposes of the new tax charge until they are actually made available to the individual.

Co-investment and carried interest exceptions

The measure takes an "if it's not out, it's in" approach, in that any amount received by the individual will be taken to be a "management fee" if it is not a repayment of an actual investment made by the individual in the fund, an arm's-length return on such an investment or carried interest. Therefore, the precise scope of those concepts is extremely important.

The original announcement in December 2014 contained narrow definitions of these carried interest and co-investment exceptions. They were widened after consultation.

Repayment of co-investments by managers in funds or returns on those investments are excepted, provided that the investments are on arm's-length terms. This means that the investments made by the managers must be of the same kind as investments that are made by external investors, 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. HMRC say that the fact that (unlike the external investors) the individual's return does not bear the cost of management fees or carried interest, or the fact that the individual has used funds borrowed on arm's-length terms to make the investment, does not prevent the return meeting the "reasonably comparable" test.

Carried interest must have returns that are genuinely contingent and vary with profits (as elaborately defined in the legislation). However, a minimum hurdle rate is not essential.

Geographical scope

A further important change from the first draft of the legislation relates to the territorial scope of the rule. Under the original proposal, if any of the management services were performed in the UK, then the entire sum would have been taxable in the UK. The final form of the legislation provides that sums are only taxable in the UK on a non-resident individual to the extent that (s)he performs the services in the UK. Any such potential liability is also subject to any applicable double tax treaty protection.

Anti-avoidance

To pre-empt the development of new structures to step around the new measure, the legislation includes a targeted anti-avoidance provision.

Conclusion

Care needs to be taken to ensure that the new anti-avoidance rule is not triggered, both in relation to new fund structures and, given that there is no “grandfathering”, in relation to existing arrangements.

If you have any questions regarding this memorandum, please contact Judith Harger in London (+44 20 3580 4705, jharger@willkie.com) or the Willkie attorney with whom you regularly work.

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