Legally speaking

It's a competitive world when it comes to carry, write *Laura Charkin* and *Charlotte Haywood* of Goodwin

Charkin: consider the bigger picture

Haywood: tax on carry under scrutiny

The economic benefits of being a recognized fund management center are clear, and governments across the world are understandably keen to attract this lucrative industry. The UK is in the midst of a fierce competition for this business, heightened by the prospect of Brexit. Although many factors are involved, at the heart of it is a price war over the cost of doing business. One key element is the tax treatment of the executives themselves and their carried interest.

It is no coincidence that the UK has long been a dominant global fund management center; it got off to a head start with the 1987 Memorandum of Understanding (agreed between the British Private Equity & Venture Capital Association, the Inland Revenue and the Department of Trade and Industry) setting out a strong and stable framework for UK-based funds, including an important agreement that carried interest could enjoy capital gains tax treatment. This, combined with the 'non-dom' tax regime, has made the UK a very attractive place for non-UK fund managers to live and work.

But the taxation of carried interest has come under close scrutiny in recent times, and while some jurisdictions are looking to emulate the UK's approach and attract the industry by allowing lower capital gains tax rates to apply, others see this as lost tax revenue and view carry as taxable income for services.

In Sweden, following a recent judgment, a proportion of carry is now likely to be taxed as salary at 60 percent, potentially with retrospective effect. President Donald Trump has also promised to close the "loophole" in the US, but what he has in mind is anyone's guess. In Spain, a recent tax ruling found that carried interest should be taxed as fee income, so the industry there is lobbying for something in line with the French and new Italian systems. The recently announced Italian regime will permit carry to be taxed as investment profits, provided certain conditions are satisfied including a 1 percent investment and five-year holding period.

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Other countries keen to promote their investment funds industry have highly competitive carried interest tax regimes; Luxembourg, for instance, has a maximum rate of around 10 percent. These jurisdictions see their chance to step in, as fund managers faced with BEPS changes increasingly look to choose one location and concentrate 'substance' there. So where does this leave the UK? Under the new regime, finalized in the Finance Act 2016, carried interest from a typical PE fund can still benefit from capital gains tax treatment, but is now subject to a minimum tax rate of 28 percent. HMRC's guidance on the regime is a critical part of its interpretation but, many months after being issued, it remains in draft form and there is still more to come (notably, guidance regarding income based carried interest).

An equally important change, which would see long-term UK resident non-doms no longer able to use the 'remittance basis,' is now up in the air after it was removed from the Finance Bill prior to the election, and although the official line is that it is still to be enacted in politics nothing is certain.

In the face of this shifting tax landscape, it is critical that global fund managers when structuring their funds obtain advice that considers the bigger picture, in terms of the tax treatment of carried interest returns, as well as fund returns. ■

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