Onshore Perspectives for Private Equity and Hedge Fund Managers

Carried Interest and Income Taxation in the US, the UK and Germany 2011

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Foreword

Investment funds, especially private equity and hedge funds, have come under scrutiny not only with regard to their (apparently fairly limited) role in the financial and credit-market crisis, but also in respect of the tax treatment of carried interest earned by managers of such funds, which is perceived by many as unduly (tax) advantaged. At the heart of the tax debate lies the question whether carried interest should be taxed as capital gain (as is presently the case in the US and the UK), on the basis that it represents an investment return, or whether the carried interest, in the alternative analysis, constitutes deferred remuneration for the managers and as such should be taxed to income.

In the US, July 2007 saw the publication of a research paper by *Kaplan* and *Rauh* entitled "Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?" which came to the conclusion that fund managers whose income consists mainly of carried interest dominate the income class of those earning annually in excess of $100 million. July 2007 also saw the first hearings of the Committee on Finance within the US Senate on the carried interest subject. Although various proposals for tax hikes affecting carried interest in "investment services partnerships" did not see the light of day in 2010, such proposals could well be resurrected this year when Congress seeks revenue-raising measures. Indeed, the Obama Administration's 2012 budget proposal includes a provision targeting carried interest in investment partnerships as a revenue raiser.

In the UK, the Treasury Committee of the House of Commons announced an inquiry into the private equity industry in March 2007 as a result of public pressure, including over the favourable capital gains tax treatment accorded to carried interest awards. Three evidence gathering sessions were held in June and July 2007, two of them with private equity firms. The Treasury Committee finally recommended that HM Treasury and HM Revenue and Customs consider the tax treatment of carried interest as part of their review of the taxation of employment-related securities. The resulting changes, which became effective on 6 April 2008, confirmed the favourable capital gains tax treatment for carried interest, but effectively increased the applicable UK capital gains tax rate from 10 percent to 18 percent (the maximum capital gains tax rate has since been further increased to 28 percent).

In Germany, the developments in the United States and the United Kingdom were duly noted and in the summer of 2007, a national debate about carried interest taxation started. In 2008, the portion of the carried interest exempt from regular income taxation was reduced from 50 percent to 40 percent.

At the start of 2011, this brochure intends to summarize and compare the current tax treatment of investment managers' income (including but not limited to the carried interest) in the United States, the United Kingdom and Germany.

This brochure is not intended to contribute to the political discussion of its subject matter; it is intended as a comparative analysis. Still, one aspect remains obvious: carried interest, unlike other "ordinary" income, reflects an equity interest in a fund and is not paid on a regular basis in any year, a clear distinguishing feature that might be said to argue in favor of a tax treatment different from that accorded to other compensation income.

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1. The United States

1.1 Carried Interest

Definition

Many fund sponsors or investment managers earn not only an annual cash management fee (discussed in more detail below) but also own an equity interest in a fund (or, possibly, in one or more related "feeder" funds, hereinafter referred to simply as a "Fund") entitling such sponsors or managers to a share of Fund income after investors have received back their capital and, possibly, a return thereon. This equity interest is the so-called "carry" or "carried interest." Under general US tax rules governing partnerships, which apply with equal force to private equity and hedge funds, income or gain is allocated to, and taken into account by, partners, including, under current law, holders of a "carried interest," and the character of such income, as recognized at the Fund level, passes through to the partners. Thus where a large percentage of Fund income is derived from long-term capital gains, an individual sponsor pays tax on such income at the (currently maximum 15 percent) rate applicable thereto, rather than the higher (currently maximum 35 percent) rate applicable to compensation income. Furthermore, the income earned upon sale or other disposition of a partnership interest, including a "carried interest," generally results in capital gain.

Partnership Classification

The primary advantage of electing partnership classification for an investment manager entity is to permit US employees who own an interest in that entity to benefit from the above-described tax advantages relating to a "carried interest" held by the investment manager. If the investment manager were itself not a partnership (pass-through entity) for US tax purposes, then individual owners thereof would not be entitled to such treatment. Inasmuch as capital gain income is not treated as compensation, it has the additional benefit of not being subject to "self-employment taxes." In particular, the carried interest is not subject to the 2.9 percent Medicare tax (generally payable on all compensation income, and increasing to 3.8 percent in 2013).

Treatment as a Corporation

If the investment manager were, by contrast, treated as a corporation, the portion of the "carry" payable to any such US employees would be taxable as a dividend when distributed to the US employee-owners, and subject to tax at a current rate of up to 35 percent. In addition, the investment manger itself would, in such case, be potentially subject to tax on at least certain US source income attributable to the carried interest.

Arguments against a Partnership

If a Fund is not expected to generate significant long-term capital gains, the benefit of a "carry", and the related benefit to US employee-owners of an investment manager entity being taxed as a partnership, is dramatically reduced. Moreover, depending upon the nature of the underlying investments made by the Fund, electing partnership classification for the investment manager could result in additional reporting obligations on the investment manager, and could subject non-US employees who own interests in the investment manager to US income tax and US tax reporting obligations on any portion of the carried interest attributable to so-called "effectively connected income" (generally income deemed attributable to the carrying on of an active US trade or business, as opposed to more passive, investment, income, as well as certain income from US real estate investments) that is allocated to the investment manager from the Fund.

1.2 Management Fee

Deferred Compensation

The 2 percent annual management fee generally will be treated as compensation income for US federal income tax purposes (subject to tax at a current maximum rate of 35 percent) and will be deductible by the Fund when paid. Prior to 2009, US employees often would agree with a corporate investment manager to defer all or a portion of the management fee for a number of years. However, effective as of 1 January 2009, section 457A of the US Internal Revenue Code basically precludes the deferral of compensation under the kinds of plans previously used by managers of offshore funds to defer taxation of the management fee. It does so by taxing any amount deferred under a nonqualified deferred compensation plan maintained by a "nonqualified entity" when the compensation vests (*i.e.*, when it is no longer conditioned on the future performance of substantial services) rather than when it is paid. For this purpose, a "nonqualified entity" means: (i) any foreign corporation unless substantially all of its income is effectively connected with the conduct of a trade or business in the United States or subject to a "comprehensive foreign income tax", or (ii) any partnership, unless substantially all of its income is allocated to persons other than foreign persons with respect to whom such income is not subject to a "comprehensive foreign income tax" and US tax-exempt persons. For purposes of the foregoing, a "comprehensive foreign income tax" means, with respect to any foreign person, an income tax of a foreign country if the foreign person is eligible for benefits under an income tax treaty between the United States and that jurisdiction, or such person can demonstrate that the foreign country has a comprehensive income tax. Although there is no definition of the latter term, presumably, it refers to tax covering a significant portion of income of persons considered tax resident in the subject jurisdiction.

Section 457A does allow deferral of income that is payable no later than 12 months after the end of the taxpayer's taxable year in which the compensation vests, but this exception has little interest to employees. It is not absolutely clear whether the statute also precludes deferral with respect to income attributable to an employee's "carried interest" as it can be argued that this interest represents equity, not compensation.

Section 457A

1.3 Pending Proposed Legislative Changes

Various bills have been introduced in the US Congress over the past few years that would change the US taxation of so-called "carried interest". Interestingly, although prompted by criticism of such interests held by hedge fund and private equity fund sponsors, these provisions, as drafted, could impact a wider range of holders of such interests.

Ordinary Income

A recent variation on these proposals would recharacterize income allocated to holders of "investment services partnership interests" as ordinary income. Gain on sales or other dispositions of such interests would also generally be taxed as ordinary income and would be required to be recognized regardless of any other applicable nonrecognition provisions. There would be exceptions to the disposition rule in the case of (i) dispositions by individuals of certain interests in "publicly traded partnerships" and (ii) contributions of an "investment services partnership interest" to another partnership, assuming certain reporting requirements are met.

Losses from "investment services partnership interests" would also be treated as ordinary, but would be allowed only to the extent that the loss does not exceed the excess of aggregate net income from prior years over the aggregate net loss with respect to such interest that was not disallowed for all prior partnership taxable years to which the rules apply. Unused losses would be able to be carried forward indefinitely. Losses on disposition of a subject interest would be treated as ordinary, to the extent of the excess, if any, of the aggregate net income with respect to the interest for all partnership taxable years to which the new provision would apply, over the aggregate net loss with respect to such interest that is allowed for all such years.

Losses

For individuals, only 75 percent of the amount of net income, net loss, or gain or loss on sale or other disposition that would otherwise be treated as

Individuals

ordinary income and loss would be so treated and the balance would be treated in the same fashion as under current law. Moreover, only 50 percent of gain or loss on dispositions by individuals of interests held for more than five years would be so treated. An "investment services partnership interest" would be defined as an interest in a partnership held, directly or indirectly, by any person, if it was reasonably expected at the time such person acquired the interest that such person (or related person) would provide, directly or indirectly, a substantial quantity of any of the following services to the partnership: (1) advising on investing in, purchasing, or selling "specified assets;" (2) managing, acquiring or disposing of any "specified assets;" (3) arranging financing with respect to any "specified assets;" and (4) any activity in support of any of the foregoing services (including supervision and support services). "Specified assets" would generally include securities, partnership interests, real estate, commodities, or options or derivatives contracts with respect thereto. Other than possibly in respect of real estate, the new rules do not appear to cover interests in partnerships engaged in active businesses. Nevertheless, concern has been expressed that, because "specified assets" include partnership interests, employees who own interests in an upper-tier partnership, which, in turn, provides service to a lower-tier partnership, could be caught by the new rules even if the underlying partnership is, in fact, engaged in an active business.

Exceptions

The new rules would not apply with respect to (1) interests acquired by investment of money or other property in a partnership, (2) partnership interests (including so-called "capital" interests), the value of which are included in income up-front, or (3) interests that are attributable to shares of undistributed partnership profits. An interest funded by proceeds of loans from the fund, or investors therein, would, however, not be excluded from the new rules.

Non-Partnership Entities

Rules similar to those applicable to partnership "carried interest" would apply to interests in certain non-partnership entities, if the holder provides investment management services to the entity and the value of such interest, or payments thereunder, is substantially related to the amount of income or gain from the assets with respect to which the investment management services are performed. An example of such an interest would be stock held by a hedge fund manager in a Cayman Islands corporation that itself is a partner in a hedge fund partnership, if the manager performs investment management services and the value of the manager's stock or dividends is substantially related to the growth and income in fund assets.

All income recast as ordinary income under these provisions would generally be required to be taken into account in determining self-employment taxes for any individual engaged in the trade or business of performing the types of services covered by the provision. Stiff penalties would apply in respect of any attempt to avoid the new provisions

Sponsors

The passage of any such "carried interest" legislation would have a profound impact on structuring fees to sponsors of partnerships covered thereunder. For example, sponsors may want to consider taking some portion of their fee in the form of a taxable "capital" interest (*i.e.*, one entitling the sponsor to a portion of built-in appreciation present on the day the sponsor is admitted), that would be excluded from the new rules, so long as they also received enough up-front cash to pay the tax attributable to receipt of such an interest. In addition, sponsors might consider selling to a related entity carried interest currently held by them prior to the effective date of any such legislation, thus capturing as capital gain appreciation built in to date.

At present no proposal to change the current rules on taxation of "carried interest" made it into legislation in 2010. That said, it is entirely possible that a measure similar to what is described above will reemerge this year, and a variation on the above proposal has been included in the Obama administration's fiscal year 2012 proposed budget.

2. UK

2.1 Carried Interest

Income or Capital Gain

The UK tax treatment of performance fees or carried interest in the hands of the UK investment manager will depend on the type and structural set-up of the Fund, the nature of the fund investments, and the investment strategy for such assets. Together, these factors determine whether the performance fees/carried interest received by the manager will be treated as income for UK tax purposes, as in the case of most hedge fund performance fees, or as capital gain, as has been the case with private equity funds since the 1987 Memorandum of Understanding between the then Inland Revenue, the British Venture Capital Association ("BVCA"), and the Department of Trade and Industry in a Memorandum of Understanding (the "1987 MOU"). The capital gains tax treatment for carried interest was reaffirmed in 2003 in a further memorandum between HM Revenue and Customs and the BVCA on the occasion of the introduction of the employment-related securities regime in Finance Act 2003 (the "2003 MOU").

Consequences

The distinction between income and capital treatment can be of material importance: the introduction of a flat 18 percent capital gains tax rate for individuals in April 2008 (increased in 2010 to 28 percent for higher rate taxpayers) created significant fiscal asymmetry between the taxation of income and capital gains, given the current maximum individual income tax rate of 50 percent. Moreover, inasmuch as capital gain is not treated as employment income, carried interest enjoys the additional tax benefit of not being subject to UK national insurance contributions. This contrasts with the treatment of hedge fund performance fees, for example, which will attract national insurance contributions when paid to managers.

A detailed analysis of the UK tax considerations applicable to the structuring of performance fees/carried interest arrangements is beyond the scope of this publication. Generally, the question whether the performance-related return is taxed as capital gain or income tends to follow the nature of the asset manager; the performance fees generated by UK resident managers of hedge funds are commonly taxable as income, whereas carried interest realizations will be taxed as capital gain.

This difference in tax treatment follows from the different structural set-up of hedge fund and private equity fund (management) groups: performance fees paid, for example, by offshore hedge funds to UK investment managers (whether directly, or via other management entities) are contractually structured as fees for services provided, and as such are classified as ordinary trading income for UK taxation purposes.

Partnerships

Carried interest awards of private equity funds making long-term investments, on the other hand, are typically structured as limited partnership interests in the investment fund itself (usually via an intermediate "carry" partnership in which the members of management become limited partners). These partnerships, including the investment fund, are set up so as to be transparent for UK tax purposes. In these circumstances, gains allocated to individual UK managers via their partnership holdings when fund investments are sold will be treated as arising to the managers directly, and are normally treated as capital gain (certainly where the fund is structured in accordance with the 1987 and 2003 MOUs). Depending on the investment circumstances of the funds, it may also be possible for UK residents but non-UK domiciled managers to benefit from the remittance basis of taxation in respect of such gains.

Where the fund investment strategy is such that capital gains treatment of carried interest receipts should be possible, two issues in particular need to be borne in mind when structuring the carried interest awards for UK resident managers.

Tax Charges

First, where a carry holder is (or within seven years prior to receipt of the carried interest was) an employee or director of any entity within the management group, the wide definition of "employment-related securities" under Chapter V of the Income Tax (Earnings and Pensions) Act 2003 ("ITEPA 2003"), and the customary contractual or economic restrictions attaching to carried interest securities means that the carried interest award (whether a partnership interest, or a share in a corporate fund) will almost invariably fall within the "restricted securities" regime of Part 7, Chapter 2 of ITEPA 2003. Under these provisions, the carried interest holder is taxed to income whenever he receives "value" from a security, to the extent such value exceeds the consideration, if any, provided. The first potentially chargeable occasion is the award of the carried interest security itself. In addition, where the carried interest is subject to economic restrictions impacting the value of the carried interest, further potential income tax charges arise on each occasion a restriction falls away, so that the security can be said to become more "valuable". This is not only undesirable from a tax (and therefore commercial) perspective, but also gives rise to the inherent uncertainties in ITEPA 2003 of quantifying the value of any economic uplift, or identifying when precisely the tax charge occurs.

To resolve this difficulty, the legislation allows managers and the employing company to make a joint tax election that enables the manager to be taxed upfront on receipt of the security by reference to its notional unrestricted fair market value (to the extent the consideration paid by him for the security is less than such unrestricted fair market value). Any further increase in the value of the security realized on a disposal is then taxed as capital gain.

Fair Unrestricted Market Value

The main practical difficulty lies in quantifying such unrestricted fair market value. HMRC and the private equity funds industry agreed under the 2003 MOU that, for private equity funds that are structured in line with the MOU, the amounts paid by the managers for their carry interest securities is accepted as the fair unrestricted market value, notwithstanding that outside investors are very likely to pay considerably more for their limited partnership interests in the same fund. Strictly speaking, no such tax election is therefore necessary, although in practice protective elections are still commonplace.

MOU Model

In circumstances where the initial receipt of the carried interest security by a manager does not fall within the provisions of ITEPA 2003 (*e.g.*, because the manager is a member of an LLP and has not held any relevant employment positions or directorships), the upfront value of the carried interest security will still need to be considered to determine whether full value has been paid or alternatively, if the receipt fails to be taxed as general income.

Secondly, on a strict interpretation of the 1987 and 2003 MOUs, the memoranda only apply to fund arrangements that are structured in line with the fund model described in detail in the memoranda; material deviations in structuring might not benefit from MOU protection. While, in practice, HMRC have not required strict compliance with the MOU structure, as the market has evolved in line with industry practice, in hybrid private equity/hedge fund structures or other arrangements such as, for example, infrastructure funds, care must always be taken to ensure that the carried interest when paid out would, in practice, also be taxed as capital gain and not income.

2.2 Management Fee

The management fee is normally treated as ordinary trading income for UK taxation purposes. UK investment managers operating their management businesses as English limited liability companies will be subject to UK corporation tax, at a rate of 28 percent (scheduled to decrease to 27 percent from 6 April 2011 and gradually further to 24 percent by 6 April 2014), on any profit (after deduction of expenses such as salaries) generated from the management fees, in accordance with the company's accounts. Salaries and bonuses payable by the company to the managers are then taxed as employment income in the hands of the individuals, subject to income tax (up to a maximum rate of 50 percent for income in excess of £150,000), and national insurance contributions.

In recent years, UK-based investment managers have increasingly opted to carry on their operations through English limited liability partnerships (LLPs). LLPs were introduced by the UK Limited Liability Partnerships Act 2001 ("LLPA") and are a hybrid between an ordinary limited company and a partnership — broadly, a corporate for commercial purposes which is treated as a tax transparent partnership for most tax purposes. The profit of the LLP is allocated among the members of the LLP in proportion to their respective income interests; members are then taxable on the income allocated to them. Accordingly, corporate members will be subject to UK corporation tax on their allocation of LLP income, whereas allocations of LLP profit to individual members will be subject to income tax, as well as national insurance contributions. Unlike with employment income which gives rise to employees' national insurance contributions for the employing company, no such contributions are payable by an LLP on profit allocations to its partners.

3. Germany

German private equity partnerships, like their UK counterparts, generally follow a two-entity approach, with one limited partnership ("LP1") as the main fund vehicle and another limited partnership ("LP2") receiving the carried interest from LP1.

Private Equity Only

Hedge funds are rarely structured using German entities so that the discussion here is limited to private equity partnerships and tax rules applicable thereto. Sec. 112 of the German Investment Act provides for separate assets with additional risks (*Sondervermögen mit zusätzlichen Risiken*), that basically fall under the hedge fund definition. To qualify for the preferential tax treatment under the Investment Act and the Investment Tax Act, the assets have to be managed potentially using leverage and/or short selling techniques. Several restrictions apply: Risk diversification criteria have to be met and holdings in companies may not exceed 30 percent of the value of the separate assets. In addition, a public distribution of the respective interests is not allowed. As a consequence, a certificate on a hedge fund portfolio in a more liberal jurisdiction might be more attractive from the German investor's point of view.

Trade or Business?

For the type of income generated at the LP1 level of our German private equity fund, it is decisive whether the Fund's activities are viewed as mere private asset management ("non-business partnership") or as a trade or business ("business partnership"). Only a non-business partnership qualifies for the advantageous carried interest taxation and avoidance of another layer of German trade tax. The German Federal Ministry of Finance issued a letter ruling in 2003, which lists the following criteria that may lead to a "business partnership" qualification:

- bank financing of the target acquisition;
- provision of collateral in favour of the portfolio company;
- extensive structure and office of the Fund;
- exploitation of a market through the use of professional experience;
- public offering of fund interests;
- short-term investment in portfolio companies;
- reinvestment of capital gains by the Fund; and

- management activities of the Fund inside portfolio companies.

Even if only one of the foregoing criteria is met, the Fund might be considered a business partnership.

3.1 Carried Interest

The divestment of a target company usually triggers the so-called carried interest after a full repayment of the other LP1 partners' capital and the additional payment of a minimum interest ("hurdle rate"). The carried interest finally received by the limited partners of LP2 ("carry holder") and channelled through the transparent LP2 provides the carry holder with a share of partnership income in excess of the participation allocated to his investment. The carry holder receives an additional part of the income in consideration of his efforts and contributions to the partnership's success.

Fee Treatment

With the implementation of the Act for the Promotion of Venture Capital in 2004, the carried interest stemming from non-business partnerships became subject to a favourable tax treatment: Sec. 18 para 1 number 4 of the German Income Tax Act ("ITA") treats the carried interest, not as a special allocation of partnership profits, but rather as a fee paid to the carry holder irrespective of the underlying source of income. Sec. 3 number 40a ITA exempts 40 percent of the carried interest from regular income taxation for non-business partnerships established after 31 December 2008 and leads to an effective marginal tax rate of 27 percent (plus solidarity surcharge and church taxes if applicable).

The foregoing characterisation of the carried interest income leads to the following conclusions:

- Carried interest from non-business partnerships constitutes service income and not capital gain;
- The participation exemption for corporations (95 percent) under Sec. 8b para 2 of the German Corporate Income Tax Act ("CITA") will not be applied to carried interest income but, rather, a 40 percent exemption at the level of the corporation will apply;
- No treaty protection related to capital gains will be applicable to carried interest income;
- The carried interest does not constitute business income within the meaning of Sec. 15 ITA so that no trade tax will be triggered

unless (i) LP1 is considered a business partnership (*see* sub para 3 above) or (ii) the holder maintains its own trade or business in Germany.

3.2 Capital Gain on Disposal of Proportionate Share (if treated differently)

Proportionate Share

Sec. 18 para 1 number 4 of the ITA is limited to the share of partnership income in excess of the participation allocated to his investment, *i.e.*, the carried interest. The treatment of the proportionate share, *e.g.*, 1 percent of the capital gain for 1 percent of the interest in a non-business partnership, that is allocated to the final recipient under Sec. 39 para 2 number 2 of the German General Tax Act ("GTA"), differs depending on the legal structure of the recipient:

Where the final recipient is a corporation, the preferential tax treatment of Sec. 8b para 1 CITA should be applicable.

Where the final recipient is an individual, the lump sum tax of 25 percent should be applicable.

3.3 Management Fee

The management fee of up to 2 percent of the fund's committed or invested capital is generally received by a corporate entity. Therefore it will be subject to the general corporate income tax of 15 percent plus a trade tax of another, approximately, 15 percent. An individual directly receiving a management fee would be subject to regular income tax at up to 47.475 percent incl. solidarity surcharge.

3.4 VAT

German VAT

Revenues derived from shares in corporations and interests in partnerships and from the respective procurement of such shares or interests are generally not subject to German VAT according to Sec. 4 number 8 lit. f of the German VAT Act. M&A advice is also exempt from German VAT under Sec. 4 number 8 lit. e and f of the German VAT Act, to the extent that the process can be viewed as bringing together a seller and buyer. Administrative activities of the management entity vis-à-vis the fund are, however, not exempt from VAT under Sec. 4 number 8 lit. h of the German VAT Act. There used to be a structural alternative in the form of a priority profit share in the partnership's balance sheet profits that, unfortunately, is no longer available. The VAT on the management fee is considered a disadvantage for the management of German fund structures, as compared, for example, to its Luxembourg counterparts (*e.g.*, SICAR).

4. Results / Recommendations

US

For now, US fund sponsors and others holding carried interest can breathe a little easier in that it looks as if there will be no adverse tax changes taking effect immediately.

However, there is no guarantee against such changes re-emerging. One would be well-advised at least to begin thinking about ways in which compensation of fund managers might be restructured so as to lessen the tax bite, should any such proposals be enacted.

UK

With the UK capital gains tax rate having increased to 28 percent for higher rate tax payers, it seems unlikely (certainly for the time being) that the discussion surrounding the tax treatment of carried interest awards will re-emerge in the UK in the immediate future. Also, the remittance basis of taxation for non-UK domiciled managers continues to be available and may provide additional relief.

However, a general hardening of the UK Revenue environment together with the continued discussions around the level and deferral of bonuses in the financial services sector, and various measures introduced at European level (such as the remuneration principles of the AIFM Directive) mean that incentivisation of private equity fund managers may in future be affected through other measures.

Germany

In Germany, the carried interest generally receives a favourable tax treatment where 40 percent of it are exempt from regular income taxation. The management fee is taxed as regular income so that the tax rate depends on the legal structure of the recipient.

German fund managers and their corporate management entities rarely relocate to other jurisdictions for tax reasons. A small number of them tried out Swiss models in the pastime but this comes along with a significant amount of structuring. Also, the AIFMD and the corresponding German implementation act will potentially further decrease the attractiveness of such structures.

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