Analysis

Carried interest taxation: the European landscape

Speed read

Over the past 15 years, many European countries (including the UK) have introduced specific regimes for taxing carried interest. The UK's statutory regime for taxing carried interest was introduced in 2015 in the form of the disguised investment management fee (DIMF) rules and carried interest rules. The UK carried interest regime supplements rather than replaces the general UK tax rules, meaning that both sets of rules need to be considered when determining the UK tax treatment of carried interest. France, Germany, Italy and Spain have also implemented specific regimes for taxing carried interest. While each regime has different conditions, qualifying carried interest is typically taxed at between 25% and 30%. The UK regime is largely an anti-avoidance regime, whereas European regimes, by contrast, were developed in order to attract international capital and fund managers to those jurisdictions, resulting in tax regimes that are at least as attractive as the UK rules.

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Fund economics 101

Before we dive into an analysis of the taxation of carried interest, we thought it would be helpful to set out a primer on fund economics and how carried interest fits into the wider fund landscape.

Limited partners in a closed-ended fund will commit a certain amount of capital to the fund. This capital is drawn down by the fund as and when it is needed for investment purposes. During the life of the fund, the manager will be remunerated for investment management services via an investment management fee. This fee is typically a percentage (e.g. 2%) of invested or committed capital.

In addition to receiving a management fee, the fund manager, the investment team, or a combination of the two, will also receive a profits interest in the fund, referred to as carried interest. At a basic level, carried interest is a profit share paid to the investment team after third party investors have received back their invested capital together with a 'preferred return'. Carried interest is often paid at a rate of 20%, and together with management fee this is referred to in the industry as the 'two and twenty' arrangement.

A worked example of typical fund economics (based on 100 of invested capital and a realisation of 200) is set out below:

Example of typical fund economics

Waterfall	Limited partners	Carried interest partnership	Total distributed
1. Return of capital	100	0	100
2. Preferred return (8%)	8	0	108
3. Catch up*	0	2	110
4. Carried interest: 80/20 split	72	18	200
5. Total profit**	80	20	100

** The catch up is required because if the distribution waterfall skipped straight to the 80:20 split, the limited partners would be distributed more than 80% of the profits because they have already received an 8% distribution of profits under the preferred return limb of the waterfall.*
*** Total profit = total amounts distributed less return of capital.*

Overview of the UK regime

The UK's statutory regime for taxing carried interest was introduced in 2015 in the form of the disguised investment management fee (DIMF) rules (found in ITA 2007 Part 13 Chapter 5E) and carried interest rules (in TCGA 1992 ss 103KA–103KH). The UK carried interest regime supplements rather than replaces the general UK tax rules, meaning that both sets of rules need to be considered when determining the UK tax treatment of carried interest.

General UK tax rules

Under general UK tax rules, carried interest holders in partnership investment funds ('executives') are taxed according to general partnership tax law. Therefore, an executive's tax treatment is based on the profits allocated to them in accordance with the partnership agreement. This means that the tax payable by an executive depends on the nature and source of those profits (i.e. income or capital gain, UK or non-UK source).

Statutory overlay

The DIMF rules treat any 'disguised fee' arising to an individual in a tax year from one or more investment schemes as trading profits, so taxed as trading income. The definition of 'disguised fee' is intentionally broad and will capture almost all sums that arise to an individual from a typical fund structure unless they constitute statutorily defined co-investment return or carried interest that is not income-based carried interest (IBCI). The majority of typical carried interest arrangements should satisfy one of the definitions of carried interest.

Where a sum meets one of the definitions of carried interest it may still be taxed as trading income under the DIMF rules to the extent that it is treated as IBCI. In general terms, a sum (or part of it) will be treated as IBCI to the extent that the weighted average holding period of a fund's investments by reference to which that sum of carried interest arises is less than 40 months. It should be noted that the IBCI rules do not currently apply to carried interest that is an employment-related security.

Provided that the sum falls within one of the definitions of carried interest and is not IBCI, it will be taxed under the carried interest rules. Where the rules apply, the entire

amount of carried interest arising to the individual is treated as a capital gain accruing to the individual (less certain permitted deductions), which is taxable at a special rate of 28%. This treatment is regardless of the underlying nature of the profits received by the fund partnership. The carried interest rules also adjust the source of carried interest, which impacts UK resident non-domiciled executives.

To the extent that the profits received are capital in nature, the carried interest rules impose an exclusive charge to capital gains tax. However, if the profits are income in nature, the executive will potentially be subject to capital gains tax under the carried interest rules and income tax under general UK tax rules.

To mitigate double tax, the carried interest rules contain a crediting provision that enables an executive to adjust their overall tax charge by the lower of the charge to tax under the carried interest rules and the charge to tax under general UK tax rules.

UK headline rates

Nature of profits	Capital gain	Dividend	Interest
Tax rate	28%	39.35%	45%

Comparison with European models

France, Germany, Italy and Spain have also implemented specific regimes for taxing carried interest. These regimes provide for reduced rates of tax for carried interest provided certain criteria are met. They can broadly be split into two categories:

- the French/Italian model treats qualifying carried interest as investment income subject to a flat rate of tax; and
- the German/Spanish model treats carried interest as employment income but provides that a proportion of qualifying carried interest is exempt from tax.

For each of the jurisdictions, we have set out a brief summary, based on our market experience, of their carried interest regime conditions and a comparison to the UK.

French regime

The French carried interest regime requires careful structuring to ensure that non-French funds' carried interest arrangements satisfy the conditions (see the table on the right).

Our main remarks on the regime itself are as follows:

- As a result of the condition that the main purpose of the fund must be to invest in shares, or other securities giving access to the share capital, of non-listed companies, the regime can pose problems for credit funds. While the UK's carried interest regime is not closed to credit funds, as a result of the application of general UK tax rules, any carried interest satisfied out of interest income will be subject to tax at 45% in any event.
- The requirement that that the carried interest rights form a single category can cause complications for funds that have deal-by-deal models of carried interest. The UK's regime, however, specifically caters for deal-by-deal carried interest, which is included as one of the definitions of carried interest in the DIMF rules.
- To qualify for the French carried interest regime, French executives must make a material co-investment in the fund. While executives often make co-investments in the funds that they manage in a UK context, this is not required and the amounts co-invested are typically lower than the amount required pursuant to the French regime.

French regime: conditions for qualifying carried interest

Condition	UK equivalent condition?
The investment fund in which the executives hold an interest must be established in an EU or EEA state that has entered into a double tax treaty with France containing an administrative assistance provision.	×
The investment fund in which the executives hold an interest must have a main purpose of investing in shares, or other securities giving access to the share capital, of non-listed companies.	×
The executives must be employed by the investment fund itself or by the fund manager.	×
The executives must be paid an arm's length remuneration with respect to their employment.	× However, this is relevant when establishing the value of carried interest for employment tax purposes.
The executives must have acquired their carried interest rights for their market value.	× However, to the extent that the executives are employees and do not pay market value for their carried interest or make an election under ITEPA 2003 s 431, a proportion of their carried interest proceeds will be taxed as employment income. There will also be employment tax charges at the point of acquisition if market value is not paid by employees for their carried interest.
The carried interest rights must form a single category of interests/rights.	×
The executives must make a co-investment equal to at least: (i) 1% of total commitments to the fund; or (ii) 0.5% of total commitments to the fund, where total commitments exceed €1bn.	×
The carried interest proceeds must not be paid out to the executives for a period of at least five years after they subscribed for the carried interest rights (for non-French investment funds).	×

French headline rates

	Qualifying carried interest	Non-qualifying carried interest
Tax rate	30% + 3% or 4% exceptional tax on high earners.	45% + 3% or 4% exceptional tax on high earners. Plus special 30% special security contribution.

Italian regime

The Italian regime has noticeably fewer conditions than the French regime (see the table, below). Additionally, many of the conditions are features of typical carried interest arrangements such that investment funds do not typically find them as difficult to satisfy.

Italian regime: conditions for qualifying carried interest

Condition	UK equivalent condition?
The executive must hold direct or indirect shareholdings, interests or other financial instruments.	✓ The DIMF rules require that the disguised fees arise from one or more investment schemes (implying that the executive has a direct or indirect interest in that investment scheme). The carried interest rules additionally require those arrangements to involve a partnership (implying that the executive holds a partnership interest).
The interest held by the executives must have enhanced economic rights compared to the interests of the investors.	✓ This is similar to the UK regime in that if the interest did not have any enhanced rights as compared to investors, it would constitute co-investment for the purposes of the DIMF rules. Accordingly, it would be taxed under general partnership tax law rather than under the UK's carried interest rules.
The executives must make a co-investment commitment equal to at least 1% of the total commitments made to the Fund.	×
The carried interest may only be paid after investors have received back their investment and a preferred return.	× However, this is equivalent to one of the safe harbour definitions of carried interest in the UK rules.
Carried interest proceeds must not be paid to the executives for a period of five years from when they acquire their interests.	×

The condition that causes the greatest difficulty in practice is the requirement that the executives must make a co-investment equal to 1% of total commitments to the fund. However, this condition is interpreted more loosely in Italy than in France, with co-investment commitments made by executives and the house (to the extent that the house is owned by the executives) included in the calculation of the 1%. This makes it easier to meet.

Italian headline rates

	Qualifying carried interest	Non-qualifying carried interest
Tax rate	26%	Employment income at marginal rates up to 43% (plus social security contributions, local surcharges and an additional 10% tax on bonuses for staff working in the financial sector).

German regime

The German regime contains relatively few conditions (see the table below).

German regime: conditions for qualifying carried interest

Condition	UK equivalent condition?
The fund from which the executives receive carried interest must be eligible for non-business treatment.	× While there is no directly equivalent condition, there is a requirement that the fund partnership should not be trading for UK tax purposes.
The carried interest must only be paid out after the investors have been repaid their paid-in capital.	×
The fund from which the executive receives their carried interest must have a purpose of making, holding and disposing a number of investments.	× No equivalent provision but see comments above in relation to the purpose condition in the French regime.

The most difficult condition to meet in practice is the non-business treatment condition, which is applied to the fund. The German tax authorities have published a circular that sets out various activities that, if undertaken by a fund, are likely to result in it being eligible for business treatment rather than non-business treatment.

German headline rates

	Qualifying carried interest	Non-qualifying carried interest
Tax rate	Employment income subject to marginal rates up to 48.5% (plus church tax, if applicable). However, a partial exemption of 40% is available, resulting in an effective rate of 28.5%.	Marginal rates of up to 48.5% (plus church tax, if applicable).

Spanish regime

In similar fashion to the German regime, the Spanish

regime contains relatively few conditions.

Spanish regime: conditions for qualifying carried interest

Condition	UK equivalent condition?
The carried interest may only be paid after investors have received back their investment and a preferred return.	× No equivalent provision but see comments above on identical condition in Italian regime.
Carried interest proceeds must not be paid to the executives for a period of five years from when they acquire their interests.	×
Carried interest proceeds cannot be derived directly or indirectly from an entity resident in another country or territory classified as a non-cooperative jurisdiction or with which no rules have been established on mutual assistance for the exchange of tax-related information.	×

The main issue with the Spanish regime is that it was introduced so recently (on 1 January 2023) and the Spanish tax authorities are yet to release any guidance on the application of the conditions, so it is often unclear how they apply to complex structures.

The most problematic condition in the Spanish regime is the condition on proceeds derived from non-cooperative jurisdictions. This is largely because the list of non-cooperative jurisdictions published contains some common investment fund jurisdictions such as Guernsey, Jersey and the Cayman Islands. There are a range of views in the market on how widely this condition should be applied.

On the more conservative end of the spectrum, some advisors have taken the position that for each sum of carried interest, the fund will have to determine whether the relevant profits were derived from or passed through a non-cooperative jurisdiction on their way to the executive. If they did, the advice is that those proceeds are tainted and cannot be qualifying carried interest for the purposes of the Spanish regime.

At the other end of the spectrum, some advisers are of the view that this condition will cause carried interest to be non-qualifying only to the extent that the fund partnership (i.e. the vehicle where the carried interest rights are set out) is located in a non-cooperative jurisdiction.

Spanish headline rates

	Qualifying carried interest	Non-qualifying carried interest
Tax rate	Employment income subject to marginal rates up to 50%. However, a partial exemption of 50% is available, resulting in an effective rate of 25%.	Marginal rates of up to 50%.

Final thoughts

While the article has focused on regime design and the different conditions imposed, we thought it would be useful to set out a comparison table (below) to show tax rates under the UK regime against the other regimes considered (France, Italy, Germany and Spain). Where marginal rates apply, the highest marginal rate is shown.

As can be seen from the comparison of tax rates, while each regime has different conditions, qualifying carried interest is typically taxed at between 25% and 30%. The exception is carried interest received by UK executives satisfied by an allocation of dividend or interest income.

The reason for the similarities in tax rates and the distinction with respect to carried interest satisfied out of income profits can be explained by the genesis of the various regimes considered.

The investment management industry in the UK is well-established and the tax treatment of carried interest can be traced back to 1987. As explained earlier in this article, the general UK tax rules apply the UK's tax rules for partnerships to carried interest arrangements. The statutory rules were primarily implemented in an attempt to curtail certain favourable tax results for executives receiving carried interest under the general UK tax rules.

The European regimes by contrast were largely developed in order to attract international capital and fund managers to those jurisdictions, resulting in tax regimes that are at least as attractive (and in some cases, arguably more attractive) than the UK rules. ■

Comparison of tax rates in key European jurisdictions

	UK	France	Italy	Germany	Spain
Qualifying carried interest	**28%:** capital gains **39.35%:** dividends **45%:** interest	**30%:** investment income **3%/4%:** contribution on high earners	**26%:** investment income	**28.5%:** employment income Church tax	**25%:** employment income
Non-qualifying carried interest	**47%:** trading income from deemed self-employment (DIMF)	**45%:** employment income (marginal rates) **3%/4%:** contribution on high earners **30%:** social security contribution paid by executive	**43%:** employment income (marginal rates) Social security contributions **10%:** tax on bonuses in financial sector	**48.5%:** employment income (marginal rates) Church tax	**50%:** employment income