TAX JOURNAL

Published on *Tax Journal*(https://www.taxjournal.com)

Labour plans crackdown on private equity tax 'loophole'

22 September 2021

The Labour party has pledged to close a tax "loophole" which allows private equity fund managers to pay a reduced rate of tax on their earnings. Shadow chancellor, Rachel Reeves MP, described the carried interest rules as a 'loophole' which gives an 'absurd tax break for the wealthy'. The party said the move could raise £440m a year.

Commenting on the news, Tom Whelan, partner at law firm McDermott Will & Emery, said: 'Carried interest isn't a form of bonus, but is instead 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 (and ideally outperformance) 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.'

Whelan's colleague, Sarah Gabbai, senior associate at the firm, added: 'The taxation of private equity already went through significant reforms in 2016, the most notable of which was 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 rate of capital gains tax for carried interest being left at 28% instead of 20%. 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% 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. Whether or not the tax system should continue to reflect this through a lower rate is a political choice, particularly when one considers the fact that executives, unlike fund investors, do not put any capital at risk in relation to their carried interest. That said, 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% for private equity executives' carried interest is no exception.'

'Another thing that people seem to forget is that the taxation of carried interest takes on the underlying character of the return flows through the private equity partnership, as is common in private equity and VC fund structures. Sometimes these will take the form of gains, but sometimes they can also take the form of dividends, which are taxed at marginal rates (above an allowance of £2,000) of 7.5%, 32.5% and 38.1%,' Gabbai added. 'So it is not as black and white as the media often makes out.'

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