HMRC Enquiries into the Tax Treatment of Carried Interest

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We are aware of an increase in the number of enquiries into the tax treatment of carried interests HMRC are raising at a House level, as well as at an individual level. These enquiries are typically aimed at several investment management professionals, and we expect this scrutiny to grow in light of the Budget. (See recent article on UK Budget 2021.)

The rules on the tax treatment of carried interest are complex. The introduction of the Disguised Investment Management Fees ("DIMF") and carried interest rules in 2015 marked a great change in the taxation of carried interest for investment management professionals working in the UK. As per our last article, HMRC published its long-awaited updated guidance on this matter in October last year, however much clarification is still needed on interpretation of the rules.

In this article, based on our experience, we have summarised some key areas of HMRC focus, how these enquiries can be dealt with and how we can help.

1. KEY AREAS OF HMRC FOCUS

The Carried Interest Exemption

Where the DIMF rules apply, amounts which are in substance management fees are subject to tax as trading income regardless of the underlying nature of those amounts at the fund level (income tax at max. rate of 45% and 46% in Scotland and Class 4 NIC at a max. rate of 2%). A key exemption from these rules is the 'carried interest' exemption, which if met means that amounts should be subject to capital gains tax at a lower rate of 28%. Even within this exemption amounts can still be brought back within the DIMF rules if certain conditions are not met.

We have noticed greater scrutiny by HMRC into the technical basis for deciding whether the carried interest exemption applies, from both investment managers and their advisors. We recommend a careful review of the application of the rules as well as documentation of the reasons for filing positions taken.

Employment Related Securities

To the extent that awards of carried interest are acquired by employees, then in general carried interests should be treated as Employment Related Securities ('ERS'). The ERS tax rules are very broad and capture arrangements which are not only made available by the employer but also by a person/entity connected to the employer.

The ERS rules can result in a PAYE and NIC withholding requirement at acquisition of the carried interest, and potentially on the ultimate pay-out. Further liabilities to income tax and employer NIC can arise if the investment manager does not reimburse their employer any PAYE due within 90 days of the end of the tax year in which the liability arose.

We have seen HMRC raise enquiries regarding why awards of carried interest have not been treated as ERS. These enquiries typically arise as part of a PAYE audit and go into the detail of whether individuals who are not currently treated as employees should be treated as employees.

Valuation of carried interest

The valuation of carried interest is very complex, requiring understanding of how and when returns are made and provided. Returns of carried interest are usually subject to various hurdles, which can be challenging to ascertain. Historically carried interests have often been reported for tax purposes as having nil-value, when HMRC would expect to see a more forward-looking approach (similar to the valuation of growth shares).

International issues

For non-domiciled individuals taxed in the UK on the remittance basis, it is no longer possible to treat carried interest as foreign source by reference to the situs of the assets disposed of (and which gives rise to the carried interest). Therefore, to the extent that they relate to UK investment management services, underlying assets that are non-UK situs will not be protected by the remittance basis.

We have seen a number of enquiries made into the technical basis of how this 'UK portion' is determined based on the current rules and HMRC guidance.

Depending on the residency of individuals receiving carried interest, foreign tax may have been imposed, and HMRC are also keen to understand the basis on which foreign tax credits have been calculated.

The above are just some key areas of focus that we have identified - by no means are they exhaustive. HMRC enquiries can arise at various points – as part of a PAYE audit, following submission of the annual ERS return in July each year, or following submission of the investment manager's self-assessment tax return. We have just seen a flurry of activity from HMRC raising queries before their 2-year enquiry window runs out on 2018/19 returns.

2. DEALING WITH ENQUIRIES

Whilst HMRC's enquiries may initially relate to a single investment manager, they could expand the scope to asking about others with the same carried interest arrangements. If so, the house should consider the potential approaches to take i.e. whether any disclosures should be made.

Where HMRC aims such enquiries at several investment management professionals, then this may be more effectively managed if the house coordinates responses. Consistency as well as ease of providing information to facilitate the enquiries can also be achieved.

Usually, deadlines are included as part of HMRC's enquiry letters and it is key to ensure efficiency in the provision of information to HMRC and streamlined communications.

3. HOW WE CAN HELP

Our experience in assisting clients with HMRC enquiries means we have developed an understanding into HMRC's interpretation of the DIMF and ERS rules and their approach to the tax treatment of carried interest. Houses and individuals receiving HMRC enquiries should determine solid strategies in how to deal with them effectively. At A&M Taxand, we can assist with HMRC enquiries including, but not limited to the following:

- Coordinating information from various parties and drafting responses;
- Acting as your nominated agent to deal with HMRC communications;
- Drafting communications to employees and investment professionals; and
- Developing tax and reporting compliant approaches in relation to your fund structures.

If you would like to discuss this or would like to discuss your fund structures more generally, please feel free to get in touch with your usual A&M point of contact, Louise Jenkins, Daniel Parry, Donald Campbell, Orion Ganase, Jordan Brown or Shirley Ly.

The Budget 2021: What You Need to Know

Chancellor Rishi Sunak has delivered the 2021 Budget. How do the policies outlined by the Chancellor impact UK businesses? Our experts have created a short report covering the tax implications across seven key areas, providing you with practical guidance on what you need to know

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