What does a Labour government mean for carried interest?

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1. Rumours during the recent UK General Election suggested a Labour government could change the way carried interest is taxed

2. Carry is currently taxed under long-term capital gains (top rate of 28%), with suggestion that it could be taxed as income, at the higher rate of 45%

3. Chancellor has since suggested an amendment, that PE managers risking their own capital would be exempt from any changes

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As the UK adapts to the new Labour Government following their election victory on 4 July, thoughts are turning to that all-important question, what does it mean for me. For UK-based alternatives fund managers, one of the most pressing questions is, what will Sir Keir Starmer do about carried interest, with tax changes mooted by Labour during the election period. ***James Duffield*** *and* ***Matt Horton*** *discuss what a Labour Government might mean for carried interest, and the wider alternatives industry.*

Carried interest, commonly referred to as "carry," is essentially the sharing of the profits from the gain achieved in an investment that is paid to the fund's general partner, typically after a fund achieves a specified minimum return. In the UK carry is taxed as a capital gain rather than income and has been since the 1987 agreement between the Department of Trade and Industry, Inland Revenue and the British Venture Capital Association (BVCA). During the recent election campaign Labour suggested there may be changes to how carry is taxed in the future. The discussion centres around whether carry is considered an investment gain or a bonus by HMRC – currently it is considered as an investment gain and taxed accordingly.

The proposed change to the way carry is taxed has been circling for nearly three years, after the then 'Shadow' Chancellor, Rachel Reeves, signposted Labour's position on social media platform X, writing that Labour would do away with what she described as a 'deeply unfair' loophole. She estimated that it could raise £440 million in tax, or more.

Latterly though, Reeves has added a caveat, indicating that private equity managers who risk their own capital will be exempt from government's proposed tax changes. This means that if a manager is investing their own money, they would continue to pay capital gains tax, which is typically lower than income tax. However, this exemption is likely to only apply to a small portion of the total investments made by the industry.

For the industry as a whole, as BVCA's Michael Moore points out in his pre-election outlook, what is most important for the industry beyond the carried interest question is, 'the need for government to meet the four investment tests – macro stability, world-class regulation, an internationally competitive investment climate and predictable policy frameworks (for the sectors in which the capital is deployed).'

For UK-based fund managers they can choose to move their fund's jurisdiction in anticipation of the changes, at a significant cost to their operations, or find ways to structure their carry in a way that helps mitigate any changes to taxation rules.

Carried interest tax in the UK

Carried interest in the industry is designed to act as a performance incentive, aligning the manager's interests with the fund's performance. In the context of private equity, venture capital, and hedge funds, carried interest is a significant component of the compensation for general partners managing the funds. It's typically calculated as a percentage of the profits generated by the fund, often around 20%, and is paid only if the fund achieves a certain minimum return, known as the hurdle rate. It is essentially a performance fee rewarding the manager for enhancing performance.

Currently, carried interest is taxed under long-term capital gains if the investment is held for more than three years, which is at a top rate of 28% (higher than the standard 20% capital gains rate), as opposed to ordinary income which can be taxed up to 45%, the rate at which income over £150 000 a year is taxed. One of the primary contingencies for this capital gains tax rate to apply is for the manager to be tax transparent for UK tax purposes. If it isn't, then the payout is taxed as dividends.

It is this that could change – with carried interest taxed at the much higher income tax rate.

Carried interest tax in other jurisdictions

Channel Islands: Jersey

Private equity funds in Jersey are structured as partnership vehicles, therefore the carried interest of any partner is considered to be a share of these capital profits and is not taxable in Jersey.

Channel Islands: Guernsey

Tax is payable on 20% of income after allowances, and taxpayers can apply for a cap on their tax based on their global earnings. There's no tax on capital gains, inheritance or value added tax (VAT) and subject to certain conditions being satisfied, carried interest does not create an income tax liability.

Ireland

There is a specific tax regime in Ireland called the Venture Capital Regime that applies to capital gains. The tax rates on carry for individuals able to apply this are as follows: 15% if the Venture Capital Regime applies, 33% if it doesn't.

Luxembourg

Capital gains would be taxable at a progressive income tax rate of 45.78% when the disposal takes place within six months of the acquisition. After six months, the capital gains isn't taxable on the disposal of the underlying shares, except where a taxpayer has substantial participation in the company of more than 10%.

U.S.

Here there are two different capital gains rates, one for those who keep their interest in the company for more than three years and one for those who don't. For those who retain their interest for more than three years the tax rate on carry is 23.8% and for those who divest before reaching the three-year mark it is 40.8%.

After so much speculation in the private markets around what changes the new UK government might make to tax, it is likely the wait will extend to late autumn at least, with the budget only expected to be delivered then.

Meanwhile, in the King's Speech on Wednesday 17 July, King Charles III announced 39 draft laws that the new government is looking to pass in the next parliamentary session. Among them a planning process overhaul to reach reinstated house-building targets, and a sovereign wealth fund. The new government hasn't made sweeping changes to the portfolios or ministries, meaning they'll be able to start implementing policies faster.

For the private markets this is potentially good news for investment, despite potential tax changes, as policy certainty and steady hands are always good for business.

To discuss the points raised in this article, please contact Matt or James.