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Invested in a better future

By email: carriedinterest@hmtreasury.gov.uk

30 August 2024

Dear HM Treasury

Re: The tax treatment of carried interest – A call for evidence

The BVCA is the industry body and public policy advocate for the private equity, venture capital and private credit (together "private capital") industry in the UK. With a membership of over 600 firms, we represent the majority of UK-based private capital firms, as well as their professional advisers and investors.

Thank you for giving us the opportunity to respond to this call for evidence. We welcome the Government's recognition that private capital channels vital investment across the UK and will play an important role in boosting economic growth. Private capital contributes to economic growth by making active investments in companies, focusing on long-term growth and operational improvement, leading to innovation, job creation and improved efficiency.

The current treatment of carried interest in the UK is – along with the wider regulatory and tax framework – at the heart of the internationally competitive investment environment which has made the UK an important hub for private capital. The treatment also reflects the long-term economics at the heart of the investment approach: institutional investors allocate risk capital to fund managers in the industry for a ten-year period (typically), in the expectation that the managers will deliver significant capital appreciation (and therefore returns) through active, long-term management, which is rewarded through a share in the realised capital return. The tax treatment reflects this economic reality and is consistent with other international jurisdictions.

The success of this approach over the past 40 years has been seen in the significant numbers of overseas investment professionals, and others in the wider industry ecosystem, who have been attracted to the UK and contributed to the role of private capital in boosting the UK economy. It is critical to the Government's ambitions for increased private investment and growth that the UK maintains its attractiveness and competitive edge for those who work in the industry and those who allocate capital to the UK for investment. The attractiveness of the UK as a destination for investment is under significant pressure at present, as large government incentives (including subsidies, grants, and tax credits) in the EU fuel intense competition for the deployment of private capital to drive overall growth.

We understand the public finance pressures and broader considerations affecting decisions on taxation, but it is vital that, whatever changes are made, the UK remains an attractive and internationally competitive place for private capital firms to locate and invest. We have provided more information below on the importance of private capital to the UK economy, and why the location of private capital managers affects where they make investments, before responding to the specific questions posed by the call for evidence. In preparing this response we have sought the views of our members and have included quotes from their replies below.

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Executive summary

Our response covers the following areas.

Economy:

- **Economic contribution**: private capital makes a significant contribution to the UK economy, generating jobs and economic growth by providing patient, long-term capital investment and expertise to private companies with high growth potential. This applies from early-stage businesses in emerging areas of the economy backed by venture capital, through to different sizes of businesses in the mature economy whose competitiveness and productivity are transformed by private equity and private credit.
- **Location of managers**: it is important for private capital managers to be based in the UK, both because of the direct contribution of the private capital industry to the economy, and because UK-based private capital managers are more likely to make investments in the UK.

Economics of carried interest:

- **Differentiation**: the economic characteristics of carried interest (or "carry") are fundamentally different from those of a salary or bonus. Carried interest is a share of an underlying investment return and reflects the partnership structure. Where fund returns are made up of capital gains, carried interest is a share of those gains. In these circumstances it is justified that carried interest is taxed as a capital gain.
- **Risk**: there is a real risk that carried interest is never received, with only around 50% of private capital funds achieving sufficient returns to pay carry. These are long-term partnerships, with funds typically lasting for ten years or more, and if the returns do not hit the high thresholds demanded by investors, no carry is paid.
- **Investor alignment**: carried interest achieves economic alignment of incentives between managers and investors, who both seek to achieve high returns. It is vital that global investors, which include pension funds with large reserves of capital which could potentially be invested in UK businesses, are not deterred from doing so through a loss of this alignment.

Structures and practices:

- **Varied market**: any changes will need to take account of wide variations in market practice and should not be overly prescriptive, as this will limit investment activity and the innovation and evolution of the industry. While the underlying principles applying to carried interest are consistent across different types of fund, there are significant variations in implementation, so changes must be made carefully.
- **Early-stage managers**: particular considerations apply to fund managers who are at an early stage in their careers, who are setting up funds for the first time or come from diverse backgrounds. Any new rules should be sufficiently broad and flexible to accommodate emerging fund managers and those with different degrees of liquidity.

The international context:

- **International competition**: around the world, carried interest is commonly taxed as a capital gain or at a lower rate. This incentivises long-term investment and recognises similarities with other entrepreneurial activity. Global competition for private capital and inward investment is extremely fierce. Any changes to the tax treatment of carried interest in the UK will be viewed in light of the carried interest tax regimes in key competitor jurisdictions, such as the US, France, Italy, Germany and others.

- **International mobility**: carried interest is key to attracting and retaining talent. Many private capital managers are highly mobile, and in light of potential tax changes including to the rules on carried interest, other countries are seen as increasingly attractive destinations.
- **Certainty and flexibility**: as requested in the call for evidence, we have highlighted some lessons that can be drawn from the approaches of other countries. Key points include the importance of certainty, and of retaining flexibility over the ways in which private capital funds can be structured.

Implementation of change:

- **Capital commitments**: external commentary has suggested that the Government may consider making the carried interest tax regime conditional on carried interest holders making a minimum capital commitment to the fund. If the government pursues this option, our view is that, if introduced carefully, this option could achieve the aims set out in the call for evidence without damaging growth and investment.
- **Forward-looking change**: it is crucial for any change to be forward-looking only, so that investors and managers are not arbitrarily penalised for very specific aspects of their arrangements set up many years ago, and that cannot now be altered, even where in general their activity remains in line with the proposed new regime. We would also advocate for extensive, purposive, and flexible transitional provisions.
- **Full consultation on detail**: we would urge the Government to consult in full on any detailed proposals before enactment, to limit the risk of substantial and serious damage to the UK private capital industry and the important investment and growth that it delivers.

Private capital investment makes a significant contribution to the UK economy

The UK is currently the largest hub for private capital investment outside the USA and is regarded as a world leading location for businesses to start up and grow, with clear and long-standing ambitions to attract global investment and grow UK businesses. In 2023, UK-managed funds raised £59.6bn to be invested around the world, including in the UK. This accounted for 52% of the total private equity and venture capital raised in Europe, reflecting the ongoing strength of the UK market.

In 2023, businesses backed by private capital directly generated £137bn of GDP, which represents 6% of the UK's total GDP or around 10% of private sector GDP. There are over 12,000 UK companies across a diverse range of sectors backed by private capital, and these currently employ over 2.2 million people in the UK. The majority of the businesses backed are outside London and 90% of the businesses receiving investment are small and medium-sized enterprises (SMEs).

Private capital investment generates UK jobs by directly driving and funding the growth and expansion of businesses.

- **Development**: private capital allows companies to develop concepts, recruit specialist talent, scale operations, invest in systems which deliver international competitiveness, open new locations, or enter new markets at home and abroad.
- **Job creation**: private capital invests in startups and emerging businesses, which are job creators as they grow from small teams to larger organisations.
- **Transformation**: private capital invests in mature businesses with untapped potential to increase jobs and profitability or underperforming companies, which can help to stabilise the business, protect existing jobs and create new opportunities as the company recovers and grows.
- **Adaptation**: private capital provides essential investment for both new and mature businesses at the cusp of innovation in areas from energy transition to emerging technologies, helping the Government to deliver on its missions for growth and clean energy.

- **Multiplier effect**: private capital helps to stimulate job creation in related sectors, such as suppliers, services providers, and local communities through increased economic activity.

Recent research from the Productivity Institute shows that private equity-backed companies experience a significant productivity boost following active private capital investment, with a positive impact on business productivity continuing even beyond the period of private capital backing.

Private capital drives economic growth by providing patient, long-term capital investment and expertise to private companies with high growth potential. Investors in private capital funds often commit capital for over ten years. This long-term capital is crucial to growing companies because it allows businesses to undertake projects and implement change that requires significant time to mature. It also supports sustainable growth by enabling companies to weather short-term market fluctuations, focus on strategic planning, and improve their operations without the pressure of immediate returns. This flexibility and patience is unique to private capital and allows more thoughtful decision-making, prioritising a company's long-term success and competitiveness over the short-term gains that can be favoured in other financial markets.

Private capital firms actively shape the management teams of the companies they back, agree strategies, bring in external operating partners to make businesses more competitive, and are focused on value creation in the businesses throughout their period of stewardship. Entrepreneurial risk-taking is at the heart of the model, with no guarantee of success. There is no entitlement to a share of the capital value created unless the investments have grown in value to hit the legally-binding and highly demanding market benchmarks, which exceed and set the investment approach aside from short term and/or passive investment strategies.

Private capital firms create direct value for the economy

In addition to the impact of private capital investment, the private capital industry makes a significant direct contribution to the UK economy. A study by a leading professional services firm shows that 140,000 people are employed in the UK by private capital firms, or by professional services firms working in the private capital sector. They collectively pay substantial amounts of tax in the UK, for instance on salaries and partnership profit shares, in addition to any tax on carried interest. The study also shows that in 2022, private capital firms contributed £17-18bn of direct GDP (including, for instance, wages, utilities, rent and expenditure on professional services).

Additionally, as a result of the significant investment ecosystem, the UK is seeing more diversity in the backgrounds of the investment professionals leading private capital firms, as well as a continued diversification of strategies into areas such as impact investing, where the UK has an impressive track record already.

The private capital industry is accountable and transparent. Uniquely, in the UK, BVCA members comply with established Guidelines for Disclosure and Transparency in Private Equity, including through publicly available annual reports and performance data. These help to respond to important questions raised about the industry by external stakeholders.

UK-based private capital managers are more likely to invest in the UK

Private capital investment managers in the UK tend to allocate a larger portion of their portfolio to domestic assets – so UK-based private capital investment professionals are more likely to invest in UK-based companies. There are many reasons why fund managers may be more successful and confident when investing in domestic markets, including in-country networks, access to information, an understanding of market opportunities and local culture, and a preference by companies to be backed by a "local" private capital firm. Any changes to the tax rules on carried interest must safeguard this flow of domestic and international investment capital into UK businesses.

Venture capital firms, and private equity businesses based beyond London in the nations and regions of the UK, have a strong local and domestic focus. The UK also derives significant competitive advantage from the presence of UK and international private capital firms in London (and around the country) who can access and understand UK investment opportunities, and associated policy frameworks, more readily. Global fund managers, with a regional headquarters in the UK, are a large importer of foreign investment capital into the UK. The vast majority of these global funds consist of non-UK sourced capital, but a substantial amount of this capital is deployed in the UK.

BVCA and Invest Europe data shows that looking at Europe as a whole in 2023, private capital investments in Europe amounted to around £86.8bn, of which £20.1bn was made into businesses in the UK. By contrast, looking at the sub-set of this which represents investment by UK-led private capital firms (those that are UK headquartered or have a UK office) over the last several years, 44-50% of the total capital invested went into companies in the UK. In other words, UK-based private capital managers are much more likely to invest in the UK than those based elsewhere.

Our data also shows that when managers are investing into the UK, if they are UK-based they are twice as likely to invest outside London and the South East than those investing in the UK from abroad. Firms which invest in the UK from abroad are, moreover, much more likely to expand their overseas offices than their UK offices as they scale up their operations and grow.

The link between the location of managers and the location of investment

Quotes from our members

"While we have made important investments in Germany and France, the large majority of our European investments have been in the UK, where our investment team is based. This is not coincidental. Having our European investment team all based in the UK makes us well positioned to find and develop conviction behind opportunities to deploy capital into UK businesses." [Global private equity firm]

"100% of our team are based in the UK and our office is in London. While we have a mandate to invest in all of North America and Europe, 100% of our European investments have been in the UK. We have the strongest links into the investment ecosystem where we are physically present which supports stronger sourcing." [Venture capital firm]

"Our experience and expectation is that investment opportunities will more frequently arise in countries where we have a physical office presence, as our deal and origination team members are more likely to build and maintain relationships with the owners/management of prospective investment targets when both are based in the same country." [Growth capital/mid-market firm]

"Over 70% of our EMEA investing teams are based in the UK. That geographic proximity has contributed to the UK occupying a "first in line" place for capital allocation in Europe. If no longer based in the UK, asset managers will lose familiarity and connectivity with the UK which would strongly impact investment allocation. The investment executives who source the investments through connecting with entrepreneurs, families, corporates, and the full private capital ecosystem (e.g. VC, mid-market etc.) will naturally start to build more of those relationships on their doorstep. This means the number of UK deals entering the initial "funnel" of potential investments would naturally decline, resulting in a higher risk of a lower fund deployment into UK investments due to less UK opportunities being considered overall." [Global private equity firm]

Our investment strategy is "primarily driven by location of investment team - whilst we do engage in investment activity in other jurisdictions, there are much greater barriers to entry and heightened competition in jurisdictions where we do not have a physical presence." [Growth capital/mid-market firm]

“Given our strategy of being hands on, it is imperative that we are geographically close to our portfolio companies.” [Private equity firm]

“Our local presence is an essential part of our strategy. Generally speaking we would not invest in a company where we do not have a local presence.” [Global private equity firm]

“We invest exclusively in UK businesses. Due to our highly engaged investment strategy we have a high level of contact with our founders. Being able to meet them face to face and being in the same time zone are definite advantages.” [Venture capital firm]

Private capital achieves high returns for institutional investors, including pension funds

Private capital fund managers actively manage their portfolio companies to improve efficiency, profitability, and growth, which enhances the value of the business. High returns are often realised through exit strategies, such as a trade sale (selling the company to a strategic buyer), or an initial public offering (IPO) on an investment exchange, such as the London Stock Exchange. Private capital also generates strong returns by investing in niche or underrepresented markets, due to less competition or higher growth potential. BVCA data shows[1] that over the ten years to December 2023, private capital funds achieved an annual return of 15%, as compared with 5.3% and 7.5% achieved by the FTSE All Share index and the MSCI Europe index, respectively.

The prominence of private capital activity here draws in investment capital from investors all around the world. While overseas investors currently contribute over 80% of private capital deployed by investment teams based in the UK, global capital flows are dynamic and will respond quickly to changing economic conditions and market sentiments.

We now consider the specific questions asked in the call for evidence.

Question 1: How can the tax treatment of carried interest most appropriately reflect its economic characteristics? The government notes that there are a range of circumstances in which carried interest is received, and that the characteristics of the reward will not be the same in all cases.

The economic characteristics of carried interest are fundamentally different from those of a salary or bonus. Carried interest is a share of a return made by investors and is designed as an incentive based on the performance of the fund’s investments. If those investments fail to deliver the outstanding performance required by investors, no carried interest is paid. The link to the performance of the fund’s investments is a key differentiator between carried interest and the rewards received by, for instance, the executives of a FTSE listed company outside the private capital sector: these executives’ rewards are linked to their personal performance and the financial results of their employer, while carried interest is linked to the financial outcomes of external investors.

The long-term and uncertain nature of carried interest means that, in the absence of a meaningful difference between the tax rate on carried interest and that on employment income, there is a risk of “market failure”. This is because the lower rate of tax means private capital managers are willing to receive carried interest, with its associated long timeframes, rather than seeking short-term returns in less long term, more liquid, more certain parts of the investment world.

[1] This represents a 10-year horizon return that factors in cashflows from all funds that were active at some point during the last ten years, regardless of lifecycle stage, together with 31st December valuations in 2013 and 2023. For more information, please refer to the Performance Measurement methodology paper, which can be found here: BVCA-Performance-Measurement-Survey-Methodology-Paper.pdf.

If the financial impact of deferred returns is no longer offset by a lower tax rate, the incentive is diminished and carried interest may cease to be economically attractive to managers in the UK. There would then be a risk that the alignment of interests between managers and investors would be lost, with a likely decline in investment risk taking and a reduction of long-term investment. This would have consequences on the scale of early-stage investment in innovative UK businesses that, with patient investment and expert guidance have the potential to be market disruptors and the next "unicorn" companies that the UK needs. This would also have consequences for more mature companies needing private capital investment and expertise to stabilise their business, expand their operations and enter new markets. We expand on the alignment point below.

Around the world, carried interest (or "carry") is commonly taxed as a capital gain or at a lower rate. Historically, this is because carried interest was structured as a partnership interest and the underlying transaction giving rise to the carried interest was the disposal of an asset, so the return, whether to the investor or manager, was capital in nature and gave rise to a capital gain. In some jurisdictions, where carried interest is less reliant on the partnership structure, a lower rate is still used to incentivise long-term investment and to create an alignment of interests between investors and private capital fund managers in creating value and achieving long-term and sustainable growth. This is a pivotal issue for UK private capital because it is essential to draw top talent into the industry to take on long-term, high-risk investments that can drive economic growth, innovation, and job creation.

Any changes to the tax treatment of carried interest in the UK will be viewed in light of the carried interest tax regimes operated in key competitor jurisdictions. The behavioural response to any changes is difficult to predict but should not be underestimated, particularly at a time when many competitor jurisdictions are actively trying to grow their private capital sector, and their associated investments.

When a fund makes capital gains, carried interest is a share of those gains

Typically, private capital funds (which are normally set up as tax-transparent limited partnerships) make their returns by disposing of assets, normally shareholdings, and making capital gains. To the extent that a fund's returns are made up of capital gains, carried interest is a share of those gains. This is recognised in the current rules for taxing carried interest, which have been significantly refined over time and which draw a carefully calibrated distinction between income and gains. Private capital funds do make other types of return, such as interest and dividends, but to the extent that carried interest is a share of income received by the fund, this is already taxed as income under existing legislation, resulting in an effective "blended" tax rate of more than 28%.

In our view, to the extent that carried interest represents a share in capital gains made by a fund partnership, it is justified that it should be taxed as a gain.

Certainty of treatment is key here, and the current rules for taxing carried interest have to date provided the industry with the necessary certainty that if all relevant conditions are satisfied, capital gains treatment will be available. While the rules are extensive, they are now well understood. This has given fund managers the confidence to base their businesses in the UK and in turn has enabled the industry to make the long-term investments that drive growth and employment across the UK.

Carried interest is paid in the long term

Carried interest is a "shared equity" model under which the managers only receive their share (the carried interest) if the fund's investments deliver outstanding performance. This involves long timeframes and entrepreneurial risk-taking, with no guarantees of success. Indeed, many fund managers never receive carried interest because the funds do not meet the required minimum return thresholds agreed with investors.

BVCA data shows that for funds which started investing over 15 years ago, there is an average period of seven years before the first payment of carried interest, with many managers waiting significantly longer. The average period is longer for venture capital, as shown in the table below.

Investment stage	Average time to first payment of carry
Large Private Equity	7.5 years
Mid Private Equity	5.7 years
Small Private Equity	7.4 years
Venture Capital	10.5 years
All investment stages	**7 years**

The long-term nature of the incentive created by carried interest is underpinned by existing legislation, whereby carried interest can be recharacterised as income under the IBCI (income-based carried interest) rules if the average holding period of a fund's investments is less than 40 months.

It is also recognised by and embedded into UK and EU regulation. In both jurisdictions, regulators have applied prescriptive remuneration rules to banks and asset management businesses to reduce the possibility of firms and individuals being rewarded for short-term risk-taking that does not translate into long-term results for investors. The Financial Conduct Authority and others have generally allowed private capital firms to disapply many of these remuneration rules in relation to carried interest, because the European (whole fund) carried interest model does not reward short-term risk-taking in the same way as, for example, an annual bonus paid to an executive at a bank. Instead, private capital managers can only receive carried interest if their investments are ultimately successful for investors, and indeed will lose their entitlement to it if the investors do not benefit.

<u>There is a real risk that carried interest is never received</u>

Based on a large sample of 320 private capital funds which started investing over 15 years ago, BVCA data indicates that only around 50% have achieved sufficient returns that carried interest would be payable. The typical lifespan of a fund is 10-12 years, with investments made in the first part of the period and realised in the later years. While some funds are extended beyond their initial lifespan, most funds are either terminated or close to termination by their 15-year anniversary.

There are more funds that never pay carried interest in the venture capital sector than in the private equity sector because the type of investments made by venture capital funds have different risk characteristics. Venture capital, private equity and private credit managers all recognise that there are no guarantees and there is some probability that funds will not pay out carried interest.

<u>Carried interest achieves economic alignment between managers and investors</u>

Carried interest is of fundamental importance to investors who are considering investing in private capital funds. This is because managers receive nothing by way of carried interest unless the capital value of the investments, and the returns from the funds, hit the high thresholds demanded by investors.

This means that the interests of private capital managers are fully aligned with the interests of investors: both are highly motivated to ensure that the fund's investments are successful. Indeed, investors demand that this alignment exists from day one and throughout the life of the fund. As a result, the terms on which carried interest may be paid are heavily negotiated between managers and investors, and investors will only commit if they are satisfied that managers are appropriately incentivised by reference to the performance of investments. It is vital that these large global investors, which include pension funds with large reserves of capital which could potentially be invested in UK businesses, are not deterred from doing so through a loss of this alignment.

Carried interest therefore binds private capital managers' incentives inextricably, and deliberately, to outstanding performance in the investments they make. This has significant positive implications for the wider economy: we have businesses that are more productive, more internationally competitive and that power growth across the country.

Carried interest is key to attracting and retaining talent

Carried interest is an essential mechanism to attract talented managers and tie them into the private capital firm. It achieves this because it is not paid for many years and is typically subject to "vesting" provisions, under which managers lose their right to receive carry, or are only entitled to a proportion of their maximum entitlement, unless they continue in their role for a certain number of years. There is considerable variation in vesting terms across the industry but there would typically be a vesting period of, say, five years, after which managers may still lose their right to carry if, for instance, they move to a competitor firm.

These features of carried interest mean that managers are highly motivated to remain with the firm and to work hard and persevere to improve the businesses in which their fund has invested, to achieve good returns for the fund's investors and ultimately themselves.

The long-term earning potential of carried interest (if investments perform well) differs in nature from the compensation packages on offer in other financial services industries, such as investment banking, where candidates may expect to have a greater short-term earning potential with higher base salaries, bonus awards and share options (which are often subject to capital gains tax).

This is essential for the success of private capital investment, which needs to approach investment on a long-term basis rather than looking for immediate gains, which would be to the detriment of the underlying investment's longevity. Our data shows that the average private capital investment holding period is 5.5 years, which contrasts with less than a year in public markets.

The current tax treatment of carried interest is seen as integral to achieving this outcome. Managers who might otherwise be unwilling to wait for an average of seven years before receiving initial carry payments are incentivised to do so by the knowledge that if and when carry is eventually received, it will be taxed as a capital gain, reflecting the underlying nature of the transactions giving rise to carried interest. If this were not the case, individuals may well decide instead to pursue a career in which all of the financial reward takes the form of higher salary and bonuses that are paid every year. The long waiting times associated with carried interest also means that the perceived stability of the tax rules is particularly important.

The importance of the tax treatment of carried interest

Quotes from our members

"If the tax treatment of carried interest were different, we would likely see a shift in behaviour… Without the current treatment, which favours waiting for long-term rewards, fund managers may lose out relative to remuneration structures found at investment banks and hedge funds. In such environments, short-term incentives dominate, leading to decisions that prioritise lower risk cash returns over sustained growth." [Growth capital/mid-market firm]

"Venture capital is a long-term high-risk business. The existing tax treatment of carry is crucial to incentivising professionals in this space, especially as carry holders put their own money at risk. Absent the current treatment, the talent pool in venture would dry up, resulting in a very material decrease in venture funds being raised, and a dramatic fall in the number of companies being funded." [Venture capital firm]

"Carried interest is an essential part of the way PE professionals are remunerated. We can attract talent who remain long term motivated thanks to carried interest. They understand that they are building their equity for the future." [Growth capital/mid-market firm]

"Our fund is small, we champion growth which takes a long time and a lot of hard work to deliver, and carried interest is the key component of remuneration (small fund yields small management fees to pay salaries). If carried interest is taxed toward similar levels as income, then we may well stop or change investment strategy." [Growth capital/mid-market firm]

"The attraction of setting up our firm (I am one of the founders) if carried interest was taxed as income would have been a lot less given the risks we take, the work over time involved to drive the value of our investments and the money we personally put at risk, no returns are guaranteed. We employ very capable people, and they would look to work and be incentivised through capital gains outside of private equity." [Growth capital/mid-market firm]

"The availability of carried interest in its current form has been important in attracting the right talent to undertake our supportive and innovative strategy. It seems reasonable to conclude that the availability of carried interest and its favourable taxation for UK individuals has created a strong incentive for investment professionals to maximise fund returns over the long-term, not only for their own benefit, but for the benefit of the firm and fund LPs." [Growth capital/mid-market firm]

"Smaller venture capital managers like ours simply cannot compete with large asset managers or banks on wages. The high-risk nature of venture capital and the long period of time required to earn the payout struggle to compete with annual bonuses making the carried interest tax regime essential to attract talent to our business. Reducing this incentive is likely to result in a migration of talent to businesses with a focus on shorter term investing and gains (and short term bonuses) such as those available from hedge funds via arbitrage or cyclical market movements rather than the generation of long term sustainable value which is in the interests of the economy as a whole." [Venture capital firm]

If the current tax treatment changes, "the location of the investment team would likely shift offshore and therefore travel in for investment decisions - this would likely reduce the exposure to the UK and create a bias to wherever the core team relocates to in this scenario" [Venture capital firm]

Question 2: What are the different structures and market practices with respect to carried interest? The government is particularly interested to understand how these differences should be taken into account as part of its reforms.

While the underlying principles applying to funds in different sectors are well established and straightforward, the scale of the UK's ecosystem is now such that there is a great deal of variety, and associated complexity in the fund arrangements across the industry. As such, any changes that may be introduced need to be forward-looking, respecting the legal realities of existing funds being at differing stage of maturity over their ten-year (or sometimes longer) duration, and not having the ability to change their structure (and associated economics) at this stage.

It is vital that any changes do not prescribe or limit the ways in which private capital funds can be set up, as flexibility in structuring is one of the key strengths of the UK's current rules. Structures develop over time and must adapt to commercial, regulatory, tax and other changes, and must take into account the needs of the (typically) international investor base. We would strongly advocate that the Government continues to engage with the industry to ensure that different variations and complexities are fully considered. For instance, any changes will need to take into account:

- the different structural profile of an earlier stage private capital firm with a focus on a specific UK sector compared with an international firm whose regime for sourcing and deploying capital and structuring investors' incentives will be set at a global level,
- the full range of investment strategies, including private equity, growth equity and venture capital but also debt, infrastructure, real estate, and others, and
- both open-ended and closed-ended funds – most private capital funds are closed-ended, but open-ended vehicles, including long-term asset funds (LTAFs), are an important route to enable access to private capital for UK pension funds and a wider range of investors.

Typical carried interest structures and market practice

In a typical structure, a private capital fund is set up as a limited partnership in which the external investors are the limited partners (LPs). The private capital firm is represented by the general partner (GP) and sometimes a separate partnership through which the right to carried interest is held (the "carry partnership"). The limited partnership agreement will typically provide that the LPs are entitled to 100% of the fund's proceeds (after fees and expenses) until each has been paid back an amount equal to the money drawn down from them to make investments and pay management fees and expenses, plus a "preferred return", also known as the "hurdle".

The preferred return is set by the investors. This is often an Internal Rate of Return (IRR), so is annual and compounded, and is typically in the range of 6-10%. For venture capital funds, the hurdle may be expressed instead as a multiple of the original investment rather than as an IRR, because the expectation is that the timescales involved may be longer than in private equity.

The pre-agreed "preferred" level of return presents managers with a significant challenge and explains why a significant number of funds never pay carried interest. The IRR takes into account the amounts invested in the fund (drawdowns) and the timing of the returns (distributions). In a simplified example, if £100 was invested (and drawn down) at the inception of the fund, then by year 7, if the preferred return is set at 8% IRR, the fund would have to return around £171 before the managers would be entitled to any carried interest.

Some of our members wait for over ten years before receiving carried interest, and the longer the holding period, the higher the barrier posed by the preferred return: in the previous example, by year 10 the fund would have to return around £216 before it is "in carry".

Once investors have been allocated a return of proceeds equal to the preferred return, any further proceeds will be split between LPs and the GP (or the carry partnership) in the agreed sharing ratio. The GP's share is called carried interest. While 80:20 is the most common sharing ratio, 85:15 is commonly seen, and there are other variations that can be determined by the LP and agreed with the GP at the outset.

Whole fund and deal-by-deal carried interest models

There are various ways in which carried interest can be allocated in private capital funds. The most common in the UK, and across Europe, is the "whole fund" structure whereby managers receive their carried interest only after the entire fund has returned all drawn-down capital to investors and achieved the preferred return.

The main alternative is the "deal-by-deal" structure, under which carried interest is paid upon the realisation of individual investments. Under the deal-by-deal model, the performance of the fund is re-evaluated throughout its life and there is a very real chance of carried interest being "clawed back" (i.e. having to be repaid) if the fund performs less well over its whole life than in its earlier years. The effect of the clawback is that these arrangements result in a similar economic outcome to a European-style fund under which carry is paid on a whole fund basis.

There are many variations on these basic categories, for instance a whole fund structure may involve a certain amount of carried interest being calculated and paid on a deal-by-deal basis, with clawback provisions if investments that are disposed of later perform less well than expected, or a late and unexpected liability arises in a fund. While it is regarded as unusual for carried interest paid on a whole fund basis to be clawed back, it does happen; we are aware that at least one of our members has a fund in this situation at present.

Who receives carried interest?

Carried interest is divided between the managers of a fund according to a methodology determined by the private capital firm. Many firms operate a system of carried interest "points" or "units" whereby carried interest is paid into a notional "pool" in which managers are allocated a number of points entitling them to a certain proportion of the pool. In many cases, this allocation happens at the inception of the fund, but is subject to vesting provisions, as indicated above.

Industry practice varies as to how widely carried interest is allocated within a private capital firm. In nearly all cases the most senior individuals (or the most senior individuals in the investment team) receive the largest share, to recognise that these individuals set the strategic direction of the investments made and to ensure alignment between the interests of these key drivers of returns and the interests of investors. Some firms limit carried interest to the most senior managers, others share it more widely within the organisation as a method of incentivising those individuals who are seen as key to the creation of value.

In addition to a right to share in any future carried interest, private capital managers normally receive a salary (if they are employees) or drawings (if they are LLP members), and often bonuses, all of which are taxed as income in the normal way. Carried interest is separate from salaries and bonuses; as described above, it is a different type of incentive which rewards the performance of investments rather than individual performance, and is much more akin to an entrepreneurial return, in that it is only received in the long term and there is a real risk it is never realised at all.

Capital commitments by managers (co-investment)

Investors often require managers to invest in their own funds ("co-invest") to ensure alignment of interests. The level of co-investment required varies considerably, from 0.5% or less to over 2% in some cases. By having "skin in the game", managers share investment risk, which helps to build trust with investors by signalling the managers' confidence in the fund's strategy and success. In practice there is a great deal of variation as to how this is achieved, depending on how the fund has been established and the requirements of their investors.

Co-investment, carried interest and management fees are agreed between the managers and investors when the fund is being set up, and are heavily negotiated. The management fees are for running the operations of the business (such as rent, IT, and back-office functions) and paying salaries and bonuses. The allocation of carried interest among individuals may differ from the allocation of co-investment, in that commonly the more senior individuals bear a greater share of the firm's overall co-investment commitment than their corresponding share of the firm's carried interest. This is because it is normally only these more senior team members who have sufficient funds, from the earlier stages of their career, to meet the level of co-investment required by investors.

A possible new requirement in the UK's tax rules for a minimum capital commitment

External commentary has suggested that the Government may consider making the carried interest tax regime conditional on carry holders making a minimum capital commitment to the fund, as is the case with the regimes in France and Italy (but not, for instance, Spain or Germany). From commentary in the media, we understand that the policy intention behind such a change would be that carried interest should only be taxed as a gain for taxpayers who have put their own capital at risk. We consider that, if introduced

carefully, this is an option that could achieve the aims set out in the call for evidence without damaging growth and investment.

If the Government pursues this option, we would strongly advocate that any such requirement is assessed at a team rather than an individual level. In other words the commitment should be measured by the amount invested by all carried interest holders in the fund and not by each individual participant. This is because otherwise the regime would be accessible only to those who already have the capital to commit, making the industry less attractive to the next generation of talented managers needed to drive long-term growth, employment and productivity.

We would also urge the Government to ensure that any changes do not constrain the ways in which carried interest and co-investment can be structured, to the extent that this is compatible with the policy objective. The flexibility in structuring that is possible under current rules is an important part of the UK's attractiveness for the funds industry. We suggest that it should be possible to achieve the policy objective here by adopting what is in effect a principles-based approach, by assessing the amounts that managers invest in a fund, without needing to constrain the manner in which they do so. Again, we would encourage the Government to consult with industry on the details of any changes, to avoid unintended consequences.

A new capital commitment requirement: implementation and transition

It would be important for any change to be forward-looking only, in the sense that it should only apply to funds that are set up after the new regime has been implemented. There will be many funds that were set up years before any new regime comes into force, with conditions agreed with investors and in keeping with current legislation in good faith. For carry holders in pre-existing funds to be excluded from capital gains treatment because they failed to comply with conditions that did not exist at the time when those funds were set up may be viewed as a form of retrospective taxation. This could be damaging to the attractiveness of the UK as a place to invest and grow business and harm confidence in the system more generally.

There is also a risk of market distortion if long-established funds are treated differently from new ones, as new funds would be established in the knowledge of, and so could be structured to comply with, the amended rules. In many cases it will be impossible to restructure carried interest and co-investment in funds that were set up many years ago, as these would be locked in by legally binding agreements.

We would also advocate for extensive, purposive and flexible transitional provisions, to acknowledge that fund arrangements have been in place for many years and to avoid the risk of damaging confidence in the long-term stability of the UK's tax system as an environment in which to base fund management businesses.

Emerging managers and small funds

Particular considerations apply to fund managers who are at an early stage in their careers, or who are setting up funds for the first time. These managers would typically not have returns from previous funds so are in a less strong position to make co-investments but are vital to the future of the private capital industry in the UK and the growth, productivity and employment that it brings. Early-stage fund managers often invest in the riskiest start-up businesses, which are frequently developing innovative technologies and are a key driver for economic growth.

Any capital commitment requirements are likely to be more challenging for smaller and emerging fund managers and could deter those businesses from establishing themselves in the UK and making their investments here. We would therefore urge caution regarding the introduction of a capital commitment requirement without careful consideration of the impacts on different types of fund manager, to avoid

damaging or distortive effects. For example, it would be important for any criteria to be sufficiently broad and flexible to capture emerging fund managers and those with different degrees of liquidity.

Question 3: Are there lessons that can be learned from approaches taken in other countries? While many other countries have specific regimes for the taxation of carried interest, their detail and conditions for access vary.

We have mentioned above that in recent years, 44-50% of the total capital invested by UK-led private capital firms went into businesses in the UK. The market for the specialised and highly talented people needed to identify, invest in and grow these companies is fiercely competitive between different jurisdictions and different industries.

It is vital for UK private capital firms to continue to attract these people to come and work in the UK, and to stay here. In previous years, the UK's reputation as a business-friendly destination has been highly successful in attracting non-British nationals. One result of this is that the UK private capital industry includes a large contingent of people for whom the UK may not be a permanent home, and who have strong family ties elsewhere. This means that many private capital managers are highly mobile, and in light of potential changes to the tax treatment of carried interest and other tax rules, including the non-dom regime, other countries are seen as increasingly attractive places to go. International firms are also much more likely, compared with ten years ago, to have offices in other European countries, making the relocation of individuals more straightforward. Another factor encouraging mobility is the increased prevalence of remote or hybrid working, in the post-covid environment.

Carried interest is critical to the international competitiveness of the UK private capital industry

Quotes from our members

"The current UK carry rules were a key factor behind our decision to locate our European team (which comprises approximately 80% EU nationals) in London. Alternative jurisdictions were considered, and there would have been a significantly higher likelihood of locating outside the UK had the UK's tax treatment of carried interest compared unfavourably to the alternatives." [Global private equity firm]

"Maintaining a competitive carried interest taxation regime is critical to retaining talent in the UK. The UK's current regime is not the most competitive in Europe but is broadly competitive with Germany and France and sufficiently competitive with the other jurisdictions to enable us to continue to operate our London-centric model to date. Significant changes to the taxation of carried interest will jeopardise our ability to sustain this model." [Private equity firm]

"Having the current carried interest treatment makes it significantly easier to attract and retain investment talent in London. The majority of our professional team are not UK nationals but have moved here because it is an attractive place to work (including the tax treatment)" [Private equity firm]

"Less than 24% of our UK-based investing team are UK nationals (36 nationalities overall, many with EU passports and therefore an automatic right-to-work within European countries) and therefore are more likely and able to transfer to more competitive European countries if there is substantially different tax treatment there vs. the UK." [Global private equity firm]

"Europe is a fragmented region and whilst the UK is the largest hub, in the event of an adverse change in the taxation of carried interest, relocating to another major European hub would be straightforward. This would be a necessity to continue to attract the quality of investment talent that our LPs would expect in order for us to make the best investment decisions. We couldn't honour that fiduciary obligation if we were unable to find the best talent in the UK." [Venture capital firm]

"The tax treatment of carried interest is a major consideration when deciding where to locate people, as the cost of delivering this to professionals is a major determining factor in the cost/benefit analysis. As a UK headquartered business we foresee potential difficulties in attracting and retaining our existing calibre of talent to the extent the UK taxation of carried interest is materially higher than other jurisdictions. Whilst we do not necessarily envisage a situation within our business whereby investment professionals immediately seek to leave the UK for tax reasons, as our business grows, we can see it being much easier to attract new talent to offices outside of the UK with more attractive overall regimes (e.g., in Germany). In theory this could, over time, move our centre of gravity away from the UK." [Growth capital/mid-market firm]

"The treatment of carried interest has a significant impact on where our people are located. The current UK regime is a key reason why, notwithstanding a very significant proportion of our London-based employees are non-UK nationals, we decided to locate our European head office (and over 95% of our European staff) in the UK." [Private equity firm]

"Our employees are highly mobile and, of the London based investment professionals, c.50% are European nationals (only 30% are British). Should the tax treatment change, it may be harder for us to keep London as our sole investment hub in Europe and might see us open offices elsewhere to remain competitive." [Global private equity firm]

Carried interest tax regimes in other countries

We have included information on key aspects of the tax treatment of carried interest in France, Italy, Germany, and Spain as an appendix to this response. There are some key differences between the regimes in these countries and that currently in force in the UK, including, in some cases, the imposition of "gateway" tests, such as a minimum capital commitment or a minimum holding period, as a condition of access to preferential tax treatment. These rules take different forms in different countries, and conditions that appear simple can sometimes cause significant uncertainty in practice. We have included, in the appendix, some commentary on the advantages and disadvantages of each regime.

A consideration worth drawing out from the French example concerns the point we make above about the importance of any rules not constraining flexibility in how funds are structured. Our members find the French rules very challenging to manage in practice, because they are prescriptive and focus on domestic French funds. For the UK to continue to attract international investment talent and be a hub for global funds, as well as to retain UK fund managers, the rules need to be principled-based and incorporate some flexibility.

Some countries, including Germany and Spain, tax carried interest as though it were income, even where the underlying return made by the fund is in the form of a capital gain. Preferential treatment is then given by treating a proportion of this deemed income as exempt from tax. We would be extremely concerned if there were a similar move by the UK to a system under which carried interest is taxed as income. This would be destabilising and would not fit with the legal and commercial realities of carried interest. We have included some further comments in the sections of the appendix covering Germany and Spain.

The USA is the world's largest hub for the private capital industry and is a draw for individuals looking to relocate from the UK. The US rules are broadly similar to the current UK regime and, in particular, do not have a condition regarding a minimum capital commitment. A key point is that further deviation between the US and UK rules could increase potential double taxation for US citizens who are UK tax resident (since they pay US tax on their worldwide income and gains regardless of where they reside).

Rules for non-residents in other countries: highlighting Italy

When private capital managers evaluate other countries' tax regimes, the specific rules for carried interest are only part of the picture. Of similar importance are the tax rules in these countries that are designed to attract people (from all business sectors) to come and work there. Notably, many of these regimes apply not only to people from other countries, but also to returning nationals, i.e. they also incentivise people to return to their home countries.

Many countries have rules of this nature that are seen as attractive, but we would particularly highlight Italy in this context, as their rules have achieved notable success in recent years. Italy operates what is referred to as a "flat tax", under which individuals of any nationality (including Italian nationals), who have not been tax resident in Italy for at least nine of the previous ten years, can pay a flat annual substitute tax of €200,000. All non-Italian income and gains will then not attract further tax (other than gains from certain disposals of foreign shareholdings, which are not automatically sheltered for the first five years of residence).

This creates significant savings for individuals with substantial income and gains arising outside Italy. Employment income can be apportioned based on how many working days are spent in Italy, so that a portion will be taxed under the flat tax rules. The regime lasts for 15 years.

Italy has also implemented a so-called "impatriate" regime for highly qualified workers. This regime is an alternative to the flat tax regime and applies to income from working activities sourced in Italy. Under these rules, if an individual has been non-tax resident for at least three years, commits to being tax resident in Italy for at least four years and mainly works in Italy, a 50% tax relief applies to Italian-source income for the tax year in which they become resident and the next four years (with special rules for employees who move within the same corporate group). The income benefitting from this treatment is capped at €600,000 per year.

Next steps

As a final comment, we would like to stress the importance of any detailed proposals being the subject of full consultation before enactment. A proper consultation process would help to ensure that the potentially complex impacts of any proposed changes can be fully considered and assessed, to limit the risk of substantial and serious damage to the UK private capital industry and the important investment and growth that it delivers.

Thank you again for the opportunity to respond to this call for evidence, and please do not hesitate to contact us if we can be of assistance in providing further information.

Yours sincerely

Michael Moore
Chief Executive, BVCA

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Appendix

Information on the carried interest tax regimes of France, Italy, Germany, and Spain

France

Tax rates

Unless it falls within the preferential Arthuis tax regime, carried interest received by French tax resident managers is subject to tax as employment income (at rates of up to 49% plus employee social security contributions of 30%).

Under the preferential regime, distributions of interest and dividend income are taxed as investment income at a flat rate of 30% (which includes personal income tax (at 12.8%) and social security contributions (at 17.2%)). Capital gains are also taxed at a flat rate of 30%. An additional 3% or 4% applies to exceptionally high earners.

Conditions

For the preferential tax regime to apply to French tax resident managers, the following conditions must be met:

1) The managers must be (or, at the date of their subscription for, or acquisition of, their carried interest shares/units, were) employed by, or corporate representatives of, either the investment fund, or a company providing management services to the fund or a company providing services to that company, in each case, for arm's length remuneration.
2) The managers must be paid arm's length remuneration for the employment or corporate representative position described in point 1 above.
3) The managers must hold carried interest shares/units in an eligible French fund (FCPI, FCPR or an SCR) or a non-French investment structure established in the EEA which has the main purpose of investing, directly or indirectly, in shares of unlisted companies (or instruments giving access to the capital of such companies), to create value for stakeholders through their management of these investments. This purpose must be set out in the establishment documents.
4) The carried interest units/shares must form a single class of units/shares.
5) The manager must subscribe for or acquire their shares/units at market value.
6) The basic position is that the subscription price for the carried interest units/shares must be at least 1% of total subscriptions in the fund of up to €1bn and 0.5% of total subscriptions above that amount. There are some variations to this basic position:
    a. The 1%/0.5% levels are proportionately reduced if the carry percentage (the percentage of returns received by carried interest holders once the preferred return has been achieved) is less than 20%.
    b. In the case of venture capital funds, the minimum level of co-investment is 0.25%, rather than 1% or 0.5%, for structures with a main purpose of investing in unlisted innovative companies or SMEs. Various conditions apply, including that the carried interest must not carry rights to more than 20% of the fund’s assets or income. There are further rules regarding how a company can qualify as “innovative”, such as by incurring a minimum percentage of its expenditure on research.

7) Proceeds from the carried interest shares/units cannot be paid earlier than five years after the date on which the fund was established (for French funds) or, for other funds, after the date the carried interest shares were issued.

Comment

The French carried interest regime is designed for French sponsored funds which are typically very simplistic when compared to non-French sponsored funds. Whilst certain of the conditions are relatively straightforward, a number of the conditions cause difficulty. In particular:

- As regards condition 1, it is highly unlikely that managers will be employed by the investment fund. If they are employed by an adviser or sub-adviser, the French tax authorities have often taken a restrictive view of the number of delegation arrangements that may apply.
- As regards condition 3, common fund structures used around the world do not qualify. In addition, the rules do not cater for carried interest being held via a separate carry vehicle (as is typical in non-French funds) which can cause some difficulty. The requirement regarding shares in unlisted companies is also interpreted inconsistently, with some advisers maintaining that the fund vehicle cannot hold debt instruments at all, while others look more purposively to the underlying investee companies.
- As regards condition 4, the French Tax Administration's (FTA's) official administrative guidelines (the "Circular") provide that, within an EU fund, carried interest shares/units must form a single category of shares/units. The key point here is that each carried interest share/unit must be subscribed at the same subscription price and must give the same rights to the net assets or to the proceeds. Deal-by-deal carried interest does not satisfy this requirement. In addition, this requirement can cause problems where new team members are allocated carried interest part way through the life of the fund.
- Condition 6 can cause a number of difficulties:
    - The co-investment requirement is applied at the level of the individual. This is a constraining factor when it comes to incentivising junior talent. While the private capital firm as a whole can reasonably co-invest significant sums, junior team members cannot and this is a limiting factor which is, as far as we are aware, unique to France.
    - For non-French sponsored funds with both French and non-French managers, it is unclear whether the 1%/0.5% condition must be determined for all carried interest units subscribed by the fund's managers or only those subscribed by French managers. In practice, French managers typically ensure that the price paid for their carried interest and the amount co-invested are at least equal to their pro rata share of the 1%/0.5% threshold corresponding to their actual percentage of carried interest. This can cause issues including access for junior members.
    - The Circular also provides that the co-investment must be made "in the investment structure". This can cause uncertainty where co-investment is structured via a parallel entity which co-invests alongside the main fund, as it is unclear whether the minimum investment requirement applies on a "vehicle by vehicle" level. Many funds have multiple vehicles for different categories of external investor, so this approach does not reflect reality.
    - As we have mentioned above, in our view it is important that any co-investment condition should be principles-based, rather than prescribing the manner in which managers can structure carried interest and their investments in the fund.

Conditions 2, 5 and 7 are more straightforward.

- In terms of condition 5, the FTA's Circular states that the "value" of carried interest shares which are subscribed upon creation of the fund, or at a time when no investment has been made by the fund, can correspond to their subscription/nominal value (which is typically only a notional amount). Where carried interest is acquired at a time when investments have been made, the FTA has accepted a liquidation value as an acceptable market value.
- In terms of condition 7, any distributions that arise prior to the expiry of the five-year period must be booked in a specific account established in the name of the French managers and blocked until the expiry of the five-year period. Typically, this involves establishing an escrow account with amounts distributed to the French managers on expiry of the five-year period.

Italy

Tax rates

There is a specific preferential regime under which carried interest is automatically categorised as financial income and subject to tax at 26%. However, even if the conditions for the carried interest regime are not met, it may still be possible for the carried interest to be financial income (and therefore taxed at 26%), but this will depend on the specific facts. In addition, the presence of the beneficial Italian flat tax and impatriate regimes (described above in the body of this response) means that it is often unnecessary for fund managers to rely on the specific tax regime for carried interest.

If the preferential regime does not apply, carried interest received by Italian resident managers is subject to income tax at rates of up to 43% (plus social security, local surcharges and a 10% charge on bonuses in the financial sector).

Conditions

For the preferential tax regime to apply to Italian tax resident managers, the following conditions must be met.

1) The manager must hold direct or indirect shareholdings, interests or other financial instruments.
2) Those financial instrument must have enhanced economic rights (usually granted in conjunction with limited voting rights and/or transfer restrictions or deferred rights to receive income).
3) The managers must be employees or directors of companies, entities or undertakings for collective investment that are resident or established in Italy or jurisdictions that exchange tax information with Italy.
4) The total investment of the managers (holding carried interest) must be at least 1% of the total capital invested in the fund (or 1% of the net equity of the company or entity). In most cases, a contribution by the private capital firm can be included in the 1%. However, as with France, it can be unclear whether the 1% applies on a "per vehicle" basis or to the fund as a whole.
5) The carried interest can only be paid after all investors in the fund (including co-investing managers) have received a return equal to their invested capital plus a minimum return (or, if there is change of control, a sale price equal to such amount).
6) The managers must hold their carried interest instruments for at least five years (or until a change of control of the issuing entity or a change of the entity managing the fund occurs).

Comment

Overall, the Italian regime has fewer conditions than the French regime and many of these conditions are features of typical carried interest arrangements and therefore create fewer unnecessary complexities to satisfy. The Italian regime is sufficiently flexible to allow it to apply across different strategies: for instance, unlike the French rules, it can apply to credit funds.

It can sometimes be difficult to assess whether the conditions for the automatic application of the preferential tax regime have been met. A relatively recent publication of a ruling by the Italian Revenue Agency (request no. 432/2023) indicated that (i) the employment condition was not met where the manager was employed by a sub-adviser and (ii) the co-investment condition was not met in the context of the parallel fund arrangements in question. Importantly however, the ruling held that despite the specific regime not applying, the carried interest in question should be classified as financial income (and so taxed at 26%) under normal principles.

In the context of Italy, please also see our comments above about the Italian €200,000 "flat tax".

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Germany

Tax rates

Carried interest payments can benefit from a 40% exemption under a preferential tax regime, resulting in an overall effective tax rate of 28.5%.

If the preferential regime does not apply, carried interest received by German tax resident managers is generally taxed as either (i) self-employment income (at rates of up to 47.5%) or (ii) income from "commercial activity" and so taxed according to the underlying source of the fund's profits (i.e. 28.5% for dividends and capital gains and 47.5% for interest[2]). The position in relation to point (ii) is not entirely certain as although it follows a ruling from the highest German court it has not yet been formally accepted by the German tax authorities.[3] In practice German tax authorities have, so far, applied this ruling in the tax assessment processes (although these are still subject to tax audits).

Conditions

For the preferential tax regime to apply to German tax resident managers, the following conditions must be met:

1) The manager must hold their carried interest through "asset management" partnerships[4] (which would include fund partnerships) only (and not partnerships that are, or are deemed to be, conducting a business or realising business income).
2) The manager must have an equity holding in a fund partnership for which they paid fair market value.
3) The carried interest should be awarded as remuneration for promoting the purposes and success of the fund and should not be remuneration for employment. In practice this means the holder should receive an arm's length salary that is separate from the carried interest arrangements.
4) The fund's purpose must be the acquisition, holding and sale of equity investments in corporations.
5) Payment of carried interest must be conditional on the other investors having first been fully repaid their contributions to the fund.

Comment

As indicated above (first paragraph of the "*Tax rates*" section) there is uncertainty as to whether the German tax authorities accept that carried interest that does not fall within the specific preferential tax regime can benefit from being taxed as income from "commercial activity".

The "asset management" condition (first condition above) is regarded as onerous and outdated. Non-German funds are deemed to be trading unless they have a "managing limited partner" or "MLP". These can be inserted but this is somewhat burdensome, especially if a tiered structure results in the need for MLPs at multiple levels.

The purpose requirement (fourth condition above) means that the preferential regime cannot apply to credit funds and certain other asset classes.

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[2] These rates apply in relation to dividends and gains from interests in corporations held by the executive via a trading partnership and to interest received by a trading partnership in which the executive has an interest.
[3] The rates in this paragraph may be slightly higher for members of recognised churches due to church tax.
[4] To fall within this category certain conditions must be met, including not entering into short term holdings.

The repayment condition (fifth condition above) is potentially problematic for deal-by-deal carry but this can be addressed by including a provision in the limited partnership agreement that German carry holders are not eligible to carried interest allocations until investor contributions have been fully repaid. Provided the German carry holders have no entitlement prior to full pay out of the contributions of the investors, the excess carry is then held back at the fund or general partner level and paid out once the investors have received full repayment.

If the preferential tax regime for carried interest does not apply and a sum of carried interest is treated as self-employed income, it can be difficult for double tax relief to be applied. This is because the classification as self-employed income is a purely German tax concept, which other jurisdictions may not adopt in relation to relevant underlying return.

From a practical perspective, treating carry as self-employment income is preferable to treating it as employment income (as with the approach taken in Spain), as there are no employer withholding or social security considerations.

Spain

Tax rates

Unless the preferential regime applies, carried interest received by Spanish resident managers is taxed as employment income at rates of approximately 50%. The exact rate will depend on the region of Spain where the manager is resident (e.g. 54% in Valencia and 45% in Madrid).

There is a specific preferential regime for carried interest under which the employment tax liability is reduced by 50% (so to approximately 25%).

Conditions

For the preferential tax regime to apply to Spanish tax resident managers, the following conditions must be met:

1) The carried interest must be income derived (directly or indirectly) from participations, shares or other rights (including success fees), which grant special economic rights in certain fund types. The entity from which the carried interest derives must be one of the following:

    a. Close-ended Alternative Investment Funds as defined in Directive 2011/61/EU of the European Parliament and of the Council of June 8, 2011, falling into one of the following categories:

        i. Entities regulated in article 3 of Act 22/2014 of November 12 (i.e. Spanish private equity and venture capital entities);

        ii. European Venture Capital Funds pursuant to Regulation (EU) 345/2013 of April 17 ("EUVECA");

        iii. European Social Entrepreneurship Funds pursuant to Regulation (EU) 346/2013 of April 17 ("EUSEF");

        iv. European Long-Term Investment Funds pursuant to Regulation (EU) 2015/760 of April 29 ("ELTIF") or

    b. Any other investment vehicles analogous to the above.

2) The manager must be an administrator, employee or manager of the fund or its management entities, or entities in its group.

3) The carried interest rights must be conditional on investors receiving a minimum return defined in the regulations or by-laws of the fund.

4) The carried interest participations, share or rights must be kept by the manager for at least five years other than where their transfer occurs mortis causa or they are settled in advance or become null and void or are totally or partially lost as a result of the change of management entity, in which case they must have been maintained uninterruptedly until these circumstances occur. (The holding period requirement does not require carried interest to be "locked-up" for the five-year period. Rather, the manager can benefit from the preferential tax rates from the outset but must rectify their tax position if they ultimately do not meet the requirement.)

5) The carried interest rights must not come directly or indirectly from an entity resident in a country or territory qualified as a non-cooperative jurisdiction or with which Spain has no regulation on mutual assistance in matters of exchange tax information.

Comment

The preferential tax regime is fairly new (applying for periods from 1 January 2023) and there is uncertainty as to how it should be applied in practice. We understand that the Spanish tax authorities intend to apply the regime restrictively.

In practice, due to the nature of the funds to which the preferential tax regime can apply, the beneficial tax treatment is not available across the full range of alternative asset classes (typically, credit funds and real estate funds do not qualify).

A key problem is the condition about proceeds not deriving from non-cooperative jurisdictions – whilst there are a range of views regarding how widely this condition should be applied, the list of non-cooperative jurisdictions contains some common fund jurisdictions.

Another practical issue arises in consequence of Spain taxing carried interest as employment income but under a special regime with partial exemption. This can be burdensome for private capital firms; in that they are required to operate employer withholding in relation to managers who have long left the firm. It also conflicts with the fundamental nature of carried interest, which is a share in a capital gain aligned with the performance of investments and is not related to employment.