30 Monck Street
London SW1P 2AP
T: +44 (0)20 7340 0550
E: technical@ciot.org.uk

The tax treatment of carried interest – A call for evidence

Response by the Chartered Institute of Taxation

1. Executive Summary

1.1. The Chartered Institute of Taxation (CIOT) is the leading professional body in the UK for advisers dealing with all aspects of taxation. We are a charity and our primary purpose is to promote education in taxation with a key aim of achieving a more efficient and less complex tax system for all. We draw on the experience of our 20,000 members, and extensive volunteer network, in providing our response.

1.2. Given that the rates and treatment of carried interest is largely a political decision, we can only add that we support the government's consultation on this matter and urge that all potential commercial implications be considered before final legislation is put forward. As part of this review into the carried interest rules, we would also advise the government include in that review the disguised investment management fee rules, in particular in relation to non-UK resident individuals and entities.

2. About us

2.1. The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. Our comments and recommendations on tax issues are made solely in order to achieve this aim; we are a non-party-political organisation.

2.2. The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

2.3. The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries.

2.4. Our members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA', to represent the leading tax qualification.

3. Introduction

3.1. This responds to HMT's call for evidence published on 29 July 2024 ("the HMT Document").

3.2. Para 2 of the HMT Document states that carried interest can currently be taxed at CGT rates of 18% and 28%. This charge is imposed by TCGA 1992 s 1H(2)(b) and under s 1H(9) the term "carried interest gains" is defined, principally by reference to TCGA 1992 s 103KA and investment management services. We assume it is gains within this definition that are the focus of the HMT Document.

3.3. Our stated objective for the tax systems include:

- A legislative process that translates policy intentions into statute accurately and effectively, without unintended consequences.
- Greater simplicity and clarity, so people can understand how much tax they should be paying and why.
- Greater certainty, so businesses and individuals can plan ahead with confidence.
- A fair balance between the powers of tax collectors and the rights of taxpayers (both represented and unrepresented).
- Responsive and competent tax administration, with a minimum of bureaucracy.

4. General understanding

4.1. As we understand it, the typical fact pattern under which carried interest gains arise is as follows:

- An investment fund is constituted as a UK or, more commonly, non-UK limited partnership ("the Fund LP").
- The manager of the fund is typically an LP or LLP (either UK or non-UK), or less commonly a company ("the IM"). The IM performs its services through its partners (or in the case of a company, its employees) ("the Individual Managers").
- The IM would typically charge a minimum investment management fee to Fund LP – typically around 2% of assets under management ("flat-rate fee").
- In addition to this flat-rate fee, the IM would receive part of its reward based upon the performance of the Fund.
- To achieve this, the Capital of the Fund LP is typically nominal and divided, typically, 80:20 between the investor partners ("the Investors") and the IM.
- The funding of the Fund LP is from the Investors, normally by partnership capital and/or loan.
- Fund LP receipts comprise income, which is normally relatively modest, and the proceeds of asset realisations. Such realisations may give rise to a gain or a loss. Such gains are normally taxable as capital gains but some may be exempt and some may be OIGs treated as income (SI 2009/3001).
- Receipts are allocated 100% to Investors until they have been repaid their loans and any contributed capital and received a preferred return up to a hurdle rate ("hurdle").
- If and when receipts cross the hurdle, receipts are then 100% allocated to the IM until the split of overall return between Investors and the IM is 80:20.
- Thereafter all further receipts are allocated 80:20.
- Investment Managers might also be given an opportunity to invest more of their own funds into Fund LP alongside Investors ("co-invest")

4.2. In cases where the IM is a company, our understanding is that the interests of the Individual Managers under the LP are employment related securities ("ERS") within the meaning of ITEPA 2003 s 421B. However the employment tax that would otherwise be imposed on the Individual Managers is normally displaced because either or both:

- The Individual Managers can show they paid market value to acquire their interests. As per the MoU of 25 July 2003 between HMRC and the BVCA this is normally nominal as at the outset any expectation the Individual Managers have is highly contingent given that the Investors must first receive their capital and a preferred return.
- Employer and employees make a s 431 election under which they are taxed on the element of undervalue when the Fund LP is entered into.

4.3. Assuming the ERS legislation is not in point, until 2015 employees were taxed under SP D12 and the equivalent income tax rules for partnerships. In other words:

- In any given accounting period the income and gains of the Fund LP were allocated to partners in proportion to entitlement to receipts in that period. This meant that until Investors had received their preferred return, the income and gains were 100% allocated to them. The allocation was 100% to Individual Managers during the catch up period (para 3(7) above) and thereafter 80:20.
- Individual Managers were subject to income tax insofar as LP income and OIGs were allocated to them. They were subject to CGT insofar as ordinary gains were allocated to them.
- In the case of both OIGs and ordinary gains, the computation was on the basis of what the Fund LP had paid for the asset disposed of. In other words gains allocated to Individual Managers took the benefit of the Fund LP's base cost even though all funding of the Fund LP was by way of the Investor loans or other contributions. This was often referred to as "Base Cost Shift".

4.4. In 2015, ITA 2007 ss 809EZA was enacted the effect of which is that the sums allocated and paid to the Individual Managers might fall to be treated as disguised investment management fees and thus as trading income. This provision is principally aimed at arrangements to convert the flat-fee into capital gains. It does not typically apply to the carried-interest because it is displaced by s 809EZB(1)(c) which applies to "carried interest" as defined in s 809EZC. Assuming that definition is met, TCGA 1992 ss 103KA and 1H charge the Individual Manages to CGT on their receipts at the rates of 18% and 28%. But income or OIGs attributed to Individual Managers under the rules described above which remain subject to income tax. There is also an exception for what is called income based carried interest but carried interest does not count as income based if it falls within the ERS definition (ITA 2007 s 809FZU). This exception for income based carried interest is thus unlikely to be in point where the IM is a company.

4.5. Assuming the Individual Managers are charged to CGT the amount charged is the full amount and not the amount computed as per ESC D12, i.e. no Base Cost Shift is taken into account. A deduction is however allowed for actual costs incurred by the Individual Manager.

4.6. We have set out our above understanding of the rules as an aid to clarity and to enable those with greater familiarity to point out where qualification is needed to our understanding.

5. QUESTION 1: How can the tax treatment of carried interest most appropriately reflect its economic characteristics?

5.1. The distinction between income and capital gains – and the reasons for their differential taxation -is a complex area with blurred boundaries. In principle the rewards of labour are income (and should be taxed

to income tax) whereas the rewards from a person taking risk with his money are capital (and should be taxed to capital gains tax).

5.2. However, this clean distinction is not always easy to maintain. Take, for instance the entrepreneur (or group of entrepreneurs) who start up a new company. They may commit relatively little share capital (perhaps a few thousand or even a few hundred pounds) but the company succeeds because of their ingenuity, good ideas and hard work. During the company's life, the owner-managers will typically pay themselves a reasonable living "wage" (either in the form of salary, bonus or dividends). But, at a suitable point, they will hope to sell their shares – hopefully for a large capital sum.

5.3. In the above case, the sale of shares is clearly recognised as a capital receipt and charged to capital gains tax. This is the case even though the original entrepreneurs may have committed little or no capital to the project – merely their hard work and good ideas. Current tax rules do not distinguish such entrepreneurs from mainstream investors in such companies, who may have committed their own money by way of investment. Indeed, it would be typical for such a start-up company to go through several funding rounds where the entrepreneurs are joined (and their equity diluted) by investors ("business angels") coming alongside them.

5.4. While this is ultimately a political choice, existing rules can therefore be said to recognise a distinction between:

- A reasonable return for a person's labour (in the above example the annual "wage" which the entrepreneurs may draw from their company); and
- The extra capital return – which may derive not only from investors committing their capital, but also from the ingenuity and super-effort of the business's owner-managers

5.5. It can be seen from the simple example above that there is a clear parallel with the typical carried-interest structure. Under the typical structure:

- The Investment Managers (who are typically senior and very experienced in growing scale-up businesses) commit their labour – and in the form of the flat-rate fee (typically around 2%) receive an income-like return for doing so. The 2% fee is clearly not nominal. Investment management fees for conventional (non private-equity) portfolios might more typically be between 50-150bps. So a 2% fee is already a good above-market return for investment management services.
- Any super-return that the Investment Managers achieve above that is only achieved once the mainstream Investors have achieved more than the hurdle-rate. The hurdle rate is again typically set at a high rate (perhaps around an IRR of 10%), so any return above that can clearly be seen to be an excess (super-) return. It therefore very clearly parallels the super-return which the entrepreneurs achieve in the simple example above.
- The sort of companies in which these funds invest are typically exactly the same start-up or scale-up businesses as in the above example.

5.6. So, while on one view, carried-interest is just the reward for labour (and should be taxed to income tax), we think that it can equally be viewed as a super-return for risk-taking – very much akin to the risk that entrepreneurs take in (often the same) start-up or scale-up businesses.

5.7. The above is obviously just based upon the typical carried-interest structure and we recognise that there are a range of circumstances in which receipts are subject to CGT as carried interest. Ultimately, therefore we recognise that it is a political judgement as to how far what Individual Managers receive as per the

description we have given above is in substance profit related pay or profit share and how far it is investment return. Given the complexity and variety of carried interest arrangements we support the government wish for feedback on the form these arrangements take and urge that no legislation be tabled until the government is satisfied it fully understands the range of commercial arrangements that give rise to carried interest and publicises its understanding so that those affected can indicate where they might disagree.

6. QUESTION 2: What are the different structures and market practices with respect to carried interest?

6.1. We have set out above our understanding of the basic structure, and in section 5 have given a reason why the super-returns from such a structure might appropriately be taxed to capital gains tax rather than income tax.

6.2. Of course, we also recognise, that there are a range of carried-interest structures and – in some of them the risk taken by the Investment Managers may be less than we have given in the "typical" example above.

6.3. We suggest that, with the wide variety of different structures and market practices, a sensible approach may be to define a statutory "safe harbour". Such a safe harbour would seek to define what proper "risk-taking" looks like (and therefore what is appropriately taxed in the same way as capital gains).

6.4. A model for this might be the salaried member rules in s863Aff ITTOIA 2005. Without going into the detail of those rules, they set a clear redline test (of who is a "true" partner) based upon a combination of:

- commitment of partnership capital and/or
- commitment of management expertise; and/or
- genuine profit-related reward.

6.5. The exact rules for carried-interest structure may need to be based upon different thresholds to the salaried member rules and/or a different combination of the above factors. And it may be that, over time, the various thresholds could be tweaked to reflect changed market practice. However, we suggest that commitment of capital; participation in management and genuine profit-related reward are the hallmarks of what makes something capital rather than income – and a test based around these (with clear parameters) would be a sensible way to proceed.

7. QUESTION 3: Are there lessons that can be learned from approaches taken in other countries?

7.1. France, Germany, Italy and Spain all have carried interest rules allowing for special (and favourable) treatment for their private equity markets. France offers a rate of 34%, Germany 28.5%, Italy 26% and Spain 22.8%. So, the current upper rate for UK CGT of 28% sits at a similar level to other European countries – none of whom have nearly as much capital under management as in the UK. We are not in any position to comment on those rates themselves, nor those of other countries and approaches to carried interest; however, to subject all carried interest in the UK to income tax rates of 45% (plus national insurance contributions) would clearly place rates beyond those of these countries. Before enacting any final legislation, we would urge the government to fully consider the potential implications of this and whether it might adversely affect the UK's competitiveness and position within the global market. It is highly desirable to have this data to determine the possible international effects of changes to the UK regime within a global market environment.

8. OTHER INPUT

8.1. The disguised investment management fee rules have complex provisions dealing with the position where the fee arises to a person other than the Individual Manger himself (ITA 2007 s 809EZDA and 809 EZDB). With certain exceptions these are applied to carried interest (TCGA 1992 s 103KG).

8.2. The language of these rules is singularly opaque and we would urge that as part of this review their clarity be improved. A particular focus should be on their application to receipts by non-resident companies owned by non-resident trusts. By way of example:

- The power to enjoy concept should be replaced by more updated rules, given that the power to enjoy concept is derived from the transfer of assets legislation, the unsatisfactory nature of which is now recognised by the review also promised on 29 July.
- TCGA 1992 s 103KE should make it clear (insofar as it does not already do so) that any UK or foreign tax suffered by the company in actual receipt of the carried interest is a deduction and that this is so even where the tax on the company is suffered in a different accounting period to that in which the carried interest is charged. In other words all forms of economic double taxation should be fully relieved.
- It should also be made clear that any valued taxed as carried interest or as a disguised fee is not taxed again if it is subsequently distributed to the individual or his family, whether in capital or income form. TCGA 1992 s 87(5B) is a partial provision in this regard but it is not comprehensive and does not extend to income tax provisions such s ITA 2007 s 731.

8.3. Also as part of the review the wider territorial aspects of the rules should be considered. How should an Individual Manager be taxed if he moves to the UK after the Fund LP is entered into but before the carry is paid? A similar point arises if the Individual Manager emigrates during that period.

8.4. The interaction of s103KA and the "mainstream" CGT calculation – both of which can currently apply – should also be improved and clarified.

9. Acknowledgement of submission

9.1. We would be grateful if you could acknowledge safe receipt of this submission, and ensure that the Chartered Institute of Taxation is included in the List of Respondents when any outcome of the consultation is published.

The Chartered Institute of Taxation

30 August 2024