Client Alert

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Changes in the UK Tax Treatment of Carried Interest

By Sonia Girgis

In the recent Summer Budget, the Chancellor announced that with immediate effect, there would be changes to the way that carried interest is taxed. In technical terms, the “base cost shift” which enabled an investment manager to take advantage of a share of the capital invested by external investors in calculating the gain on its carried interest, has been abolished. Going forward, only actual investment by an individual participating in the carried interest can be taken into account in calculating the capital gain on the realisation of underlying investments. This measure is intended to ensure that individuals pay the full rate of capital gains tax on their economic gain from carried interest. Legislation was published on 15 July 2015, and HMRC guidance followed on 20 July 2015.

Essentially, a quirk in the UK tax rules on partnerships, in accordance with long-standing practice of HMRC, meant that, in a fund scenario, an investment manager would be taxed on an amount which was less than the distribution it actually received from the fund. Some of the external investors' base cost in the fund would be transferred to the investment manager. From a technical perspective, there would then be a profit shift from the investors to the investment manager, which is the base cost shift. This base cost shift would have the effect of reducing the effective rate of capital gains tax paid by investment managers. Given that the highest rate of UK income tax is currently 45%, this treatment had made an already attractive rate of 28% on capital gains even more desirable.

For UK taxpayers who receive carried interest, this recent change will result in an increased tax burden.

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