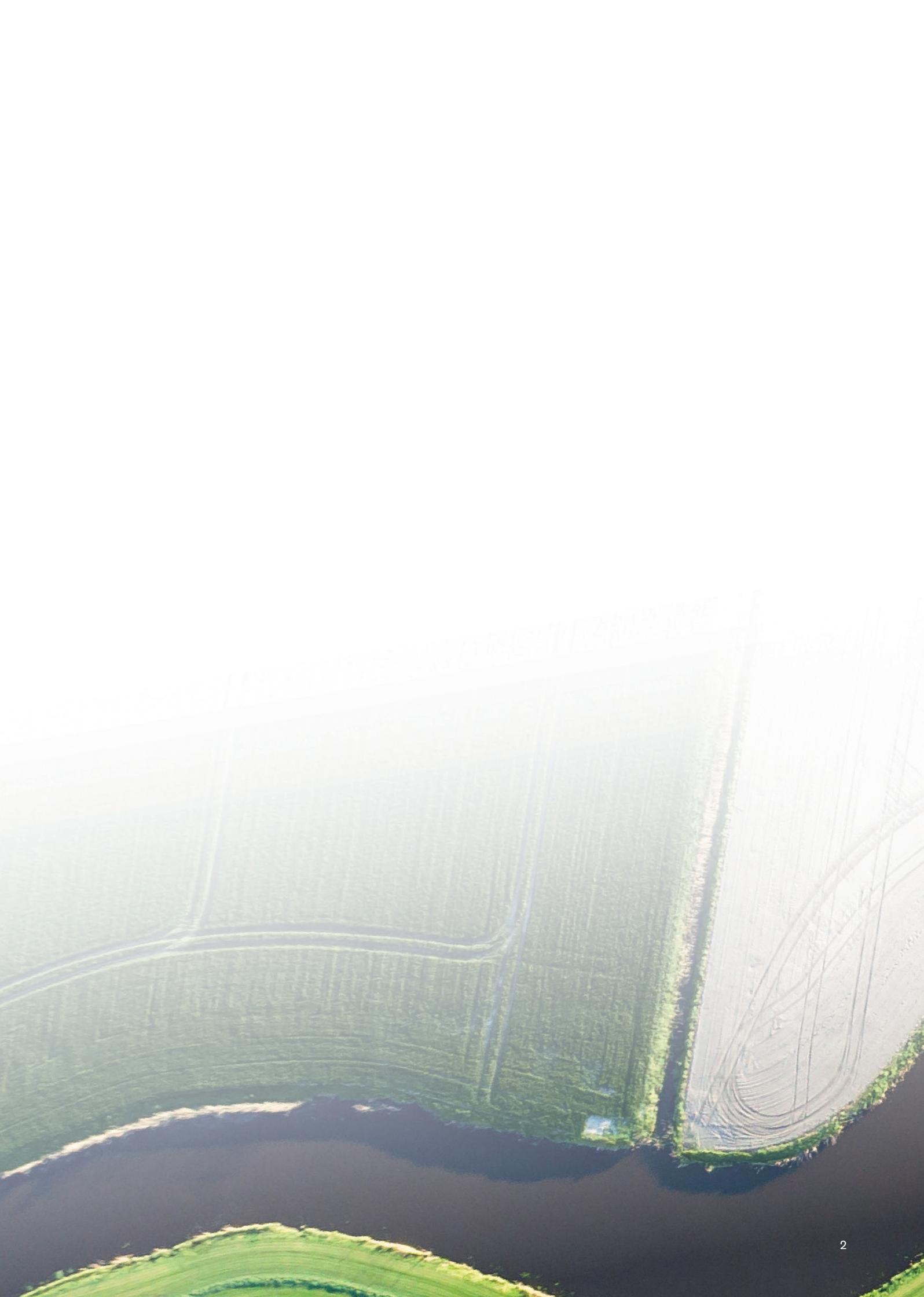


MACFARLANES

Reforming carried interest





Introduction

Private capital is of significant and growing importance to the UK, both as a source of vital investment for UK projects but also as an industry that is itself a key component of the UK's financial services sector. Currently, London is second only to New York as the world's leading private capital hub. That status has been earned over many years and is the result of a confluence of factors, one of which is the tax treatment of private capital executives.

Post-Brexit, the UK is facing huge competition for private capital talent from other European countries. Those countries have scented an opportunity and have been seeking to seize it by improving their regimes for the private capital industry. To date, the vast majority of executives have remained in the UK but that position is not guaranteed.

A key focus of those European regimes is the taxation of carried interest – that is, the share of investors' profits that the fund executives receive.

The Government's stated policy is to reform the taxation of carried interest in the UK. That is presented as a revenue raising measure that will pay for public spending commitments. However, our view is that a straightforward abolition of the current tax treatment of carried interest is unlikely to raise money and could in fact cost revenue.

We have prepared this paper to set out the background to carried interest taxation, and to consider ways in which:

- the Government can fulfil its policy pledge; and
- in doing so, avoid negatively impacting an industry in which the UK is and should continue to be a world-leader.

How is carried interest currently taxed in the UK?

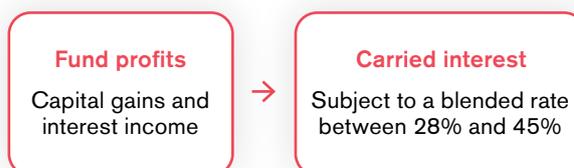
The basic rule is that carried interest is taxed according to how the underlying investment returns out of which it is paid are ordinarily taxed.

Private equity funds



For private equity funds, which make equity investments, the fund profits are primarily capital gains. Carried interest paid out of such gains is subject to capital gains tax (CGT) at a special rate of 28% (compared to the ordinary CGT rate of 20%). Any carried interest paid out of income is taxed at income tax rates. The overall effect is therefore a blended rate some way above 28% (we estimate c.30-32% on average).

Credit funds



For credit funds, which invest in debt, the profits are likely to include a higher proportion of interest income, which is subject to income tax at 45%. The overall effect is therefore a blended rate in the higher 30%.

This general approach is subject to two exceptions

1

Executives that are LLP members and hold carried interest in funds with an average investment holding period of less than 40 months are subject to the “Income Based Carried Interest” or “IBCI” rules. The IBCI rules subject their carried interest distributions to a combined income tax and NICs rate of 47%.

2

Secondly, carried interest (which is not IBCI) relating to investment management services an individual performs outside the UK is regarded as foreign-sourced. Remittance basis taxpayers are only liable to pay tax on such carry if they remit the proceeds to the UK. This will no longer be the case when the remittance basis is abolished albeit that change is subject to the scope of any replacement in-patriate regime.

Why is carry taxed this way?

Carried interest distributions are different to the more conventional kinds of income and gains that the tax system deals with in other contexts.



Carried interest is unlike ordinary performance-related remuneration, such as a banker's bonus. It is a proprietary share of the profits of particular investments and contingent on the performance of those investments.

Private capital funds generally invest for the long term so there is typically five–seven years between carry being awarded on inception of a fund and the point at which the individual executives start to receive carry proceeds. In some respects, this is similar to the kinds of long-term equity based share plans that are commonly used to incentivise senior company employees (for which the returns are also typically taxed as capital gains).



Carried interest represents a share of the fund investors' profits that the executives receive as part of the overall investment return arrangements of the fund. However, executives typically also make a co-investment of their own money in the fund. In effect, carried interest levers the return on that co-investment.

In our view carried interest distributions do not fit easily into the conventional categorisations that exist in the tax system. The special 28% rate that applies to such distributions can therefore be seen as reflecting this unique nature, which sits somewhere on the spectrum between an investment return and earned income.

How do other countries tax carried interest?

Major countries with financial centres have special tax regimes under which carried interest is taxed at a lower rate than earned income.

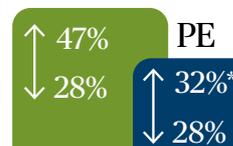
Some of those regimes – such as those in Germany and France – are long-standing, while Italy and Spain have recently reformed their regimes in an effort to become more attractive locations for private capital businesses. The US also has a similar regime under which private equity carried interest is generally taxed as a capital gain rather than income.

We have illustrated below the typical rates of tax applicable to private equity and credit funds in the US and the largest European countries. Countries take a variety of approaches to taxing carried interest. Some opt to apply entry conditions that limit the circumstances in which a special tax treatment applies. Further, some have the preferential regime as a capital gains tax charge and some have the regime as an income tax charge at a preferential rate.

UK

Tax rate applicable to carried interest:

Credit



Holding period: 40 months

Co-investment requirement:

Remuneration requirement:

* Assuming a proportion of carry is satisfied by income

Spain

Tax rate applicable to carried interest:

Credit



Holding period: 5 years

Co-investment requirement:

Remuneration requirement:

New York

US (New York)

Tax rate applicable to carried interest:

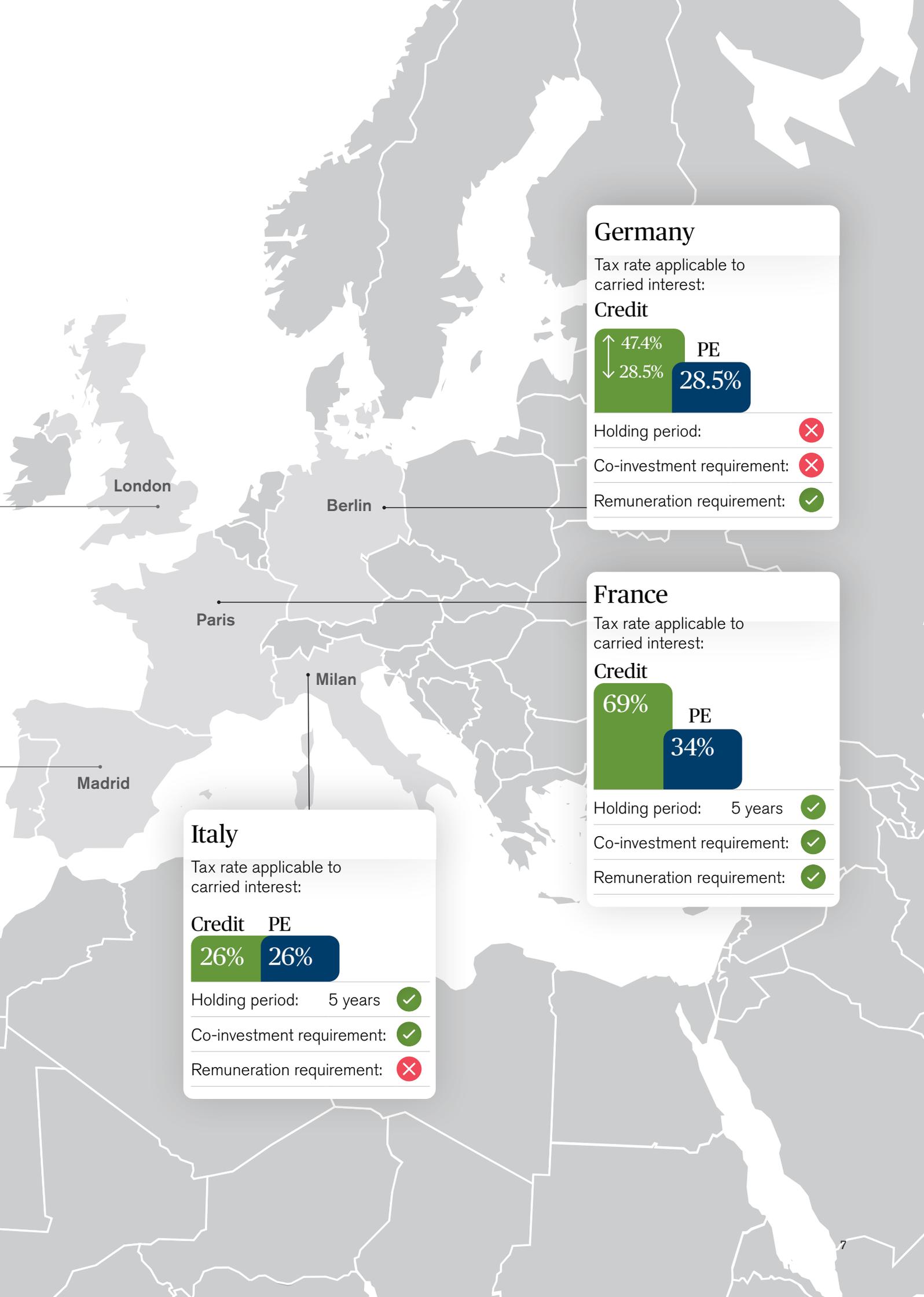
Credit



Holding period: 3 Years

Co-investment requirement:

Remuneration requirement:



Germany

Tax rate applicable to carried interest:

Credit



Holding period:

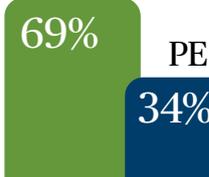
Co-investment requirement:

Remuneration requirement:

France

Tax rate applicable to carried interest:

Credit



Holding period: 5 years

Co-investment requirement:

Remuneration requirement:

Italy

Tax rate applicable to carried interest:

Credit PE



Holding period: 5 years

Co-investment requirement:

Remuneration requirement:

London

Berlin

Paris

Milan

Madrid

The case for reform

The Government is committed to reforming the tax treatment of carried interest.

As noted above, we do not think it is appropriate to equate carried interest to earned income but in any event there are important considerations that should be borne in mind in shaping potential reform.



International landscape: major European countries are competing to attract private capital businesses, and the UK should have regard to the approaches those countries are taking. While there is scope for reform, ideally the UK would remain in the European mainstream in terms of how it taxes carried interest.



Revenues: the objective of any reform should be to raise Exchequer revenues to invest in public services while safeguarding the industry. It is not clear that taxing carry as earned income would do this.



Signalling: The Government's policy should send a positive signal about the UK's attitude to the private capital industry, which is a key component of the UK's financial services ecosystem, and to private investment generally – the mobilising of which is crucial to accomplishing the Government's industrial strategy missions and supporting job creation.

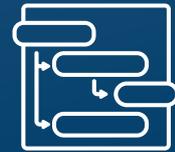
None of these factors precludes the possibility of reform that addresses concerns around fairness. However, we consider that should be done in a way that keeps the UK in the European mainstream and grows the UK private capital industry.

How could carry be reformed?

As illustrated above, the UK's c.28% rate of tax for carried interest in private equity funds is already positioned in the European mainstream. That suggests there is limited scope to raise headline rates without harming the UK's competitive position. However, there are other policy levers that could be used as part of any reform.

Gating questions

Reform could take the form of amending the existing framework (for example, adding a co-investment condition) or could potentially be more fundamental in treating carry as service income with a preferential rate (like Spain and Germany).



There are many ancillary issues that inform the approach to be taken including how quickly the changes need to be introduced, how the rules should apply to in-patriates and expatriates (and the interaction with tax treaties), how different asset classes are distinguished within the regime and the potential interaction with broader reform to capital gain tax. Any change will also trigger the question of transitional relief for existing funds with the more prescriptive the future regime the greater the need for transitional relief.

Conditions

Carried interest regimes generally include conditions that define the circumstances in which the special tax rate will apply. The European countries in our comparison generally apply more restrictive conditions than the UK currently does. The main conditions used by other countries include:



Holding period

France, Italy and Spain apply conditions that ensure individuals will not qualify for the special rate of tax if they receive carried interest distributions during the first five years of a fund's lifetime. This targets those countries' regimes at carried interest relating to long-term investments.

Minimum co-investment

Both France and Italy require executives to have invested a minimum level of their own capital in a fund as a co-investment for their carried interest to qualify for a special tax rate. This ensures that the executives are exposed to a material potential downside from their investment in the fund.

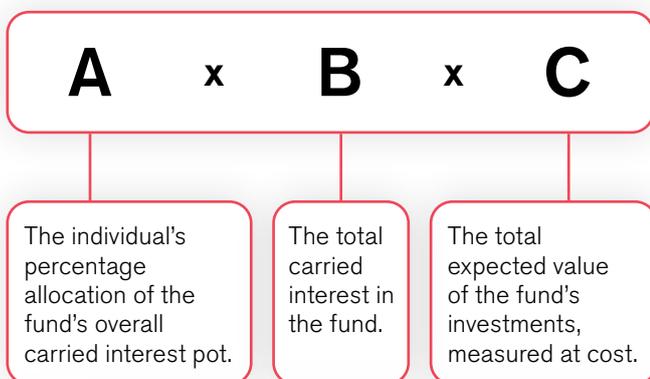
Co-investment condition

One option for reform is making access to a preferential carried interest tax regime subject to a co-investment condition being satisfied.

When considering the rationale behind a co-investment condition, it is helpful to understand the concept of “money at work” (MAW) in the context of carried interest.

MAW represents the notional investment value that corresponds to an individual’s carried interest entitlement.

The MAW for each individual fund executive in relation to a fund is calculated as:



As an example, if a fund is expected to make a total of £1bn of investments and the carried interest is entitled to 20% of fund profits, then the MAW for an executive with a 1% allocation of the carried interest pot will be £2m (£1bn x 20% x 1%).

If the fund achieves (for example) a 100% return, then the individual's carry payments will be £2m (i.e. 100% of their MAW).

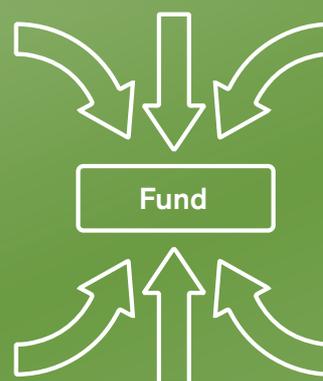
A good way of looking at a co-investment requirement to access a preferential carried interest regime (applied at an individual level) is that it would put a maximum on the ratio that an individual's MAW bears to their actual investment.

For example, under the French rules, the individual in the above example would need to have made a co-investment of £100,000 to access the French carried interest regime (the aggregate co-investment made by the team of executives would therefore need to be at least £10m). In other words, under the French rules, an individual cannot have a MAW arising from carry which is more than 20 times their co-investment in the fund. Under the French rules, that ratio increases to 40 times to the extent that the fund is greater than €1bn in size.

Co-investment condition

If a co-investment condition was introduced into the UK rules it would need to reflect the myriad of ways executives directly and indirectly make co-investments into funds in which they hold carried interest. While there will usually be direct co-investment, there will also often be material indirect co-investment including through co-mingled team co-investment vehicles and the manager group. Leverage is also often used. There would need to be a way of capturing these indirect co-investments in the rules. In France and Italy investment fund structures are generally “local”, and therefore fit straightforwardly within those countries' rules. However, UK executives tend to participate in more complex, global structures – any new rules would need to take this into account.

Furthermore, any new co-investment condition should arguably include derogations for certain types of funds which the Government is seeking to encourage. For example, venture, credit and/or infrastructure funds could be subject to lower co-investment requirements if they are undertaking activity which is particularly supportive of the Government's growth agenda.



Contacts



Damien Crossley
Partner
DD +44 (0)20 7849 2728
damien.crossley@macfarlanes.com



James McCredie
Partner
DD +44 (0)20 7849 2129
james.mccredie@macfarlanes.com



Sophie Donnithorne-Tait
Partner
DD +44 (0)20 7849 2670
sophie.donnithorne-tait@macfarlanes.com



Alicia Thomas
Partner
DD +44 (0)20 7849 2773
alicia.thomas@macfarlanes.com



Joe Robinson
Partner
DD +44 (0)20 7791 4211
joe.robinson@macfarlanes.com



Mark Baldwin
Senior Advisor
DD +44 (0)20 7849 2603
mark.baldwin@macfarlanes.com



Rhiannon Kinghall Were
Head of Tax Policy
DD +44 (0)20 7791 4131
rhiannon.kinghallwere@macfarlanes.com



Bezhan Salehy
Tax Policy Specialist
DD +44 (0)20 7849 2290
bezhan.salehy@macfarlanes.com



Macfarlanes LLP

20 Cursitor Street London EC4A 1LT

T +44 (0)20 7831 9222 | F +44 (0)20 7831 9607 | DX 138 Chancery Lane | [macfarlanes.com](https://www.macfarlanes.com)

The information contained in this submission is confidential, to be used for the sole purpose of evaluating this tender. It should not be disclosed to a third party.

Its provision does not create a business or professional services relationship. The submission does not constitute legal advice and should not be acted on or relied upon as doing so.

Macfarlanes LLP is a limited liability partnership registered in England with number OC334406. Its registered office and principal place of business are at 20 Cursitor Street, London EC4A 1LT.

The firm is not authorised under the Financial Services and Markets Act 2000, but is able in certain circumstances to offer a limited range of investment services to clients because it is authorised and regulated by the Solicitors Regulation Authority. It can provide these investment services if they are an incidental part of the professional services it has been engaged to provide.

© Macfarlanes 2024 (0724) 14c