Analysis

Incentivising fund managers: carried interest v growth shares

Speed read

Incentivising managers in a tax-efficient way has always been a challenge for the funds industry, and carried interest structures have traditionally been a popular means of ensuring managers have a stake in the performance of the investments they manage without being taxed at unfavourable income tax rates on returns from those investments. The taxation of gains received by managers under these structures, as capital gains rather than trading income, is determined by HMRC's 1987 agreement with the BVCA and a subsequent memorandum of understanding. However, this is now being questioned and the recent crusade against carried interest and its vilification in the press are already encouraging consideration of alternative incentivisation structures. One such alternative which is particularly worthy of attention, on the basis that the pre-tax economics can be structured to be very similar to carried interest, is growth shares.

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One of the key challenges facing investors is how to incentivise those responsible for managing their investments and ensure that their interests are aligned with those of the investors. This challenge endures in large part due to the significant difference in the UK tax rates for income (subject to income tax at rates of up to 45% plus, for employment-related income, NICs) and for capital (subject to capital gains tax at a maximum rate of 20%, or 28% for carried interest or residential property). No-one wants to pay 47% tax if they can pay 20% or 28%, so it is important to individual managers that they receive returns in the form of capital where possible.

Carried interest

For the last few decades, carried interest structures have been popular with both individual managers and fund sponsors. In a typical carried interest structure, managers will acquire a relatively small carried interest in the fund (most commonly structured as a limited partnership) which will entitle them to a percentage of returns from the fund once the investors in the fund have received a return of the amounts invested plus an agreed return (e.g. 8%); once that hurdle is met, the carried interest holders would typically be entitled to 20% of further returns from the fund, which for a well-performing fund can be extremely lucrative. This type of structure is attractive to investors, as they get a priority return while the managers are incentivised to make sure the fund performs well, while managers are attracted by the prospect of significant rewards (acknowledging that they may get nothing if the fund does not achieve sufficient returns).

In addition, this type of structure has historically been beneficial to managers as HMRC agreed with the BVCA in 1987 (under the '1987 Guidelines') that they would respect gains received by managers through these structures as capital gains rather than trading income, while a subsequent memorandum of understanding entered into between HMRC and the BVCA in 2003 (the 'MoU') has the effect that such returns should not generally (provided the fund is structured in the way described in the MoU) be treated as employment income.

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There has been intense scrutiny of the tax treatment of carried interest over recent months, with the Labour Party committing to legislate to ensure that carried interest is taxed as income (describing the current arrangements as a 'loophole' in the tax system and arguing a change would address unfairness and generate additional tax revenues) and assertions being made that the 1987 Guidelines and the MoU offer a concessionary treatment that is incorrect as a matter of law (with a particular focus on the trading v investment distinction). In this context, particularly with judicial review proceedings being proposed, it seems plausible that changes may be made to amend or clarify the UK tax treatment of carried interest, which may push funds to consider alternative means of incentivising their managers – this may have a number of tax and non-tax consequences for those involved.

Recent legislative developments

With this background, it is worth noting that the last ten years have seen a number of legislative changes that have made the tax treatment of carried interest more complicated than much of the recent commentary would suggest and less favourable than was previously the case.

In particular, these changes include:

1. The introduction with effect from 8 July 2015 of TCGA 1992 Part 3 Chapter 5, which means carried interest holders no longer benefit from base cost shift when the carry hurdles are satisfied (i.e. they do not inherit the portion of the investors' base cost attributable to the percentage of the fund they acquire once the hurdles are satisfied, as was previously the case under Statement of Practice D12 as applied to carried interest structures by the 1987 Guidelines). This prevents carried interest holders getting a tax free windfall when the carry

hurdles are satisfied and means that they will be subject to tax on all gains from carried interest, thus bringing carried interest into line with other investments; and

2. The introduction with effect from 6 April 2016 of the income based carried interest rules in ITA 2007 Part 13 Chapter 5F, which provide that some or all of the returns from carried interest will be treated as income rather than capital (notwithstanding the 1987 Guidelines and the MoU) where the fund's average holding period for investments is less than 40 months. This is critical, as these rules essentially acknowledge the trading v investment (and therefore income v capital) distinction and address this by setting out a formal statutory basis for determining whether or not carried interest should be treated as income or capital, based on the average holding period of investments (which is one of the factors that would be taken into account in analysing trading status under the 'badges of trade' derived from case law, per HMRC's *Business Income Manual* at BIM20205 onwards).

The income based carried interest rules are particularly important in the context of the proposed judicial review of HMRC's treatment of carried interest pursuant to the 1987 Guidelines, since they override that treatment on a statutory basis which is not inconsistent with existing case law principles regarding what constitutes trading activity.

Is there an alternative?

Whether or not legislative amendments are actually made to the tax treatment of carried interest, the latest crusade against carried interest and its vilification in the press are already encouraging consideration of alternative incentivisation structures. Although not without critics, one alternative which is particularly worthy of attention, on the basis that the pre-tax economics can be structured to be very similar to carried interest, is growth shares. Growth shares are shares of a special class, the rights of which are designed to ensure that the holder of the shares benefits only from future growth. In the context of a comparison with carried interest, a hurdle can be applied to returns under growth shares in a very similar way as for carried interest, such that the growth shares would not have any immediate entitlement to returns but would be entitled to a share of returns above a specified threshold that has not yet been achieved at the date they are acquired. Growth shares will typically not carry any voting or dividend rights, although there is nothing preventing them from doing so, so the holders of growth shares would normally only receive any returns on a winding up or other exit (for example, via a sale).

Tax treatment of carried interest v growth shares

As already noted, growth shares can be structured in such a way as to achieve a similar pre-tax outcome to carried interest – but how does their tax treatment compare for managers?

(Note: What follows assumes that the manager is resident and domiciled for tax purposes in the UK only – if the manager is resident and/or domiciled elsewhere, the analysis inevitably becomes more complex. It also assumes that the manager is an employee of one or more entities in the fund structure – if the manager is a partner in an LLP, some of the analysis may be different.)

Acquisition of the carried interest/growth shares

For the manager, both carried interest (typically in the form of an interest in a limited partnership) and growth shares are likely to be treated as employment-related securities, on the basis that the manager's right to acquire the carried interest/growth shares arises by virtue of the manager's employment with the fund management entity. This means that, in both cases, the difference between the amount the manager pays to acquire the asset and the market value of that asset will be treated as employment income and subject to income tax (at a maximum rate of 45%) and NICs. (Note: The manager will typically be required to, and will want to, enter into an election under ITEPA 2003 s 431 (a 's 431 election') to provide for any upfront tax charge to be calculated by reference to the unrestricted market value of the relevant security (being the market value disregarding any restrictions, for example leaver restrictions) to ensure that any future appreciation is within the capital gains tax regime. This article assumes that a s 431 election would be made.)

> The pre-tax economics [of growth shares] can be structured to be very similar to carried interest

If the manager is acquiring carried interest and the fund structure is aligned with the typical fund structure outlined in the MoU and the other conditions set out in the MoU are satisfied, HMRC will generally accept that the amount paid by the manager to acquire the carried interest is the unrestricted market value of the carried interest at the date of acquisition such that no upfront tax charge arises.

There is no equivalent guidance for growth shares (at least so far as fund managers are concerned, as opposed to the managers in private equity backed investee companies), so the usual principles would apply and a formal valuation would be advisable. However, if similar hurdles apply as to a typical carried interest structure, it is likely that the growth shares would have a relatively low value at the date of acquisition such that the excess (if any) of that value over the price paid to acquire the growth shares may not be significant and any consequential tax impact may be small.

In either case, the manager's employer company would need to consider the position and make (and record) a reasonable best estimate of any PAYE liability for the company. To the extent any amount is to be treated as employment income, the employer company would be liable to deduct and account for income tax and primary class 1 NICs (or, if other amounts being paid to the manager are insufficient to permit such deduction, to enter into arrangements to collect those amounts from the manager) and also to account for the corresponding secondary class 1 NICs.

Returns while holding the carried interest/growth shares

For carried interest, once the hurdles are met, the manager will be entitled to a portion of the profits and gains of the underlying limited partnership as they arise (and will be taxed accordingly, even if those profits and gains are not distributed). Since the limited partnership structure through which the carried interest is held will be transparent for tax purposes, those returns will retain their original character and be taxed accordingly (unless the income based carried interest rules apply to recharacterise any amount as income). For example, interest will be taxed as income at the standard rates (with the maximum rate being 45%), dividends will be taxed as income at the dividend tax rates (with the maximum rate being 39.35%), etc. Some fund structures will permit 'cherry-picking' of income streams so that the managers' share can be satisfied using income or gains that will be taxed at lower rates in the hands of the managers.

The position is different for growth shares, as a typical growth share scheme would not generate returns while the manager holds the growth shares, as growth shares generally do not have any dividend rights. If growth shares do have dividend rights, interim returns would take the form of dividends and be taxed as income at the dividend tax rates (with the maximum rate being 39.35%).

Returns on an exit

On an exit from a carried interest structure at the end of the fund's life, a manager would typically be receiving distributions of capital gains from the underlying limited partnership which, subject to the application of the income based carried interest rules, would be expected to be treated as capital receipts subject to capital gains tax at the carried interest rate (which is 28% for higher and additional rate taxpayers).

If a manager were to dispose of their carried interest, this would typically be treated as a capital disposal (assuming that the manager has made a s 431 election to take the carried interest out of the restricted securities regime) and the same rates would apply.

A disposal of growth shares on either a sale or a winding up would be treated as a capital disposal (again assuming that the manager has made a s 431 election) and the standard capital gains tax rate (20% for higher and additional rate taxpayers) would apply.

(Note: Although a detailed analysis is beyond the scope of this article, there are clearly other tax distinctions to take into account in comparing the respective merits of an investment structure that facilitates carried interest and an investment structure that accommodates growth shares – in particular, since a limited partnership is transparent for tax purposes and therefore suffers no 'entity level' tax, for parity of treatment at holding vehicle level it would be necessary to ensure that a holding company issuing growth shares did not suffer any tax leakage. On the other hand, it is possible that a holding company structure would allow the surrender of losses or the tax-neutral transfer of assets between investee companies in a way that is not necessarily possible with a limited partnership as the holding vehicle, although this is subject to the structure of the growth share scheme and the relevance of these benefits in any given case. So there are a number of tax issues to be considered beyond the implications for the managers.)

Non-tax advantages and challenges of growth shares

From a structural perspective, the key difference between growth shares and carried interest is that the former involves an interest in a company while the latter is typically an interest in a (limited) partnership. This is significant if new managers come into a structure partway through its lifespan: a company issuing growth shares can issue additional classes of shares with different hurdles so that new managers do not benefit from prior growth (and thus do not dilute existing shareholders), but it is very difficult to achieve the same result through a partnership structure without involving multiple tiers of interests and disposals of partnership interests by other parties (with potential adverse tax implications). A growth share scheme may, therefore, actually offer greater flexibility to incentivise all managers appropriately throughout the lifetime of an investment programme.

However, when it comes to extracting returns, the company v partnership distinction results in the carried interest structure being more flexible: a partnership holding multiple investments can dispose of one and distribute the proceeds of that disposal without altering the fund structure or the treatment of future investments, while it is more challenging to extract capital from a holding company that has made a disposal due to company law restrictions around distributions, redemptions of share capital, etc.

This then raises questions around the level at which growth share schemes should operate: should growth shares be issued at investment level rather than holding company level? This would offer the opportunity for managers to benefit from exits from individual investments, but this alters the alignment of interests as sponsors would lose the incentivising effect of returns being based on aggregate performance. It also, arguably, requires the question of trading v investment to be reconsidered: might holding growth shares in multiple investee companies cause managers to be considered to be trading for tax purposes?

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Conclusion

In summary, it is by no means certain that there will be changes to the tax treatment of carried interest: significant change is likely to require a change in government, and the timing and outcome of the next general election are unknown. However, questions have been raised and there would certainly be merit in putting the principles set out in the 1987 Guidelines (to the extent not already overridden by statute) and the MoU on a statutory footing so that there is no debate around the intention of Parliament and the validity of the tax treatment that is applied.

If changes are to be made, the nature and extent of these is currently unpredictable, including as to whether they would be targeted specifically at carried interest or would apply more widely such that other incentivisation structures (including growth share schemes, which have their own critics) would also be affected.

In the meantime, sponsors would be advised to consider their options and ensure that they take advice on the ways in which they are contemplating incentivising managers, taking into account both tax and non-tax considerations (for the managers and for other investors), and that the managers understand the potential tax consequences of those arrangements. ■

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