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Labour's tax crackdown would hammer UK private credit sector

BY KATHRYN GAW AND SUZIE NEUWIRTH / GLOBAL NEWS / UK NEWS / A&O
SHEARMAN AYMEN MAHMOUD DECHERT JAMES BURTON KEVIN CUMMINGS
MARK STAPLETON MCDERMOTT WILL & EMERY RACHEL REEVES

Labour's carried interest tax reforms would have a costly impact on the private credit sector and could lead to a talent exodus from the UK, according to legal experts.

The Labour Party has pledged to raise £565m a year by changing the taxation regime for private markets managers' profits from successful deals, known as carried interest.

Currently, these earnings are taxed as capital gains, levied at a lower rate than income.

"Many private credit funds will have a carried interest arrangement rather than a performance fee arrangement," said Mark Stapleton, tax partner at law firm Dechert.

"Of course, if these proposals come in, there's a serious concern that they will all be turned into income, potentially taxable at the highest rates."

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Reports of the proposed tax changes have mainly centred on private equity firms, which have a more obvious capital gains structure due to their sale of holdings in companies.

One global private markets fund manager told *Alternative Credit Investor* that it has very little exposure to carry, with the vast majority of its earnings coming from management fees. But Stapleton says this is not typical for private credit funds and carried interest is often adopted by the sector's managers.

"With a private equity fund, they're selling companies so that's a capital gain, but with private credit, it's often income in nature such as interest payments," said Stapleton. "But even so, it's usually possible to make sure that a good proportion of what is returned as carried interest is capital in nature and can get capital gains tax treatment.

"This is especially relevant for distressed debt funds, which can make pull-to-par gains.

"Another example is lending by special situations funds, where the fund may also get something like a warrant alongside a loan that will produce a capital gains return, so that would also have an impact."

Shadow Chancellor Rachel Reeves (pictured) clarified the proposals last month to indicate that carried interest would continue to be taxed as capital gains if fund managers put their own capital at risk alongside their investors.

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"If Labour wins, it seems clear that pure carried interest, which arguably is the performance-related bonus in the views of the Labour Party, is likely to be impacted," said Kevin Cummings, partner at law firm McDermott Will & Emery.

"But Labour may leave alone co-investment through carry structures, whereby managers co-invest into funds, which is separate from pure carried interest but also gets capital gains treatment.

"I think that will be a really critical point, as to whether co-investment is also subject to income tax.

"There are stronger economic arguments as to why co-investment should not be subject to income tax and therefore may be excluded from any potential future reform."

Cummings said that this is "likely to encourage further co-investment" by private credit fund managers.

Global battle for talent

The other question is whether these tax changes would make the UK uncompetitive on a global scale.

"The real issue is, when one country makes these types of changes in isolation, there's a competitive risk that those people that are mobile decide that the tax consequences are no longer as attractive as working elsewhere," said Stapleton.

"The US is always talking about potentially taxing carried interest as income but then the conversation goes away because there's a powerful lobby on this point."

Read more: [Private credit managers earned €13.7m last year](#)

James Burton, global tax partner at A&O Shearman, agrees that the proposed tax changes could have an impact on attracting the best talent.

"The measures proposed by the Labour Party are specifically intended to increase the tax paid by investment fund managers," he said. "It seems inevitable that those affected will consider the impact of these changes on their personal circumstances."

However, Burton notes that some other countries, such as France, have tax regimes for carried interest that include a requirement for capital to be invested.

"In that sense, a similar rule in the UK may not be seen as uncompetitive," he added. "However, it will depend on the detail."

Lack of clarity

Uncertainty around the specifics of the new rules is creating worries for private credit fund managers.

Dechert's Stapleton said that Labour's proposals are currently a key topic of discussion among his clients.

"They are keen to know what the changes actually mean, as Labour has said that it's going to close this loophole, but on the other hand they have made it clear that there's going to be a consultation," he said.

"My clients are still structuring things in the hope of getting capital gains on carried interest. It may be optimistic, but there's the hope that it will take time to get the rules in place or perhaps there will be a compromise, whereby they're taxed at income but at an intermediate rate. Most clients are worried about it but don't know what to do at this point as it's not completely clear."

Whatever the political climate, private credit is well placed to weather the changes, according to industry stakeholders.

"Private credit has built its business, its reputation and its approach by being incredibly flexible from a capital deployment perspective," said Aymen Mahmoud, partner at McDermott Will & Emery.

"And I think they're going to be equally that way from a capital management perspective."

Photo credit: Chris McAndrew / UK Parliament

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Shadow Chancellor Rachel Reeves
Credit: Chris McAndrew / UK Parliament

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