Taxation of Carried Interest – International Bar Association: Annual Conference 2018 Rome

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Speakers

Fulvia Astolfi *Hogan Lovells, Rome*

Elena Rowlands *Travers Smith, London*

Jean Schaffner *Allen & Overy SCS, Luxembourg*

Gordon Warnke *KPMG, New York*

Introduction

The panel addressed recent trends in taxation of carried interest in Luxembourg, Italy, the United Kingdom and the United States. The session co-chair, Jörg W Lüttge, started off by presenting the agenda of the panel, including overview of carried interest regimes in Luxembourg, Italy, the UK and the US, and two case studies: European-style fund structure and US-style fund structure.

Basic fund structure

The session co-chair, Joe Duffy, continued and outlined the features of a European-style fund structure.

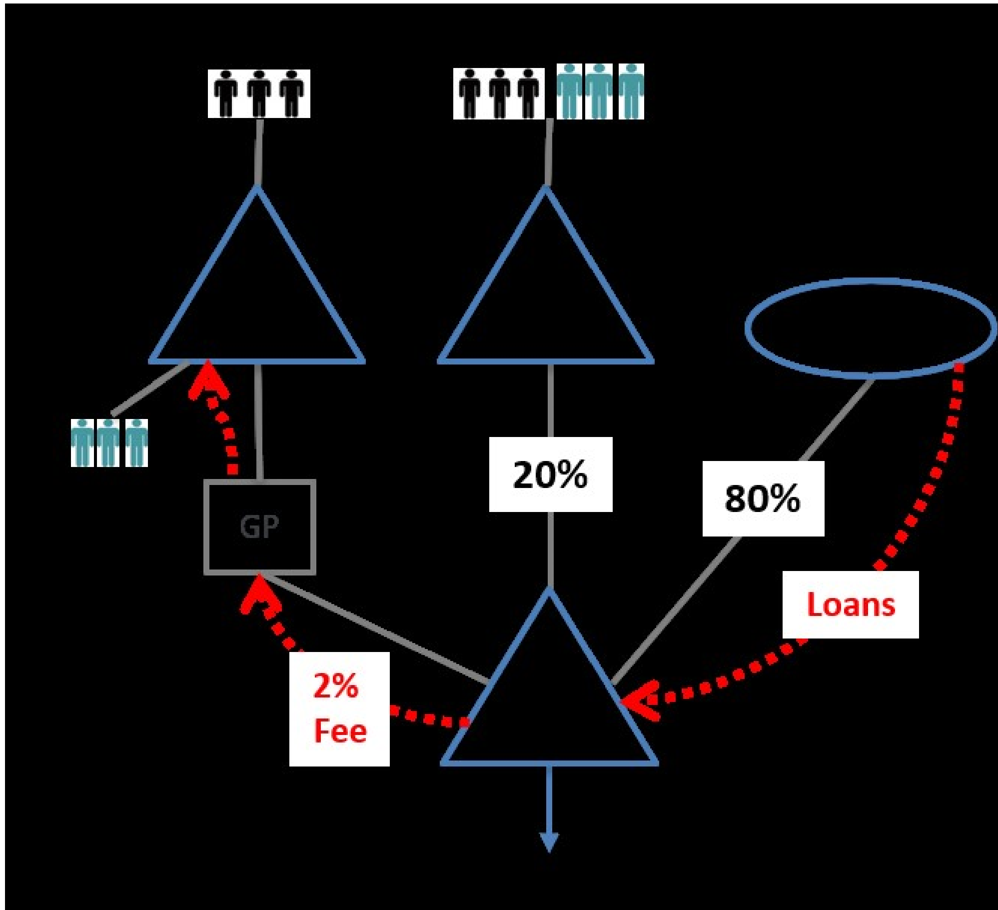

Figure 1: basic fund structure

- The legal vehicle of the fund is a Limited Partnership (LP).
- The manager of the fund is the general partner who is responsible for managing the investments and receives an annual management fee (say, two per cent of capital commitment): the individuals working for the manager consist of employees and members. They receive remuneration for services; certain employees and members of the manager are also entitled to subscribe for carried interest share ('carried interest holders').
- Carried interest holders (say, 20 per cent) and investors (say, 80 per cent) provide capital contributions into the fund (typically at market value being low value).
- Investors provide substantial priority loan commitments to the fund.
- Fund uses capital and loan draw-downs to make investments.
- Upon exit (and after payment of management fees) returns are as follows: repayment to investors of drawn-down loans; preferred return/hurdle rate payment to investors; catch-up payment to carried interest holders; remainder: 80 per cent to investors and 20 per cent to carried interest holders.

Duffy raised the questions at issue: How is the 20 per cent return to the carried interest holders taxed? Capital gain or ordinary income? Employment income or service fee? He pointed out that there are no general international tax rules. The methodical approach to answer the questions at issue is, therefore, reports from a particular country perspective.

Overview of carried interest regimes in Luxembourg, the UK, Italy and the US

Gordon Warnke started with a brief explanation of the US tax rules on carried interest taxation. He pointed out that carried interest can defer the timing and change the character of the income to a carried interest holder. An individual who receives a 'profits interest' in a partnership in exchange for providing services (ie, a carried interest) is generally not taxed on the receipt of the interest. Income and gain subsequently generated by the partnership may be allocated to the carried interest holder. Long-term capital gain from the partnership that is allocated to the carried interest holder is taxed at a preferential rate (generally 23.8 per cent compared to up to 37 per cent for ordinary income). A new rule recently adopted as part of the US tax reform increases the holding period requirement from one year to three years to obtain favourable long-term capital gain tax rate. Where the increased holding period is not met, the tax rate on such gain is generally increased from 23.8 per cent to 40.8 per cent. These rules apply to capital gains with respect to an applicable partnership interest (API), which appears to include both capital gains allocated to a partner from a partnership with respect to a disposition of the partnership's assets ('inside gain'), and capital gains on the disposition of the partnership interest by the partner ('outside gain'). Gordon Warnke further addressed issues for non-US resident carried interest holders. Non-US persons are subject to US tax with respect to income that is effectively connected with a US trade or business (effectively connected income, ECI), or certain income from sources within the US. For a partnership with ECI, US withholding tax (WHT) is imposed on ECI allocable to non-US partners at the highest applicable tax rate (37 per cent for individuals; 21 per cent for corporations). A non-ECI is generally subject to US tax if it is a US source (eg, dividends paid by a US corporation). Thirty per cent US WHT applies, subject to reduction under an applicable tax treaty between the US and the recipient's country of residence. Capital gains are generally exempt from WHT and, therefore, not subject to US tax. Certain portfolio interest is also exempt from WHT.

Jean Schaffner continued with a brief explanation of the Luxembourg tax rules. He pointed out that Luxembourg resident managers are subject to a 20 per cent WHT on interest while salaried income is fully taxable. Capital gains on shares and bonds which assume that the managers acquire shares or bonds are exempt after a six month holding period (assuming less than ten per cent shareholding). He then moved to the carried interest rules: carried interest is taxed at 25 per cent of the ordinary tax rate (roughly 11 per cent tax charge) if carry is granted within five years of Luxembourg tax residence. The favourable tax treatment only applies for the first ten years of tax residence. Jean Schaffner further addressed issues for non-Luxembourg resident carried interest holders. While dividends are subject to 15 per cent WHT, there is no WHT on interest (except profit participating bonds), capital gains and share redemptions.

Fulvia Astolfi continued with a brief explanation of the Italian tax rules. The salary paid to the managers qualifying as employment income or income assimilated to employment, is subject to taxation in Italy. Until 2017, it was debated whether carried interest paid to the managers qualified as employment income (subject to individual income taxes up to 43 per cent) or as a capital gain (subject to a substitutive tax at 26 per cent). The new rules passed in 2017 set out that carried interest qualifies as a capital gain if the following conditions apply:

- the income is generated (directly or indirectly) by the holding of shares, quotas and other financial instruments (‘Instruments’) bearing extraordinary remuneration rights and issued by companies, entities and investment funds;
- the income is cashed by employees and directors (‘managers’) of said entities or of other entities linked to them by a direct or indirect control or management relationship;
- the managers holding such Instruments have invested (in the aggregate) at least one per cent of the entire investment made by the fund;
- the managers' remuneration accrues only after all other investors have cashed an amount equal to the capital invested plus a minimum return on it (as set out in the entity rules);
- the managers retain their investment for a minimum holding period of five years or until the exit from the investment by the fund.

Elena Rowlands continued with a brief explanation of the UK tax rules. She pointed out that the UK tax rules are quite complex and follow a five-step process:

- Step 1: Is the carry an ‘employment-related security’? Carry is an employment-related security if it is made available by reason of employment. General rule – if less than market value is paid for the carry, income tax and social security charges can apply. If certain conditions are satisfied, the UK tax authorities accept that market value has been paid.
- Step 2: Do the disguised investment management fee (DIMF) rules apply? If so, are the returns received ‘carried interest’ such that the exemption from the DIMF rules applies? Any amounts received from a collective investment scheme by an individual providing investment management services are taxed as trading income unless the amounts are taxed as employment income or constitute co-invest or carried interest. There are two specific definitions of ‘carried interest’ one of which must apply. Carried interest in a typical private equity structure should fall within the exemption.
- Step 3: How is the carry taxed under ordinary principles? If the fund and the carry vehicle are tax-transparent limited partnerships, the taxation of the carry depends on the type of profit generated by the fund (ie, capital gain (20 per cent), dividend income (38.1 per cent), interest (45 per cent) or loan principal (0 per cent)).
- Step 4: How is carry taxed under the 2015 capital gains tax rules? All carry receipts (even loan principal) are taxed as capital gain (28 per cent, not the 20 per cent rate). If carry is also subject to income tax under ordinary principles (see Step 3, ie, because the source of the carry is interest or dividend) there is a credit for the double tax – the higher tax amount is always paid.
- Step 5: Is the carry taxed under the income-based carried interest (IBCI) rules? If the carry is an employment-related security (see Step 1), IBCI rules do not apply. If the carry is not an employment-related security, IBCI rules need to be considered. A proportion of carried interest can be taxed as trading income depending on the average holding period for which the fund holds its investments. If the average holding period is: 36 months, 100% is taxed as trading income; ≥ 36 months but < 37 months, 80% is taxed as trading income; ≥ 37 months but < 38 months, 60% is taxed as trading income; ≥ 38 months but < 39 months, 40% is taxed as trading income; ≥ 39 months but < 40 months, 20% is taxed as trading income; 40 months +, 0% is taxed as trading income.

Case study 1: European-style fund structure

Jean Schaffner explained Case study 1, a typical European-style fund structure.

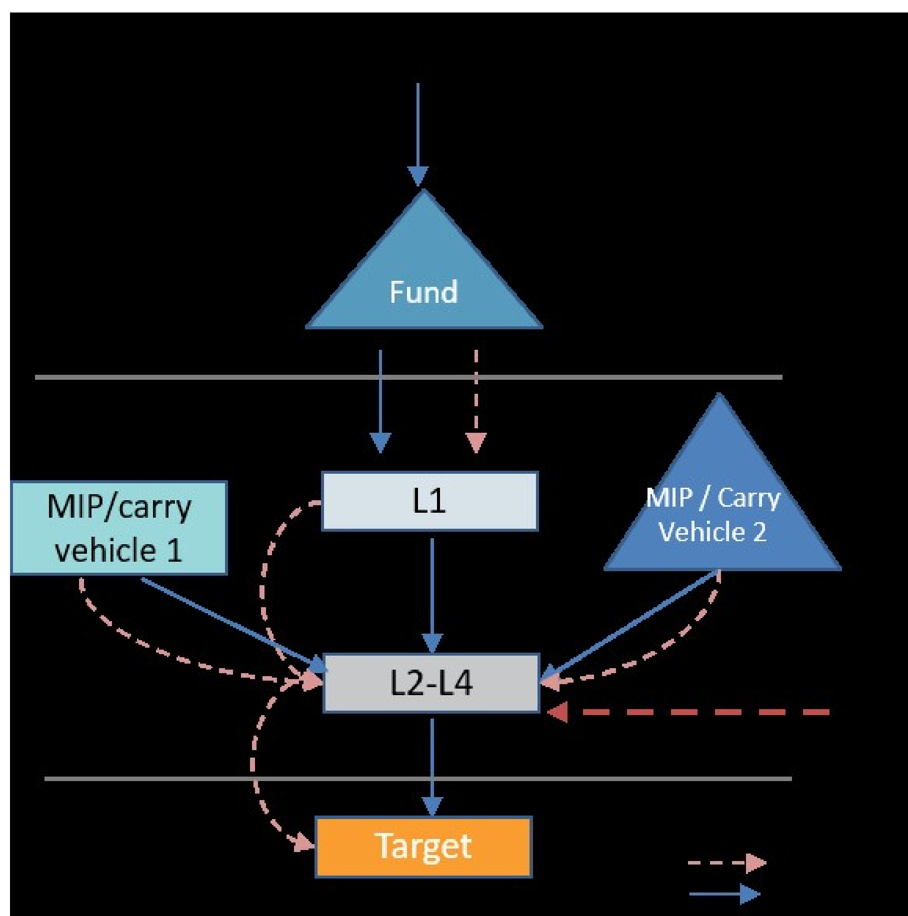

Figure 2: European-style fund structure

- Several layers of (usually opaque but may be checked transparent for US tax purposes) LuxCos (L2-L4 with L1 being a 'super holding company' used for several investments), held by an offshore fund.
- Carried interest and/or MIP (management incentive plan for managers of target): often similar structures, usually managers/carry holders are non-residents; carry holders may also invest at fund level and not below fund and MIP may be organised in target jurisdiction.
- Carry/MIP vehicle usually organised in Luxembourg, either transparent or opaque.
- Possible preference for equity treatment by managers. Possible hybrid treatment (as investors are individuals ATAD, BEPS may not apply).
- Fund promoter usually prefers *pari passu* investment by managers (if managers only hold equity, there could be tax leakage on back-to-back financing – more an issue for MIPs, as a carry package usually disregards debt funding).
- Investments by MIP should mirror investments by fund, otherwise MIP would have to bear the costs of tax leakage of Luxco (via a lower return).
- Vehicle 2 (eg, Lux SCSp) would be tax transparent; to be confirmed whether transparency is recognised by manager jurisdiction.

- Tax opaque vehicle (Vehicle 1) may be taxable on return, except if it has matching expenses (TP rules to be observed). Possible use of a Luxembourg securitisation vehicle financed with equity (no active management possible).
- Fund may have golden share in MIP vehicle (MIP vehicle may have a GP provided by fund); control seems less important for carry vehicle.
- Call/put options to enable exit; often dedicated Luxco held by fund as counterparty for options (conditions for participation exemption to be observed); good/bad leaver provisions for MIP.

Gordon Warnke started with a brief explanation of the US taxation of US resident carry holders. US resident carry holders are generally subject to US tax on any income/gain allocated from fund investments (eg, capital gain and dividend or interest income). The income/gain is determined at partnership level and allocated to respective partners, who are taxed currently on their share of income/gain. A credit against US tax is generally available for foreign taxes paid on such income. Warnke referred to the new section 1061 holding-period requirement that must be satisfied to obtain preferential long-term capital gain treatment. It could deny a preferential tax rate for capital gains where applicable partnership interest (API) and/or fund assets are held for less than three years. He concluded that the impact of the new provision is limited if the fund's investment approach is to hold assets for longer than the three-year holding period. Warnke pointed out that carry vehicle for US residents could be structured as 'S' corporation because a partnership interest held by a corporation is not an API to which section 1061 applies. An 'S' corporation is generally afforded pass-through treatment under US tax law. The US Treasury, however, has announced that forthcoming regulations will provide that a corporation does not include an 'S' corporation for this purpose.

Fulvia Astolfi continued with a brief explanation of the Italian taxation of the Italian resident carry holders. Upon assignment/subscription of the managers' participation, it has to be ascertained whether employment income in kind is earned (in case no market value of the participation is paid by the managers). She pointed out that foreign partnerships are not seen as pass-through entities for Italian tax purposes and thus income and gain earned by the partnership are taxed with the managers as dividends and only in case of distribution. Upon disposal/redemption of the participation, if the participation is held by the manager through a Manco, there is a 1.2 per cent taxation at the level of Manco and a further 26 per cent taxation at the level of manager if Manco distributes its profit. In the case of direct participation in the partnership by the manager, there is a 26 per cent taxation at the level of the manager. The same taxation applies in the unlikely scenario of dividend distribution by the partnership.

Case study 2: US-style fund structure

Gordon Warnke explained Case study 2, a typical US-style fund structure:

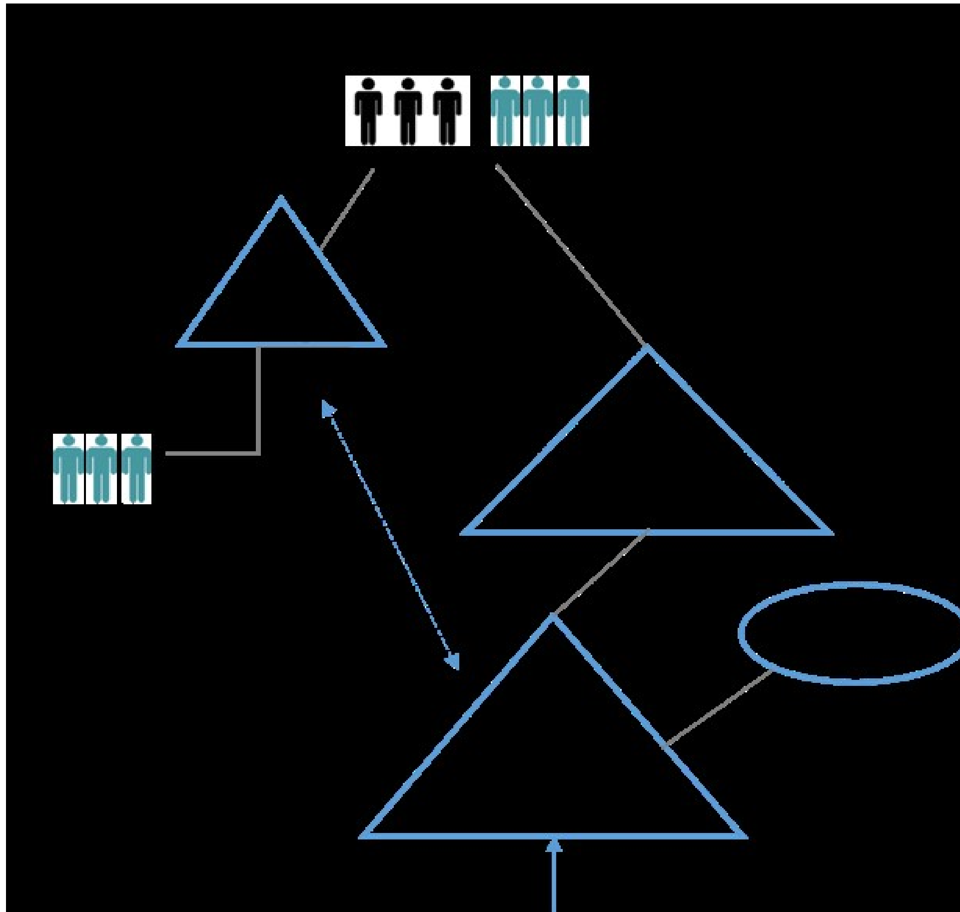

Figure 3: US-style fund structure

Gordon Warnke continued with a brief explanation of the US taxation of US resident carry holders. He pointed out that UK and Italian carry holders are generally subject to US tax on any income that is effectively connected with a US trade or business (ECI). If there is no US trade or business with respect to investment activity, carry holders are subject to US tax only on US-source income. The income/gain is determined at partnership-level and allocated to respective partners, who are taxed currently on their share of income/gain. US WHT (30 per cent) on investment income (eg, dividends) is subject to reduction under US tax treaties with the UK and Italy. Capital gains and certain portfolio interest are generally exempt from US tax. Warnke pointed out that the insertion of a corporate 'blocker' (above or below the fund) may protect carry holders from US tax.

Elena Rowlands continued with a brief explanation of the Italian taxation of the UK resident carry holders. There is no UK tax on acquisition of carry. If less than market value is paid for the carry, income tax and social security charges can apply. Elena continued with an explanation of the UK taxation on carry returns:

- disguised investment management fee rules (DIMF) – returns are taxed as trading income (47 per cent) unless exemption is available, eg, exemption for carry interest;
- taxation of carry under ordinary principles depends on US fund returns – capital gains (20 per cent), dividend income (38.1 per cent), interest (45 per cent) or loan principal (0 per cent);
- taxation under the 2015 capital gains tax rules – all carry returns are subject to a minimum tax of 28 per cent with credit for any tax paid, so the higher rate is always paid in practice;
- the income based on carried interest rules depends on the average holding period of the US fund's investments. If the period is 36 months or less, 100 per cent is taxed as trading income (47 per cent), if 40 months or more, zero per cent is taxed as trading income. Not applicable where carry is acquired by reason of employment.

Fulvia Astolfi continued with a brief explanation of the Italian taxation of Italian resident carry holders. Upon assignment/subscription of the managers' participation, it is necessary to ascertain whether an employment income in kind is earned (in case no market value of the participation is paid by the managers). Foreign partnerships are not seen as pass-through entities for Italian tax purposes and thus income and gain earned by the partnership are taxed with the managers as dividends and only in case of distribution. There is a possible mismatch in the timing of taxation of the inside gain and related issue in the recovery of the foreign tax credit. Upon disposal/redemption of the participation, if the participation is held by the manager through a Manco, there is 1.2 per cent taxation at the level of Manco and a further 26 per cent taxation at the level of manager if Manco distributes its profit. In the case of direct participation in the partnership by the manager, there is 26 per cent taxation at the level of the manager. The same taxation applies in the unlikely scenario of dividend distribution by the partnership.

Summary

The session co-chair, Jörg W Lüttge, closed the session with a summary of the takeaways:

- a 'carried interest (CI)' is an interest in an investment fund disproportionate to the capital interest held by the fund initiators/managers;
- many countries characterise CI as investment income (capital gains/dividends) rather than as ordinary income and tax it at lower rates;
- specific conditions for preferential treatment (frequently minimum holding periods) vary from country to country;
- in cross-border scenarios (fund and carry holder resident in different countries), CI is usually taxed in carry holders' home countries, potentially with WHT in source country/tax credit in home country; and
- potential double taxation if source countries do not characterise CI as investment income.

https://www.ibanet.org/Article/NewDetail.aspx?ArticleUid=97B5B39A-2671-40B5-89D9-A70FCD1EB715