



## Level-20 - Carried interest arrangements

January 2024

# Welcome



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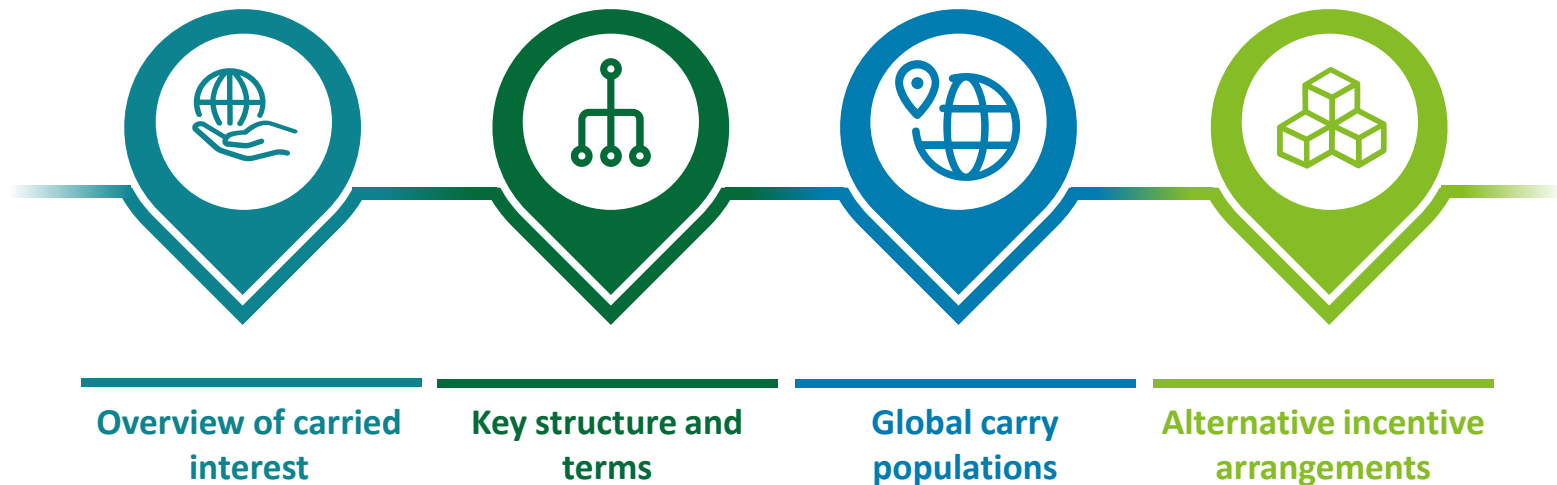
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# Introduction

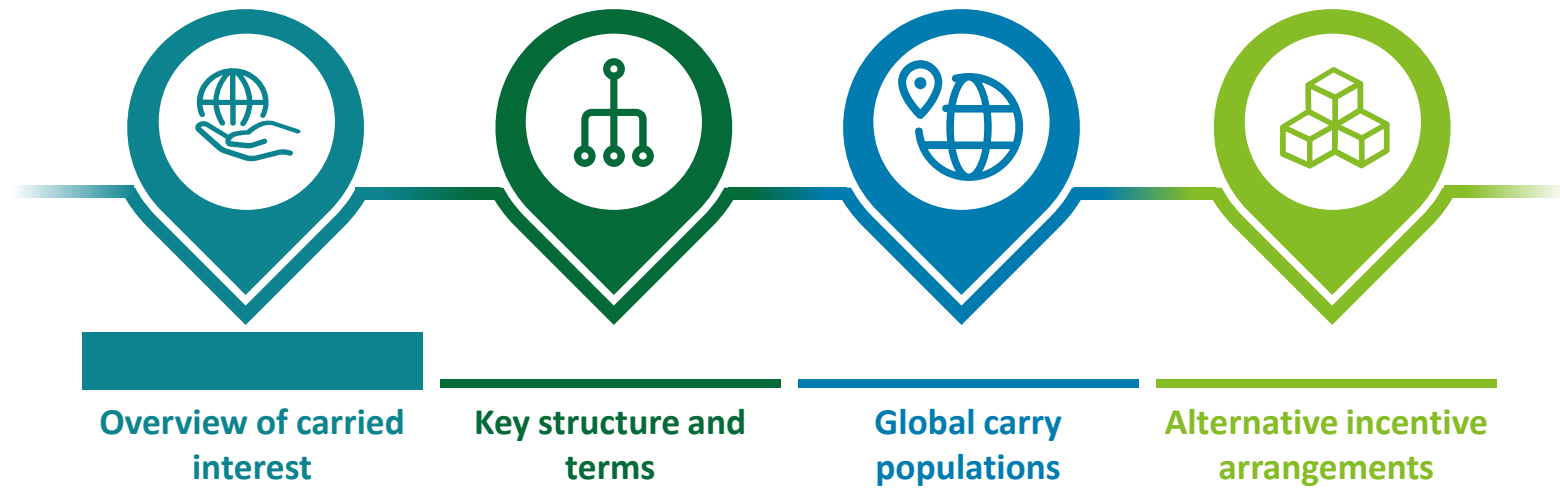
## Overview & Contents

The following presentation, sets out a high-level overview of carried interest arrangements aimed at alternative asset managers and the context for them, including:



Of all of the alternative asset management investment strategies, Private Equity is the most long-standing and the reward arrangements in place within those investment strategies have been used as the foundations for the reward arrangements in other investment strategies (e.g. Real Estate, Infrastructure, Credit). As such, the content included within this presentation has been put together with a Private Equity focus.

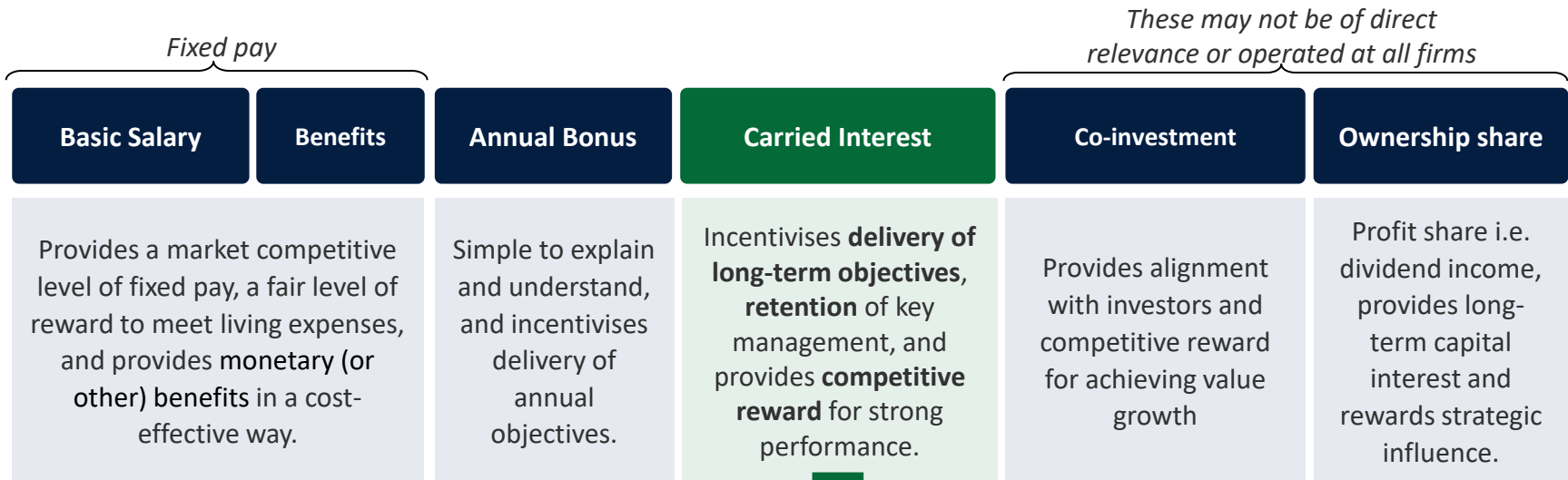
# Overview of carried interest



# Overview of carried interest

## What is carried interest?

### Key elements of the reward package



## What is carried interest?

- A performance fee / profit sharing arrangement that allows certain individuals to participate in the performance of the fund itself, subject to achieving certain pre-agreed economic conditions.

Carried Interest is a **longer-term incentive** compared to annual, fixed pay. Subject to fund performance, carry typically starts to pay-out after 4-7 years from the start of the life of the fund.

Allocating carried interest provides **direct alignment with investors**, rewarding performance of the fund's investments.

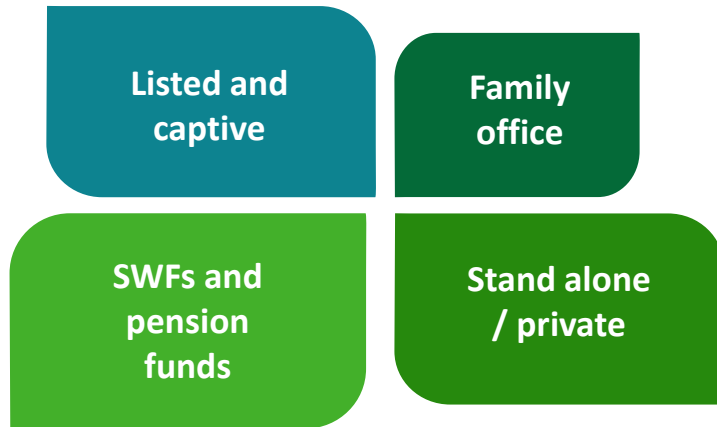
Carry can be a **tax efficient** form of reward, subject to how it is **structured and the jurisdiction** of the participant.

# Overview of carried interest

## Carried Interest influences

- The form and structure of a carried interest arrangement can vary for a number of reasons.
- The most significant influences on such structures include the asset class and the ownership of the fund manager:

### Ownership



- The impact of ownership on the structure of a carry scheme can be complex and often vary dramatically (e.g. listed vs private and captive vs standalone).
- As such (and for simplicity) this workshop will not go into significant detail on the nuances of these.

### Asset class

#### Private Equity

PE is the most mature and prevalent asset class, and leads market practice with regard to carried interest.

#### Real Estate and Infra

Where the strategy is similar to a PE strategy (e.g. in terms of investment profile and nature of returns), we find significant similarities in carried interest plans.

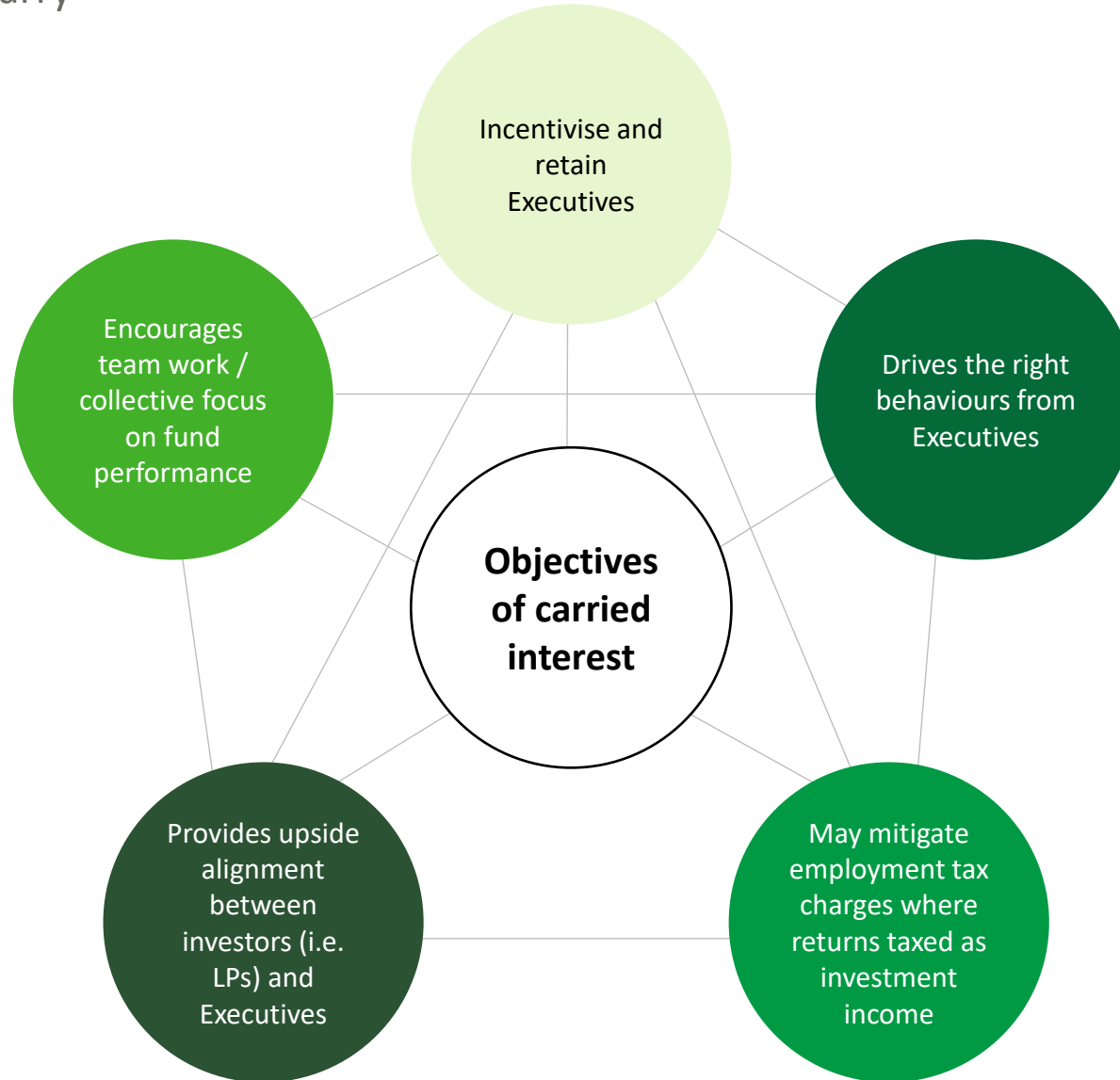
Where the strategy significantly differs from PE (e.g. long-term horizons, focus on yield generation), greater variation is seen in market practice.

#### Private Debt

Where the strategy is similar to a PE strategy, there may be significant similarities in carried interest plans. However, there is an increased focus on dynamic carry plans where tax optimisation is less of a driver.

# Overview of carried interest

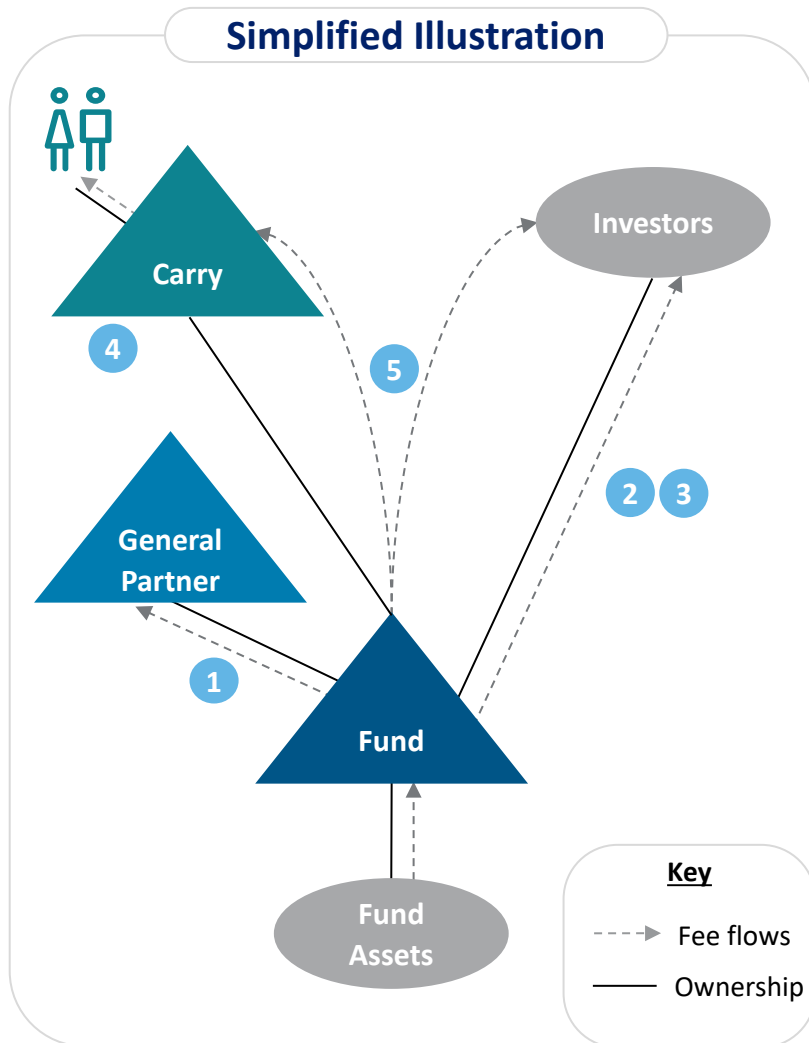
## Objectives of carry



# Overview of carried interest

## Fund economics and fee flows

The following sets out a typical private equity fund “waterfall”, explaining the fees that flow between the various entities in the structure.

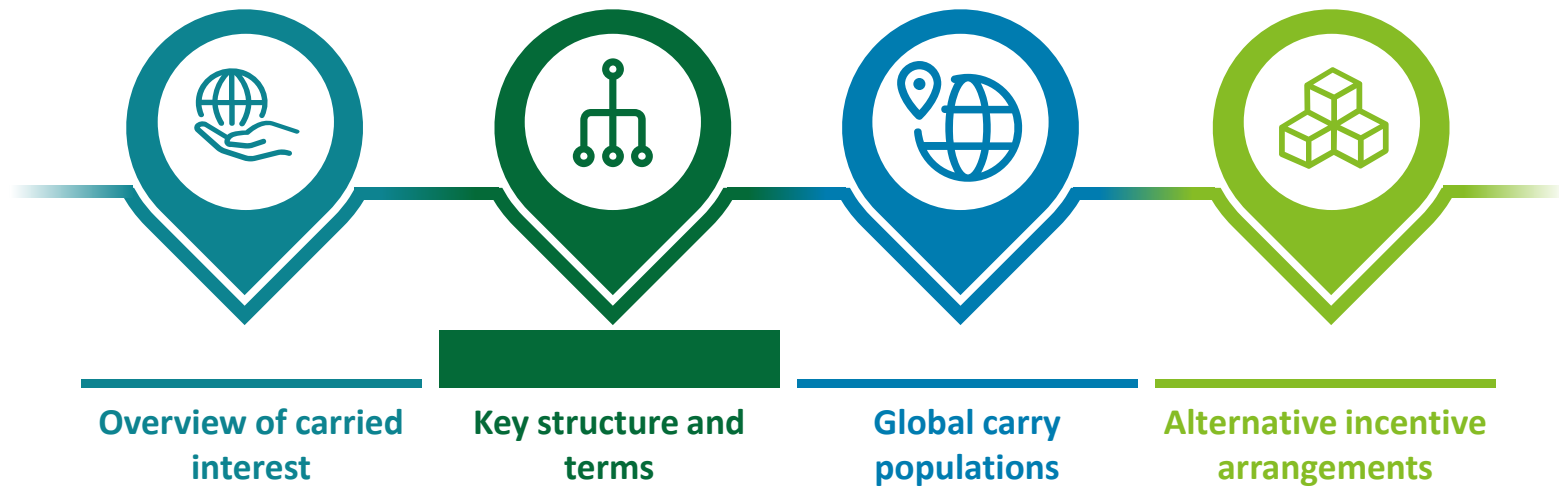


## Carry “waterfall” explained

The returns from the fund assets (commonly referred to as the ‘waterfall’) would typically be as follows:

- 1** Management fee to the GP – typically 1.5% to 2% of total capital that the investors have committed to invest;
- 2** Return of capital to the investors until they have repaid their capital;
- 3** Preferred return to investors (sometimes referred to as a hurdle), e.g. 8% IRR;
- 4** Catch-up paid to the Carry Partnership until it has received its return of capital and their agreed share of profits in respect of the preferred return (e.g. 20% of profits); and
- 5** All remaining profits are allocated to the Investors and the Carry Partnership in line with their partnership arrangements. (e.g. 20% of profits to the Carry Partnership and 80% to investors (i.e. LPs))

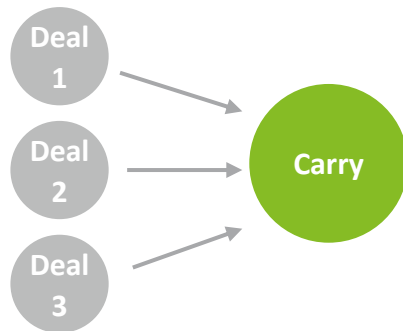
# Key structure and terms



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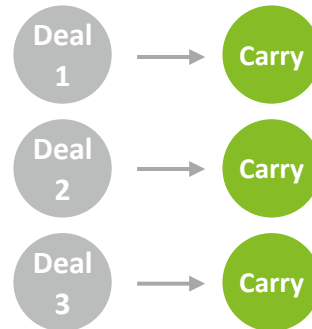
## Form of carried interest

### Whole-of-fund



- All deals assessed as a whole when determining whether the carried interest hurdle has been met.
- This approach therefore takes account of overall fund performance.
- More common amongst European investment houses.

### Deal-by-deal



- Deals assessed on an individual basis to determine if carried interest will be paid out on a particular deal.
- Carried interest may be paid out on particular deals even where other deals have not performed as well.
- More common in the US than Europe

### Hybrid deal-by-deal



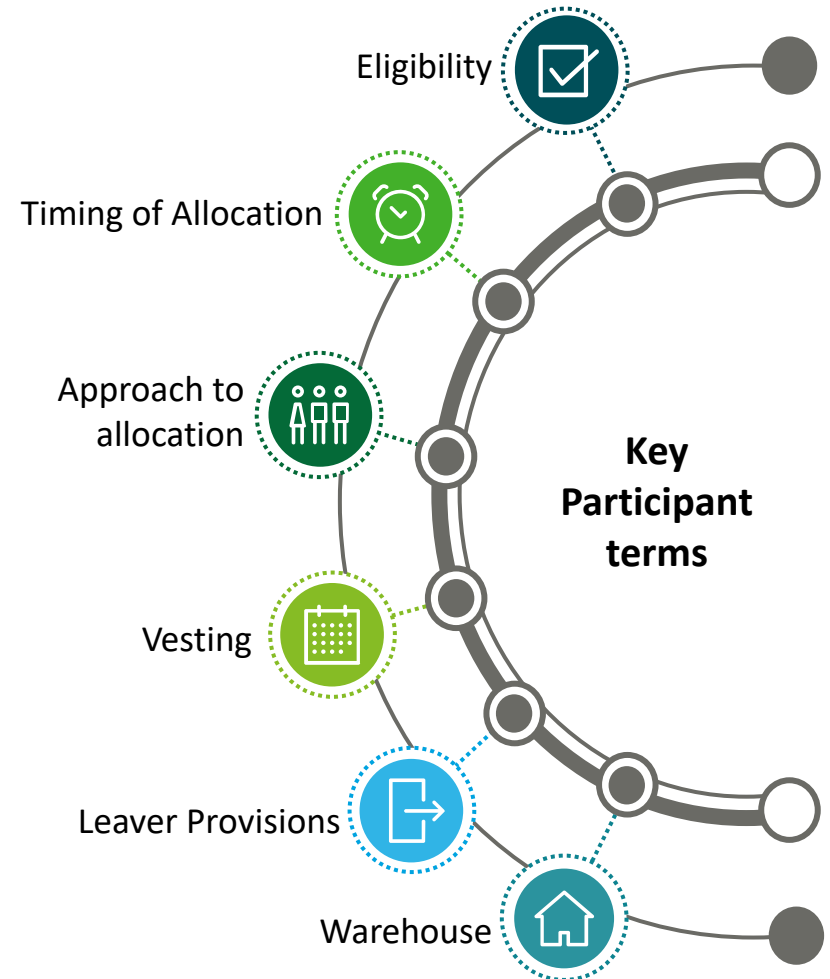
- Carried interest agreed on a whole of fund basis with investors
- Additional allocations of WoF carry may be made to fund managers based on the performance of particular deals.

# Key structure and terms

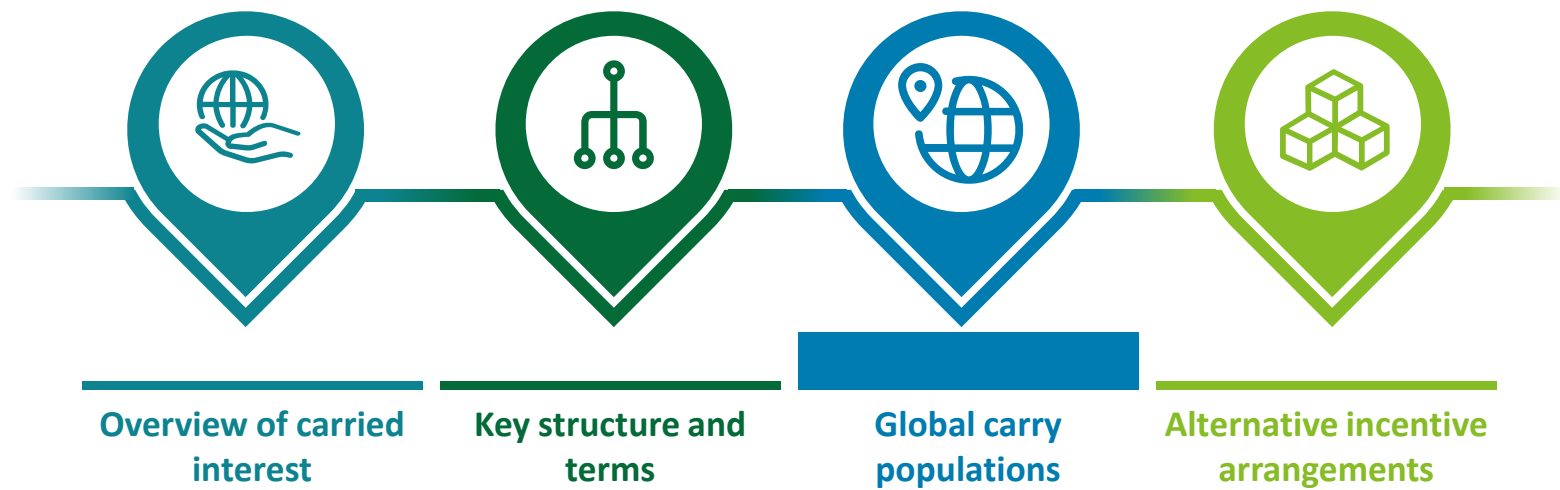
## Terms agreed with investors

The terms of a carried interest structure are first agreed with the investors being the LPs, i.e. the **'external terms'** or headline terms. Included below are details of what those terms are and some general market practice details on each within Private Equity.

### Headline terms agreed with investors



# Global carry populations



# Global carry populations

## International developments

Typically, asset managers seek to structure carried interest arrangements such that they are taxed as investment returns, rather than employment income. However, not always possible in all jurisdictions

### Current landscape

#### Beneficial regimes

- A number of jurisdictions have beneficial or qualifying regimes.
- Some of these will apply without additional complex structuring, whilst others require significant effort to meet the relevant conditions.
- Tax authorities globally becoming increasingly familiar with these arrangements, resulting in more jurisdictions introducing specific regimes.

#### Emerging markets

- In emerging markets, often no clear rules on the tax treatment of carry which requires a “general principles” approach.
- However, a number of these jurisdictions have broader anti-avoidance provisions which can have significantly adverse implications if triggered.
- May also be a risk returns are regarded as employment income absent rules to the contrary.

#### Internationally mobile employees

- Significant increase in internationally mobile employee populations post covid-19.
- Raises complex tax issues including:
  - Moving from a jurisdiction with a beneficial regime to one without (or vice versa);
  - Appropriate tax elections;
  - Double tax treaty considerations

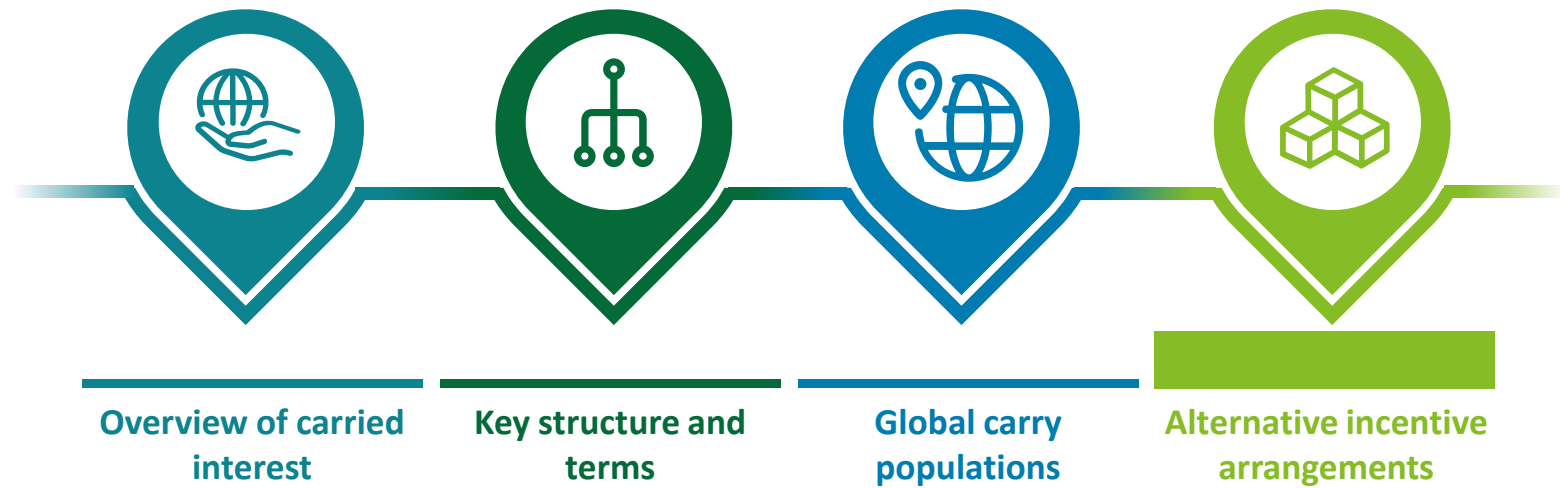
### Approaches to structuring

1. Structure for all

2. Jurisdictional / regional structuring

3. No specific structuring

# Alternative incentive arrangements



# Alternative incentive arrangements

## Other performance fee structures

### Carried interest plan or phantom plan

- Incentive typically based on realisation of capital growth over the long-term.
- Pay-outs linked to returns made above a pre-determined hurdle rate.
- Pay-outs typically do not occur for the first c.7 years.
- Commonly structured as 'true' carry i.e. a share of the underlying profits return but can be delivered as cash bonus.

### Cash long-term incentive

- Awards based on achievement of performance over mid to long-term.
- Typically, highly bespoke structures, reflecting the nature of the investments.
- Often linked directly to strategic performance over the period as well as fund performance.
- Can be used to reward and incentivise a broader population over the longer-term.

Potential scenarios where alternative performance fee sharing arrangements are implemented:

### Funds with longer time horizons (e.g. 15+ years)

For these funds, the need for participants to wait 15+ years from first award of carried interest to potential pay-out is generally viewed as too distant to motivate the investment professionals and can potentially lead to disenfranchisement and increased turnover.

As a result, structures can be implemented such that the horizon is brought forward and cash flows brought in line with more traditional schemes in the market.

### Yield-generating funds

Pay-outs geared off asset realisation may not be viewed by external investors of the fund manager as appropriate to support yield-generating strategies, both in terms of rewarding the right performance and also driving individual behaviours (e.g. timing of disposal assets).

A high proportion of returns under yield-generating funds typically income-based, there are generally limited tax benefits from using a traditional carried interest structure.

Questions?



# Speaker Bios

**Olivia Biggs** is a Partner in our Funds Advisory Team and co-leads the Reward in Funds practice.

Olivia specialises in the design of senior executive remuneration arrangements from a reward, tax and regulatory perspective across the alternative asset management market.

She has c20 years' experience in this area across private equity, venture capital, infrastructure and real estate.

Recent projects have included fund structuring for major European private equity houses including the design of the carry and co-invest arrangements across multiple jurisdictions.

Olivia has Global and UK responsibility for Deloitte's Private Equity Firm and Fund Services in her roles on Deloitte's Global and UK Private Equity Executives.

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**Danielle Jassal** is a Director in our Funds Advisory Team and has over 15 years' experience advising a range of alternative asset managers.

Danielle focuses on both fund structuring and designing and implementing incentive arrangements for senior executives, from both a tax and reward perspective.

This includes advising on the design and tax treatment for employers and employees of global carried interest, co-investment long term incentive arrangements, with significant experience in designing carry and co-invest to meet the requirements of beneficial local regimes.

Danielle's clients span across the breadth of alternative asset managers, including large private equity, infrastructure, venture capital, captives and family offices.

Recent projects include global carried interest and co-investment structuring for a large PE house, the design and implementation of a bespoke leveraged co-investment arrangement considering complex anti-avoidance provisions as well as fund structures for both infrastructure and a family office.

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