

The Tax Treatment of Carried Interest: CenTax Response

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1 About CenTax

We are researchers at the Centre for the Analysis of Taxation (CenTax), a research centre co-hosted by LSE and University of Warwick. CenTax is dedicated to improving public understanding of tax policy and helping to design a better tax system, by generating evidence that is rigorous and relevant to policymakers and the public. Further information about CenTax is available via our website.

Our work focuses on tax policy design and the measurement of tax policy outcomes. We conduct cutting-edge research on the behavioural and economic impacts of tax policy changes and have contributed substantively to debates on tax policy in the UK over recent years. We use HMRC administrative data accessed through a secure research environment that allows us to compare academic research findings with official government costings, providing insight into how policy analyses are conducted.

We sent this in response to the government's call for evidence on The Tax Treatment of Carried Interest which can be found [here](#).

2 Introduction

We welcome the reform to carried interest introduced in the Autumn Budget 2024 as a partial step in the right direction. However, our report published shortly before the Budget, entitled 'Reforming the Taxation of Carried Interest: Revenue Modelling' provides evidence that the government could have raised additional revenue by setting a higher tax rate.¹ Moreover, the effective tax rate announced at the Autumn Budget 2024 fails to meet the government's previously stated commitment prior to the General Election to align the taxation of carried interest with other "performance-related pay".² On any conceivable definition, the reform announced at the Autumn Budget 2024 does not achieve this.

Our response addresses a broader range of issues around carried interest taxation than those contained in the specific questions on the consultation,

¹Advani, A., Gazmuri-Barker, S., Mahajan, S., Poux, C., & Summers, A. (2024a). Reforming the Taxation of Carried Interest: Revenue Modelling. See also Advani, A., Gazmuri-Barker, S., Mahajan, S., & Summers, A. (2024b). Ten Key Facts about Carried Interest.

²Change Labour Party Manifesto 2024, p.19.

as we disagree with the premise that carried interest should be taxed at a lower rate than other forms of performance-related pay. We address three main issues. First, we discuss the behavioural assumptions (as reported in the OBR EFO) that were used in costing the government's announced reform. Second, we explain why we disagree with the introduction of a special income tax deduction for carried interest. Third, and notwithstanding our preference for a higher effective tax rate on all forms of carried interest, we highlight some problems with introducing qualifying conditions to access the preferential tax treatment of the 2026 regime.

3 Migration assumptions used in the government's policy costing

We agree with the government and the OBR that migration is the most important behavioural response to an increase in taxation of carried interest over the scorecard window. This means the revenue effects of an increase in the tax rate on carried interest is crucially dependent on the migration elasticity used in modelling the reform. The OBR EFO indicates that the government's policy costing was based on an assumption that around 12% of carry recipients would migrate in response to (at most) a 6.1 percentage point (pp) increase in the tax rate applied to carried interest.³ We think the migration elasticity implied by this estimation is implausibly high relative to our own and other existing international evidence.

Our analysis found a much lower migration elasticity than we infer must have been used in the OBR costing.⁴ We highlight three main factors that explain this lower elasticity:

- Carry only represents a share of the overall remuneration of private equity managers (for 68% of taxpayers receiving carry, this amounts to not more than 50% of their total remuneration) which means that an increase in the tax rate to carry results in a smaller reduction in take-home pay.
- Although almost half (44%) of all carry recipients are foreigners, the vast majority has been living in the UK for more than 10 years (91% of carried interest received by non-UK taxpayers is received by those that have been in the UK for at least 10 years), meaning that they are relatively 'sticky' in their location decisions.

³The tax rate on carry would increase from the current rate of 28% to 34.1% from tax year 2026 onwards. However, currently carried interest returns that have an income nature are subject to income tax rates, and this differentiated tax treatment will end with the 2026 regime.

⁴Supra n. 4.

- We find that carry recipients are no more mobile than other top earners, with around 5% of foreign carry recipients leaving each year after five years of residence, declining to 1-2% per year for the longest stayers.

Whereas the government's policy costing estimates that the 2026 regime would bring on average £100m additional revenues per year after tax year 2026, our modelling indicates that even on a 'worse case' scenario an increase in the effective tax rate to 34% would raise at least £170m.⁵ More importantly, our analysis indicates that additional revenue could have been raised by setting a higher rate, and the implied revenue-maximising ('Laffer') rate is in the region of 44%-47%, which is in line with current effective tax rates on other forms of performance-related pay.⁶

4 A special income tax regime for carried interest

4.1 General comments

The regime applicable from 2026 will bring the taxation of carried interest into the income tax regime (the 2026 regime). We welcome this as a step towards recognising that carried interest represents remuneration for the provision of investment management services. The consultation document goes on to claim that it is justified to exempt 27.5% of 'qualifying carried interest' because it has three 'unique characteristics': that it is a direct share of profits of the funds, that there is a lengthy period between award and payout, and that there is a material risk of not being received.⁷ However, we disagree that these characteristics justify any preferential tax treatment compared with other forms of performance-related pay, for two reasons.

Regarding the first characteristic (carry being a share of the fund's profits) we believe this is a result of the tax preference historically given to carried interest and does not reflect an inherent feature of the services provided by private equity managers. Indeed, since the 1987 memorandum of understanding between BVCA and the Inland Revenue⁸ the tax advantage given to carried interest was based on the argument that carried interest should be subject to the tax treatment corresponding to the underlying

⁵Advani et al (2024a), Appendix A, Table A1.

⁶Advani et al (2024a), Appendix A, Figure A1.

⁷The Tax Treatment of Carried Interest: Call for Evidence (HM Treasury, October 2024).

⁸British Venture Capital Association. Statement approved by the Inland Revenue and the Department of Trade and Industry on the use of limited partnerships as venture capital investment funds (26 May 1987).

transactions of the fund. The only way of achieving this result was by structuring carry as a share of the profits of the underlying fund.

These same characteristics are present in other remuneration structures that do not get a preferential tax treatment (or at least not nearly as generous). For instance, share options plans share all of these features of carry, yet the tax preferences for share options plans are strictly restricted to a maximum value.⁹ Beyond that, the entire value of the share options will be subject to income tax and NICs under the general tax rates. More broadly, success fees for litigating lawyers also share these characteristics of delay payment and material risks, yet they do not receive such a generous tax treatment. Bonuses are also subject to a material risk of non-payment but they do not receive any tax break for that reason.

4.2 Territorial scope

We strongly welcome the planned change in territorial tax treatment of carried interest under the 2026 regime, which means that non-UK residents can be subject to tax on their carry if it relates to investment management services provided in the UK. Again, this is an implicit recognition – correctly – that carried interest is in substance a reward for services not a return on capital at risk. These new territorial rules more closely align the tax treatment of carry with other remuneration for services. We have the following suggestions on the implementation of this new regime.

- Avoid creating incentives to leave UK before 6 April 2026: the new territorial scope should apply to any non-residents from 6 April 2026, regardless of when they became non-residents.
- Restrict compliance costs: we would accept that there should be some provision to disapply the taxation of carried interest on non-residents who only spend minimal time in the UK and are not former residents.

Double tax conventions (DTCs): the government should take steps to safeguard against the risk that the new territorial scope of the 2026 regime would be disapplied by DTCs. This risk arises because both the Business Profits article (art. 7 in OECD model)¹⁰ and the Employment income article

⁹Preferential tax treatment is limited to: shares worth £9,000 per year under a SIP, a maximum of £6,000 per year under a SAYE scheme, up to £60,000 under a CSOP, and up to £250,000 for EMI schemes.

¹⁰If carried interest is taxed as trading income, this would be the article that would likely apply to it for the purpose of DTCs.

(art. 15 in OECD model)¹¹ give residence countries exclusive taxing rights in most situations. We think that this risk can be addressed by treating carried interest as trailing income, in a similar way to a bonus that is paid a year later but relates to employment while UK resident.

4.3 The 72.5% multiplier

The 2026 regime will only tax 72.5% of qualifying carried interest under income tax and class 4 NIC, which would lead to an effective tax rate of 34.1%. We have two main comments:

- The specific percentage chosen does not appear to have any principled rationale. The resulting effective tax rate (34.1%) does not align the tax treatment of carry with any other returns from labour or capital under income tax.

We do not think there is a clear argument for having different multipliers depending on the tax band of the recipient. As the multiplier reduces the tax base, it will not affect the progressive structure of the overall tax schedule among carry recipients.¹²

5 The problems of qualifying conditions for preferential tax regimes

5.1 General comments

The consultation document suggests that the 2026 regime could include certain additional requirements to access the preferential tax treatment beyond the current minimum holding period required by the Income-based carried interest rules. We do not support the introduction of additional requirements. As above, we disagree with the government's decision to preserve a lower effective tax rate for carried interest compared with other forms of performance-related pay. But having done this, we think that the imposition of essentially arbitrary restrictions on access to this preferential tax regime will only serve to increase complexity and create economic distortions in the private equity industry, without any significant upside for public finances.

¹¹The UK could legislate that even though carried interest is taxed as trading income, its substance is that of employment income and therefore this should be the article that regulates its taxation in an international context.

¹²The multiplier represents a breach of horizontal equity between those receiving carried interest and those with a similar level of income from other sources. But within carry recipients, the multiplier preserves the progressivity of the tax schedule.

5.2 Minimum co-investment requirement

Gains from co-investments that private equity executives make at ‘arms-length’ (i.e. on the same terms as third party investors)¹³ are already taxed at the main Capital Gains Tax rate and would not fall within the new regime for carried interest. The effect of a co-investment threshold is to ‘unlock’ a preferential tax rate on carried interest for which the executives or firm typically have not put any capital at risk. In other words, the premise of a co-investment threshold, in relation to the ‘nature’ of the carried interest, is essentially spurious.

There are several reasons why a co-investment threshold is a bad way to define access to a preferential tax rate for private equity executives:

Economically distorting – if additional co-investment was optimal from a fund performance perspective, then one would expect that third party investors would already have demanded it. In our view, the appropriate level of co-investment is best determined by the investor market rather than effectively mandated by government via a tax subsidy.¹⁴

Open to ‘gaming’ – the government appears to have contemplated numerous complex design issues associated with implementing a co-investment threshold. However these are addressed, they would inevitably open up a raft of new opportunities for tax planning, which are likely to be very inefficient and introduce further distortions.

Inappropriately targeted – in practice, executives with less personal wealth would likely find it more difficult to meet the co-investment threshold and so would be more likely to face the full headline tax rate on their carried interest.¹⁵ It is hard to think of good reasons for targeting the tax break in this way.¹⁶

5.3 Minimum holding period

We want to highlight that any policy that distorts the holding period of investment should be avoided. Although the consultation document refers to the holding period of “the carried interest rights”¹⁷ there is a risk that such

¹³Strictly, the terms need only be ‘reasonably comparable’: s.809EZB(2) ITA2007.

¹⁴An exception might be if there were liquidity constraints leading to sub-optimal levels of co-investment; however, in that case it would be better to target policies at easing the liquidity constraint.

¹⁵Of course, one could devise rules to overcome this concern by finding ways to allow less wealthy executives to meet the co-investment threshold without putting their own capital up front or at risk, but this rather undermines the stated basis of the policy.

¹⁶One reason might be if wealthier private executives (who are likely more senior within firms) were much more responsive to tax rates than less wealthy (i.e. likely more junior) executives.

¹⁷Supra n. 8, p. 21-22.

a condition would affect the holding period of investments, as carried interest is a share of the fund's return. For that reason, we disagree with establishing any holding period as a condition to access a preferential tax treatment.

There are two assumptions that seem to underlie any regime that (directly or indirectly) creates incentives for longer holding period of investment. First, that there is some benefit on private equity holding investments for longer. Second, that market incentives are insufficient to make actors in the private equity sector hold investment for this (longer) optimal period. We are not aware of empirical evidence that supports any of these assumptions.

Failing such assumptions, creating tax incentives for holding investments for longer would be very distortive, and would create tension between the incentives of private equity managers (hold investment for long enough to access a lower tax on their carry) and investors (disposing investment at whichever time would get them the best return). This would weaken the attractiveness of the UK as a global asset management hub, with no corresponding upside that we can see.