September 2020

BVCA comment on Carried Interest and Capital Gains Tax

The Office of Tax Simplification is undertaking a review of Capital Gains Tax at the request of the UK government and has called for evidence. The BVCA has submitted a response to that consultation and this short briefing paper provides background and context for that submission.

The UK Private Equity and Venture Capital industry

- The UK has the largest private equity and venture capital ecosystem in Europe, and it is the second largest globally. **BVCA members invested over £43bn into 3,230 UK businesses from 2015-2019, 60% of which was outside of London and included £11bn into the Midlands and the north of England** (see Appendix). Companies backed by private equity and venture capital ("PE/VC") currently employ 972,000 people in the UK and the majority are SMEs. PE/VC has a strong track record of investing in innovative companies, including those in digital, deep tech, biotech and life sciences, as well as R&D intensive businesses.

- The industry itself generates significant numbers of highly-skilled jobs – both within the PE/VC industry and the supporting professional services community - and adds a significant dimension to the country's global importance as a financial services hub.

- **PE/VC will play a significant role in the recovery of the UK economy from the COVID-19 pandemic**, backing entrepreneurs and management teams across all the nations and regions in the UK to develop transformational technology, further social and environmental objectives, grow businesses, support employment, expand internationally and boost UK productivity.

- PE/VC firms understand the need to factor in economic uncertainty as they make their **long-term investment decisions**. They invest throughout the economic cycle, including during shocks and downturns, drawing on the deep expertise obtained as the industry has grown substantially in scale over the past 30 years. Over this period the PE/VC industry has routinely out-performed other asset classes and UK, European and global public market indices, delivering significant returns for a wide range of people, including UK pensioners. The industry covers the full spectrum from small VC funds to those raised by the largest global firms.

- The UK PE/VC industry is a successful demonstration of **'global Britain'** second only to the USA in terms of scale, thus reinforcing the UK's wider role as a globally significant financial centre. PE/VC firms attract significant investment flows into and through the UK. In 2019, nearly 90% of funds raised by UK-based managers came from international investors, with 40% coming from North America and around 20% from each of Asia Pacific and the rest of Europe. Half of recent EU-wide fundraising took place in the UK.

- **The UK must remain an attractive investment destination and competitive location for asset managers to encourage capital to continue to be deployed in the UK and retain the country's positioning as a global investment hub.** The full benefits of recent HMT initiatives, such as the review of the UK's funds regime and approach to asset holding companies, will only be realised if asset managers base themselves here as well.

The taxation of carried interest and capital gains tax

- **Carried interest is an established, high risk participation arrangement that aligns the interests of PE/VC managers with those of investors and supports long-term and sustainable investment into unlisted companies.** It is a share of a PE/VC fund's profits allocated to the manager and by its nature, is a long-term return based on the **overall success of a fund.** It therefore creates a **powerful alignment model** between PE/VC executives and the investors in a fund. On average, carried interest payments will begin in year 7 of a 10-year fund if the fund is successful.

- The UK recognises that **carried interest should be taxed as a capital gain and this principle is adopted by all major jurisdictions with a developed PE/VC industry**. This principle reflects the risk and long-term nature of the carried interest model.

- **The BVCA believes that, so far as carried interest and management equity are concerned, the boundary between income and capital is conceptually drawn in the right place and its integrity is fully protected by existing rules**. The UK has a comprehensive regime for the appropriate taxation of carried interest, which has been significantly refined over time and most recently in the Finance Act 2016. The combined effect of the UK's rules is that carried interest will only be taxed as a capital gain (at the minimum rate of 28% with income taxed at higher rates), if:

    - there is a **significant risk** that it will never pay out;
    - it is contingent on the **fund generating value and making a realised overall profit** on investments;
    - the carried interest is **satisfied out of capital proceeds** realised by the fund (with income included in the carried interest distributions taxed as such at higher rates); and
    - investments on which the carried interest depends are **held by the fund long-term** or the carried interest is subject to the comprehensive employment tax and employment related securities rules.

  Income tax rates of 38.1% and 45% are applied to investment returns comprising dividends and interest respectively.

- In the VC, emerging/first time fund manager and smaller end of the PE funds industry, management fees will be lower as they are based on smaller fund sizes. Any carried interest received when a fund performs well, therefore comprises a more significant part of those managers' long-term arrangements.

- Carried interest is not guaranteed for any PE/VC manager. A PE/VC fund may not achieve the agreed return in which case there would be no carried interest payments. A significant proportion of fund managers do not receive carried interest and the range of returns across the UK industry is included in the BVCA's annual Performance Measurement Survey (available here).

- Carried interest is also prevalent in other asset classes such as real estate, debt and infrastructure.

International comparison

- The investment environment in the UK needs to be as attractive as possible to encourage capital to be deployed in the UK. This means **the UK must maintain a competitive regime for asset managers that will fund investment in entrepreneurship, growth, productivity and innovation across the UK**. Investment activity data consistently shows that the UK has a higher proportion of investment in Europe and we believe this is in part because PE/VC firms are often headquartered here or have a meaningful operating footprint here. For example, the UK received 23% of the €94bn invested into European portfolio companies in 2019 (*Source:* Invest Europe).

- In an ever more complex operating environment, the tax, legal and regulatory advantages of establishing a PE/VC fund and/or manager in the UK have been eroded as overseas jurisdictions have developed more favourable regimes and the UK has not kept pace with these developments. Other jurisdictions continue to evolve and strengthen their operating frameworks to ensure they remain competitive with the UK.

- **The UK now has one of the highest rates of tax on carried interest in Europe and internationally.** The minimum CGT rate of 28% only applies to long term gains and does not apply to income included in carried interest distributions (income is taxed at 38.1% or 45%, which can make the effective tax rate on carried interest higher than 28%) and so many executives will pay higher blended rates. By comparison France, Germany and Italy do not apply higher rates to income as shown below. The headline UK rate (which will often be lower than the actual effective tax rate) is higher than the effective tax rate in some competitor European jurisdictions and only slightly lower than the equivalent rate in others. Although not shown in the table below, carried interest received in Switzerland and Luxembourg may also be subject to an attractive tax treatment, particularly where executives move into the relevant jurisdiction from abroad.

Comparison of the UK tax regime to other major PE/VC jurisdictions

	Expected effective tax rate (upper rates unless rate is flat) (%)						
	UK	**France**	**Germany**	**Ireland**	**Italy**	**Singapore**	**US (federal)**
Specific carried interest tax regime?	Yes	Yes	Yes	No	Yes	No	Yes
Taxed as employment income?	No	No	Yes (subject to 40% exemption from tax)	No	No	Yes / No (if received as foreign dividends / capital gains)	No
Capital gains	28%	30% (plus 4% for high earners)	28.5%	33%	26%	22% / 0*	20% (if held for 3 years or more)
Interest	45%	30% (plus 4% for high earners)	28.5%	40%	26%	22% / 0*	37%
Dividends	38.1%	30% (plus 4% for high earners)	28.5%	40%	26%	22% / 0*	37% (unless qualifying dividends)
Size of PE/VC market USD billion (by funds/capital raised, includes fund-of-funds and secondaries) ***Source: Preqin 3/9/20***							
2019 Global $687.1bn	$53.8bn	$22.2bn	$4.1bn	$0.2bn	$1.2bn	$4.5bn	$427.0bn
2019 Europe $102.8bn	52.3% share	21.6% share	3.9% Share	0.1% share	1.1% share		

**Foreign source income received or deemed received by a Singaporean tax resident individual is exempt from income tax. Singapore does not tax capital*

- Meanwhile, other jurisdictions are moving to improve their carried interest tax regimes. Hong Kong is in the process of introducing what is described as a "highly competitive" regime and France has relaxed the requirements of its beneficial carried interest regime for managers who move to France or who manage funds that are larger than €1bn.

- Any further increases to the UK tax rate on carried interest will **risk damage to the UK's competitiveness** and undermine the government's clearly stated policy of developing the UK as an attractive location for the asset management industry, with a corresponding **reduction of investment and entrepreneurial activity in the UK** as other jurisdictions attract PE/VC firms and entrepreneurs.

Conclusion

The UK is one of the most attractive places in the world for entrepreneurial investment, leading to innovation, transformation and wealth creation to the benefit of the entire country. The UK PE/VC industry provides the foundation for this activity and demonstrates how the UK can compete and succeed on the global stage.

Other jurisdictions have reacted to this success by enacting a series of reforms, not just through targeted tax regimes, but also with innovation in the legal and regulatory operating environment.

The UK must continue to nurture and develop the environment for entrepreneurs and investors. A further hardening of the carried interest tax regime, which is already one of the highest in Europe and beyond, should be avoided. Instead, the focus should be on encouraging long-term investment to transform UK companies into the global success stories of tomorrow and that will allow the country to lead in the new industries and opportunities that the future presents.

Appendix – Investment by region, BVCA members 2015-2019

2015-2019 BVCA Report on Investment Activity	£million invested
London	18,049
East and South East	8,924
Midlands	4,509
Yorkshire & North East	2,997
North West	3,585
Scotland	1,640
Wales & South West	3,366
Northern Ireland	120
Other (Channel Islands)	338
Total	**43,528**