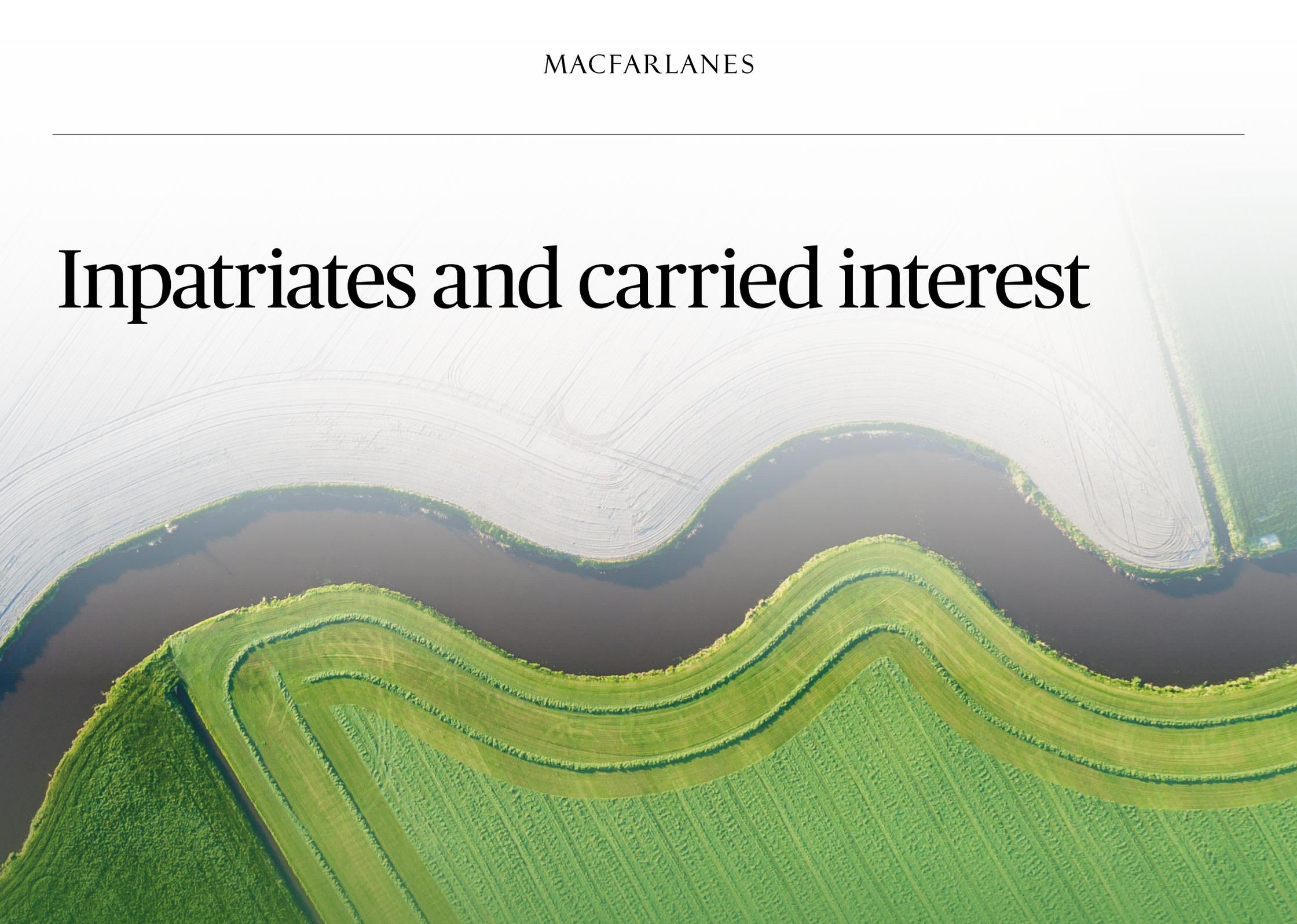


MACFARLANES

Inpatriates and carried interest



Background

- HMRC data shows that for the 2022/23 tax year £3.7bn of carried interest gains were reported on UK tax returns by 3,100 individuals.¹
- Over the four tax years for which information is available, HMRC data shows that on average 27% of carried interest recipients were non-doms, but that those individuals accounted for 40% of reported carried interest receipts.²



- Added to that, it is known that, amongst the carry recipient population, the lion's share of carry is received by the most senior executives.
- Putting those two facts together, it is clear a small number of non-dom carried interest recipients receive a significant proportion of total reported carried interest gains.

How are non-doms taxed?

- Under the current rules, during their first 15 years of UK residence non-doms are entitled to pay tax on foreign source income and gains only to the extent those proceeds are brought into the UK (the remittance basis regime). The part of any carried interest that is attributable to duties performed outside the UK is treated as foreign source for this purpose.

- After 15 years of UK residence, non-doms are generally taxed like other UK residents. However, provided they maintain an intention to leave the UK, non-doms can still benefit from favourable direct tax and inheritance tax (IHT) treatments in relation to assets held in certain trusts provided that those trusts were settled by them before the end of their 15th year of UK tax residence and are not added to after that date.

Proposed tax policy changes

- Under the Government's proposals, the 15 year remittance basis window will be replaced with a four year period of exemption for foreign income and gains (FIG) for new arrivals to the UK. This is referred to as the "in-patriate regime" below. The direct tax benefits of trusts in the private capital setting would also in effect be removed as would the IHT protection for trusts, subject in both cases to any transitional relief.

Protecting the tax base

- As set out in our modelling overleaf, total European carried interest receipts are growing and the UK receives the lion's share. It is important the UK retains that share. In our view, that in turn requires that current non-dom carried interest holders remain in the UK and that the flow of future talent to the UK is not significantly reduced. There is scope for the UK to raise significant tax revenue from this population and their remaining in and coming to the UK is important if the UK wishes to retain its lion's share of the tax revenue (and broader economic benefits) from the European private capital industry.
- Both aims require a competitive carried interest regime, a requirement we consider separately in our "Reforming carried interest" paper.
- Retaining current residents also requires sensible and fair transitional rules in connection with the proposed changes to the taxation of trusts mentioned above. When the current rules were introduced in 2017 individuals were effectively encouraged to set up trusts that would now be put at a disadvantage. In our view it would therefore be reasonable for the Government to provide for a degree of grandfathering for those existing trusts.

- Maintaining the flow of new talent to the UK requires competitive in-patriate rules for workers, that would sit alongside the generally applicable (four year) FIG regime described above. The Government has announced that it intends to consult on the design of a replacement for the current Overseas Workday Relief (OWR) rules. We believe that this presents an opportunity for the Government to more closely examine the treatment of in-patriate workers and design appropriate rules that would address the taxation of income and gains (including carried interest) attributable to:

- duties performed prior to becoming UK resident; and
- duties performed outside the UK by in-patriate workers during their early years of UK residence.

- In our view it would be reasonable for such worker-focused rules to apply for a longer period than the general four year FIG regime, given the amounts concerned would be connected to work performed outside the UK (as opposed to passive investment income).

Trend in total carried interest

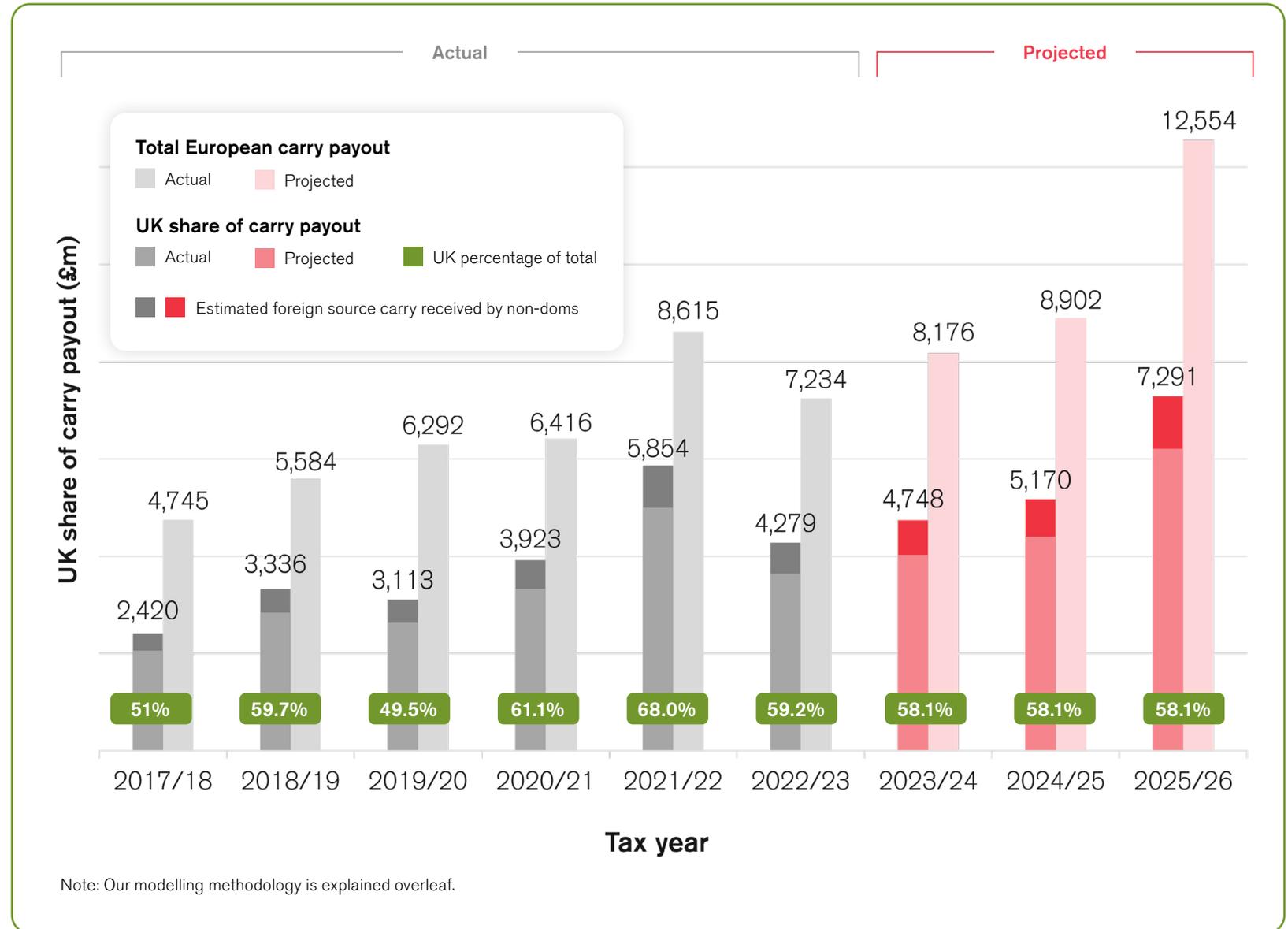
- The private equity industry is inherently cyclical. Publicly available data on European private equity funds shows that:
 - annualised fund returns have varied between 8% (for the 2005 "vintage") to 23% (for the 2018 "vintage") – seemingly driven by general economic conditions; and
 - fund raising has also fluctuated but with an underlying upwards trend. The 2005 "vintage" was at the time a record year with \$55bn raised. However, the three largest fundraising years on record are now 2018, 2019 and 2020, with \$90bn, \$100bn and \$185bn raised respectively.
- These factors combine to produce the figures in our modelling overleaf. They show that, while fluctuating, total European carried interest is on an upward trajectory to record levels.

¹ Sourced from HMRC response to a Macfarlanes Freedom of Information request. That £3.7bn figure does not include foreign source carried interest arising to remittance basis taxpayers who did not remit that carry to the UK. Such carry does not need to be reported. We estimate that including such carry would increase the total carry proceeds of those 3,100 individuals by £500m to £750m.

² These figures include both individuals who have been UK resident for fewer than 15 years (and who qualified for the remittance basis of taxation), and those who, having been in the UK for at least 15 years, did not therefore qualify for the remittance basis.

UK share of European carry

- We estimate that, in recent years, the UK's share of the European carried interest receipts has varied between 42% and 54%. This is high in absolute terms and disproportionate to the UK's share of European GDP.
- That out-sized share reflects London's status in recent decades as a preeminent financial centre, and the UK's historical role in leading the growth of the European private capital industry.
- Our modelling shows that, if the UK's historical share of European carried interest is maintained in the future, while there will be some fluctuations there will be an overall trend of increasing receipts, with the potential for record receipts of over £7bn in 2025/26, and beyond.
- However, it cannot be assumed that the UK's share will remain constant. In our view, to bolster the UK's position the Government should maintain an attractive regime for in-patriate workers (in addition to the four year FIG regime) and introduce appropriate IHT transitional rules in relation to trusts. That would encourage the next generation of private capital talent to come to the UK, and realise (and be taxed on a share of) their carried interest gains here as opposed to in other European countries, ensuring an outsized proportion of European carried interest continues to be taxed in the UK.



Notes on methodology

1. Our data source is a commercially available database published by Preqin that contains information on fund assets under management (AUM) and returns for European private equity funds, analysed into annual "vintages".
2. We have used that data to determine both the AUM and net return (expressed as a multiple) for funds that we expect will pay carry in each tax year. The figures for each tax year are based on the average of the vintages for four, five and six years prior – for example, tax year 2021/22 includes the 2014, 2015, and 2016 vintages.
3. For the tax years 2023/24 to 2025/26 we have assumed net multiples based on the average of the fund return multiples seen in recent years.
4. Using that information we calculate the implied fund profit and carry payout for each year. We estimate that c.15% of the carry payout is received by corporate groups rather than individuals and have reduced the total accordingly.
5. We have obtained data from HMRC on the total carried interest gains reported on UK tax returns for the years 2017/18 to 2022/23. We estimate that, in addition to these amounts, UK resident non-doms receive foreign source carry equal to c.15% of the reported total, and have increased the total accordingly.
6. Using that data we have calculated the implied UK share of total European carry for years up to and including 2022/23.
7. We have then assumed that (if there is no mobility) in future years the UK share of total European carry will be equal to the average for 2017/18 to 2022/23.
8. Based on the actual data on fund sizes and assumed values for fund return multiples, we have then extrapolated the expected UK carry receipts for 2023/24 to 2025/26.

There are several factors that give rise to uncertainty in the projections, including:

- European PE executives will have received carry from non-European funds;
- carried interest may be owned by corporate groups rather than individuals – while we have reflected that in our calculations, that is based on an assumption that 15% of carry is held by corporates;
- the time at which a fund pays carry distributions will depend on the performance of that fund's specific investments, so fund "vintages" will not map precisely on to tax years in which carry is paid;
- the source data is expressed in US dollars, and we have converted it using a fixed FX rate of \$1.278:£1;
- the fund net return multiples for 2023/24 onwards are assumed; and
- some UK residents that are non-doms will also have received foreign-source carry that is not taxable unless it is remitted to the UK – while we have reflected this in our calculations, that is based on an assumption that such carry equals 15% of taxable UK carry receipts.

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