Corporate finance briefing

Taxing carried interest

Proposals for change

The tax treatment of private equity funds, in particular how to tax the carried interest earned by the managers of these funds (sponsors), has been the subject of a good deal of recent scrutiny in both the UK and the US. The carried interest (or "carry", as it is often referred to) is the share of the gains realised from the fund's underlying investments to which the sponsors are entitled. The percentage of carry assigned to the sponsors is typically 20% of the overall gain after return of capital to investors.

To a large extent, the debate centres on the appropriate tax rate that should be paid by sponsors, which in part depends on whether the carry is viewed as a return on a successful capital investment, or as deferred consideration for investment management services successfully performed.

The current difficulty for the authorities stems from the need to balance a generous capital gains tax regime that sought to promote an entrepreneurial culture and the taking of investment risk, and which (somewhat unintentionally) has enabled the private equity industry to become a spectacular success, against the growing unease at the financial inequalities created and the ever-present need to raise further revenue.

The current position

In 1987 the Inland Revenue (now HM Revenue & Customs) and the British Venture Capital Association (BVCA) signed a memorandum of understanding (1987 MoU) in which they agreed that carried interest should be taxed as capital (*www.hmrc.gov.uk/manuals/ctmanual/CTM36580.htm*). The subsequent introduction of taper relief in the Finance Act 1998, which reduces the capital gains tax rate based on the length of time an asset has been owned down to a minimum of 10% for business assets, including investments in unlisted companies, meant that carried interest was usually taxed at 10%. The Finance Act 2002 reduced the required holding period to two years.

In addition, UK resident but non-UK domiciled sponsors can generally benefit from the remittance basis of taxation, in that they are only taxed on non-UK capital gains to the extent that the proceeds are brought into the UK (*section 12, Taxation of Chargeable Gains Act 1992*). This could apply to carried interest gains where the carry and fund investments are held offshore and the fund investments are non-UK.

An unusual feature of the present debate is that the question as to how carried interest should be taxed is currently the subject of intense debate on both sides of the Atlantic (*see box "The US position"*).

Proposals for change

The principal industry concern in the UK has been that the 1987 MoU would be revoked and that carried interest would be taxed as ordinary (albeit deferred) income when received. The 1987 MoU had been implicitly reaffirmed in 2003 when the treatment of carried interest and co-investments for sponsors under the restricted employment securities regime of Schedule 22 to the Income Tax (Employment and Pensions) Act 2003 was agreed in two further memoranda of understanding (2003 MoUs) (*www.hmrc.gov.uk/shareschemes/bvca_and_fb2003_managers.pdf* and *www.hmrc.gov.uk/shareschemes/bvca_and_fb2003_carried_interest.pdf*) (*www.practicallaw.com/0-102-4694*).

The recent high profile media coverage of the discussions in the UK, while largely correct on the treatment of carried interest, has been occasionally misleading in that, for example, many reports failed to mention that the annual management fees payable by a private equity fund to sponsors are subject to income tax, typically at the higher tax rate of 40%. However, intense press coverage and the resulting political pressure led many observers to argue that some change was inevitable.

In the Pre-Budget Report of 10 October 2007, the Chancellor announced the introduction of a flat capital gains tax rate of 18%, together with the abolition of taper relief and indexation allowance, from 6 April 2008 (*see News brief "The Pre-Budget Report: not everyone's Darling", www.practicallaw.com/8-378-8785*). The Pre-Budget Report did not suggest, however, that either the 1987 MoU or the 2003 MoUs were to be revoked. As a result, carried interest would still be taxed as a capital gain, albeit at 18% for disposals made after 6 April 2008.

The upside of the proposed abolition of taper relief is that the 18% rate would be available for any capital gains realised in respect of carried interest after 6 April 2008. Accordingly, a number of thorny practical issues, such as calculating the two-year holding period before the maximum business assets taper relief rate

The US position

In the US, carried interest is taxed at capital gains rates (as private equity funds are treated as partnerships for tax purposes) as long as underlying fund investments generating the carry return are held for more than one year.

Two proposals have recently been put forward to change the tax treatment of sponsors of private equity and hedge funds:

- A bill introduced in October 2007 by Congressman Charles Rangel (the Rangel Bill) contains a proposal that income from any "investment services partnership interest" (and any gain on the disposal of such an interest) would be treated as ordinary income from the performance of services, taxable at ordinary income rates (currently 35%) (*H.R. 3970*). This would apply to any person who provides (directly or indirectly), in the active conduct of a trade or business, a substantial quantity of services to the partnership consisting of investment, valuation and related advice in respect of any "specified asset", including securities, real estate and commodities.

- The Rangel Bill also contains a proposal which is intended to prevent sponsors from using offshore tax haven corporations and other structures to defer taxes on compensation received for providing investment services. Currently, individuals can defer paying tax on compensation until it is paid, as long as the corporate payer defers its deduction. Many funds have used structures where management fees are paid by funds to an offshore entity which defers payment to the ultimate US taxpayer or principals. This proposal would require deferred compensation owed by such offshore entities for investment services performed by the principals to be taken into income as it accrues, regardless of the timing of payment, as long as the entitlement to the fee is not conditional on future performance of substantial services. Any amounts owed but not currently ascertainable would be taken into income when ascertainable, with an interest charge imposed on the deferred tax liability.

It is difficult to say how likely enactment of the US proposals is, given the current political climate in the US and the upcoming Presidential elections in 2008.

applies, the arguments as to when the taper relief clock starts, and the requirement for the investee securities to be "unlisted", would no longer be of concern in connection with carried interest determinations.

A second change announced in the Pre-Budget Report that could affect the private equity industry involved the taxation of non-domiciled foreigners living in the UK. Under the proposed changes, the remittance basis of taxation would continue to be available in return for an annual payment of £30,000 where non-domiciliaries have been resident in the UK for seven years (until such time, the remittance basis would be available without the payment). In many circumstances, £30,000 will seem a good investment for sponsors in order to obtain remittance-based treatment on carry gains.

Going forward

The UK is at present one step ahead of the US in the debate. The changes to the capital gains tax rates announced in the Pre-Budget Report should become law unless the current lobbying by British industry groups leads to either a full or partial reversal. It is fair to assume for now, however, that a full reversal in relation to the capital gains tax rate payable by sponsors of private equity funds is unlikely. How the more radical US proposal to tax carried interest as ordinary income rather than capital gains will affect the debate in the UK remains unclear.

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