CARRIED INTEREST ACCOUNT CLEANSING

CARRIED INTEREST

Historically, the payment of carried interest was structured such that it was derived from an offshore entity and non-domiciled individuals were able to protect these returns from UK taxation using the remittance basis of taxation. However, in the 2015 Summer Budget on 8 July 2015, it was announced that carried interest would at a minimum be charged to UK tax to the extent that services were performed in the UK. As such, UK resident, but non-domiciled individuals would no longer be able to protect the entirety of their carried interest from UK taxation.

Carried interest is now subject to UK capital gains tax at a rate of 28% to the extent that services are performed in the UK. The remittance basis can still protect 'foreign' carried interest to the extent that services are performed outside the UK and that the funds are not brought into the UK.

CARRIED INTEREST NOW CHARGED TO UK CAPITAL GAINS AT A RATE OF 28%.

However, how can an individual practically segregate the carried interest received that relates to UK services performed and foreign services performed? Sometimes; the partnerships paying the carried interest can 'split' payments of carried interest between the UK and foreign services. However, this is not always possible, and it requires an accurate assessment of the individual's split of time before the payment of carried interest. Even if funds have now introduced procedures to segregate carried interest, distributions may have already been made to executives which were not segregated.

MIXED FUNDS

For those individuals seeking to utilise the remittance basis, we often see the creation of mixed funds containing carried interest. This can create significant problems when it comes to utilising funds in the UK. If the relevant partnership does not split payments; we often see the following scenario:

SCENARIO 1

Offshore bank account, funded with 100% of carried interest, for which 80% will be taxable in the UK and 20% will not be taxed in the UK.

In this basic example; if the individual claims the remittance basis the UK tax charge will be 22.4% of the total amount received (80% UK duties @ 28%). However, if the individual wanted to use the carried interest funds to pay the taxes due; the mixed fund rules would kick in and deem that the funds brought into the UK were first the foreign carried interest amounts. As such; the individual would increase their UK tax liability by 5.6% (20% foreign duties 'deemed' to be remitted @ 28%). Thereby getting no effective benefit from the remittance basis.

This document has been written for the general interest of our clients and contacts to stimulate further thought and enquiry. It does not contain answers to specific situations and it is therefore essential to treat it as a prompt to take specific advice on any real and particular issues. We believe that the facts as summarised in this document are correct as at the time of going to press in August 2018. If we discover that the document might be read in a way that conveys a misleading impression (whether by tone, content, error or omission) we will make the necessary changes and draw attention to what has been changed once we become aware of the need to do so. We will not be responsible for any action taken by a reader who relies on the document but does not seek further advice to answer any specific query. Frank Hirth PLC Registered in England and Wales: Number 03945095. © 2018 Frank Hirth

As previously mentioned, some funds request that their investment managers provide a split of their UK/foreign duties and can split the payments of carried interest between UK and foreign duties. This is a better situation, but still can create some significant issues such as the following scenario:

SCENARIO 2

Offshore bank account A

This account holds the 80% of the carried interest payments, based on the UK/foreign split that the investment manager provided.

Offshore bank account B

This account holds the 20% of the carried interest payments, based on the UK/foreign split that the investment manager provided.

Often when in this situation; the individual assumes that he has two distinct and useable baskets. Bank account A contains amounts taxed in the UK and therefore can be remitted. Bank account B contains amounts not taxed in the UK and should be kept overseas. At a basic level, this is correct, but there are some pitfalls to be wary of in relation to bank account A.

Firstly, the 28% rate of carried interest is a capital gains rate and assumes that the amount received is capital in nature. When using the remittance basis and not remitting these funds, this assumption remains valid. However; when the amounts are physically brought into the UK, HMRC taxes the true nature of the carried interest. As such; any investments in debt funds that can kick out a significant amount of interest income may be taxed at 45% upon remittance into the UK. We also see similar issues when it comes to real estate funds and when rental income is included as part of the carried interest received.

Secondly, the ability to assess the nature of the income received only works with entities that are considered flow through (partnerships) for the purposes of UK taxation. We often see an LP entity which will allow any capital gains generated to be passed onto the respective partners. However, we often see LLCs in fund structures which are considered opaque for the purposes of UK taxation. As such, any payments from an LLC to a UK resident will be considered dividend income, without regard for the capital gain that may have been generated.

Therefore, individuals should be wary of remitting the balance of bank account A into the UK without first understanding the underlying income/gains that have generated the carried interest and understanding how the funds will be treated upon remittance.

Both the scenarios outline how a UK tax liability can be generated, without an effective way of paying the associated tax due.

THE AMOUNT OF CARRIED INTEREST CAN DETERMINE HOW MUCH IS TAXABLE IN THE UK.

ACCOUNT CLEANSING ALLOWS INDIVIDUALS TO IDENTIFY AND SEGREGATE DIFFERENT TYPES OF INCOME AND GAINS WITHIN A MIXED FUND.

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ACCOUNT CLEANSING

Fortunately, there is a limited time opportunity to perform an 'account cleansing'. These rules were introduced at the same time as the new 'deemed domiciled' rules in April 2017 and provide a 2-year window for individuals to cleanse any mixed funds.

The account cleansing concession ends on 5 April 2019 and is a unique opportunity to arrange your offshore accounts and ensure that you are maximising your available UK funds.

Account cleansing allows individuals to identify and segregate different types of income and gains within a mixed fund without following the traditional mixed fund remittance ordering. In scenario 1; this would allow an individual to transfer out the UK element of the account to bring into the UK without first remitting the foreign portion. In scenario 2; this would allow the individual to identify any gains generated specifically from LPs (or other flow through entities), which can be remitted into the UK without incurring any additional charges.

To qualify for account cleansing an individual must have claimed the remittance basis in a year prior to 6 April 2017.

FUTURE PLANNING

Whilst we encourage individuals to utilise this limited time opportunity, we are also conscious that recipients of carried interest will not have the use of this concession post 5 April 2019. As such, it is imperative that payments after this date are structured in a way that individuals can utilise their UK taxed amounts in the UK.

Often, the funds have the ability and information available to split the carried interest payments efficiently, but a lack of knowledge around the subject can create problems down the line. Frank Hirth are happy to work with funds directly to harmonise the tax position of investment managers.

HIGHLY EXPERIENCED DUAL US/UK HANDLERS AS WELL AS SPECIALIST TEAMS.

For more information about any of these services, please contact Directors:

James Murray
James.Murray@frankhirth.com

Alex Jones
Alex.Jones@frankhirth.com

Michael Lewis
Michael.Lewis@frankhirth.com

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