KEY POINTS

What is the issue?

Carried interest is excluded from the normal protected settlement regime that applies to settlors who are not domiciled in the UK as a matter of common law.

What does it mean for me?

Those advising non-domiciled private equity executives resident in the UK are more constrained in the planning they can recommend, when compared to traditional techniques used for non-UK domiciliaries.

What can I take away?

An exploration of the advantages of UK-resident non-domiciliaries transferring carried interest to a trust and the ways to mitigate any 'dry' tax charges that may otherwise arise.

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Carry on, regardless

PATRICK HARNEY AND CHRISTOPHER EAMES OUTLINE TAX- AND ESTATE-PLANNING CONSIDERATIONS FOR CARRIED INTEREST IN THE UK

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Carried interest has recently come under public scrutiny in the UK, following the Labour Party's suggestion that it would tax carried interest as income should it win the next general election. Ironically, so far as the remittance basis and protected settlements are concerned, the rules relating to carried interest are more stringent than for other investment gains. Despite these restrictions, however, there are meaningful estate-planning advantages to settling carried interest onto a trust that constitutes an excluded property settlement for inheritance tax (IHT) purposes. Carried interest is an ideal asset for estate planning because it usually has a small value at the beginning and a large value at the end. With that in mind, this article explores the advantages of UK-resident non-domiciliaries transferring carried interest to a trust and ways to mitigate any 'dry' tax charges that may otherwise arise.

WHAT IS CARRIED INTEREST?

Carried interest dates from the 16th century, when a ship's captain on voyages from Europe to Asia and the Americas would, while contributing no capital, get 20 per cent of the profits from the carried goods in return for taking on the perils of the journey. In the

21st century, this has evolved into a remuneration structure favoured by private equity executives.

The broad principle of carried interest is that senior executives receive a proportion of the underlying return on the investments made by the fund once a certain hurdle has been achieved. Typically, investors must receive all of their invested capital back plus a return of 8 per cent before any carried interest will be paid. Once this hurdle has been achieved, the executives share in any further return on the investments, with this further return usually split 20:80 between executives and outside investors. As the private equity executives typically do not contribute significant amounts of their own capital, they are in effect carried by the other investors, hence 'carried interest'. For the purposes of this article, the authors will assume that the carried interest being transferred to a trust is subject to the carried interest capital gains tax (CGT) regime and will be taxed at the special rate of 28 per cent.[1]

THE BENEFITS OF EXCLUDED SETTLEMENT PLANNING

An excluded property settlement is a trust funded by an individual who is non-UK domiciled under common law and non-UK deemed domiciled that holds non-UK-*situs* assets. The prize of a well-structured excluded property settlement in IHT terms is significant:

- the non-UK assets[2] in the trust remain outside the territorial charge to IHT even if the settlor dies domiciled or deemed domiciled in the UK[3] and even where the settlor can benefit from the trust;[4] and
- as the trust assets are outside the territorial charge to IHT, they are outside the IHT relevant property regime in respect of entry, decennial and exit charges.

Any UK-*situs* assets in the trust will be subject to IHT in the ordinary way, subject to any applicable estate tax treaty relief.

APPLICATION OF EXCLUDED PROPERTY SETTLEMENT PLANNING

For excluded property settlement purposes, carried interest is just like any other asset. Provided the carried interest asset in the hands of the executive has foreign *situs*, the entitlement to carried interest can be transferred to an excluded property settlement. This allows non-UK domiciled and non-UK deemed-domiciled executives to transfer their entitlement to carried interest to a trust before the carried interest has paid out, in circumstances where they may have become deemed domiciled in the UK by the time the investments have been realised.

'The prize of a well-structured excluded property settlement in IHT terms is significant …'

PROTECTED SETTLEMENTS

An excluded property settlement is an IHT concept. By contrast, a protected settlement is an income tax and CGT concept. Whereas the same trust can and usually does constitute both, the rules for protected settlements are considerably more prescriptive than those for excluded property settlements. A protected settlement is a non-UK-resident settlement settled by a non-UK-domiciled and non-UK deemed-domiciled individual. Provided the settlor does not become domiciled in the UK as a matter of common law and the other relevant conditions are satisfied, the non-UK income and the capital gains[5] of the trust will be 'protected' from arising basis taxation[6] on a deemed-domiciled settlor until such time as they or another UK-resident beneficiary receive a benefit from the trust.

Protected settlement treatment does not apply to offshore income gains, which are taxed on a UK-resident deemed-domiciled settlor on an arising basis. When a UK-resident beneficiary receives an income distribution, it is taxed as income under general principles subject to the remittance basis. If the same beneficiary receives a non-income benefit or a capital payment from it, they will be subject to UK tax to the extent that benefit matches accumulated income and gains inside the trust and, where the remittance basis is available to the beneficiary, to the extent remitted to the UK.

CARRIED INTEREST IN A PROTECTED SETTLEMENT

Unfortunately, carried interest that falls within the 28 per cent CGT regime cannot benefit from protected settlement treatment. That is because carried interest has its own distinct code that determines when carried interest is said to 'arise' to an individual. In short, the definition of 'arise' means that when carried interest arises to the trustees of a trust, the carried interest will be deemed to arise to the settlor who will be taxed on the gain.[7] Importantly, the transfer of carried interest into a trust is deemed to be an occasion on which carried interest arises and the settlor is deemed to receive market value for the right to carried interest.[8] To the extent the investment management services were performed in the UK, the private equity executive will not be able to claim the remittance basis on the deemed gain regardless of the *situs* of the underlying investment.[9] In practice, this will require carried interest to be settled into the trust shortly after it is granted and before it has increased in value.

This is not to say that a protected settlement is useless for those entitled to carried interest returns. Although the carried interest will not be protected when it arises, the proceeds from the carried interest when they are paid out but retained in the trust can be used to invest in other assets that do benefit from protected settlement treatment. This is the case even if the settlor has by that stage become deemed domiciled in the UK and so would not be able to settle the proceeds arising from carried interest onto a trust if they were received personally.

His Majesty's Revenue and Customs also accepts that it is possible to make a distribution to the settlor with the purpose of allowing them to meet their tax liability when the carried interest pays out, without suffering a further charge to income tax or CGT under the matching provisions.[10] This ameliorates what would otherwise be a dry (or double) tax charge when the carried interest arises, which would act as a deterrent.

CONCLUSION

For those considering settling an excluded property/protected settlement, the takeaway from this article is that with careful planning one can carry on with carried interest.

#ESTATE PLANNING #INVESTMENT #RESIDENCY OR DOMICILE #TAXATION #TRUSTS #UK

1 s.1I(1)(a), *Taxation of Chargeable Gains Act 1992* (the 1992 Act) **2** Of course, as an excluded property settlement is a creature of UK domestic law, the potential application of the UK's ten estate tax treaties must always be considered. For example, art.5(4) of the *US/UK Estate Tax Treaty* gives exclusive taxing rights to the US in the case of a settlement created by a US domiciliary who is not a UK national, even if the assets are situated in the UK, with the exception of immovable property in the UK and business property of a permanent establishment in the UK. **3** s.48(3), *Inheritance Tax Act 1984* **4** This is accepted by His Majesty's Revenue and Customs (HMRC). See *HMRC Manual* at IHTM14396. **5** Other than gains from UK land and UK land-rich companies. **6** 'Arising basis' is the method of tax for those who are UK resident and domiciled. **7** ss.809EZDA and 993, 2007 Act **8** ss.17 and 103KB, 1992 Act **9** s.103KC, 1992 Act **10** *HMRC Manual* at IFM37430