Client Update

Receiving UK Carried Interest: The UK Metamorphosis

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"As Gregor Samsa awoke one morning from uneasy dreams he found himself transformed in his bed into a gigantic insect." So begins Kafka's angst-riddled story, "The Metamorphosis".

We're not suggesting that investment fund managers have physically changed into beetles, but HMRC have certainly altered their approach to the industry as if UK fund managers had in fact undergone a mass transformation. From benign indifference, almost overnight, there has been a change bordering on the repulsion evidenced by Gregor's family on his transformation (excluding carried interest from the new 20% capital gains tax rate is the most recent example of this treatment). Fund managers can be forgiven for feeling a little sensitive and it would be understandable if, like Gregor, they wished to hide under a sofa.

To recap, in the past year we've had the Disguised Investment Management Fee rules, abolition of base cost shift on carried interest and the deemed UK sourcing of carried interest all within a year. At times, the blend of absurdity bordering on surrealism which has characterised some of the proposals has lent a distinctly Kafkaesque feel to the proceedings. The latest set of changes around the income based carried interest rules is no different. The draft income based carried interest rules published in December last year were characterised by a lack of understanding of how carried interest works in a commercial setting. Particular areas of concern surrounded debt funds, funds of funds and secondaries, venture or other growth funds and anyone operating a non-standard buyout strategy.

Today the revised draft legislation has been published. As announced last week, the average holding period at which carried interest switches from "bad" or income based carried interest to entirely "good" carried interest, eligible to be taxed at the much lower capital gains tax rates, has been shifted from four years to **40 months**, with an accelerated taper starting at 36 months. This is a definite

improvement, and one which should bring a significant amount of comfort to many funds that they will fall outside of these rules.

This is the headline change announced in last week's budget, but the changes run much deeper and it is fair to say that the legislation has undergone a metamorphosis of its own—in no way as dramatic as that of man to bug, but much more beneficial to anyone receiving carried interest in the UK. That said, the rules are dense and definitely not for the fainthearted. Anyone approaching them should do so in a quiet room with a damp towel around their head and hours, if not days of time stretching out ahead of them. Given this, we set out in this update only the headline points arising from today's legislation.

- There will be a special regime dealing with **venture capital**. This regime will allow for follow-on investments and part disposals to be made into and out of minority-stake investments without resetting the average holding period clock. To get within this regime certain conditions need to be satisfied, including that the fund be a "venture capital fund" and that the "venture capital investment" is a "relevant investment". The conditions are fairly involved and delve into the nature of the portfolio company – for example, the fund's involvement in the board, what the portfolio company does with the investment, for how long it has been trading and whether there is an intention that the company may list.
- There will also be a regime dealing with funds investing in **real estate**. This regime takes into account the fact that often investments are not equity-based investments meaning that follow-on investments cannot be quantified in terms of equity holdings but rather as investments into the land or acquisitions of adjacent land. Again, to benefit from this regime the fund will need to satisfy certain conditions, amongst which is the requirement that the fund does not benefit from any other special regime under these rules and that over the life of the fund it will invest 50% of its value in land to be held for at least 40 months.
- The rules applying to **debt funds** have been revised significantly. The regime is now much more realistic, especially when read in conjunction with the unwanted short term investments exclusion (discussed below) which means that debt funds should no longer be penalised for syndicating out loans. We note that there is still the rebuttable assumption that a direct lending fund produces income based carried interest, which is unhelpful.
- Provision is made for "**unwanted short-term" investments**. This regime is helpful for funds, especially debt funds, who typically take large positions in an investment and then later syndicate out part of the investment. Inevitably

there are a series of conditions which need to be satisfied for an unwanted short term investment to be outside of the income based carry rules. Notably, the time limit for such disposal to take place is variable depending on the asset class; for investments in land the period is 12 months, securities in unlisted companies 6 months and "direct loans" either 120 days or 6 months depending on the other investments made by the fund. Broadly these timings seem in step with reality but will need to be borne in mind by management teams when planning such activities. The overall makeup of the fund's investments will also need to be considered: the regime ceases to apply once it is reasonable to suppose that 25% of the fund's investments will be in unwanted short term investments.

- **Funds of funds** and funds focussing on **secondaries** should also be able to take some comfort from the new rules. There are fairly involved conditions that need to be satisfied before the regime is available to an investment manager. Unfortunately, the rules as they stand do not appear to take account of the direct investment strategies that many secondaries funds operate. There are also targeted anti avoidance rules aimed at preventing people using the regime to reduce their proportion of income based carried interest by using fund of funds structures outside of a fund of funds strategy. Once within the regime, the investment team will be able to view the fund interest invested in as the "investment" for the purposes of the legislation rather than having to track through to the underlying portfolio investments.
- Carried interest is capable of being **conditionally exempt** from the income based carried interest rules for up to ten years after the day on which the fund starts to invest (rather than the four originally provided for) if the carried interest is calculated out of the fund's profits after the investors have received repayment of all or substantially all of their investments (be it on a whole fund or deal by deal basis).
- **Special opportunities funds** are covered with a new concept of "loan to own" which seems intended to allow a debt for equity swap to have one continuous holding period. The definition is however curiously tortured.
- The exclusion for carried interest holders operating in an **employee** environment has been retained.
- Investment managers receiving carried interest in the UK in respect of **services performed for the fund prior to their arrival** in the UK will be able to receive a proportion of their carried interest outside of this regime.

With each of these regimes the key will be passing the qualifying conditions – or passing through the gateway—to access the beneficial treatment. Careful consideration needs to be given as to what these conditions mean in practice,

how they interact with the rest of the legislation and what future fund and deal structuring should look like. Funds will also need to consider how they deal with investments not meeting the requisite conditions and for funds outside of the special regimes how they should treat carried interest on outlier investments.

This should give you a flavour of the legislation; on the whole it appears to be a step in the right direction, but it is certainly not going to be easy to navigate the new rules. We intend to supplement this update with a more reasoned analysis of the legislation and its implications in a series of breakfast seminars and conference calls on the 19 and 20 April, for which invitations will be sent shortly. We are, of course, very happy to speak with you in advance of these sessions.

Today's legislation takes effect for carried interest arising on or after 6 April 2016. We suggest that, where possible, investment fund managers postpone distributions of carried interest until the legislation has been fully considered. As Gregor reminded himself when trying to work out logistics in his new and confusing reality, "calm—indeed the calmest—reflection might be better than the most confused decisions."

Accepting that on the whole these changes are welcome, one is left pondering three questions, particularly in light of the penal rate at which carried interest is taxed as capital gain. The first is why do the rules have to be so complex? Secondly, is a 6 month period really appropriate as a dividing line between income and capital treatment? Finally, what is wrong as a policy matter with an investment doing well and being realised quickly? Another book of Kafka comes to mind: "The Castle".

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Please do not hesitate to contact us with any questions.