Response to Consultation

THE TAX TREATMENT OF CARRIED INTEREST – A CALL FOR EVIDENCE

About the Investment Association

The Investment Association ('IA') champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £9.1 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 48% of this is for overseas clients. The UK asset management industry is the largest in Europe and the second largest globally.

Executive Summary

The Investment Association welcomes the opportunity to contribute to HM Treasury's Call for Evidence on the *Tax Treatment of Carried Interest*.

While the use of carried interest has been less common in the IA membership, which has primarily comprised of '*traditional*' fund managers, many of these traditional fund managers are now expanding their product offering into the private markets space in the hope of capitalising on the growth in Alternative assets. This reaction has been necessary due to changing investor demand and a need to be able to offer investors access to a variety of private assets including real estate, infrastructure, private equity, private debt and other new and evolving asset classes, many of which commonly involve the use of carried interest structures, in order to better align the incentivisation of the manager with investment performance.

As investment management businesses continue to evolve their operating models there is a wider interlinkage between public and private markets in terms of people and services that different parts of our sector use and have access to. It is with this interlinkage in mind that we are responding to this Call for Evidence.

Investment into private markets (those assets that are not traded on public markets) have grown rapidly in recent years. They now represent over $12 trillion in global AuM[1] and are projected to keep expanding as investors seek new sources of income, capital growth and diversification. Private markets are also an area which provide utility far beyond their headline numbers. This economic '*tail*' includes an entire ecosystem built to support this sector; including investment research, fund administration, custody, prime brokerage,

[1] IA Policy Briefing on Private Markets, March 2024

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cash management as well as a host of high-value ancillary legal and professional services businesses designed to facilitate alternative investment.

The success of the UK's investment management sector increasingly rests in the UK being seen as a global location which can cater for all investors across all asset types – acting as an international marketplace for investment management. In order to compete in these evolving investment mandates UK investment managers need to employ bespoke compensation arrangements to attract the skills and expertise necessary for our wider, continuing success.

This global success is a vital part of how investment management creates growth here in the UK and contributes to the financial security of households across the country.

Today, our members own, on behalf of their clients, a third of UK listed companies and invest in many thousands of unlisted and high growth companies, infrastructure projects, and of course buy UK government debt. We provide over 126,000 jobs and are responsible for 5.5% of the UK's total exports in services.

Even more fundamentally, having a world leading investment management sector right here in the UK makes it easier for British savers and investors to access the very best products and expertise which helps them to become more financially resilient. Without the UK's strength as a global centre for investment management investors, and the managers who invest on their behalf, would not benefit from the same range of opportunities to invest nor reap the benefits of that investment in later life.

In our response below we wish to highlight a number of important considerations to ensure that any changes are relevant, necessary, proportionate and deliver on the government's objectives to deliver economic growth to the UK in a manner that helps protect the UK's attractiveness as an investment management location of choice.

➢ Competitiveness

The UK is behind only the US as a leader in investment management of private assets. To help support the government's growth agenda, it must remain **competitive** to benefit from the expected growth that is projected within the private markets arena with Global Alternative AuM expected to reach $38 trillion by 2028[2].

➢ Certainty and predictability

The UK's current approach to taxation of carried interest is a result of planned UK tax policy which has been settled for decades. It has been clearly articulated since the Memorandum of Understanding was signed between HMRC and the BVCA in 1987 and the subsequent update in 2003 for the changes made as part of the Finance Act 2003.

The resulting regime has become a well-understood international standard for incentivising outcomes and rewarding performance to investors.

Any changes to UK policy need to be **well-considered, well-consulted, must be simple to understand and apply which will in turn assist the industry with fuller and more accurate compliance**.

Consideration must be made to any potential impact on common carried interest models, including investment structures that operate cross-borders. It is typical that carried interest holders from

[2] Appendix 3 of BCG's GLOBAL ASSET MANAGEMENT REPORT 2024 22ND EDITION

multiple jurisdictions often hold their carried interest through a single co-mingled vehicle. The government should ensure that any changes or additional requirements made to the UK carried interest tax regime do not negatively impact non-UK carried interest holders e.g. aggregated co-investment requirements.

Nor should any proposed changes impact the burgeoning market for Qualified Asset Holding Companies ('QAHCs') which are increasingly being utilised within carried interest structures and whose benefits we know the government well understands.

- **Grandfathering and transition**

These factors must all be carefully considered before bringing about any changes to this already complex set of rules.

The risks of rushing into making any significant changes to the tax regime for carried interest cannot be overstated and could have a disruptive impact on trillions of existing capital investment.

As an example, where a new UK taxation regime for carried interest required a minimum co-investment, it will likely prove impossible for taxpayers and/or managers to rebuild existing structures, many of which are closed-ended, to meet such a requirement.

- **Ability to attract international capital and talent.**

The investment management industry relies on international capital and talent that governments worldwide seek to attract through a range of tax, regulatory and other measures. Carried interest, particularly with some form of co-investment requirement, is an incredibly popular mechanism for investors seeking to incentivise the highest levels of investment performance. Investors want to offer strategically negotiated carried interest conditions as a way of retaining top-tier talent in the highly competitive field of investment management. While looking at the tax treatment of carried interest and other measures, the UK also needs to reflect on and consider the impact on future access and attractiveness to capital, investors and talent, and its resulting impact on the economy.

It is vital to understand that the UK is not an international outlier in its tax treatment of carried interest. There are a host of dedicated carried interest regimes across the US, Europe and Asia all specifically designed to attract and retain international investment management businesses while offering value for money and tax revenues for domestic stakeholders. The rate of tax on carried interest in the UK at 28% is significantly higher than in the US (23.8%) the leading international investment management jurisdiction for private assets and in recent years both Spain and Italy have looked to enhance the attractiveness of their carried interest regimes. We expand on these comparisons in our answer to Question 3 below.

Based on the above, the IA would urge extreme caution in seeking to alter the carried interest regime without due consultation. If not well considered, consulted on and delivered proportionately, from a position of relative strength, the UK has far more to lose than to gain from other international rivals when changing their approach to carried interest.

Our Response

Reflective of constraints on our members' ability to comment on the use of carried interest structures we have restricted our comments to Question 3 which focuses on approaches of other international jurisdictions.

Question 3: Are there lessons that can be learned from approaches taken in other countries? While many other countries have specific regimes for the taxation of carried interest, their detail and conditions for access vary.

The overarching lesson to be learnt from other international regimes is that the UK approach to carried interest, while complicated, has been a success and driven the UK to become a popular location from which to manage carry-based structures over the last 40 years.

That success has contributed significant domestic benefit as Alternatives assets continue to generate more than half of all global investment management revenues[3] despite representing less than a quarter of total AuM, bolstering domestic profits of UK based managers who operate in private markets. Those global revenues are only going to increase as these markets mature with fees expected to expand to $343bn by 2027. Currently 22%[4] of our members operated Alternative strategies with many more looking at branching out to compete for private market mandates in the near future.

And the UK is uniquely placed to benefit from that global growth. The UK competes for investment mandates all across the globe. Our data for all assets (including private assets) shows that last year IA members managed £9.1 trillion on behalf of their clients from the UK. Almost half (49%) of these assets are managed on behalf of overseas clients, representing £4.5 trillion. This includes £2.5 trillion and £925 billion on behalf of European and American clients, respectively. Assets managed for Middle Eastern clients were among the fastest growing in 2023, with assets under management increasing by 15% to £275 billion in 2023 (£245 billion, 2022).

No other European or Asian carried interest tax regimes have been as successful as the UK in attracting global investment management business, which is evidenced by the relative scale of adoption of the UK regime versus the rest of Europe and Asia.

Below are a series of member comments on the relative strengths and weaknesses of the UK and other countries' regimes, complete with commentary on what *elements* the UK should seek to retain and what it should seek to avoid:

- The effective tax rates applied to carried interest in the UK are generally comparable to those in Europe.
- The US also has a successful carried interest tax regime, which has many of the same principles as the UK regime. The US tax rate on long term capital gains is lower at 23.8% than the carried interest capital gains rate in the UK of 28%.
- The UK taxation of carried interest is centred around a '*classical*' European waterfall calculation. Whilst this has recently been addressed via the creation of an elective accruals basis of taxation (primarily to align the taxation of US natural participants subject to capital gains taxation in the UK and the US), there may be unintended consequences if carried interest were to be aligned to another source of income (e.g. trading or miscellaneous income).

[3] Appendix 2 of BCG's GLOBAL ASSET MANAGEMENT REPORT 2024 22ND EDITION
[4] Table 2 of the Investment Association's Investment Management Survey 2022/23

- The entry requirements for carried interest tax regimes in Asia (e.g. Hong Kong) create significant barriers to global participation and are targeted at domestic funds only. However, from an international competitiveness perspective, the highest rate of income tax in Asia is generally much lower than the UK (e.g. 15% in Hong Kong and 24% in Singapore) therefore making these regions more attractive to investment managers, outside of any carried interest tax regime.
- In Europe, some of the carried interest tax regimes are new (e.g. Spain and Italy) and are therefore untested, whereas others are more established (e.g. France and Germany) but contain requirements which pose significant barriers to participation for global investment managers. If the UK wants to be successful as an attractive location for global investment, we urge Treasury to avoid these pitfalls. For example: Some European regimes (e.g. France, Italy) include a mandatory co-investment requirement. Our members' experience of these regimes shows that, due to the rigid and inflexible nature of these requirements, which are designed for simple domestic fund structures, global asset managers are unable to meet them despite investment team members making significant personal fund investments. If the UK where to employ some form of co-investment requirement it should avoid discouraging global participation. A successful co-investment requirement would need to be flexible enough to include all types of investment in complex global structures both through direct, indirect and co-mingled team and management co-investment vehicles, and serious consider the use of common forms of leverage. In addition, where carried interest vehicles include participants from multiple jurisdictions, co-investment requirements should be targeted towards domestic participants only.
- Any new UK regime should consider a modernising approach and include consideration for carried interest arrangements which can accommodate new strategies and structures for the UK asset management industry that address investor needs and requirements, whilst retaining the economic alignment between managers and their employees and investors. On similar lines, any regime would be of greater benefit to the UK asset management industry, and arguably to the UK economy, if geared to apply to various asset classes (a pitfall to learn from the German regime which damages itself by limiting its application to interests in trading businesses without obvious policy justification).
- The French regime considers that certain vehicles are '*tax opaque*' compared to general consensus across other jurisdictions that such vehicles would ordinarily be considered as '*tax transparent*'. For example, a Luxembourg SCSp is likely, on balance in a number of fact patterns, to be treated as '*tax opaque*' under the French regime. The learning here is that an attempt to require the use of UK vehicles, or vehicles that might otherwise be unusual for other jurisdictions, could narrow the usefulness against clear commercial requirements and is unlikely to help sustain a competitive advantage for the UK funds industry.
- When making a comparison between jurisdictions, it is important to consider the political overlay and policy objectives guiding the carried interest regimes. For example, some European regimes (e.g. France) are clearly designed to benefit domestic funds, rather than as a tool to attract global investment. Therefore, these European regimes might not be an appropriate benchmark for a UK regime which intends to encourage investment.
- It is also important to consider the wider tax environment in other jurisdictions, outside of the specified carried interest regimes. For example, Italy has a generous regime for foreign workers who have recently settled in the country, which would be considered attractive to mobile investment professionals.

These points are not an exhaustive list of factors to consider but a collation of member comments that we have been able to gather in the short period we have had to discuss other international carried interest regimes with them.

After reflecting on the responses to this Call for Evidence we would urge the government to consult more widely on their plans for carried interest and as part of that engagement we would be happy to work with our membership to offer more detailed case studies on the mechanics of individual regimes.