Labour plans crackdown on private equity tax ‘loophole’

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The UK Labour party has announced plans to crackdown on the private equity tax “loophole”.

The reforms would focus on carried interests, with Labour proposing to tax the returns on investment as salary.

However, Tom Whelan, a partner at law firm McDermott Will & Emery, explained that carried interest is not a form of bonus, but is actually a return on investment which only becomes payable once a minimum return threshold has been hit for fund investors.

It is designed to incentivise performance by the fund managers in their investment decision making.

“Any decision to increase taxes is clearly a political one, but it would be wrong to characterise carried interest as a bonus. Accordingly, it should continue to be taxed as capital gain at the relevant capital gains tax rates in force at the relevant time,” Mr Whelan argued.

Carried interest is not guaranteed for investors.

For example, many high street retail brands have not survived the past 18 months. As these retail investments have not paid off for the private equity funds that invested in them, the executives won’t have earned any carried interest from these investments.

This shows “there is indeed risk attached to investing and that earning carried interest is not a foregone conclusion,” Mr Whelan concluded.

Meanwhile, Sarah Gabbai, a senior associate at McDermott Will & Emery, noted that private equity taxation was already reformed in 2016.

This led to the disappearance of the base cost shift, the re-casting of priority profit share payments as “disguised investment management fees” taxable as trading income, and the rate of capital gains tax for carried interest being left at 28 percent instead of 20 percent.

“So although the rate for carried interest is higher than that of other gains, it is still lower than that of income tax. For the 28 percent rate to apply, there must be a significant risk that the super-profit will not arise, which supposedly reflects the high risk, high reward nature of carried interest,” she explained.

Ms Gabbai also argued that targeting particular sectors for tax hikes has not “traditionally proven to be the most efficient way to raise revenue, and raising the rate of capital gains tax to 45 percent for private equity executives’ carried interest is no exception”.

James Paull, head of the incentives group at advisory firm Andersen in the UK, added: “Although a relatively small number of arrangements can pay out very large amounts, it is wrong to suggest that carried interest is a certainty, or that the tax position is based on a ‘loophole’.

“[Keir] Starmer clearly wants to use hindsight to tax something which at grant has little or no value - the fact that such arrangements may in the future payout does not make it right to change the tax system for some ill-perceived abuse loophole.

“This is nothing more than a thinly veiled attack on the ‘evil’ private equity sector.”

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