THE TAX TREATMENT OF CARRIED INTEREST: A CALL FOR EVIDENCE

BPF RESPONSE

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Introduction

The British Property Federation (BPF) represents the UK real estate sector, an industry that contributes £110bn a year to UK GVA, and supports 2.5m jobs – one in 13 of all jobs. We are invested in communities across the UK – revitalising our cities and shared spaces, re-imagining our town centres and creating vibrant new places designed for the way we live today.

Our members invest and develop all kinds of commercial real estate from offices, retail and logistics properties to data centres, lab space and medical premises. Our members also invest in larger scale professionally managed residential rental asset classes - predominantly purpose-built student accommodation and 'Build to Rent'.

As the economy changes and new business structures evolve, it is right to take stock of whether the tax system is delivering fair and comparable outcomes for similar activities and returns. We recognise the importance of fairness and integrity in the tax system - and the challenge of striking the right balance between other competing priorities, such as delivering a simple and competitive tax system which encourages growth and investment.

Executive summary

Property is owned, invested in and developed by a wide range of individuals and businesses, with different objectives and risk appetites. Given its size and value, commercial property, and larger residential assets are typically owned collectively by companies or funds – including private equity real estate (PERE) funds.

A property's lifecycle typical spans several decades with the initial development, followed by several cycles of refurbishment, re-negotiation of leasing and borrowing terms, attracting new tenants etc – before finally, the property may need to be knocked down or significantly redeveloped to serve different businesses and local needs. Different investors are attracted to different stages of the property life cycle - for example, institutional investors such as pension funds, generally have a lower risk appetite, and will primarily acquire fully developed properties which have already been let to tenants. At the other end of the spectrum, PERE funds will typically have higher risk appetites, and be willing to take on underperforming assets, and fund refurbishment and development activity to attract new tenants or renegotiate lease and lending terms to improve the rental returns generated by the asset. Each different investor plays a crucial role in the real estate investment life cycle.

As with the broader private equity sector, PERE investment structures typically include a carried interest element – which is designed to ensure that the incentives for the senior fund manager executives are well aligned with the performance of a fund, over that fund's life – which is typically in the region of 8-10 years. Further information on the real estate investment sector and the role of PERE funds, is set out in appendix 2.

The concept of investment vs trade in the real estate sector (and therefore whether different returns would be treated as income or capital), has been well debated and considered by case law over many decades. While the tax treatment of rental receipts is fairly clear cut, and will be treated as income in most cases, the tax treatment of returns on the sale of an asset will generally depend on a number of factors, including the length of time the asset has been held for. At one end of the spectrum, a housebuilder would generally sell houses as part of their trade, with no intention to hold the assets for any period to derive rental income -

and so returns on selling their assets would generally be income in nature. Conversely, in the context of a typical PERE fund, the assets will be held for much longer time periods – deriving rental income from the assets until they are eventually sold. Given the following typical hallmarks of caried interest returns in PERE funds:

- *The timeframes involved*: carried interest returns would generally be paid out at the point assets are disposed of - towards the end of a fund's life – and generally only after the other investors have received their capital back.
- *The carried interest holders do not have a guaranteed return on their investment* – carried interest holders would not typically be paid until the other investors have received their original capital back (in addition to the pre agreed 'target' annual returns).

The general view among property tax practitioners is that carried interest returns should be generally treated as capital in nature in most typical PERE funds.

Our response to the call for evidence questions are set out in appendix 1. Pease get in touch if you have any follow up questions, or if you would like to arrange a meeting to discuss further.

Best regards,

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Structure of this response
Appendix 1: Response to call for evidence questions
Appendix 2: Overview of real estate investment and private equity real estate (PERE)
appendix 3: Typical PERE structure diagram

Appendix 1: Responses to the call for evidence

Question 1: How can the tax treatment of carried interest most appropriately reflect its economic characteristics? The government notes that there are a range of circumstances in which carried interest is received, and that the characteristics of the reward will not be the same in all cases.

The concept of investment vs trade in the real estate sector (and therefore whether the return would be treated as income or capital), has been well debated and considered by case law over many decades. While rental receipts are treated as income for tax purposes (in most cases), the appropriate tax treatment of returns on the sale of the asset is generally more complex, and will depend on a number of factors – such as the length of time the asset has been held for. The returns of the PERE fund to the investors will generally reflect the underlying nature of these different real estate returns.

A typical PERE fund would be set up for a defined period of around 8-10 years. Buildings would be acquired at the beginning of the fund's life, refurbished or repositioned in some way (including renegotiations of lease and lending terms) to maximise rental returns. Eventually, the asset will be sold towards the end of the fund's life. The carried interest returns would generally be paid out at the point assets are disposed of, towards the end of the fund's life (typically after investors have had their original capital investment repaid in addition to the annual target return). As a result of the longer timeframes involved, and the fact that the returns are not guaranteed, the general view among property tax practitioners is that carried interest returns should be generally treated as capital in nature in many typical PERE funds.

There will of course be cases where returns to carry holder would be income in nature – such as returns of rental income, or where an asset is sold much more quickly than anticipated. Again, this would broadly reflect and be aligned with how the returns would be taxed if they invested in the underlying real estate directly – and there are already rules established to deal with this within the income-based carried interest (IBCI) rules.

Question 2: What are the different structures and market practices with respect to carried interest? The government is particularly interested to understand how these differences should be taken into account as part of its reforms.

Please see appendix 2 for more information on the roles of PERE funds within the real estate investment sector.

The typical characteristics and structure of PERE funds are likely to be similar to other private equity funds – and in particular, the carried interest structure is primarily set up to ensure that the incentives of the senior executives in the fund manager, are well aligned with the performance of the fund, during the life of the fund. It is worth noting that this carried interest payment can be made to a corporate entity in some corporate PERE structures – but it is more common for a PERE fund to use transparent/partnership structures – an example of which is set out in appendix 3.

As touched on above, there is a lot of case law and precedent around what constitutes trading and investment activity (and therefore capital and income returns) in the context of real estate businesses. The nature and tax treatment of PERE returns is broadly consistent with this analysis, so the tax treatment of carry returns from PERE funds seems relatively uncontroversial in this context.

Furthermore, we would note that many real estate fund structures recognise the importance of investors receiving a similar tax treatment on their returns from real estate funds, as if they had invested in the real estate directly – and PERE funds structure are consistent with this.

Finally, we would reiterate that the time frames involved in PERE fund investments are, by their nature, are medium to long term. The process of acquiring properties, refurbishing/repositioning them, re-leasing/re-gearing etc generally takes several years.

Question 3: Are there lessons that can be learned from approaches taken in other countries? While many other countries have specific regimes for the taxation of carried interest, their detail and conditions for access vary.

1. We are pleased that the Government recognises the importance of understanding approaches taken in other countries – particularly given the global nature of the asset management industry. In order for the UK to remain competitive, it is sensible to remain broadly in line with approaches taken in other countries – and in particular, avoid being an outliner in terms of both complexity or total tax burden.

2. This summary of carried interest regimes from DLA Piper provides a helpful overview of different countries' regimes and tax rates – as well as a diagram illustrating a typical private equity fund structure.

Appendix 2: Overview of real estate investment and private equity real estate (PERE)

What is real estate investment?

All individuals, most businesses and central and local government all require real estate. Some own and manage their own real estate, while others lease business or residential premises from property owners. The decision to own or lease depends on financial position, relative requirements for stability or flexibility, market conditions and many other considerations.

The real estate industry is typically understood to cover businesses whose primary business revolves around physical 'bricks and mortar' real estate development (or redevelopment), and rental income generation and growth over the medium to long term. However, it can also include others, such as those who buy property with a view to a quick sale at a profit (either following development or not); and those who gain economic exposure to property indirectly (for example by acquiring mortgage backed securities, shares in property companies or units or other interests in collective investment vehicles).

It is very common for commercial property to be rented, rather than owner-occupied. In the UK, around 55% of commercial property is rented, compared to only 36% of residential property. The prevalence of separate ownership and occupation of commercial property is a natural consequence of the fact that commercial property is expensive to acquire and relatively slow and costly to buy and sell, whereas most businesses often want to be able to alter their property footprint easily and quickly as the size, strength and needs of their business change over time.

It is particularly important for smaller businesses and many retailers to be able to change their property holdings as business conditions change, so commercial property in these sectors is commonly owned by professional property businesses and rented out to the occupier businesses. Without this flexibility, businesses would have to tie up considerable amounts of capital in their own premises, rather than being able to use it to grow and develop.

Who invests in real estate and why?

Investors in commercial real estate are a diverse group, ranging from institutional investors such as pension and sovereign wealth funds to individual retail investors. Ultimately, however, the majority of investment into commercial real estate in the UK (and in most mature economies) provides pensions and savings for ordinary households around the world.

Real estate is attractive to investors as it has relatively low correlation with other asset classes and therefore offers healthy diversification characteristics. It also has the capacity to deliver relatively stable income returns over the medium to long-term (particularly attractive for matching the long-term liabilities of pension funds and insurance companies) as well as the prospect of capital appreciation. Historically, UK commercial property has delivered a total return of between 5 and 10%, lower than returns from the FTSE but higher than those provided by UK government bonds.

The role of private equity real estate (PERE)

PERE is the name given to an approach to real estate investment that shares a number of similarities to 'mainstream' private equity investment in operating businesses. PERE funds are generally closed-ended investment arrangements with a pre-determined life (typically between seven and ten years) and investors have very limited (if any) redemption opportunities. Investors in PERE funds are typically institutions such as pension funds and life companies, but may also include university and other endowment funds and charities. Investors from all round the world invest in PERE funds. The fund vehicle is generally transparent for tax purposes and limited partnerships are often preferred.

Private equity real estate funds typically have a higher risk appetite than many other investors in real estate – and are willing to invest in risker investment propositions. This could involve acquiring an underperforming asset which needs to be refurbished or re-leased (or both) – or even a complete development or regeneration project. Not all investors are willing to take on the risk associated with development and refurbishment activity – and so private equity real estate businesses play an important role in the real estate investment lifecycle.

Appendix 3: Typical PERE fund structure