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Carried interest for fund managers

Features in key
jurisdictions

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Introduction

During the last decade, the shape and source of capital flows and investment have fundamentally shifted. Private capital continues to flow into all asset classes including real estate, infrastructure, private credit, and private equity. Fund managers want to receive their carried interest and co-investment returns in the most tax effective way - whether structured as classic carried-interest, ratcheted carry, hybrid carry, diverted carry, multi-waterfall carry, super carry or as a single performance-based fee. Yet, to minimize the risk in a challenging and rapidly evolving tax environment and optimize as such the return on investments, efficient tax structuring of carried interest schemes has become more important than ever.

This toolkit highlights the main tax structuring products available for carried interest payments to fund managers in the major fund jurisdictions – France, Germany, Luxembourg, the Netherlands, Spain, the UK, and the U.S.

The information included herein is solely for preliminary information purposes and is not intended to be, nor should it be construed to be, legal or tax advice. It is contained herein based on the tax laws presently in force at the date of this publication, and is thus subject to any change in law that may take effect thereafter. It is therefore of utmost importance to consult our firm as to the effects of state, local or foreign laws to which they may be subject before any investment decision is taken.

We are globally experienced in drafting and advising with respect to below areas, including some which are only locally specific:

- Carried interests, promotes and incentive fees
- Strategy-appropriate vesting arrangement
- Tax outcomes of carried interest shifts during fund life
- Tax distributions
- Management fee waivers/conversions
- Tax-motivated carried interest deferrals
- Special limited partners and other employee equity participation structures
- UBTI and ECI sensitive carried interest structures
- Legislative and regulatory changes
- Employment tax election

France

Legal scheme

Certain qualifying entities or funds (based in an EU member state or EEA country) can issue carried interest units to their French-based employees and managers.

Qualifying carried interest can benefit from a special tax regime, whereby it is treated as capital gains and taxed at a flat 30% rate (including income tax and social contributions), rather than employment income, subject to certain conditions.

Conditions with respect to the beneficiaries

- Carry out **employee or manager functions** in a **qualifying vehicle**, such as:
 - a French SCR (*société de capital-risque*)
 - a European capital venture entity incorporated in a EU/EEA member state that has a DTA with France
 - a management company of FCPR portfolio
- Receive an **arm's length remuneration** with respect to their employment contract or corporate officer functions (i.e., in the range of usual market remunerations for the activities in question)

Conditions with respect to the instruments

- Represent the **same class** of shares/units
- Represent a **minimum percentage** of the amount of total subscriptions of the issuing entity:
 - 1% of the portion of subscriptions below €1bn
 - 0.5% of the portion of subscriptions in excess of €1bn
- Represent a **long-term** investment (minimum 5-year holding period)
- Be subscribed or acquired at their **fair market value**

Alternative tax efficient structures

Alternative schemes may be set up for the benefit of employees/managers, such as restricted stock unit or stock-option plans, which may benefit from special tax and social security regimes subject to certain conditions.



Germany

Legal scheme

The tax treatment of carried interest in Germany depends on the type of fund.

Carried interest paid by an asset-management (*vermögensverwaltender*) fund can benefit from a special tax regime whereby 40% of the carried interest is tax-exempt. 60% will be taxed at the individual's tax rate as self-employed income. However, this exemption only applies if, under the carry agreement, any carry payment is subject to the condition of a full recovery of initial investments of the investors.

Carried interest paid by a trading (*gewerblicher*) fund, on the other hand, does not benefit from this preferential tax regime. Trading funds include funds that generate trading income based on their activities (*gewerblich tätig*) and funds that are deemed to generate business income based on their legal form (*gewerblich geprägt*). In these cases, the carried interest is generally considered as a service remuneration and as such, is fully taxable as self-employed income at the individual's tax rate.

However, recent German tax court rulings imply that in case of a trading (*gewerblicher*) fund (where the special tax regime does not apply), the carried interest would under certain conditions nevertheless be 40% tax exempt (for individuals) because it is qualified as disproportionate divided distribution. The relevant conditions are inter alia:

- the carry is strictly profit-dependent;
- the carry payment is not treated as a business expense for accounting purposes; and
- there is no contractual obligation of the initiator to render any services. Contrary to this approach, the German tax authorities still qualify the carried interest as a fully taxable remuneration for services rendered by the initiator to the fund and it is not yet clear whether they will follow the view of the tax courts.

Typical arrangements in practice

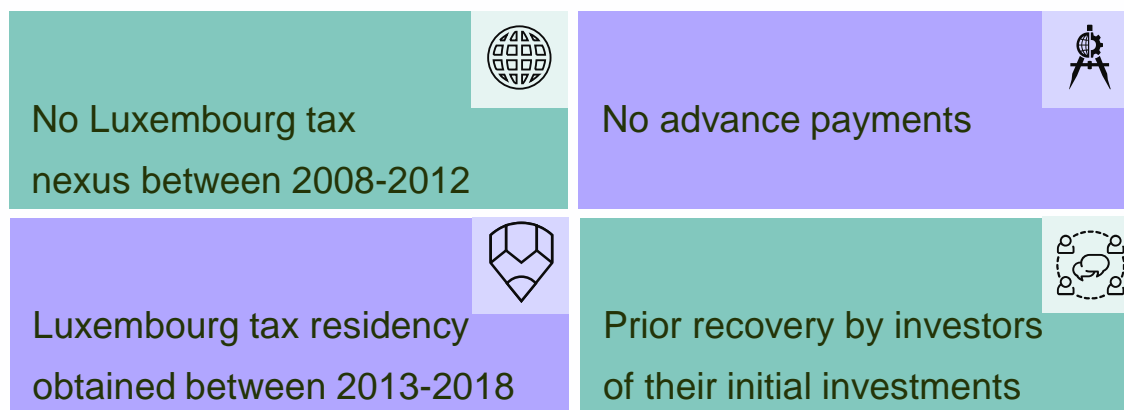
Under common German carried interest schemes, initiators invest in the fund through a carry vehicle which is usually an asset-management partnership which is fully tax transparent. This vehicle provides greater flexibility for corporate law purposes. It is also possible to set up the carry vehicle as a tax-opaque vehicle.



Luxembourg

Legal scheme

Carried interest taxation at 25% of the global tax rate (leading to a maximum tax rate of 10,5% based on the current maximum individual tax rate of 42 %) for management teams of alternative investment funds, subject to certain conditions:



Alternative tax efficient structures

Issuance of warrants, beneficiary interests, units, etc. whose repurchase can be made under certain conditions:

- free of withholding tax (“WHT”)
- with 0% Luxembourg capital gain taxation

Set-up of a carried interest vehicle (“CarryVe”) as a tax transparent partnership to:

- ease carried interest allocation
- provide confidentiality of carried entitlement from other investors

Set-up of a tax opaque CarryVe to benefit under certain conditions from the following:

- no WHT on dividend distributions to CarryVe
- exemption on dividend income and capital gains
- 50% dividend exemption for Luxembourg manager



Netherlands

Legal scheme

- For individuals, depending on the specific characteristics, the carried interest would be subject to tax in Box 1, Box 2 or Box 3 for Dutch personal income tax purposes. Albeit no legislative proposal is currently pending in this respect, the rules regarding taxation of carried interest in The Netherlands may be subject to change at some point in the future. This should therefore be monitored.

Box 1: employment or lucrative interest

- If deemed salary, wage tax should be withheld by the employer (to be credited against personal income tax payable).
- If the carried interest forms a lucrative interest, any income and gains taxable.
- Progressive income tax rate with a maximum of 49.50% (for 2024).

Box 2: substantial interest

- Direct or indirect share interests or option rights of at least 5% in a carry vehicle and any loans granted thereto.
- Progressive income tax rate with a maximum of 33% (for 2024).
- Can be applied to lucrative interest under certain conditions (as described below).

Box 3: savings and investments

- Deemed annual taxable income based on the individual holder's yield basis.
- Flat tax rate of 36% (for 2024).
- Methodology likely subject to change in the future due to Supreme Court judgements on taxation on deemed returns.
- Unlikely to apply to carried interest.

Alternative carried interest structure: lucrative interest taxed in Box 2 instead of Box 1

Set up a personal holding or pooling vehicle ("Holding").

- Fund manager holds a substantial interest (in short, at least 5% of the shares) in Holding.
- Holding holds an interest of at least 5% of the nominal share capital in carry vehicle (or additional feeder company).

Holding distributes at least 95% of profits received by way of dividend to carry holder during the same calendar year.

- Holding applies participation exemption on profit distributions received or gains derived provided all criteria are met.

Carry holder taxed in Box 2 for dividend income.

- Effective combined Dutch tax rate between 24.5% - 33% (for 2024) (participation exemption at the level of Holding, no taxation in Box 1).



Spain

- Until 2023 Spain did not have a specific tax regime for carried interest (except in the Basque Regions and Navarra) and the Spanish tax authorities have considered that it shall be characterised as “employment income” (subject to top marginal rates of 45%-54%, depending on the region), instead of investment income (top tax rate of 28%), on the basis that it remunerates services as managers and does not derive from position as shareholder.
- However, with effect as of year 2023, the Spanish Government introduced a special tax regime applicable to carried interest paid to managers with tax domicile in Spanish territory (other than Navarra and Basque Regions):

Tax treatment

Carried interest is characterised as “employment income” (and thus subject to top marginal rates ranging between 45% - 54%).

But only 50% of the carried interest would be subject to tax, which results in an effective rate close to the rates applicable to investment income / capital gains.

Scope

This special tax treatment only applies to directors, managers or employees of the following entities (or of its managing entities or entities of its group):

- Closed-ended AIFs defined in AIFM Directive 2011/61/EU and included in any of the following categories: Spanish venture capital funds (SCRs and FCRs), European venture capital funds, European social entrepreneurship and long-term investment funds; and
- Other investment entities/funds similar to the funds mentioned in (i).

Bonuses or incentives received by directors, managers or employees of qualifying entities that are linked to the carried interest to which such entities are entitled to this tax regime.

Requirements

The 50% tax exemption only applies if, amongst other requirements:

- The carried interest is subject to other investors obtaining a minimum preferred return;
- The carry shares or rights are held during at least 5 years with certain exceptions (partial collections before the 5-year period are allowed); and
- The carried interest rights do not derive, directly or indirectly, from an entity resident in a non-cooperative jurisdiction or with which Spain does not have rules on mutual assistance for the exchange of tax information.

Other typical arrangements to remunerate fund managers

- Bonus generated over a period of more than 2 years: 30% tax reduction (cap of €300k), subject to certain requirements.
- Call option over shares acquired at market value (based on Black-Scholes formula): gain treatment on cash-settle exercise.



United Kingdom

Carried interest treatment usually requires a partnership-based fund structure.

Managers invest in the fund through a carry vehicle which is usually a tax-transparent partnership.

Carried interest taxed as capital gain at 28% rate (rather than as income at 45% rate) for UK resident managers, provided the five key tests listed below are met.



Managers subscribe alongside other investors, paying same per unit of capital, to prevent employment tax charge on acquisition;



Carry is not a disguised fee but arises from a share of profits of the fund and returns to investors are determined by reference to those same profits;



Employment tax election (s431 election) made on acquisition to ensure no employment tax charges when carry paid out.



Carry paid from capital gains rather than income – usually from profits arising on disposal of fund investments;



Right to carry derived from manager's employment OR fund investments meet average holding period test (40 months for full capital treatment); and

Next step

In the Autumn 2024 Budget, the UK Government announced fundamental changes to the way that carried interest will be taxed in the UK. Major change in this area was expected and there will be a number of qualifying conditions, including an average holding period test to apply from April 2026. However, the changes are not as drastic as many in the UK's asset management industry had feared. More details [here](#).



United States

Benefits

- Both grant, and vesting, of carried interest should be tax free.
- LTCG rates may apply to carried interest upon monetization.
- Tax distributions are typically made to cover phantom income.

Requirements & features

- Issued by an entity that is a “partnership” for U.S. tax purposes.
 - The legal entity form may vary (limited partnership; limited liability company).
- Entitlement to share only in future profits, not current capital.
 - Future profits must be subject to “entrepreneurial risk”.
- Minimum holding period required, and interest can be subject to transfer restrictions.
- Often includes clawback obligations.

Impediments

- U.S. treasury regulations require a three-year holding period for LTCG treatment for certain carried interests.
 - Asset class is relevant to the application of the three-year rule.
 - Certain monetization events may result in full or partial STCG taxation.
 - Prior consideration of these rules is advisable.
- Frequent discussion and proposed legislative changes to LTCG for carried interests and LTCG rates.

Current U.S. maximum tax rates for individuals

Long-Term Capital Gain (LTCG)

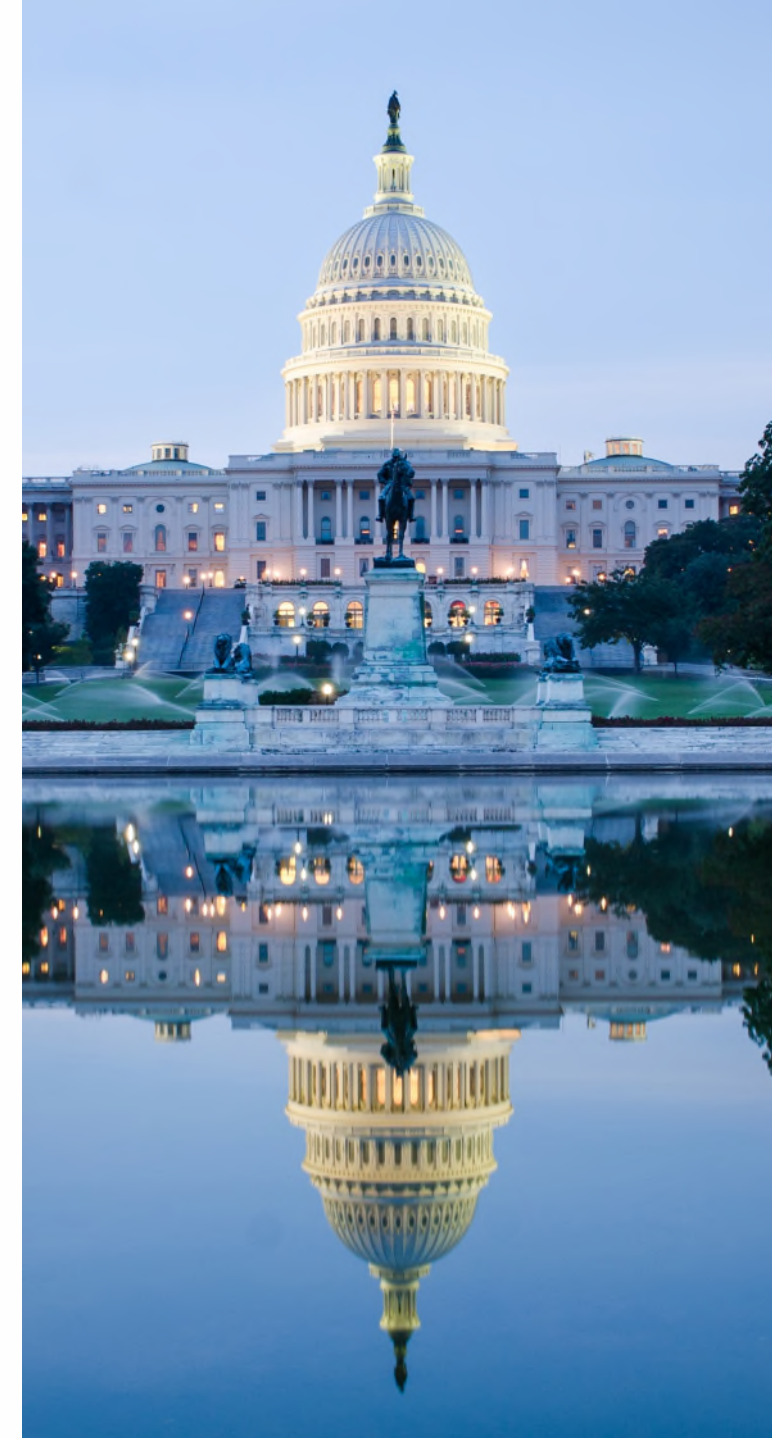
- U.S. federal rate = 20%
- Net investment income tax of 3.8%
- State and local tax rates vary
- No employment tax or employer withholding

Short-Term Capital Gain (STCG)

- U.S. federal rate = 37%
- Net investment income tax of 3.8%
- State and local tax rates vary
- No employment tax or employer withholding

Compensation

- U.S. federal rate = 37%
- “Medicare” tax of 3.8% over certain thresholds
- State and local tax rates vary
- Employment taxes and employer withholding apply



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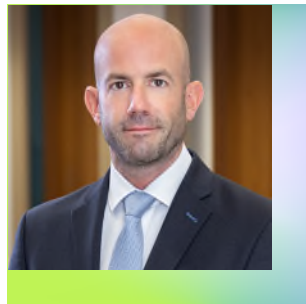
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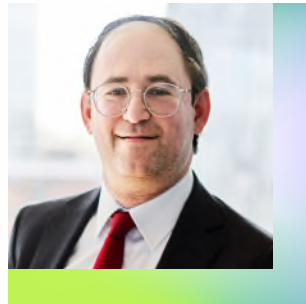
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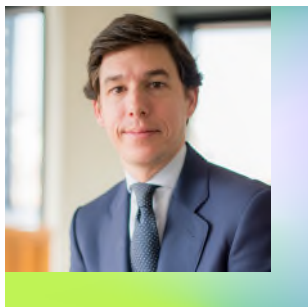
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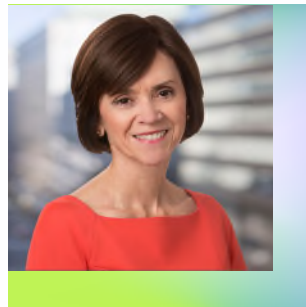
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