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British Private Equity and Venture Capital Association (BVCA)

Taxing 'carried interest' appropriately

The Good Law Project has recently published critiques of the way in which "carried interest" is taxed. The first part of their analysis relates to the issue of fund "trading", an argument put forward by Mr Dan Neidle in an article in the British Tax Review. The key point made in that article is that PE/VC funds are trading entities and the returns to the managers should already be charged to income tax in full. The BVCA has prepared a separate paper in response to this article, arguing on the basis of established tax principles and case law that this perspective is incorrect.

Beyond this issue, the Good Law Project describes the established tax treatment of carried interest as a "loophole". The BVCA disagrees.

Private equity and venture capital (PE/VC) fund managers have an interest in funds they manage. For historic (even archaic) reasons this "equity interest" is called a "carried interest" – in essence it is analogous to others who have a share or stake in the company they work for. If an individual has a share in the company they work for and it does well, they will benefit from that. The share may pay a dividend or the person may be able to sell the share at a profit and pay capital gains tax (CGT) (usually at a rate of 20%) on that profit. This return is not employment or trading income - nor is the return from carried interest.

Building on the principle that a manager's interest in the fund they help to run is equivalent to a share in a company, it follows that if the fund does well, the manager will benefit, but equally if it does not, the manager will get little or nothing by way of return. It is fundamental to the PE/VC model that carried interest is not guaranteed for any PE/VC manager: if a PE/VC fund does not achieve the agreed return (set out contractually in fund documents and typically at a rate which is higher than those achieved on public markets) there is no carried interest pay-out. A significant proportion of fund managers do not receive carried interest and there is a range of returns across the UK industry (as evidenced by decades of data collected by the BVCA).

Additionally, PE/VC fund managers have to buy into the funds they manage. Investors will always require fund managers to invest very significant amounts of their own money in the funds they run. That is what should be expected to ensure that investors and managers' interests are aligned and remain so throughout the length of funds which commonly last for 10 years or more. Managers therefore share in the risks as well as the gains in the equity interest in the fund.

It can take many years for a fund to perform well enough to start making distributions to carried interest holders. On average, carried interest payments will begin in year 7 of a 10-year fund if the fund is successful. If a manager leaves the fund during that period, they will forfeit some or all of their carried interest. Before a fund manager can receive a carried interest distribution, investors (typically pension funds, insurance companies, charities and overseas investors) must usually have received all their investment back plus a significant return, agreed at the outset.

If the fund does well and managers receive a distribution from the fund, they pay tax on what they receive, which depends on what the fund receives. If they receive capital from the fund (e.g. because the fund has sold an asset and is distributing the proceeds) they pay CGT. The UK recognises that capital distributions received by carried interest holders should generally be taxed as a capital gain. This reflects the risk and long-term nature of the carried interest model. In addition, in the UK if carried interest holders receive income from the fund, they pay income tax.

Fund managers pay a special rate of CGT on capital they receive. Their rate of CGT is 28%, whereas the normal rate is 20%. In addition, if the fund receives income, they pay income tax on their share of the fund's income. Many managers pay tax on their carried interest at effective tax rates above 28%. In addition, if the fund does not hold its investments for an average period of 40 months or more, some or all of the carried interest distributions may be taxed as income.

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The UK has a comprehensive regime for the appropriate taxation of carried interest, which has been significantly refined over time. The combined effect of the UK's rules is that carried interest will only be taxed as a capital gain (at the special rate of 28%), 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% (39.5% from 6 April) and 45% are applied to returns comprising dividends and interest respectively.

As mentioned earlier, many other countries with a developed PE/VC industry have a tax regime for carried interest which produces broadly similar (and in some cases simpler or better) outcomes to the UK rules. The tax regime for carried interest in the UK is broadly in line with the position in Germany, France, Italy and (the most recent country to introduce a carried interest regime) Spain. These regimes all recognise the position of carried interest as a long-term, risk-based interest in a fund.

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; this can make the effective tax rate on carried interest higher than 28%. 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.

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 laws to ensure they remain competitive with the UK. If the UK is to retain a vibrant, dynamic PE/VC industry, it cannot allow its tax, legal and regulatory regimes to fall behind those of competitor jurisdictions.

Any further increases to the UK tax regime 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.

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