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Case Number: TC09138

FIRST-TIER TRIBUNAL
TAX CHAMBER

Appeal reference: TC/2021/02740
TC/2021/02791

Carried Interests - application of transitional provisions in F(No.2)A 2015; interaction of section 103KA(2) TCGA and the QCB rule – are QCBs assets?

Heard on: 7 & 8 November 2023
Judgment date: 17 April 2024

Before

TRIBUNAL JUDGE BOWLER
MS CATHERINE FARQUHARSON

Between

CHARLES FERGUSON-DAVIE
NICK EDWARDS

Appellants

and

THE COMMISSIONERS FOR HIS MAJESTY'S REVENUE AND CUSTOMS

Respondents

Representation:

For the Appellant: Nicola Shaw KC, instructed by the General Counsel and Solicitor to HM Revenue and Customs

For the Respondents: Akash Nawbatt KC and Bayo Randle of Counsel, instructed by Herbert Smith Freehills LLP

DECISION

INTRODUCTION

1. The Appellants are private equity investors who were partners as such in Moorfield Real Estate Fund II Carried Interest Limited Partnership ("the CIP"). They became entitled to amounts of carried interest ("the Carried Interest Amounts") in the tax year ended 5 April 2016. The appeals concern amendments to the Appellants' tax returns for that year pursuant to new provisions introduced by the Finance (No. 2) Act 2015 ("F(No.2)A 2015") directed at the taxation of carried interest and similar returns. Prior to the introduction of F(No.2)A 2015 recipients of carried interest structured through investment via a partnership benefitted from what was described as the "base cost shift" which, in essence, reduced the chargeable gain taxed. The new provisions removed the base cost shift. They were introduced with immediate effect on announcement, but certain amounts of carried interest – those which arose "in connection with the disposal of…assets of…partnerships" before 8 July 2015 – were grandfathered such that they continued to be taxed under the previous rules.

2. The main issue for determination is whether the grandfathering provision (in s. 43(2) F(No.2)A 2015) applies. If so, then the amounts are not chargeable under the new provisions contained in s. 103KA-KH Taxation of Chargeable Gains Act 1992 ("TCGA") (and indeed are not chargeable to capital gains tax ("CGT") at all because under the old regime no chargeable gain in fact arose).

3. These are lead cases under Rule 18 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Regulations 2009 in relation to common or related issues of fact or law relating to profits or gains that were distributed to the CIP in the tax year ended 5 April 2016. The appeals of 24 other individuals who were limited partners in the relevant year, and who were entitled to a share of profits or gains distributed to the CIP, were stayed until 60 days after the release of the Tribunal's decision in the lead appeals.

BACKGROUND AND PROCEDURE

The assessments / amendments under appeal

4. The Appellants appeal against closure notices issued to each of them under Section 28A(1B) and (2) Taxes Management Act 1970 by HMRC on 16 and 18 July 2019 assessing them to capital gains tax applying the carried interest legislation at s103KA-KH TCGA.

BURDEN OF PROOF

5. The burden of proof rests with the Appellants to show that they are entitled to apply the rules applicable to carried interest payments prior to 8 July 2015 to the Carried Interest Amounts. The ordinary civil standard of the balance of probabilities applies.

EVIDENCE

6. There is a hearing bundle of 2033 pages. Within that is a statement of agreed facts.

7. Mr Ferguson-Davie was not cross examined. His Witness Statement was taken as read. Mr Edwards also gave evidence orally at the hearing and was cross examined. We find that his evidence given orally on the first day of the hearing and in his Witness Statement was consistent and reliable and we have given it full weight.

8. On the second day a note regarding the calculation of the internal rate of return ("IRR") for the CIP was handed to us in response to questions we had raised about how it had been calculated. We have given the evidence in that note less weight where it is inconsistent with the evidence provided otherwise. In particular, the note said that the IRR based on both actual returns and unrealised returns was 11.3% by 30 June 2015. However, as we explain below this was not the measure used to calculate whether the hurdle to pay the Carried Interest had been

passed under the limited partnership agreement. We therefore rely on the evidence of the bundle and the oral evidence to make findings as to when and on what basis the IRR of 9% was reached.

AGREED FACTS

The CIP

9. The CIP was registered as a limited partnership in England and Wales under the Limited Partnerships Act 1907, under Registration No. LP012498, on 4 October 2007.

10. The relationship between the partners in the CIP is governed by a limited partnership agreement that was amended and restated on 26 November 2015.

11. The general partner of the CIP is Moorfield Real Estate Fund II CIP Limited. All of the limited partners in the CIP in the relevant period for these appeals (being the tax year ended 5 April 2016) were individuals who were employed by and worked for companies in the group of companies of which the parent company is and was Stessa Trading Limited, and which included Moorfield Group Limited and Moorfield Investment Management Limited (the "Moorfield Group").

The Funds

12. The CIP was a limited partner in two real estate investment funds, named Moorfield Real Estate Fund II "A" Limited Partnership ("MREF II A") and Moorfield Real Estate Fund II "B" Limited Partnership ("MREF II B") (together, the "Funds").

13. The Funds are limited partnerships governed by English law and were formed on 26 October 2007 for the purpose of making, owning, and managing real estate investments.

14. The relationship between the partners in each of the Funds was governed by a limited partnership agreed that was amended and restated on 8 July 2013 (each an "LPA"). The LPAs are in substantially the same terms. Under the LPAs, each of the partnerships was established for a term of eight years, ending in October 2015, which could be extended by agreement.

15. The Funds shared a common general partner, Moorfield Real Estate Fund II GP Ltd (the "General Partner").

16. In addition to the CIP, there were several other limited partners in each of the Funds (the "Limited Partners", which term does not include the CIP for the purpose of this statement of facts).

17. The General Partner appointed Moorfield Investment Manager Limited as the Investment Manager of each of the Funds and appointed Moorfield Group Limited as the Asset Manager of each of the Funds.

The investments made by the Funds and their subsequent disposal

18. Between July 2008 and April 2012, the Funds acquired 16 UK real estate investments (each a "portfolio investment") and continued to make further investments in the portfolio investments after April 2012.

19. MREF II A and MREF II B acquired and held each of the portfolio investments in parallel, with MREF II A holding an interest of approximately 54.7% in each portfolio investment, and MREF II B holding an interest of approximately 45.3% in each portfolio investment.

20. In the period from February 2009 to March 2013, the Funds drew down a total of £388.8 million of capital that had been committed by the Limited Partners, substantially all of which was in the form of loans from the Limited Partners to each of the Funds.

21. The Funds were managed as if they were a single fund, and combined quarterly financial reports were prepared for the partners in the Funds.

22. A table of the portfolio investments is set out in Schedule 1, showing the dates of acquisition and disposal of each of the investments, the equity cost (i.e. cost of investment made by the partners in the Funds) and the amount realised on disposal for each investment.

23. Between January 2010 and August 2014, the Funds disposed of six of the portfolio investments.

24. In December 2014, the Funds contracted with a real estate fund managed by Lone Star Global Acquisitions, Ltd., a US-based private equity real estate firm, to dispose of nine of the remaining 10 portfolio investments (the "Lone Star Transaction"). The majority of these disposals were completed on 6 February 2015 and the final disposal under the Lone Star Transaction, of a 50% shareholding in a company named New Sovereign Reversions Limited, was completed on 1 June 2015.

25. Following the completion of the Lone Star Transaction, the one remaining portfolio investment was in a company named Audley Court Limited which, together with its subsidiaries, was in the business of developing and operating retirement villages in the UK (the "Audley Court" portfolio investment).

26. On 14 December 2015, the Funds contracted to sell the Audley Court investment to an entity owned by Moorfield Audley Real Estate Fund "A" Limited Partnership and Moorfield Audley Real Estate Fund "B" Limited Partnership ("MAREF"). The partners in MAREF included the CIP, a number of the Limited Partners in the Funds, and other external investors. The disposal was completed on 14 December 2015. The sale price for the disposal was £158.6 million, of which £30 million was deferred consideration that was payable on 6 January 2015.

The net income and gains of the funds

27. The quarterly accounts of the Funds for the quarters ended 31 March, 30 June, 30 September and 31 December 2015, and 31 March 2016, show that the net income and gains (i.e. the net realised profits) of the Funds at the end of each quarter were as set out in Schedule 2.

Allocation of net income and gains

28. Pursuant to Clause 8 of each of the LPAs, the net income and gains/losses of the Funds were required to be allocated to the partners in the following order of priority:

(1) first, to the Limited Partners until they had each been allocated a preferred return in an amount equivalent to a 9% per annum annually compounded internal rate of return ("IRR") on their loan and capital contributions to the Funds ("Preferred Return");

(2) second, 40% to the Limited Partners and 60% to the CIP, until 20% of all allocated profit had been allocated to the CIP; and

(3) thereafter, 80% to the Limited Partners and 20% to the CIP.

Distributions to partners

29. Pursuant to Clause 9 of each of the LPAs, the proceeds of the disposal of assets, and any other net income and gains of the Funds, were required to be distributed to the partners in the following order of priority:

(1) first, in payment of the General Partner's Share;

(2) second, in repayment of contributions made by the General Partner;

(3) third, in repayment of capital contributions made by the Limited Partners;

(4) fourth, in repayment of loans advanced to the Funds by the Limited Partners; and

(5) fifth, in distributing profits that had been allocated to the partners under Clause 8 of each of the LPAs, in the same order of priority as the profits were allocated (i.e. in the same order of priority as is set out in paragraph 28 above).

30. The dates and amounts of the distributions that were made by the Funds to the Limited Partners and to the CIP up to and including 6 January 2016 are set out in Schedule 3. The distributions to the CIP were in in the sum of £42,160,149.50, of which £32,160,149.50 was distributed in cash, with the remaining £10m being reinvested into MAREF. The parties are agreed that the total amounts allocated to the CIP (as above) satisfy the definition of "carried interest" in s.103KH (1) TCGA 1992 and ss. 809EZC-D Income Tax Act 2007 and "arise" within the meaning of s.103KG TCGA 1992 and s.43 (5) Finance Act (No.2) 20151.

31. For the avoidance of doubt, HMRC's position is that the 9% IRR (per paragraph 28(1). above) was not reached until the disposal of Audley Court and it was only then when the CIP (in which the Lead Appellants were partners) became entitled to allocations and distributions from the Funds (as per Clause 8 and 9 of the LPAs).

FINDINGS OF FACT

32. We make the following additional findings.

33. The Audley Court investment was the largest investment made by the Funds. Its cost was shown in the accounts as £161.1m whereas the next largest investment was shown at a cost of £66.1m. The total cost of the investments was £462.1m.

34. The sale of the Audley Court investment was the last disposal made by the Funds. All other investments had been sold before 8 July 2015 and all had been at a profit. The sale of the Audley Court investment was at a loss and it was the only one sold at a loss.

35. The cash proceeds of the disposal of Audley Court were used to make distributions to the Limited Partners in satisfaction of their preferred return. However, as it was sold at a loss the profit which was reflected in the Carried Interest Amounts was not generated by the sale of the Audley Court investments.

36. On 14 December 2015, the remainder of the Limited Partners' preferred return (£81,007,208) was allocated and distributed to them as well as part of their entitlement to the profits in excess of the preferred return (£13,333,333) and part of the carried interest owed to the CIP partners (£20m) (see Schedule 3).

37. On 6 January 2016, the remainder of the Limited Partner's entitlement to the profits in excess of the preferred return (£18,133,158) was allocated and distributed to them as well as the remaining part of the carried interest owed to the CIP partners (£22,160,150) (see Schedule 3).

38. The Carried Interest Amounts arose after 8 July 2015; they arose on 14 December 2015 (as to £20m) and 6 January 2016 (as to £22,160,150) when the Carried Interest Amounts were allocated and distributed to the partners of the CIP.

39. The completion of the Lone Star Transaction had allowed the Funds to distribute £320 million to the Limited Partners on 9 February 2015. £263.8 million of the £320 million completed the repayment of the Limited Partners' loan and capital contributions of £388.8 million, and the remaining £56.2 million was a distribution of profits. The Funds also retained cash reserves in order to support the business plan for the Audley Court investment.

40. The proceeds of the pre-Audley Court disposals which arose prior to 8 July 2015 were allocated and distributed to the Limited Partners (with some cash retention for the Audley Court

investment) and not the carried interest partners. The carried interest partners were not liable to tax on those disposal proceeds received by the Limited Partners.

41. The carrying value of the Audley Court investment in the Funds' accounts was lower than the cost of the investment, because the carrying value was equal to the net asset value of the Audley business, which had been loss-making.

42. As Mr Edwards explains in his Witness Statement, for the purposes of allocation and distribution of profits to partners, net income and gains would not include any unrealised gains or losses such as accounting adjustments to reflect changes in fair value: only realised income and gains could be allocated and distributed. This is consistent with the terms of the LPA which defined the capital gains and losses allocated to the partners as the realised gains and losses.

43. As Mr Edwards further explains, the precise amount of the 9% IRR could only be ascertained once it had been paid, which meant that there was no formal allocation of any net income and gains to the CIP before the Preferred Return had been paid to the Limited Partners.

44. In the "Chief Finance Officer's review" which Mr Edwards prepared for the second quarter of 2015 (June 2015) quarterly reports, he included the following regarding the recognition of carried interest (i.e. allocations and distributions of profit to the CIP):

> "In line with our UK GAAP accounting policy we are only permitted to recognise carried interest when it is likely to arise, so we have not yet included provision for it in the UK GAAP accounts."

45. Substantially the same note was included in the quarter three (September 2015) accounts which even at that stage included a note saying:

> "The NAV is stated before carried interest, as it is the [General Partner's] view that the likelihood of a carried interest payment accruing remains contingent on future realisations and is not sufficiently likely to permit inclusion in the quarterly accounts".

46. As Mr Edwards confirmed orally, whether the fund passed the 9% IRR hurdle could not be determined until the Audley Court investment was sold. Furthermore, in order to achieve the 9% IRR Audley Court had to be sold for a minimum price. This in turn meant that whether carried interest would be payable at all was dependant on the Audley Court investment being sold and the price at which that sale took place. The sale in fact realised proceeds of £157.1 million but a sales price was not sufficiently certain by 30 September 2015 for the carried interest to be recognised in the accounts. In May 2015 Lone Star had valued the Audley Court investment at no more than £55m.

47. An IRR calculation of 6 January 2016 prepared by Mr Edwards shows that:

(1) the Limited Partners' loan and capital contributions were repaid in three tranches,: by a distribution of £25 million made on 27 March 2014, a distribution of £125 million made on 13 August 2014, and a distribution of £263.8m made on 9 February 2015 (forming part of a distribution to the Limited Partners of £320m in aggregate that was made on 9 February 2015);

(2) from that point onwards, distributions of net income and gains (i.e. of the profits of the Funds) could be paid, firstly to the Limited Partners in satisfaction of their entitlement to the Preferred Return on investment representing a 9% IRR. The calculation shows that the 9% IRR threshold was satisfied by distributions to the Limited Partners on 9 February 2015 and 14 December 2015 in the total amount of £137,174,108 (described in the IRR calculation as "Cashflows to achieve 9% IRR of which £56,166,900 was paid on 9

February 2015 and £81,007,208 was paid on 14 December 2015 (as part of a distribution of £94,340,541.42 to the Limited Partners);

(3) after payment of the Preferred Return to the Limited Partners, the CIP became entitled to receive distributions of profit alongside the Limited Partners, which amounted to £42,160,149.95 of profit distributions to the CIP in aggregate on 14 December 2015 and 6 January 2016.

48. The disposal of the Audley Court investment yielded sufficient proceeds to satisfy the Preferred Return (thereby entitling the CIP to share in the profits of the Funds (i.e. to carried interest)) and it enabled the overall level of profit to be established. However, as a loss-making disposal, it could only detract from (as opposed to contribute to) the profits which the Carried Interest Amounts represented. As far as those profits were concerned, they were generated in their entirety by the prior disposals.

49. The investment in Audley Court was in the form of a qualifying corporate bond ("QCB").

THE LAW

50. Section 43 FA 2015 inserted new provisions into the TCGA as follows.

51. Section 43(1) inserted the new s103KA TCGA which stated:

> (1) This section applies where—
>
> (a) an individual ("A") performs investment management services directly or indirectly in respect of an investment scheme under arrangements involving at least one partnership, and
>
> (b) carried interest arises to A under the arrangements.
>
> (2) If the carried interest arises to A in connection with the disposal of one or more assets of the partnership or partnerships—
>
> (a) a chargeable gain equal to the amount of the carried interest less any permitted deductions (and no other chargeable gain or loss) is to be treated as accruing to A on the disposal, and
>
> (b) the chargeable gain is to be treated as accruing to A at the time the carried interest arises.
>
> (3) If the carried interest arises to A in circumstances other than those specified in subsection (2), a chargeable gain of an amount equal to the amount of the carried interest less any permitted deductions is to be treated as accruing to A at the time the carried interest arises.
>
> (4) Subsections (2) and (3) do not apply in relation to carried interest to the extent that-
>
> (a) it is brought into account in calculating· the profits of a trade of A for the purposes of income tax for any tax year, or
>
> (b) it constitutes a co-investment.repayment or return.

52. Therefore s103KA(2) deals with carried interest arising in connection with the disposal of one or more assets of the partnership and s103KA(3) deals with carried interest arising in other circumstances (for example, the receipt of dividends).

53. Section 103KH TCGA provides that carried interest "in relation to arrangements referred to in section 103KA(1) (a), has the same meaning as in section 809EZB of ITA 2007 (see sections 809EZC and 809EZD of that Act)".

54. Section 809EZC provides the meaning of "carried interest" as follows:

(1) For the purposes of section 809EZB "carried interest" means a sum which arises to the individual under the arrangements by way of profit related return.

This is subject to subsections (3) to (8) (sums where no significant risk of not arising); and see also section 809EZD (sums treated as carried interest).

(2) A sum which arises to the individual under the arrangements does so by way of "profit-related return" if under the arrangements—

(a) the sum is to, or may, arise only if—

(i) there are profits for a period on the investments, or on particular investments, made for the purposes of the scheme,

or

(ii) there are profits arising from a disposal of the investments, or of particular investments, made for those purposes,

(b) the amount of the sum which is to, or may, arise is variable, to a substantial extent, by reference to those profits, and

(c) returns to external investors are also determined by reference to those profits; but where any part of the sum does not meet these conditions, that part is not to be regarded as arising by way of "profit-related return".

(3) Where—

(a) one or more sums ("actual sums") arise to the individual under the arrangements by way of profit-related return in a tax year, and

(b) there was no significant risk that a sum of at least a certain amount ("the minimum amount") would not arise to the individual, so much of the actual sum, or of the aggregate of the actual sums, as is equal to the minimum amount is not "carried interest".

(See subsections (7) and (8) as to how the minimum amount is to be apportioned between the actual sums where more than one actual sum arises in the tax year.)

55. Section 809EZD provides for further amounts which are to be treated as carried interest:

(2) A sum falls within this subsection if, under the arrangements, it is to, or may, arise to the individual out of profits on the investments made for the purposes of the scheme, but only after—

(a) all, or substantially all, of the investments in the scheme made by the participants have been repaid to the participants, and

(b) each external investor has received a preferred return on all, or substantially all, of the investor's investments in the scheme.

(3) A sum falls within this subsection if, under the arrangements, it is to, or may, arise to the individual out of profits on a particular investment made for the purposes of the scheme, but only after—

(a) all, or substantially all, of the relevant investments made by participants have been repaid to those participants, and

(b) each of those participants who is an external investor has received a preferred return on all, or substantially all, of the investor's relevant investments;

56. Section 103KG sets out the meaning of "arise" in the new TCGA carried interest provisions and states that:

> For the purposes of this Chapter, carried interest "arises' to an individual ("A") if, and only if, it arises to him or her for the purposes of Chapter 5E of Part 13 of ITA 2007.

57. It is common ground that the Carried Interest Amounts arise under the legislation after 8 July 2015.

58. However, under s43(2) the commencement and grandfathering provision provides that the changes introduced by s43(1) FA 2015:

> " have effect in relation to carried interest arising on or after 8 July 2015 under any arrangements, unless the carried interest arises in connection with the disposal of an asset or assets of a partnership or partnerships before that date."

59. The grandfathering only applies to carried interest arising in connection with the disposal of assets (i.e. under s103KA(2)) and not in relation to carried interest arising in other circumstances (i.e. under s103KA(3)).

60. Section 43(5) provides that in s43(2) "arise", "arrangements" and "carried interest" have the same meanings as in Chapter 5 of Part 3 of TCGA 1992 (as inserted by s43(1)).

THE APPELLANTS' CASE

61. Ms Shaw made extensive submissions in her skeleton argument and orally at the hearing. For the sake of brevity we only summarise key points made by her.

62. Ms Shaw submitted that the new legislation applied to carried interest arising on or after 8 July 2015 (the date of its announcement) – i.e. with immediate effect (so as to prevent any "forestalling: see para 1016 of the Explanatory Notes to the F(No.2)A 2015) but on a prospective basis only, save in circumstances where the carried interest is derived from a disposal of assets which took place before that date: see para 1012 of the Explanatory Notes to the F(No.2)A 2015. That exception provided a carve-out to the application of the rules.

63. The purpose of the new provision was, therefore, to ensure that "tax is paid on true economic gains" in respect of carried interest: see para 1016 of the Explanatory Notes to the F(No.2)A 2015.

64. Ms Shaw recognised that it is common ground that the threshold for the new rules to apply is met. The carried interest in question did arise after 8 July 2015; it arose on 14 December 2015 (as to £20m) and 6 January 2016 (as to £22,160,150). Therefore it is within the new legislation unless the grandfathering carve-out contained in s43(2) F(No.2)A 2015 applies which requires deciding what is meant by "in connection with". However, Ms Shaw submitted that the words "in connection with" must take their meaning from the statutory context in which they appear and the objective they pursue: *London Luton Hotel BPRA Property Fund LLP v. HMRC* [2023] EWCA Civ 362.

65. In this case, Ms Shaw submits that the statutory context is the introduction of an entirely new CGT regime for the taxation of carried interest, the objective of which is to capture the actual economic gain enjoyed by carried interest holders, thereby overriding the outcome which would otherwise have resulted from the previous application of general CGT principles. As a result, where the disposal of assets to which the actual economic gains are referable took place before 8 July 2015, the resulting carried interest is not within the new charge to tax. Carried interest arises "in connection with" the disposal of assets before 8 July 2015 where the profit-related return (which is a share of the actual economic gains) is derived from the disposal of those assets.

66. Ms Shaw urged consideration of the Explanatory Notes and the fact that they used the term "derived from" which, she says, points to looking to the disposal of assets which

represents the source of the economic gains. Such an interpretation not only accords with the purpose of the legislation, but is consistent with the general presumption against retrospective legislation (see for example, in *Arnold v. Central Electricity Generating Board* [1988] AC 228).

67. Ms Shaw submitted that it would give rise to obvious unfairness if carried interest arising on or after 8 July 2015 but which was, as a matter of economic reality, a share of profit from the disposal of assets before that date, was caught. Furthermore, HMRC's interpretation offends the presumption against retrospective legislation.

68. Ms Shaw says that the nature of carried interest, from both an economic and a legal standpoint, is that it is a "profit-related return": see s. 809EZC ITA 2007. As such, the disposal of assets with which it is most closely connected is the disposal of assets which generated the profit.

69. Furthermore, carving out carried interest which is a share of profits accruing on disposals which took place before the announcement is entirely consistent with the anti-forestalling objective. The profits in this case were entirely generated by the disposals prior to 8 July 2015; i.e. the disposals prior to the sale of the Audley Court investment which only contributed a loss.

70. Ms Shaw submitted that it is not the disposal of assets per se which 'gives rise' to carried interest – i.e. which causes carried interest to 'arise' for the purposes of CGT – but rather the allocation of carried interest. When the legislation refers to carried interest arising in connection with the disposal of assets, it is referring to the disposal of assets which generated the profits of which the carried interest is a share. The disposal is not itself the causative event of the carried interest.

71. HMRC's contention that the carve-out was only intended to apply where the entitlement to carried interest had already 'crystallised' before 8 July 2015, but had not been received until after that date, draws an arbitrary distinction. The whole point of the carve-out is that carried interest may not in fact arise at the time of the disposal of assets to which it relates.

72. HMRC's interpretation is tantamount to reading the words "in connection with" as meaning "on" i.e. "unless the carried interest arises [on] the disposal of…assets…before that date". This is wrong. If the carve-out can only apply in respect of carried interest arising on a disposal of assets which takes place before 8 July 2015, then there are no circumstances in which it can operate because, by definition, if the carried interest arises on a disposal of assets before 8 July 2015 it cannot also have arisen on or after that date.

73. Alternatively, Ms Shaw suggested at the hearing that, having regard to the need to achieve fairness by leaving profits accrued prior to the change in rules taxed under the previous system, the grandfathering carve-out should be read as permitting apportionment.

74. In relation to HMRC's QCB argument, Ms Shaw submitted that even if the Carried Interest Amounts arose in connection with the disposal of the Audley Court investment which comprised or included the disposal of QCBs, QCBs are still "assets" for the purposes of the TCGA: see ss. 21 and 117 TCGA. Consequently the Carried Interest Amounts are potentially subject to s103KA TCGA and therefore the grandfathering provisions of s43(2) F(No.2)A 2015 are relevant.

HMRC's Case

75. We have also merely summarised the main points of the submissions made on behalf of HMRC.

76. Mr Nawbatt also relies on the case of *London Luton* in deciding what is meant by "in connection with". He says that the interpretation of those words should take into account the

fact that an immediate change was made removing what was perceived to be the unfair result of the base cost shift.

77. He submitted that in fact the only disposal that the Carried Interest Amounts arose 'in connection with' was the disposal of the Audley Court investment, which took place in December 2015 (after the s43(2) cut-off point) and therefore the grandfathering provision has no application. No carried interest had arisen prior to the disposal of the Audley Court investment and no carry would have arisen but for that disposal. Further, had the investment not been sold for a sufficiently high price, the IRR would not have been met and no Carried Interest Amounts would have been paid.

78. Mr Nawbatt submitted that the Appellants' arguments rely on a flawed interpretation of the legislation, which assumes that carried interest arises "in connection with" a disposal even if the disposal did not give rise to any entitlement to the carried interest. When considering the purpose and legislative context, there is no reasonable basis for this broad interpretation.

79. The purpose of the grandfathering provision was to exempt individuals whose entitlement to carried interest crystallised by virtue of a disposal before 8 July 2015, but the carried interest "arose" after that date. In the interests of fairness, it was appropriate to tax all whose entitlement to carried interest had already crystallised before the cut-off date (whether or not they received it prior to that date) in the same manner.

80. Section 103KA (2) is only concerned with the specific disposal(s) which can be within the charge to CGT for "A" (or a person specified in s.103KG), and which trigger(s) the carried interest; in other words, the disposal that enables the fund to reach the necessary IRR. Applying s103KA (2) to the Carried Interest Amounts, the disposal which triggered or gave rise to the entitlement to the payment of carry is the Audley Court investment disposal; no other disposal is relevant to s103KA (2); by extension no other disposal can be relevant to the application of s43(2) F(No.2)A 2015.

81. Whilst the Audley Court investment disposal itself was made at a loss, it contributed to the overall return of the fund and was essential to meeting the IRR. If the value of that investment had been negligible, then no carried interest would have arisen and there would be no tax charge under the current or previous rules.

82. Mr Nawbatt commented that typically, a fund's assets are sold over a period of several years, with carried interest entitlement crystallising at the end of the fund's life. It can often take up to ten years for carry to accumulate within a fund, so on the Appellants' construction of the transitional provision, the legislation might only take full effect up to a decade after coming into force. As the legislation was intended to take effect immediately, with the aim of correcting an inequality under the previous tax system, Mr Nawbatt submitted that it would be absurd that any carried interest that arose from a fund which had made a disposal prior to the introduction of the rules (and which failed to achieve the preferred return until a post 8 July 2015 disposal) would not fall within the scope of the charge.

83. Mr Nawbatt submitted that it is not retrospective to change the tax treatment of carried interest arising from arrangements which are already in place – including where disposals which contribute towards meeting the preferred return have already happened.

84. He submitted that the use of the term "derived from" as a synonym for "arises in connection with" in the Explanatory Notes, supports the Respondents' argument that the only relevant disposal is the specific disposal which triggers the carried interest or the disposal from which the carried interest is obtained.

85. As a separate matter, Mr Nawbatt submitted that in this case there was a particular interaction of the new rules and the general CGT rules which affects these Appellants, but will

not necessarily affect others disputing the application of the transitional provisions. Section 103KA (2) is concerned with chargeable disposals. Disposals of assets that are not chargeable disposals fall under s103KA(3) to which the grandfathering rule in s43(2) does not apply. It is common ground that the assets disposed of in relation to the Audley Court investment were QCBs which are not chargeable assets under TCGA and therefore s103KA(3), not s103KA(2), applies. Consequently the grandfathering provision is not applicable in any event.

DISCUSSION

86. The key facts in this case are that:

(1) all of the CIP's investments were disposed of prior to June 2015 except Audley Court and all of those prior disposals contributed to the profits whereas the disposal of the Audley Court investment contributed a loss. However, the 9% IRR was only achieved once the sale of the Audley Court investment took place and that was after 8 July 2015. If that sale had not taken place (or the sales price had been too low) that hurdle would not have been met and no carried interest would have been payable;

(2) the evidence, including the accounts, shows that as at 8 July 2015 the disposal of the Audley Court investment was still uncertain;

(3) the parties agree that the Carried Interest Amounts arose under s103KG after 8 July 2015 when the disposal of the Audley Court investment took place.

87. The question for us is then what is meant by the words "the carried interest arises in connection with the disposal of an asset or assets of a partnership or partnerships before [8 July 2015]"? In particular, in this case do those words address the disposals which generated the profits of the partnership, i.e. the disposals of all the investments other than that in Audley Court and all of which took place before 8 July 2015? Without those profits the Carried Interest Amounts would not have been payable.

88. We have decided that the Carried Interest Amounts "arose in connection with" the disposal of the Audley Court investment which took place after 8 July 2015 such that the grandfathering does not apply for the following reasons.

89. In the *London Luton* case Lady Justice Whipple and Lady Justice Falk considered the correct approach to interpreting the words "in connection with" stating that the words will usually take their meaning from those which surround them and the wider context, so that both broad and narrow meanings are possible.

90. When we consider the broader context of the words in this case, we take into account that the purpose of the relevant clause in s43(2) F(No.2) A 2015 was to provide an exception from a substantial change in the way in which carried interests would be taxed which was implemented with effect from announcement. As the Appellants recognise, that immediate implementation was designed to prevent forestalling.

91. To put this in context, prior to 8 July 2015 private equity partnerships were subject to the ordinary capital gains tax rules applying to partnerships. HMRC's view of how capital gains tax rules apply to partnerships is set out in Statement of Practice D12 (SoP D12). At the point at which the profit hurdle was satisfied and the entitlement to carried interest arose each investor was treated as disposing of part of its share in the partnership and as transferring part of its base cost in the partnership's assets to the carried interest holders. This is known as the 'base cost shift'. The base cost shift therefore meant that the carried interest holders paid tax on an amount less than their actual gain.

92. However, the F(No.2)A 2015 changes set out a new regime for the taxation of carried interest and in particular, removed the availability of that base cost shift. As is common ground,

the purpose of the new legislation was to bring within the charge to tax the full amount of the economic gain which is ultimately enjoyed by the carried interest holders. The changes were introduced with immediate effect, save that in relation to the provisions contained in s103KA(2) grandfathering applied to cases where the carried interest arises in connection with the disposal of an asset or assets of a partnership or partnerships before 8 July 2015.

93. Notably, the grandfathering was not applied to all carried interest payments which related to generation of profits prior to 8 July 2015. It did not apply to carried interest payments to which s103KA(3) applies; and for the payments to which s103KA(2) applies it is specifically rooted in the concept of amounts "arising" in connection with one or more disposals. The concept of "arises" is a defined term; we are not able to construe it beyond its definition in s103KG TCGA.

94. Both parties have relied on the Explanatory Notes accompanying the new legislation in their submissions. There was some dispute at the hearing as to whether we could look at Hansard as well, but even if we simply refer to the Explanatory Notes we see that they say that the new rules were "introduced to support the government's policy that taxation should be fair and, to that end, should so far as possible reflect the reality of circumstances. It ensures that tax is paid on true economic gains enjoyed by the individuals affected by the new rules." That is clearly drawing a distinction with the previous regime under which carried interest recipients received the benefit of the base cost shifting with the result that they did not pay tax chargeable gains on their economic gains calculated in the usual way but by reference to some other lesser amount. It is that concept of economic gain - the gain calculated without the benefit of the base cost shift - we consider is being referred to, not as Ms Shaw submitted, the underlying profit which leads to a carried interest payment being made. Furthermore, the notion of fairness implies that Parliament was ending the "unfair" previous system. In so doing we agree with Mr Nawbatt that the Notes provide a strong pointer that Parliament would have intended the grandfathering protection to be narrowly circumscribed.

95. Those Notes refer to carried interest that arises on or after 8 July 2015 being within the new regime, unless that carried interest is <u>derived from</u> a disposal of partnership assets which took place before that date (underlining added). Ms Shaw submitted that the words "derived from" indicated that "in connection with" should be considered to address where the profits which led to the payment of the carried interest came from. As Audley Court's disposal was at a loss, the carried interest did not come from it.

96. However, we do not agree with that construction. We consider that the core concept in the grandfathering rule is the "arising" of the carried interest in connection with one or more disposals. The rule is not addressing the profits to which the carried interest relates. We also agree with Mr Nawbatt that when one looks at "derived from" in that context, the Carried Interest Amounts came from the disposal of Audley Court. As we have found, without that disposal and without it taking place at a minimum sales price, there would have been no Carried Interest Amounts.

97. Ms Shaw submits that construing "in connection with" in this way means that little is added to the concept of carried interest arising after 8 July 2015. Furthermore, she argues that HMRC's interpretation is nonsensical as it effectively says that the new regime applies to carried interest arising on or after 8 July 2015 unless the carried interest arises on the disposal of assets before that date. However, we agree with Mr Nawbatt's submissions that examples can be identified which clearly fit within, and using, the wording of the grandfathering provision. Those examples include where carried interest payments were held in escrow until after that date.; or a disposal prior to 8 July 2015 triggered carried interest which could only be paid after 8 July 2015, due to partnership rules on profit allocation; for example, where profits

could only be allocated on a quarterly basis, during a period after 8 July 2015. The examples turn on the specific meaning of "arises" provided for this legislation. We agree that unfairness could result should the new carried interest provisions apply in those circumstances as there is no principled reason for distinguishing between persons in the above circumstances and others who may have received distributions of carried interest before 8 July 2015.

98. Ms Shaw's submissions have focussed on what disposals have generated the profits out of which the Carried Interest Amounts were paid. The disposal of assets with which the Carried Interest is then most closely connected is the disposal of assets which generated the profit, i.e. those before 8 July 2015. In essence, therefore, Mr Nawbatt focusses on the disposal triggering entitlement to the Carried Interest Amounts and Ms Shaw to the generation of the underlying profit for that return.

99. We have concluded that we consider Mr Nawbatt's approach more closely aligns with the natural meaning of the words in their context of the new regime. We consider that the natural meaning of the words is such that the Carried Interest Amounts arose after 8 July 2015 in connection with the disposal of the Audley Court investment. It was that disposal which caused the Carried Interest Amounts to arise.

100. We also agree with Mr Nawbatt that the grandfathering provision has to be set in the context of s103KA(2) to which it applies. It is of particular note that the draftsman has used the same "in connection with the disposal of one or more assets" wording in s103KA(2) as in the grandfathering rule. We agree that s103KA(2) is only concerned with the specific disposal(s) which triggers the carried interest; in other words, in this case the disposal that enabled the fund to satisfy the necessary IRR. It is only that disposal which can fall within the charge under s103KA(2). "In connection with the disposal of an asset" in the grandfathering rule of s43(2) F(No.2)A 2015 must therefore be tied into the s103KA(2) disposal, which in this case is the disposal of the Audley Court investment, and no other disposal. It is the disposal in connection with which the carried interest arises which is the key, not other disposals or receipts generating underlying profit to which s103KA(2) has no effect.

101. Ms Shaw submitted that this conclusion means that the legislation is retrospective but we do not agree. We agree with Mr Nawbatt that the presumption against retrospective legislation addresses the impact of legislation on transactions which have already happened. There are numerous instances of legislation changing the tax treatment going forward of existing arrangements and on occasions with no, or very limited, grandfathering. This is in the very nature of anti-forestalling provisions.

102. Ms Shaw raised at the hearing that we could consider the possibility of apportionment. She submitted that to the extent that an amount of carried interest arises partly in connection with the disposal of assets before July 2015, and partly in connection with a disposal of assets after July 2015, there is no conceptual difficulty with apportioning the amount so as only to carve out the proportion that arises in connection with the disposal of assets prior to July, and the rest would then be subject to the new regime.

103. We decline to follow this approach despite its apparent attractiveness as an ostensibly fair way of applying the new regime. We recognise that the courts have at times interpreted legislation as permitting apportionment without clear language to that effect. However, we are not inclined to do so in this case for the following reasons:

(1) the draftsman has used apportionment wording within the new regime provisions in s103KA(4) stating that s103KA(2) and (3) do not apply "to the extent that" carried interest is brought into account in taxing the recipient to income tax on profits of a trade or the carried interest constitutes a co-investment repayment or return. There is no reason

why the draftsman would use such wording in s103KA itself for particular purposes and then fail to use it in s43(2) if apportionment was envisaged;

(2) as Mr Nawbatt identified, the Explanatory Notes state that "When carried interest arises on or after 8th July 2015 the gain will normally be equal to the sum received." There is no suggestion that there was any intention for there to be apportionment, or for the new rules to apply to only part of the carried interest that arises after 8th July 2015; and

(3) as a practical matter in this case we struggle to see on what basis the apportionment would take place. All of the profits were generated by the pre-8 July 2015 disposals so apportionment based on profit achieves no more than saying that in fact the Carried Interest Amounts arose in connection with those earlier disposals.

The QCB argument

104. Mr Nawbatt submitted that as the Carried Interest Amounts arose in connection with the disposal of the Audley Court QCB the Carried Interest Amounts fall to be dealt with under s103KA(3) such that in this case, in any event, s43(2) F(No.2)A 2015 does not apply.

105. We have concluded that the Carried Interest Amounts arose in connection with the Audley Court investment disposal. That in itself, as Ms Shaw submitted, is the end of the matter as we have concluded that the grandfathering in s43(2) does not apply on its own terms and the appeals must be dismissed.

106. However, we have been asked to express a view regarding the QCB issue for completeness. We recognise that if the QCB argument is correct, the preceding analysis is flawed as it has proceeded on the basis of the wrong provisions in this case. It is therefore incumbent on us to address the issue even if it cannot alter the outcome of the case.

107. Ms Shaw submits that QCBs are assets for the purposes of the TCGA as shown by ss21 and 27 TCGA and that brings the QCBs within s103KA(2).

108. Section 1 TCGA provides that:

> "Tax shall be charged in accordance with this Act in respect of capital gains, that is to say chargeable gains computed in accordance with this Act and accruing to a person on the disposal of assets."

109. Section 21 then says that all forms of property shall be assets.

110. The provision in s115 which says that gains on QCBs fall outside the charge to CGT refers to the gain accruing on the disposal of a QCB not being a chargeable gain. It does not exclude QCBs from the ambit of the s21 description of assets.

111. While one might consider it strange that interests in a transparent partnership can convert a non-chargeable gain into a chargeable gain (i.e. change the nature of the gain accruing on a QCB from being non-chargeable to chargeable) that is exactly what s103KA does whether the QCB falls within s103KA(2) or (3). Indeed, that capital gains tax treatment of carried interests is at the very heart of the Memorandum of Understanding between the BVCA and Inland Revenue on the income tax treatment of Venture Capital and Private Equity Limited Partnerships and Carried Interest of 25 July 2003.

112. On the face of the legislation we see no reason to narrow the scope of the wording in s103KA(2) to assets which when disposed of, give rise to a chargeable gain. The section directs that it is addressing carried interest arising in connection with the disposal of an asset. The QCBs are assets and therefore the Carried Interest Amounts arising in connection with the disposal of them fall within s103KA(2).

113. Consequently, it is necessary to consider whether s43(2) applies, as we have above.

CONCLUSION

114. We therefore conclude for all the reasons set out above that the Appellants' appeals are dismissed. The amendments made by the closure notices issued to each of them on 16 and 18 July 2019 are confirmed.

RIGHT TO APPLY FOR PERMISSION TO APPEAL

115. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

JUDGE TRACEY BOWLER
TRIBUNAL JUDGE

Release date: 17th APRIL 2024

Schedule 1
Portfolio investments acquired by the Funds since inception

Investment name	Date acquired	Equity cost (£)	Date of realisation	Amount realised by the funds on disposal (£)	IRR on particular investment disposal
Mitchells & Butler HQ	30 January 2009	11.0m	January 2010	21.9m	98.0%
Capital Pub Company	December 2009 to September 2011	5.1m	August 2010	11.7m	66.6%
Primark Logistics unit	3 August 2009	15.4m	March 2013	30.2m	54.8%
Safestay	18 April 2011	4.2m	May 2014	6.3m	16.8%
Logistics Property Partnership	31 August 2012	66.1m	July 2014	111.4m	24.2%
Printworks, Exeter	22 December 2011	15.5m	August 2014	28.1m	30.7%
Brindleyplace, Birmingham	7 July 2010	30.8m	February 2015	57.8m	16.1%
Salisbury House, London	20 January 2012	22.0m	February 2015	79.7m	56.6%
Skypark, Glasgow	2 November 2010	26.7m	February 2015	62.2m	24.9%
Towers, Manchester	23 November 2011	26.2m	February 2015	53.8m	26.2%
Pinnacle, Leeds	7 February 2011	23.9m	February 2015	32.6m	8.6%
Mercure Hotels	13 July 2010	14.4m	February 2015	17.5m	5.2%
Shearings Hotels	4 July 2008	4.5m	February 2015	9.1m	12.3%
Velocity Village, Sheffield	12 April 2012	15.5m	February 2015	35.8m	45.0%
Sovereign Reversions	12 October 2010	19.8m	June 2015	23.8m	4.5%
Audley Court	20 October 2008	161.1m	December 2015	157.1m	N/A (sold at loss).
TOTAL		462.1		739.0	

Schedule 2

Profits of the Funds as at quarter end

Quarter end date	Retained profit and loss at end of quarter	Profits distributed in quarter	Cumulative profits distributed to date (over life of Funds)	Cumulative profit and loss to date (i.e. retained profits plus cumulative distributed profits)
31 March 2015	£162,941K	£56,167K	£56,167K	£219,108K
30 June 2015	£163,278K	-	£56,167K	£219,445K
30 September 2015	£162,690K	-	£56,167K	£218,857K
31 December 2015	£53,916K	£104,341K	£160,508K	£214,424K
31 March 2016	£5,637K	£50,293K	£210,801K	£216,438K

Schedule 3
Distributions made by the Funds

Date of Distribution	Distribution in repayment of Limited Partner loans and capital contributions	Distribution of the Preferred Return of profits to Limited Partners	Distribution of profits in excess of Preferred Return to Limited Partners	Distribution of profits in excess of Preferred Return to CIP	Total Distribution
28 March 2013	£25,000,000				£25,000,000
13 August 2014	£100,000,001				£100,000,001
9 February 2015	£263,833,099	£56,166,900			£319,999,999
14 December 2015		£81,007,208	£13,333,333	£20,000,000	£114,340,541
6 January 2016			£18,133,158	£22,160,150	£40,293,308
Total	£388,833,100	£137,174,108	£31,466,491	£42,160,150	£599,633,849