Remittance basis and carried interest

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A UK resident non-domiciled fund manager has asked whether the remittance basis applies to his carried interest, in light of the significant changes introduced by the July 2015 summer Budget, FA 2015 and FA 2016.

Typical fund structure

The typical structure employed by non-dom fund managers pre-July 2015 was as follows:

- The fund manager/investment advisor would establish either a UK LLP or UK limited company that he and others would own.
- The fund itself would typically include one or more tax transparent partnerships.
- The fund vehicle would comprise a vehicle that qualifies for a participation exemption for dividends and capital gains.
- The fund manager/investment advisor would receive: a management fee of circa 2% of total committed funds; and a carried interest in the fund (generally 20% of upside).

Carried interest

The carried interest was often structured via a separate partnership. (Scottish LPs are favoured because they have separate legal personality and are tax transparent, such that the manger is, in effect, investing directly in the fund.) The management fee is taxed as income, whereas the carry was subject to capital gains tax (this latter point was confirmed in the memorandum of understanding between the BVCA and Inland Revenue dated 25 July 2003).

Carried interest arises to fund managers as a reward for outperformance. However, before it becomes payable, all of the investors' original capital must be repaid, plus a defined return on their investment (the hurdle rate). For most PE funds, the hurdle is about 8%.

Carried interest is very tax efficient, as unlike all other forms of employment remuneration, carry holders (who paid nothing for their carry – it's always given to them for free) were able to utilise their investors' contribution as their own base cost (the 'base cost shift'). This had the effect of significantly reducing the effective tax rate on the carry (to circa 10% and even lower in some cases).

The base cost shift

The carry holders were able to use the investors base cost through utilising the flexibility inherent in the partnership rules and SP D12. These rules allowed partnerships to reorganise internally (primarily as regards movements/allocations of profit share) without triggering a disposal. As regards carry (a partnership asset), such a reorganisation would trigger a disposal with the offshore investors deemed to have disposed of their base cost to the carry holders. The 'kicker' was that, as the investors were not UK tax resident, there was no impact for them.

A further refinement to this (the 'enhanced base cost shift') meant that provided the carry partnership revalued the underlying investments every year, any upwards increase was added to the carry holder's base cost.

The net effect of these provisions was that carried interest was taxed disproportionately favourably when compared to other forms of employee equity participation, stock options, restricted stock, etc. Given the political and economic climate, such an imbalance was unlikely to be sustained.

Autumn Statement 2014

The genesis of the 2015 changes to the carried interest rules were contained in the Autumn Statement 2014 and FA 2015 that focused on disguised investment management fee income (DIMF) (ITA 2007 ss 809EZA–809EZD). The DIMF rules were designed to counteract arrangements whereby management fees were being recharacterised as carried interest rather than trading income. The DIMF rules provide the majority of the definitions for the carried interest provisions.

FA 2015

The reform to the tax rules governing carried interest was included in FA 2015 that promulgated TCGA 1992 Part III ss 103KA–103KF. The provisions put an end to the base cost shift and taxed carried interest on an equal footing with other forms of remuneration. Thus, where carried interest arises to an individual and that individual has not provided any consideration to acquire access to that carry, the full amount received is subject to 28% UK capital gains tax (carried interest is specifically excluded from the new 20% rate).

The particular rub of the new legislation is that it specifically targets UK resident but non-domiciled individuals (see TCGA 1992 s 103KC). Thus, to the extent the investment management services were performed in the UK, the remittance basis of taxation will be disapplied. This has far reaching consequences for investment activity in the UK.

Alternative strategies

Advising on the above matters has been depressingly difficult for the past 24 months, due to the way in which legislation was introduced and then repeatedly amended. Critical and far reaching changes were not introduced to the bills until the very last minute and it seems clear that no coherent or logical policy objective was determined prior to drafting the relevant legislation.

Our original proposal considered the use of employee shareholder shares (ESS) through which to structure the carried interest. While sufficiently flexible, a £100,000 cap on ESS, introduced in FA 2016 ss 88 and 89, put paid to the practical efficacy of these arrangements. Structuring arrangements to avail of entrepreneurs' relief (ER) was also considered but abandoned with the introduction of the phoenixing and cash box (transactions in securities) rules (see ss 33–35).

For the majority of the passage of Finance Bill 2016, it appeared that the easiest solution would be to exclude the use of any partnership structure from the whole of the fund arrangements. While this potentially complicated the position for the UK resident and domiciled participants, it was elegantly simple. However, the FA 2016 provisions were amended immediately prior to enactment to capture structures that did not include a partnership (see s 83(12)).

The net effect is that structuring carried interest for both domiciled and non-domiciled individuals to avail of lower effective rates is now rather complex. Given our client's mobility, the primary solution is for our client to spend as many days out of the UK as possible and undertake his activities whilst abroad. While undoubtedly tax effective, we worry that the unintended effect of the legislation will be to drive investment funds and their advisers from the UK. ■