



THE TAX TREATMENT OF CARRIED INTEREST

Issued 30 August 2024

ICAEW welcomes the opportunity to comment on the tax treatment of carried interest call for evidence published by HM Treasury on 29 July 2024, a copy of which is available from this [link](#)

ICAEW considers that the current taxation of carried interest in the UK is on a par with taxes charged in other countries and that any changes could adversely affect the level of investments made in growing UK businesses, as well as delaying new investments. Any changes could also affect the ability to recruit and retain talented individuals in the UK, especially when considered in conjunction with the proposed changes to the taxation of non-UK domiciled individuals and the charging of VAT on private school fees.

This response of 30 August 2024 has been prepared by the ICAEW's Tax and Corporate Finance Faculties.

The Corporate Finance Faculty is ICAEW's centre of professional expertise in corporate finance. It contributes to policy development and responds to consultations by international organisations, governments, regulators and other professional bodies. It provides a wide range of services, information, guidance, events and media to its members, including its highly regarded magazine *Corporate Financier* and its popular series of best-practice guidelines. The faculty's international network includes member organisations and individuals from major professional services groups, specialist advisory firms, companies, banks and alternative lenders, private equity, venture capital, law firms, brokers, consultants, policy-makers and academic experts. More than 40 per cent of the faculty's membership are from beyond ICAEW. ICAEW has supported and the faculty and its members have been key contributors to *Private Equity Demystified: An explanatory guide* by John Gilligan and Mike Wright, since it was first published in 2007. The commentary and in-depth explanations are supported by findings of peer-reviewed academic studies and the book has featured on reading lists of leading universities and business schools.

Internationally recognised as a source of expertise, the ICAEW Tax Faculty is a leading authority on taxation and is the voice of tax for ICAEW. It is responsible for making all submissions to the tax authorities on behalf of ICAEW, drawing upon the knowledge and experience of ICAEW's membership. The Tax Faculty's work is directly supported by over 130 active members, many of them well-known names in the tax world, who work across the complete spectrum of tax, both in practice and in business. ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark the tax system and changes to it, are summarised in Appendix 1.

ICAEW is a world-leading professional body established under a Royal Charter to serve the public interest. In pursuit of its vision of a world of strong economies, ICAEW works with governments, regulators and businesses and it leads, connects, supports and regulates more than 169,000 chartered accountant members in over 146 countries. ICAEW members work in all types of private and public organisations, including public practice firms, and are trained to provide clarity and rigour and apply the highest professional, technical and ethical standards.

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KEY POINTS

VALUE OF THE PRIVATE EQUITY (PE) SECTOR TO THE UK ECONOMY

1. Before we address the specific questions raised by HM Treasury, we would like to highlight the value that the PE sector brings to the UK economy.
2. According to the British Private Equity & Venture Capital Association (the BVCA), the UK is consistently the second largest country for the level of funds invested via PE funds, second only to the USA. The amounts under investment in the UK are often equivalent to or greater than the total of funds under investment in the other major Western European economies combined. This data can be found at Table 2 of BVCA's [Report on Investment Activity 2023](#). Table 7 also shows that Growth capital and Buyout capital, which together are seen as the backbone of the PE industry, are by far the biggest areas of investment in the UK by PE firms, when compared to early-stage venture capital financing.
3. *The Private Equity Activity Report 2023* by Invest Europe indicated on page 21 (attached as Appendix 2) that 32% of the funds raised in the UK in 2023 were investments from pension schemes. This indicates that the UK population likely do benefit, and probably without realising it, from the growth that PE offers, in the form of uplifts to their pension pots.
4. The BVCA provided further [data](#) in 2024 showing the economic benefits generated by UK PE firms.
5. In January 2023, HMRC [responded](#) to a freedom of information request for totals of the carried interest figures disclosed on individuals' capital gains tax (CGT) self assessment pages for the three tax years from 2018/19. The figures provided were:

Tax year	Carried interest disclosed (£)
2018/19	2,901,000,000
2019/20	2,707,000,000
2020/21	3,411,000,000

6. The Financial Times (FT) noted on 31 May 2023 that in the 2020/21 tax year, £2.7bn of the £3.4bn (79%) of carried interest was received by 255 UK senior PE executives. Also, according to the [FT](#), on 27 June 2024, 2,550 people in the UK receive carried interest profits, so it appears that it is the top 10% who have the largest carried interest receipts. The other 90% of carried interest recipients do not receive such significant amounts.
7. In addition to the CGT paid on carried interest receipts, the other amounts received by PE managers, such as fees and Income-Based Carried Interest (as outlined below) will be liable to income tax. ICAEW considers that HMRC or HM Treasury should also provide details of the income tax and national insurance contributions paid by those working for PE funds, including an analysis of the distribution, to provide visibility of the true scale of the tax contribution made by PE funds.
8. The figures available that are highlighted above demonstrate that the PE sector provides significant investment in UK businesses, as well as attracting talented people domestically and from overseas who contribute substantially to the exchequer. There are many businesses with a higher risk profile that might otherwise struggle to raise funds, were it not for the investments provided by PE funds.

THE CURRENT TAX TREATMENT OF CARRIED INTEREST

9. In 1987, the Inland Revenue and the Department of Trade and Industry approved a [statement](#) from the BVCA that limited partnerships would be treated as transparent, meaning that any taxes would be charged, as appropriate, on the limited partner investors, the PE fund itself (as the general partner) and those working for the PE funds.
10. The current tax treatment of carried interest is based on the Memoranda of Understanding (MoU) dated 25 July 2003 between the Inland Revenue and the BVCA, the first covering employment-related [securities](#) and the second covering the treatment of PE limited partnerships and [carried interest](#). As such, the current taxation of carried interest is operating clearly within the existing UK tax system and describing it as a 'loophole' is misleading. Any tax calculated based on the MoU will have been agreed with the UK tax authorities and is therefore in accordance with standard practice.
11. In addition, since then, several anti-avoidance provisions and other measures have been introduced, which would combat any abuse of the MoU. These include:
 - The 2015 carried interest CGT rules aimed to create a CGT liability on the full amount of carried interest receivable, essentially by limiting the recipient's CGT base cost under the rules for partnerships to the amount they paid for their carried interest entitlement. The Disguised Investment Management Fee rules (DIMF) rules were also introduced to tax fees for investment management services, which are not linked to the performance of the fund, as income rather than capital receipts.
 - The 2016 income-based carried interest (ICBI) rules, ensure that shorter term receipts of carried interest (receivable up to 40 months) are now liable to income tax, as if they were DIMF, rather than to CGT. The 2015 and 2016 rules were designed in consultation with the PE industry.
 - The employment-related securities rules.
 - The offshore funds rules.
12. These rules are aimed at preventing the design and use of any avoidance arrangements.
13. We are concerned that any disruption to the agreement reached with the industry on taxation of returns from PE could damage this valuable part of the UK economy.
14. It is important that any of our members who advise clients on the taxation of carried interest are not seen as potentially having breached the Standards for Tax Planning that were introduced by the 1 March 2017 version of *Professional Conduct in Relation to Taxation (PCRT)* – a document that HMRC has endorsed and to which our members are professionally bound. Referencing an agreed and long-standing tax treatment as a 'loophole' impugns the reputation of professional advisers.
15. Our members support simplified rulemaking for carried interest and competitive tax rates. If any changes are to be made to the tax treatment of carried interest, we would advocate that the Tax Faculty's Ten Tenets in Appendix 1 are taken into consideration.

INTERACTION WITH THE NON-DOMICILE/REMITTANCE BASIS CHANGES

16. Our members have advised that PE firms operating in the UK have a high percentage of non-UK domiciled employees/partners, particularly in the large global funds where the higher earners are often found. Such individuals may already own homes in other jurisdictions, are internationally mobile and can easily leave the UK.
17. Any changes to the taxation of carried interest must be considered in the context of the wider changes that are being made to the taxation of non-UK domiciled individuals and the remittance basis rules. Depending on the exact treatment agreed going forward, our members consider that these changes could make it harder for PE funds to retain and recruit professionals to the UK with expertise in growing businesses and might accelerate the departure from the UK of non-UK domiciled employees/partners who may leave earlier than they might otherwise have done.

18. For example, individuals who might previously have come to the UK for seven years until they became liable to the £30,000 remittance basis charge, may now only remain in the UK for the four years that they can make tax-free remittances under the proposed foreign income and gains (FIG) regime.
19. In addition, there is a risk that non-UK domiciled senior managers who have been involved in the PE industry since its early days in the 1990s, will retire earlier than they may have done and leave the UK, potentially creating a gap in knowledge and expertise. Our members are concerned that small to mid-market UK PE firms will be disproportionately affected by such departures.
20. Without this talent, UK businesses would lose the access to risk capital that these managers provide, and the UK economy would be deprived of associated investment and growth.
21. Non-UK domiciled individuals who have ongoing interests in overseas PE firms can currently use the remittance basis for up to 15 tax years of UK residency and will pay tax on their foreign income and gains if and when they remit them to the UK. If the proposed changes are introduced, those who will not be eligible for the four-year FIG regime face being taxed on receipts from offshore funds, regardless of whether they have remitted the funds. These individuals may not have carried out any work in the UK for those funds and the tax treatment will diverge from how they expected to be taxed at the point they received their entitlement to carried interest and other sums.
22. If changes are also made to the taxation of carried interest, this will be a “double whammy” that could risk triggering an exodus from the UK PE industry.
23. While ICAEW has not carried out a comprehensive survey of members, we have spoken to some who regularly advise clients on the taxation of carried interest. The general consensus is that their clients would probably remain in the UK if the rate of CGT on carried interest increased to somewhere in the low-to mid-30% range, but that clients would be more likely to leave the UK if carried interest became taxable as income.

GRANDFATHERING

24. Consideration should be given to the effective date of any prospective changes to the taxation of carried interest and whether any transitional or grandfathering provisions are offered to existing PE structures. Some of these structures would have been established 10 years ago or more and fund managers have a legitimate expectation that receipts arising from those structures would only be taxed as capital gains. A rise in CGT rates or recategorisation as income could lead to delayed exit from investments and, in turn, slower reinvestment in other businesses. Any changes with retrospective application, will affect carried interest that has not yet been released.

DOUBLE TAXATION

25. Any prospective changes to the UK tax treatment of carried interest need to reflect typical arrangements between the UK and overseas jurisdictions, such as the OECD model income and capital taxes treaties. Consideration should also be given to the interaction with any treaties that do not follow this model to prevent double taxation where interest is treated as capital in one jurisdiction and income in the UK.

CONCLUSION

26. The PE industry currently makes a significant contribution to the UK's economic growth, generating investment and tax receipts from those working in the industry. The government should take care to ensure that any proposed changes do not jeopardise these contributions and that the UK tax system remains internationally competitive.
27. ICAEW would be happy to provide feedback on any specific amendments to the current rules which may be announced at the 2024 Autumn Budget.

ANSWERS TO SPECIFIC QUESTIONS

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

28. The government notes that there are a range of circumstances in which carried interest is received, and that the characteristics of the reward will not be the same in all cases. It is therefore very difficult to give a general answer to this question. However, we set out below some key characteristics that frequently arise in PE arrangements.
29. Funds are usually structured as limited partnerships, with the fund manager acting and investing as the general partner and the external investors becoming the limited partners. *Private Equity Demystified* states on page 42 that:
- “the problem that needed to be solved was: how can a group of institutions and individuals create a limited liability structure that would bind them together as investors for a finite period without creating multiple tax charges?
- Note that the starting point is not to avoid tax, it is to avoid duplicating tax charges whilst maintaining limited liability. Each investor should be taxed according to their individual tax position. The problem was to avoid creating a vehicle that would also be taxed before the investors were paid out.”
30. The book goes on to explain why other vehicles are not used. If a limited company was used as the investment vehicle, it would have a corporation tax liability and would need to be liquidated when the investment period ends. The investors would then also be taxed on the liquidation distribution. The investors are often exempt from CGT, so the corporation tax charge on such a limited company would put investors in PE at a disadvantage over buying and selling shares in quoted companies. In a traditional partnership structure, the partners jointly and severally guarantee each other's liabilities, which unconnected investors would not want to do.
31. The co-investment by the PE firm aligns the interests of the fund managers with those of the investors and means the PE firms share in the risks if funds are not successful. Carried interest is seen as the reward for taking that risk.
32. There is a risk element to the investments made by PE funds, which are considered to be higher risk than investing in listed UK share funds, because of the illiquidity of the investments. Gains on quoted shares are taxable at CGT rates. The government recognises that investment schemes, such as the enterprise investment scheme (EIS) and venture capital trusts (VCT) acknowledge the risky nature of those investments (which are made on a considerably smaller scale than PE funds) and as such, offers income tax and CGT reliefs as an incentive to investors. Venture capital investments are a form of PE, where investments are made in businesses in their early and emerging stages. In contrast, PE funds are those who invest in established businesses and seek growth through efficiencies. The economic characteristics of carried interest are therefore akin to the profits made on EIS and VCT investments.
33. There is no guarantee that carried interest will be paid, as not all funds make sufficient profits to pay carried interest. This is because other payments must be made first, such as:
- the management fee (around 2% of the funds that the external investors have committed to provide) which is paid to the general partner;
 - the repayment of loans used to acquire investments;
 - the 'preferred return' (or 'hurdle rate') to external investors (the limited partners) of say 8% to 10% of the amounts they have loaned;
 - the 'catch up' phase in some agreements, which is where the carried interest holders receive 100% of distributions until they have received 25% of the investor's preferred return.

34. Only then is the remaining “super-profit” (or carried interest) shared between the external investors, who typically get an 80% share, with the other 20% going to the PE firm and its employees or partners.
35. John Gilligan, co-author of *Private Equity Demystified* and a director at the Said Business School, has drawn ICAEW’s attention to the 1989 Special Commissioners’ case of 3i Plc, which held that 3i was an investment company and not a trading company. The case is relevant because it determined that 3i undertook similar activities to those carried out by PE funds today, as 3i invested in businesses by acquiring share capital or making loans. This supports the argument that in economic terms, the receipts of a PE fund (subject to the later DIMF and ICBI rules) are more akin to capital receipts than trading receipts. The case pre-dates the digitisation of Tribunal cases, but can be accessed [here](#).
36. The 2003 BVCA MoU, was intended to match the economic characteristics of the return for fund managers with the tax treatment. This states:
 - All fund managers should be paid a full market salaries and bonuses for their day-to-day work (para 7.11).
 - Carried interest is not directly related to the work performance of any individual (para 7.6). It is a longer-term award, not an annual bonus or performance reward (paras 7.6 & 7.11).
37. ICAEW has been advised by the BVCA that the average time that a fund takes to pay out carried interest is seven years. As such, individuals do generally work for the same PE fund for many years. The longer-term nature of carried interest is therefore risky and requires patient investment.
38. Chapter 1 of *Private Equity Demystified* provides a useful comparison of the investments made by PE funds, with investments in publicly quoted shares. The book outlines that a key difference is that publicly listed shares are liquid, in that an investor can easily sell their shares if they are not happy with the company’s performance. PE funds are illiquid in that can only really dispose of their investments by way of a public floatation or sale to a third party, and if a fund is not happy with the company’s performance, it would look to replace the management team.

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

39. The government is particularly interested to understand how these differences should be taken into account as part of its reforms.
40. The investment and reward structures do vary and depend on the sectors the PE funds invest in (eg, infrastructure, real estate, credit, debit, etc). However, there are similarities across the structures, as noted for Question 1, with the use of limited partnerships, where the fund manager is the general partner and also provides management services. The external investors (plus any co-investors) make a capital contribution to become limited partners and they also commit to making loans to the fund. The PE fund will use those loans, along with commercial borrowings, to acquire investments or make loans in businesses.
41. Chapter 2 of *Private Equity Demystified* describes different fund structures and the components of PE fund managers’ reward. It notes on pages 55-56 that there are two basic models for carried interest:
 - The American model, where carried interest is calculated and paid on a deal-by-deal basis, and provides for a clawback if other investments made by the fund underperform. This model usually results in carried interest being paid earlier than the European model.
 - The European model, where the carried interest is based on the fund’s overall performance.
42. The typical life span of a PE fund is 10 years (known as a ‘ten plus two’), where the fund invests for the first six years, is wound up after 10 years unless the standard two-year extension is invoked. The terms on which carried interest will be paid are set out when the

fund is established. The terms may provide an additional entitlement for employees who are promoted during the period the fund operates.

43. Generally, even junior employees get a share of the carried interest, with some firms operating a 'house pot'. However, an individual who joins a fund after the investment window has closed will not have any entitlement to the carried interest arising in the fund. Similarly, an employee who leaves a PE firm before the fund ends, is likely to lose their carried interest entitlement.
44. More senior employees/partners will also be offered the chance to put their own money in, known as 'co-investment' and will share in both the preferred return and the 80% share of the carried interest that are available to the external investors.

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

45. While many other countries have specific regimes for the taxation of carried interest, their detail and conditions for access vary.
46. The following studies by DLA Piper and Macfarlanes, which are in the public domain, provide a useful comparison of how different jurisdictions tax the receipts of PE firms:
 - DLA Piper's multi-jurisdictional [comparison](#) from September 2023
 - Macfarlane's June 2023 [comparison](#) of the UK and major European regimes.
 - Macfarlane's April 2024 [comparison](#) of the UK and US carried interest regimes.
47. ICAEW considers that these analyses show that the current way the UK taxes fund manager's income and carried interest is competitive on a global scale, with any increases in UK taxes likely to have a detrimental effect on attracting and retaining talented individuals in the UK.
48. Investment appetite and decisions require certainty, ideally for the lifespan of each fund. And the market (investors and PE managers) also requires reasonable time to adapt to changes. In the UK, past consultations on considered reforms have created a predictable regime.
49. Other countries do make unforeseen changes and these create uncertainty for both investors and PE fund managers. Italy, for example, in April 2017, suddenly doubled the flat rate of managers' aggregate co-investment to 1% of the total fund, in order for carried interest to be taxed as capital. Italy also has a minimum five-year investment period to obtain capital treatment.
50. If changes are made to the taxation of carried interest as well as changes to the taxation of non-UK domiciles, this will be a "double whammy" that could risk triggering an exodus from the UK PE industry.
51. Our members have told us that PE managers are looking to leave Sweden, which currently lacks specific rules for taxing carried interest. This is apparently due to the uncertainty of the tax treatment of carried interest, following recent court decisions that it is taxable as employment income there. In response, the Swedish authorities have recently announced a [consultation](#) on how carried interest should be taxed there and one of their stated aims is to retain managers in Sweden.
52. The UK may choose to mirror the above regime in Italy (and we understand France has a similar requirement) to require a minimum level of co-investment in order to qualify for CGT treatment for carried interest. We point out that, if minimum co-investment is prescribed at the individual level rather than the aggregate (or fund) level, the more junior individuals, particularly in the larger funds, will be disadvantaged, as they would need to borrow large sums (ie, be highly leveraged) in order to fund their co-investment. This in turn would be a deterrent to attracting talented individuals to the UK PE sector. Clarification should also be provided as to whether contributing equities in other businesses would be acceptable as a form of co-investment.

APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.
4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see <https://goo.gl/x6UjJ5>).

APPENDIX 2 – INVEST IN EUROPE DATA

