Carried interest for fund managers

Features in key jurisdictions

June 2022

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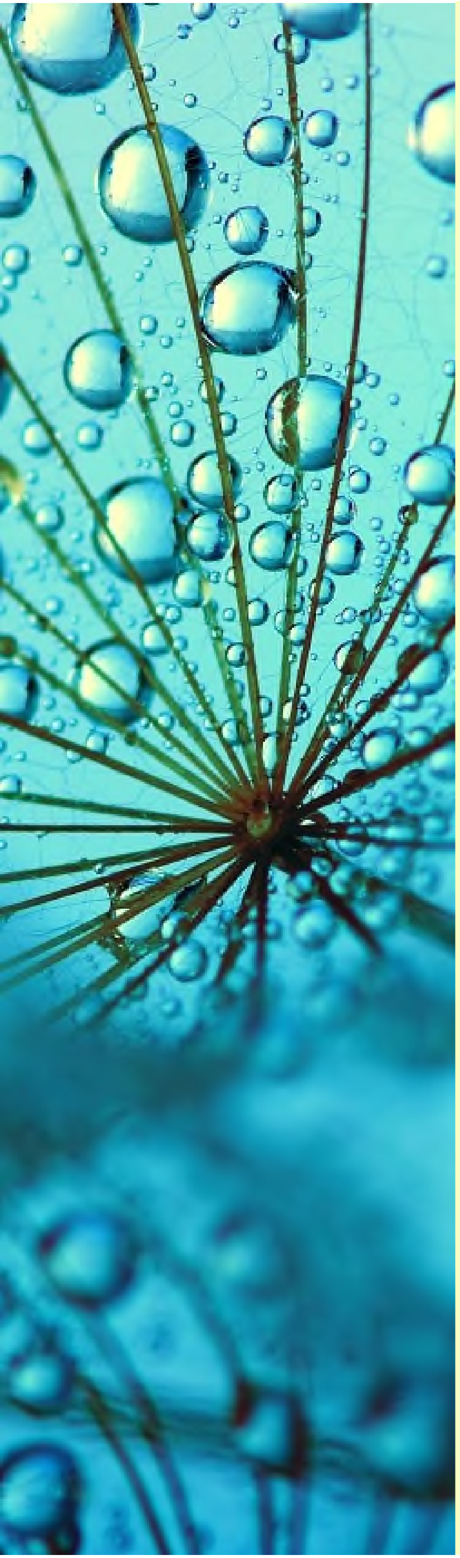


Introduction

During the last decade, the shape and source of capital flows and investment have fundamentally shifted. Private equity and debt markets have grown and are becoming more mainstream, more diverse, and more liquid. Private capital continues to flow into all asset classes including real estate, infrastructure, private credit, and private equity. Private capital has become a very large and rapidly growing market segment and we’re already seeing that private capital investors are playing an important role in the global economy's recovery as we emerge from the COVID-19 crisis.

Against this backdrop, efficiently structuring carried interest incentives has become more important than ever. With high amounts of money at stake, fund managers will 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.

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.

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

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.

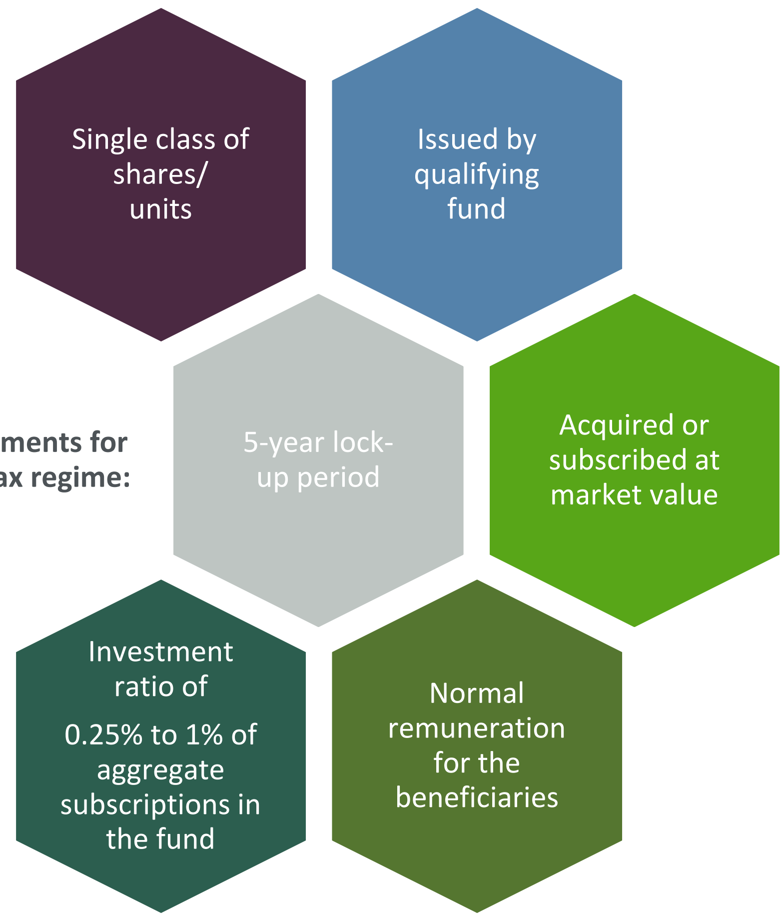
Carried interest for fund managers

France

Certain qualifying entities or funds (incorporated 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.

Main requirements for the specific tax regime:



Carried interest for fund managers

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:

(i) the carry is strictly profit-dependent;

(ii) the carry payment is not treated as a business expense for accounting purposes; and

(iii) 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.

Carried interest for fund managers

Luxembourg

Legal scheme

Carried interest taxation at 25% of the global tax rate for management teams of alternative investment funds, subject to certain conditions:

- No Luxembourg tax nexus between 2008-2012
- Luxembourg tax residency obtained between 2013-2018
- No advance payments
- Prior recovery by investors of their initial investments

Alternative tax efficient structures

Issuance of warrants, beneficiary interests, units, etc. whose repurchase can be made under certain conditions:	Set-up of a carried interest vehicle ("CarryVe") as a tax transparent partnership to:	Set-up of a tax opaque CarryVe to benefit under certain conditions from the following:
• free of withholding tax (“**WHT**”) • with 0% Luxembourg capital gain taxation	• ease carried interest allocation • provide confidentiality of carried entitlement from other investors	• no WHT on dividend distributions to CarryVe • exemption on dividend income and capital gains • 50% dividend exemption for Luxembourg manager

Carried interest for fund managers

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:

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 2022).

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.
- Flat tax rate of 26.9% (for 2022) .
- Can be applied to lucrative interest under certain conditions (as described below) .

Box 3: savings and investments

- Fixed deemed annual taxable income based on the individual holder's yield basis.
- Flat tax rate of 31% (for 2022)
- Methodology likely subject to change due to recent Supreme Court judgement 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

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

- Fund manager holds a substantial interest (at least 5% of the shares) in Holding.;
- Holding holds an interest of at least 5% of the nominal share capital in carry vehicle.

2 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 dividend distributions received provided all criteria are met.

3 Carry holder taxed in Box 2 for dividend income.

- Effective combined tax rate of 26.9% (participation exemption at the level of Holding, no taxation in Box 1).

Spain

Current situation

Spain does not have a specific tax regime for carried interest (except in the Basque Regions and Navarra, which have recently approved special tax regimes for carried interest schemes for managers who have their tax domicile in these regions).

Spanish tax authorities have considered (in tax rulings of 2003 and 2016) that carried interest shall be characterised as "employment income" on the basis that it remunerates personal services as managers and does not derive from position as shareholder or from participation in the capital.

Therefore, today there is a high degree of uncertainty as to the tax treatment of the carried interest as (i) "employment income" (subject to top marginal rates of 45%-54%, depending on the region, and subject to WHT at source by the employer) or as (ii) investment income (top tax rate of 26%).

Draft legislation expected for January 2023

In December 2021 the Spanish Government approved a draft bill including a special tax treatment (intended to enter into force in 2023) for carried interest paid to managers with tax domicile in Spanish territory (other than Navarra and Basque Regions). This draft bill is still to be discussed in Spanish Parliament, and thus is subject to changes. Main features are:

Carried interest is characterized as "employment income" (and thus subject to top marginal rates ranging between 45% - 54% depending on the Spanish region),

But only 50% of the carried interest would be subject to tax, which results in an effective rate close to the top rate of 26% applicable to investment income / capital gains.

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):

(i) Close-ended AIFs defined in AIFM Directive 2011/61/EU and included in any of the following categories: Spanish venture capital funds and other closed-ended funds regulated in Spanish Law 22/2014, European venture capital funds, European social entrepreneurship funds and European long-term investment funds; and

(ii) Other investment entities similar to those funds.

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

(i) the carry shares or rights are held during at least 5 years (with certain exceptions) and

(ii) the carried interest rights do not derive, directly or indirectly, from an entity resident in a country or territory defined as non-cooperative jurisdiction or with which Spain does not have rules on mutual assistance for the exchange of tax information.

Carried interest for fund managers

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 paid from capital gains rather than income – usually from profits arising on disposal of fund investments;
- 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;
- Right to carry derived from manager's employment **OR** fund investments meet average holding period test (40 months for full capital treatment); and
- Employment tax election (s431 election) made on acquisition to ensure no employment tax charges when carry paid out.

Carried interest for fund managers

United States

Objectives

- No tax to carried interest recipient upon receipt or vesting.
- LTCG rates apply to carried interest upon fund LTCG monetization.
- Appropriate tax distributions 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 of future profits, not current capital.
  - Future profits must be subject to "entrepreneurial risk".
- Minimum holding period.
- Often include clawback obligations.

Impediments

- 2017 U.S. law changes and recently-finalised 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.
- LTCG rate change increases are included in the Biden Administration tax plan.
- Further law changes circumscribing LTCG for carried interests.

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%
- State and local tax rates vary
- Employment taxes and employer withholding apply

Carried interest for fund managers

Our experience (1)

French private equity house

In the implementation of a syndication SPV and the structuring of the transaction/management fees in relation to the acquisition of Canadian assets.

Asset manager

On a major restructuring of their Luxembourg special limited partnership with multiple compartments (conversion into RAIF), including a carried interest scheme, the fund holding private equity, real estate and transferable securities assets globally.

Luxembourg tax resident

In relation to the tax analysis and structuring of carried interest to be granted by a Luxembourg entity operating in the private equity sector.

International infrastructure fund

On the Spanish tax implications of a carried interest structure through a carried interest limited partnership.

International private equity fund

On the Spanish tax implications of a carried interest structure through a class of shares with special economic rights included in the bylaws.

Investment and consulting firm

On Luxembourg funds due diligences and carried interest schemes investment related.

Major UK listed and private investment funds

On carried interest structures.

The management team for leading UK asset manager's real estate debt funds

On their co-investment and carried interest arrangements.

The management team for UK based international asset manager's infrastructure funds

On their management incentive and carried interest arrangements.

Carried interest for fund managers

Our experience (2)

The management team for U.S. asset management firm's UK real estate funds

On their management incentive and carried interest arrangements.

U.S. clients

Regularly advise a broad array of funds and their portfolio companies on U.S. tax issues in connection with the design and implementation of carried interests and new U.S. legislation and tax proposals affecting carried interest arrangements.

Private equity firm

On restructuring its carried interest arrangements in the UK.

U.S. focused asset manager

On the acquisition of a Spanish leading suppliers of containers for waste storage and collection across Europe and Latin America, through a Luxembourg investment and financing platform including a carried interest structure.

UK private equity house

On the launch of a £80m private equity fund, including the associated management co-investment and carried interest arrangements for the fund principals.

Specialist infrastructure fund manager

On the launch of one of their seven funds including on carried interest structures.

Large fund sponsor

On creating and managing a variety of real estate funds, including work on cross-investment, carried interest arrangements and fund terminations.

UK banking group

On the co-investment and carried interest arrangements for its captive venture capital investment business.

Carried interest for fund managers

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