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What is carried interest and how will Labour's plans affect private equity executives?

Plans by the new chancellor, Rachel Reeves, for higher taxes on 'carried interest' profits made in the private equity sector have stirred up debate in the City of London

BY RORY SACHS AND YUSUF KUNDGOL

Along with the axing of the non-dom regime, HNW city executives could be taxed more on the profits they make in private equity deals / Image: Shutterstock

In private equity funds and deals, leading executives have typically received a share of the profits if the investment has performed well — but only once investors have received their payout.

Typically, this is done on an 80:20 basis between the limited partners (LPs) who have provided the capital, and general partners, the private equity professionals organising the deal.

The share of these profits is known as 'carried interest' or 'carry', and is taxed in the UK at a capital gains rate of 28 per cent.

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The new chancellor of the exchequer, Rachel Reeves, has called the current rules benefitting PE professionals 'absurd', while the Labour Party manifesto contains a pledge to close what it has called a 'loophole' in tax legislation.

'Labour will address unfairness in the tax system,' the manifesto reads. 'Private equity is the only industry where performance-related pay is treated as capital gains. Labour will close this loophole.'

The plans, according to the manifesto, could generate as much as £565 million for HMRC by 2028/2029, though the document is light on the detail about what taxes will replace it, and whether income taxes will be levied.

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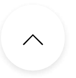

Meanwhile, a pre-election analysis by the taxman estimated the changes could lead to a reduced tax take-in of £3.3 billion if the policy ran from 2025 until 2029.

Tax advisers warn the move could prompt some private equity executives to abandon London in favour of other regimes with lower taxes on carried interest. 'London has got fantastic infrastructure, but if the tax differential is significant, then maybe it's a tipping point for fund managers,' Matthew Braithwaite, partner at Wedlake Bell, told *Spear's*.

[See also: Where are the new non-dom hubs? Advisers reveal leading destinations after Labour win]

How does carried interest work?

Carried interest payments in the UK have been around since the origins of the private equity industry in the City of London in the 1980s.

In May 1987, the British Private Equity & Venture Capital Association (BVCA) signed a memorandum of understanding with the UK's Inland Revenue (replaced by HMRC in 2005) and the Department for Trade and Industry, setting out the arrangements for taxation for private equity investment funds and the use of limited partnerships.

The memorandum of understanding stated private equity firms would be subject to capital gains tax on any carried interest profits made after the completion of a PE deal.

The carried interest rules have become somewhat less generous in recent years. In 2015, David Cameron's coalition government increased the rate payable on carried interest from 20 per cent to 28 per cent, as part of its new Disguised Investment Management Fee (DIMF) rules.

Carried interest arrangements are also common in the US and across Western Europe. Other jurisdictions have slightly more favourable rates compared to the UK, including Germany (where some of the carried interest is tax-exempt and some is taxed at 27 per cent), Italy (26 per cent) and Spain (27 per cent). Some fear the Labour Party's pledged changes may make the City of London less competitive to these other jurisdictions.

Tax advisers tell Spear's that London could become a less competitive centre for deal-making if levies on City executives are too high / Image: Shutterstock

What are Labour's plans for carried interest?

The Labour Party expects to raise £565 million a year by 2028-29 by changing the rules for fund managers.

Currently, there is a lack of clarity on what will replace the capital gains rate on carried interest payments, though the closure of the 'loophole' may involve extending the current Disguised Investment Management Fee rules. Under these rules, carried interest payments could be designated as 'trading profits', meaning they could be subject to normal rates of income tax, up to 45 per cent, according to private client firm Buzzacott.

Labour could also choose to raise the tax burden on carried interest payments to be in line with normal employment income taxes (which would include National Insurance contributions), which could lead to an effective tax rate higher than 50 per cent, or to the level of taxes on dividend payments, which sits at 39.35 per cent for additional tax rate payers.

[See also: Sir Nicholas Mostyn, ex-judge and family law legend, on his next chapter]

Given the lack of policy detail, it is also unknown whether Labour will alter the rules to tax the profits generated by the fund as a whole or on the profit share taken by different individuals.

Could carried interest be spared?

Yet recent comments given by Rachel Reeves to the *Financial Times* have given some the impression Labour will leave some carried interest payments under the CGT rules.

Reeves said she did not think it was right that 'what is essentially a bonus is taxed at a lower rate than employment income, when you're not putting your own capital at risk.' But she added that for those putting their 'own capital at risk' it was 'appropriate that you pay capital gains tax.'

Since then, some City of London professionals have speculated that where firm managers have invested a significant amount of their own capital, profits earned may be excluded from any of Labour's changes.

'Rachel Reeves' point was that if you had invested your own money into a fund, whatever return you get from that is probably a personal investment, and so therefore would qualify as carried interest,' Christine Cairns, a private client tax adviser at PwC, told *Spear's*. 'So that has given a bit of relief, though we don't have any details.'

Cairns added: 'The BVCA has spent a lot of time with the Labour party, and [when] you read their updates, they are confident we will get to a regime that is fair, and not punitive.'

How would changes affect the City of London?

The tax measures will affect a reasonably small minority of financial professionals in the City, with Treasury analysis indicating that 3,000 private equity dealmakers receive carried interest. Between them, the sum of carried interest generated by the City is currently around £5 billion.

As many PE professionals receiving carried interest are internationally mobile, some believe the proposed tax rise could lead to a net loss for the Treasury if executives choose to leave the UK for more favourable jurisdictions to run private equity houses.

[See also: The UHNW non-doms leaving the UK to escape a Labour government]

Advisers also suggest that Labour's proposed tax-grab on private equity profits shouldn't be viewed in isolation. HNW executives working in the City may also have to grapple with increased private school fees following Labour's tabled VAT levy, changes to the non-dom status, as well as tighter rules governing the use of offshore trust structures.

Some tax experts believe private equity executives might be tempted to head for 'la dolce vita' in Italy if the eventual levies on the City are too high / Image: Black Tomato

Along with the eventual axing of the non-dom regime, the tax hike 'has the potential to massively increase [many PE professionals'] effective tax rate,' Withers partner Ceri Vokes told *Spear's*. 'For many, that's too much'.

However, some tax advisers believe there are reasons to still be hopeful for the City of London.

'We need a timely intervention by the new chancellor, to give the market certainty'

'I have had conversations with other private equity houses, where they have said, "well, actually, we want to remain in the UK, because the UK is still a good place to do business",' says Cairns. 'And even if the tax rate on carried interest goes up, it wouldn't be that much more compared to what you're taxed on in the US or Canada, so it's actually not that much of a change.'

Her sentiment is echoed by Braithwaite, who says that 'there are real reasons why people continue to come and invest in the UK.'

He explains: 'The UK's taxing system, by comparison to others, is still relatively competitive, [while] the political landscape is relatively benign compared to other jurisdictions. We're not talking about Jeremy Corbyn-style politics.'

Reeves' softer comments might also be comforting for those looking for signals that Labour is not planning more widespread increases in capital gains tax rates. The topic was conspicuously absent from the party's election manifesto.

Vokes says many are waiting until the Autumn Statement before making their next move. 'There's a big group that are watchfully waiting. For them, the budget announcement and what the draft legislation says will be absolutely key.'

She adds: 'We need timely intervention by the new chancellor, to give the market the certainty that it needs and that really has been lacking.'

Topics in this article : **tax** , **Wealth management**

Rory Sachs

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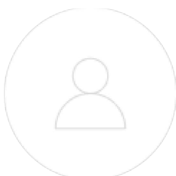

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