# The Tax Justice Network UK

and

# Tax Research LLP

## Written Submission of Evidence on Private Equity to the Treasury Select Committee

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## Summary

This submission argues that private equity funds enjoy three unwarranted tax breaks. They usually do not pay tax on their capital gains, they receive excessive tax relief on interest paid resulting in little or no current tax being paid on their UK profits and the taxation of income attributable to carried interests as capital gains is economically unjustifiable.

As a result it is suggested that the first two tax breaks provide private equity funds with an unfair competitive advantage by lowering their cost of capital and the last provides it with a further unfair competitive advantage by lowering its cost of employing key staff. Each distorts the UK financial markets in ways that are harmful to those markets themselves, the companies that are quoted on them and their ability to secure the capital and management resources to operate for best benefit for the UK as a whole. This is the principle reason for requiring change in the way in which private equity is taxed in addition to the loss of tax and increased social inequality that also justify that change.


[1] Richard Murphy is a senior adviser to the Tax Justice Network and a director of Tax Research LLP. See http://www.taxresearch.org.uk/Documents//RichardMurphycvJuly2006.pdf accessed 12-7-07


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Required tax changes are proposed in this paper. First of all it is suggested that income attributable to carried interests be taxed as such under income tax rules. This would eliminate market distortions, reduce abuse of the domicile rules, open the market for management talent, eliminate an unwarranted subsidy of the employment costs of these funds, end the taxation by concession which currently exists in this sector without statutory support and increase social cohesion.

Next it is proposed that explicit thin capitalisation rules be introduced to prevent the abuse of interest payments from the UK to offshore entities to eliminate the charge to UK tax by companies operating in this sector. In addition, it is suggested that tax relief should not be given on interest paid on loans incurred by a UK company that directly or indirectly arose to assist the acquisition of its shares by a third party. This, it is suggested would end the subsidy currently provided by the UK Exchequer to the owners of capital in this sector, would create a level playing field for all types of fund in the financial markets and would reduce the loss of tax in the UK arising from financial manipulation in the private equity market. This also supports company law that suggests this support can be illegal if supplied directly.

Finally a review of tax residence rules and the rules with regard to controlled companies is suggested to develop strategies that prevent the avoidance of the taxation of capital gains arising on the sale of corporate assets located in the UK. This would, again, prevent the effective subsidy provided at present by the UK tax system to the private equity sector, which reduces its cost of capital and provides it with unfair competitive advantage effectively allowing it to acquire quoted companies at undervalue due to the tax relief the private equity sector enjoys.

It has been suggested that to tackle these issues is to risk the private equity market moving out of the UK. This is not true for the following reasons:

a. These activities are already not here for many purposes: they are paying little or no tax so the economic footprint they have here in terms of a return to society is already very low;
b. The companies they want to buy are here, and this will continue to be the case;
c. The support services they need are here and this will continue to be the case.

As such any change is not likely to be detrimental to the UK, the retention of profits here or on tax paid here.

In contrast the upside of the proposed changes is significant:

a. Some, and maybe significant amounts of, tax will be paid;
b. Taxation by concession will be stopped;
c. The UK will no longer be subsiding an activity that does not require state aid;
d. The effective assignment of significant amounts of UK taxation revenue for the benefit of those who are already amongst the wealthiest people in the world will be reduced;
e. Substantial distortions in the UK market for corporate executives will be eliminated, so cutting their rewards, and reducing a cause of significant friction and inequality in society;
f. The cost of capital of private equity companies will be increased, so reducing their competitive advantage. This will mean that:
    i. they compete more fairly with existing corporate finance structures which are proven, are accountable and relatively (when compared to offshore) transparent;
    ii. stability will be enhanced, which has not been proven to be the case and is inherently unlikely of private equity,
    iii. jobs and markets will be protected as a result.
g. The role of the City will be supported in the face of competition from offshore with the inherent threat that poses to the world financial and taxation regulatory environment.

For these reasons the actions proposed in this report are recommended to the Committee.

## 1. What private equity is

Private equity is the term now usually applied to a part of what is more generally called the venture capital market.

Venture capital was, until private equity began to predominate, the provision of funding, usually provided in the form of cash, to new, growth businesses. It is still the case that this type of venture capital fund usually invests in companies that are too risky for standard capital markets or bank loans. The funds used by venture capitalists are usually provided by wealthy investors, investment banks and other financial institutions. Because of the risk associated with these venture capital operations they have been offered tax reliefs and incentives with the intention of attracting capital to new businesses with high growth potential. The average investment by a venture capitalist in each company with which they are involved has tended to be small. For example, a limit of £15 million was set for Venture Capital Trusts (VCT) operating in the UK until 2007. A VCT is a specific investment vehicle established under taxation laws to attract targeted tax reliefs in the UK[2]. That limit has now been reduced by the Finance Act 2007 to £2 million under rules restricting unfair competition stipulated by the European Commission[3].

The private equity arm of this market has operated differently. The characteristic that most readily identifies it is that it raises its cash from private funds (although this is being challenged by recent flotations of major players in the USA). The resulting private equity funds then commonly acquire companies quoted on stock exchanges and take them private. In the process they will frequently take active control of the companies they acquire, changing management teams, the business model and its financial structure. The usual aim is to sell the company, either on a publicly quoted stock exchange or to another entity within three or four years of having taken control of the company. The objective is to make a substantial capital gain at the time of this sale.

The sums involved in this type of venture capital private equity operation are completely different from that dedicated to the venture capital market, behind which it has often sought shelter. In the UK the largest deal has been the buy-out of Alliance Boots plc by private equity operators KKR for £11.1 billion[4].

## 2. The private equity business model

Private equity funds tend to have a distinct business model, which is relatively simply to understand as it is generic, i.e. it does not change whatever the business at which it is targeted.

In the first instance a target company is identified. This is one which is considered to be underperforming its market potential. Reasons might be:

a. Weak management;
b. Difficult trading but with key underlying strengths;

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[2] See http://www.hmrc.gov.uk/guidance/vct.htm accessed 7-7-07
[3] See http://www.hm-treasury.gov.uk/media/3/4/bud07_completereport_1757.pdf paragraph 3.77 accessed 7-7-07
[4] http://www.telegraph.co.uk/money/main.jhtml?xml=/money/2007/04/24/bcnboots24.xml accessed 7-7-07

c. A balance sheet that does not reflect the value of underlying assets e.g. the company owns a strong property portfolio which is not fully reflected in the company's value.

The company is acquired by the venture capitalist through an open bid on a stock exchange. It is possible that activist hedge funds might now play a part on destabilising the company first. The acquisition will be funded in three ways:

a. A tiny proportion will be paid for out of the capital of the private equity fund being used to finance the deal. That private equity fund will very often be located in an offshore tax haven. The ownership of the acquired company will almost certainly be registered in such a location, for example Alliance Boots plc is now owned through Gibraltar[5];
b. A substantially larger part (maybe 1,000 times the amount paid for out of private equity capital) will be paid for out of loans funds provided by the investors in the private equity fund for its use, with interest due on this sum usually being rolled up for payment at the time profits are earned. The investors provided approximately £3.4 billion of the funds needed to acquire Alliance Boots plc in this way.
c. A substantial further part, usually significantly more than the funds provided by the investors in the scheme whether by way of capital or loan, will be paid for out of borrowed funds. This borrowing will usually be from a consortium of banks. As much as possible of this debt will be located offshore in low tax areas. Banks provided approximately £9 billion of the funding needed to acquire and finance Alliance Boots plc.

Once acquired the private equity operator will:

a. Strip assets out of the company e.g. sell off the property portfolio of the company to realise cash and repay loans used to acquire it at the first possible opportunity. That portfolio may well then be leased back to the company for its continued use, but this will add a cost it had not previously suffered;
b. To compensate for this other costs will usually be cut: the reduction in staff at Primera is a typical of this approach. There are few businesses where costs cannot be squeezed in the short term;
c. As much of the remaining debt arising on the purchase of the company as is possible is loaded onto the balance sheet of the

[5] Data from http://ir.allianceboots.com/allianceboots/storage/abscheme_may07.pdf accessed 9-7-07

company that has been acquired. This cannot be done directly or the company would be providing assistance to acquire its own shares, which is illegal, but the outcome can always be achieved through inter-company loans entered into after acquisition. The reason for this is straightforward. The UK has, subject to minor transfer pricing issues, allowed the deduction of all interest paid by a company as an offset against its profits so providing tax relief in full on such payments. The offset of interest against profits in the UK does, therefore, save tax at 30% in the UK. The receipt of that interest offshore in a place where it is not taxed on receipt turns the tax relief into a direct subsidy for the private equity fund acquiring the UK operation by permanently reducing its cost of capital. The AA, for example had almost £1.9 billion of bank debt on its balance sheet at 31 December 2006 leaving it technically insolvent by more than £200 million and a loss making enterprise. This is not a reflection of the business of the AA. The company made an operating profit of £223 million in 2006. The insolvency was because of the debt.

d. Sells the company as soon as profits increase (excluding interest charges). Not all the debts are usually sold with the company so that the new owner acquires the company either debt free or subject to a manageable debt burden. The debt not sold is repaid using the proceeds of sale.

From this analysis it is clear that the main ways of making money are:

a. Stripping profit out of the UK tax free through the payment of interest;
b. Selling assets that have been stripped of their value at a profit;
c. Manipulating the tax system for their benefit.

The net result is that the owners of quoted companies (mainly pension and life assurance companies) subsidise this industry by receiving too little for their assets at the time of original sale to the private equity fund, and then overpay to buy them back. This imposes a burden on ordinary people. In addition, UK tax is not paid because of the interest paid which guarantees this, but the owners of the debt receive those interest payments offshore tax free. This is a second subsidy from ordinary people in the UK to this industry.

There is a third subsidy inherent in this process of transferring wealth from the ordinary people of the UK to those either already wealthy, or offshore, or both. This is inherent in the taxation of what is called the 'carried interest' in private equity funds.

## 3. Carried interest

Private equity of the form being discussed here is described as follows in the memorandum agreed between the Inland Revenue (now HM Revenue & Customs) and the British Venture Capital Association dated 25 July 2003[6]. That described a private equity venture capital (VC) fund as involving:

> *investors contributing a small amount of capital to an English limited partnership and also agreeing to advance substantial additional amounts by way of interest-free loans to the partnership. This is because the limited partners are liable only up to their partnership capital and there is a prohibition on returning capital before winding up. The proportions of loan to capital contributed by investors will vary but the proportion represented by capital will often be less than 0.01% of the total investment.*

In addition to these investors there will be what are called "carried interest holders". These persons will work for the promoters of the venture capital fund, a typical promoter having many such funds. As the HMRC : BVCA agreement notes:

> *The carried interest holders will contribute capital so as to ensure that they have 20% of the total capital contributions such that, after repayment of the loans and the preferred return (see below), they become entitled to a 20% share in the net profits if the fund is successful. For example, in a fund of £100 million of investor money the investors might subscribe for capital of £10,000 and loan commitments of £99,990,000.*

It follows that in this structure the carried interest holders may subscribe just £2,500.

As the Agreement also notes:

> *The partnership will pay a priority profit share (often called the "management fee") to the general partner of, typically, 1.5%-2.5%p.a. of aggregate commitments. Typically the general partner will pay much of this to a management company or advisory company, who will use it to pay operating expenses such as salaries, rent etc.*

[6] http://www.hmrc.gov.uk/shareschemes/bvca_and_fb2003_carried_interest.pdf accessed 12-7-07

That "general partner" will be the employer of those holding the "carried interest". The rewards of the private equity partnership are split so that:

a. The loans provided by investors are repaid first;
b. Interest is then paid on the loan capital provided by the investors, usually at an above average rate;
c. Only then is profit distributed. This will be distributed to ensure that the rewards are paid in total 80% to the investors and 20% to those holding a carried interest in the partnership.
d. Typically private equity funds are earning rates of return substantially in excess of interest rates and as such there has been substantial profit to distribute to the carried interest holders. This is, in effect a transfer of assets offshore from out of the UK tax net to the untaxed offshore world, with the cost being borne by shareholders in the companies that are asset stripped during this process and by the UK Treasury. Ordinary people lose out either way.

## 4. The tax issues

There are three major tax issues of concern in the operation of private equity funds:

a. The taxation of the capital gains arising in these funds when the assets they own are all registered offshore and as such are not subject to tax on capital gains on sale in this country when sold even though all or most of the underlying business that gives rise to that gain takes place here and the fund might for most purposes be managed in the UK;
b. The tax relief on the interest deducted from tax relief on profits earned in the UK, which interest was incurred to allow the private equity fund to buy the company that generated those profits and not in the course of its trade;
c. The taxation of the carried interest of the general partners in the private equity funds.

This requires in turn consideration of the following issues:

a. How the residence of a company is determined so that the capital gains it earns are taxed appropriately;
b. When interest relief should be given for taxation purposes;
c. How the income attributable to the carried interests of general partners in private equity funds should be taxed.

The options available with regard to each of these issues are considered next before an approach for their appraisal in the context of private equity is suggested and a resulting policy outlined.

## 5. Taxation of capital gains

Companies are not liable to capital gains tax in the UK, this being a tax only charged on individuals, partnerships and trusts. A company does however pay corporation tax on its capital gains at its normal corporation tax rate.

Offshore locations such as Jersey and Guernsey, which are much favoured by private equity funds do not charge capital gains to tax, whether the person enjoying the gain is a company or individual.

There is as a result an obvious incentive for a private equity fund whose main profits will result from the making of capital gains to register the shares that they own offshore. The Alliance Boots example already noted, where Gibraltar has been used for this purpose, might be seen as typical.

At present the only way to make a company with offshore gains arising on the sale of assets located in the UK (and UK shares are located in the UK under tax rules) subject to UK tax is to challenge the residence of the company. A company's residence is broadly determined in the UK by:

b. Where it is incorporated;
c. Where its central management and control is.

If a company is incorporated in the UK it is resident here. If its central management and control is here it is resident here even if it is incorporated elsewhere.

Most private equity operations have many offshore subsidiaries. These entities may well be wholly owned by the UK parent operation, or a parent operation located in another major country, but rigorous care will be taken to suggest that they are not resident in the UK but are located in a tax haven (which need not, just to confuse matters, be that in which they are incorporated). This offshore residence is proved by the holding of board meetings and the approval of board minutes in the location where residence is claimed to be and by nothing else. The logic is that if a board meeting takes place in a location on a regular basis then that must be where the central decision making of a company is located.

This might have been true in the 1920s when, in the age of the steam ship travel was slow and the location of a meeting was hard to shift without considerable effort. In the 21st century the retention of this rule is a matter of farce. Four flights from London have arrived in Jersey before 10.30 on any weekday morning. Most will return shortly afterwards. It is possible to arrive in Jersey during the morning and be back in London for lunch. What this means is simple. It is now possible to claim that a company is resident in somewhere like Jersey when in fact all the decisions with regard to that company are actually taken in the UK, with the paperwork for a meeting simply being shipped with the directors on a plane to Jersey airport where the documents are signed in front of a local lawyer who provides the evidence of the participants presence before they get on the next flight back to London, all for the sole purpose of avoiding UK tax.

This is so easy as a form of abuse that it must be stopped. The UK is losing large sums of tax on capital gains as a result. None of the current anti-avoidance rules on shifting profits ashore e.g. that on controlled foreign companies, adequately tackle this issue as they consider issues relating to income, not gains.

## 6. Deduction of interest

The UK has what HM Revenue & Customs call a "generous regime for relief of interest."[7] This is undoubtedly true. Generosity has, to date, broadly meant that interest paid has been relieved without questions asked. If proposals in a consultation document issued in June 2007 are adopted restriction on the amount of interest claimed by UK members of a multinational group by reference to the group's total consolidated finance costs may be introduced[8]. However, the proposal is that:

> *interest claimed by the UK members of a multi-national group should be restricted by reference to the group's total consolidated external finance costs1. In the Government's view, if the UK sub-group has higher actual finance costs than the entire group's overall external*

[7] http://customs.hmrc.gov.uk/channelsPortalWebApp/downloadFile?contentID=HMCE_PROD1_027592 paragraph 1.8 accessed 12-7-07

[8] http://www.pwc.com/extweb/insights.nsf/docid/444919BABD7DB1008025730200417353 accessed 12-7-07

*finance costs, this strongly indicates that the UK sub-group's finance costs are not commercial*[9].

In principle this might appear to deal with the issue in adequate fashion, but this would be only be true if it was the UK company alone that was heavily geared with regard to borrowing. If the group as a whole was geared or the group only worked in the UK (as, for example, in the case of some of the retail focussed private equity buyouts and the AA) then there would be no resulting restriction. As such this proposed rule change is not adequate to deal with the private equity environment and further consideration needs to be given to this area.

## 7. Carried interest

The issue with regard to carried interest is relatively simple. It is whether the income attributable to the carried interest should be taxed as a capital gain or as income.

As the BVCA memorandum noted above makes clear, the amount of capital contributed by the general partners who enjoy the benefit of the carried interest is tiny, usually being much less than 0.1% of the total funds used in a deal and of purely notional value in relation to the returns usually paid on this investment. As such there is widespread belief that this return does not represent a capital return, but is income, and should be subject to income tax. Indeed, but for the BVCA agreement that would be the situation, and this would leave participants in private equity funds in the same situation as many employees (including their rivals in quoted companies) who pay income tax on the value of their share options.

The strength of this opinion is reflected in an article in the Financial Times on 12th July 2007[10] in which it was reported that:

> ***Tax change on carried interest proposed***
>
> *By Krishna Guha in Washington*
>
> *Published: July 12 2007 02:36 | Last updated: July 12 2007 02:36*

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9 http://customs.hmrc.gov.uk/channelsPortalWebApp/downloadFile?contentID=HMCE_PROD1_027592 paragraph 5.7 accessed 12-7-07

10 http://www.ft.com/cms/s/47886aea-2fff-11dc-a68f-0000779fd2ac,_i_nbePage=1c573392-3015-11da-ba9f-00000e2511c8.html accessed 12-7-07

*Most experts believe that the carried interest paid to general partners in private equity firms and hedge funds should be viewed at least in part as income that should be subject to income tax, Peter Orszag, director of the US Congressional Budget Office said on Wednesday.*

*The CBO analysis comes amid growing political pressure in the US and Europe for changes in the tax treatment of carried interest, which is generally treated as capital gain rather than income, and typically taxed at a low rate.*

*Mr Orszag, a former adviser to President Bill Clinton, told Congress "most legal and economic analysis suggests that carried interest represents, at least in part, a form of performance-based compensation for services undertaken by the general partner".*

*He said most analysts agree that a general partner who manages a fund's investments has a different economic role to the fund's passive investors.*

*Most also agree that the carried interest paid to the general partner is not primarily based on a return to capital he or she puts at risk, he added.*

*"If the purpose of the preferential rate on long term capital gains is to encourage investors to put financial capital at risk, there is little reason for that preference to be made available to a general partner, whose risk involves his or her time and effort rather than financial capital," Mr Orszag said.*

*The CBO director highlighted three alternative ways of reforming the tax treatment of carried interest – all of which would lead to some or all of the payment being taxed as income.*

*First, carried interest could be viewed as an option on future profits, valued according to an option pricing model and taxed as income at the time the right to it is awarded.*

*Second, it could be viewed as a fee for management services and taxed as income at the time it is paid out.*

*Third, it could be viewed as the return on an interest-free loan made to the general partner by the passive investors in the fund. In this* *case the general partner would pay income tax on the benefit represented by the lack of interest payments on the loan, but capital gains tax on any subsequent profit.*

*Mr Orszag warned that as long as there was a difference between the tax rate on income and capital gains people will try to turn income into capital gain, as defined by tax law.*

None of these options consider taxing the benefit as a gain. Nor should anyone in the UK consider that as an option. If good taxes align the economics of a transaction with the tax charge upon them (and that is now generally considered to be the case) then the only possible option for taxing the income paid to those owning the carried interest in private equity funds is to charge them to income tax.

## 8. Reasons for change

To date the analysis that has been offered on these tax issues in the press in particular appears to have focussed upon the wrong issues. The consideration has been of the outcomes resulting from these taxation treatments. In particular analysis has focussed on the obvious, and widely acknowledged injustice of many holders of carried interests paying tax at lower rates than the cleaners they employ in their offices[11]. The other significant taxation issues have not been properly considered. They would be the principal issues however if the private equity taxation was considered in its proper context.

The proper context is that the three tax abuses noted provide private equity firms with opportunity to access markets which other market operators are effectively denied and as such an unlevel playing field has been created in the capital finance markets that can be exploited by the private equity industry to its advantage, and at cost to the efficiency of the financial markets as a whole and to the particular companies that suffer the attentions of this sector in particular.

The reason for tackling these issues is in part one of tackling social injustice. The importance of that is acknowledged and supported by the paper. But the real reason for change is the eradication of inappropriate incentives within the market system that are distorting that financial system in the UK to the detriment of the City of London and other key elements of the financial services sector.

[11] http://www.thisismoney.co.uk/news/article.html?in_article_id=420989&in_page_id=2 accessed 12-7-07

## 9. The three injustices

The three injustices that are occurring are as follows:

### a. Capital gains

The benefit of this relief is significant. In the UK capital gains are treated as profits when made by companies and are rarely taxed at 30% for a wide variety of reasons. My own comprehensive research of tax paid by FTSE companies in the period 2000 to 2004 showed that an average tax rate of around 22% might be expected, or a little less after allowing for reliefs on reinvestment now available in some cases[12].

Private equity funds may well pay no tax on their capital gains as they are recorded offshore and are probably retained offshore[13].

Supposing that the tax rate is only 20% this still has a significant impact. If a gain of, say £100 million is made, the net worth if made by a UK company would be about £80 million after tax for its shareholders. The worth if earned by an offshore private equity fund would be up to £100 million. This is a rate of return 25% higher than that of the UK quoted company.

This depresses the relative value of the UK company and inflates that of the offshore fund. Alternatively, it means that a person able to manipulate these offshore benefits (as many wealthy individuals can) will prefer to provide funds to a private equity fund than the UK stock market, because the return on the latter may be 20% lower than that in the private equity fund. This has the resulting effect that the cost of raising funds for the private equity fund is lower than that for an onshore quoted company putting the latter, which are at the centre of the London financial markets, at a competitive disadvantage.

The result is twofold. The incentive to asset strip, which is the business model of the privet equity fund, is high. Second, the ability of the City based company with a long term track record of management to fend off this attack is significantly reduced. This is harmful at almost every level to the UK. The unfair access the tax

[12] http://www.taxjustice.net/cms/upload/pdf/Mind_the_Tax_Gap_-_final_-_15_Jan_2006.pdf accessed 12-2-07
[13] http://www.taxjustice.net/cms/upload/pdf/Price_of_Offshore.pdf accessed 12-7-07 shows that at least 30% of the wealth of high net worth individuals is maintained offshore, largely or entirely tax free.

system gives to private equity does in consequence cause widespread harm. It is for this reason that the abuse needs to be tackled.

## b. Interest

There would be little cause for concern if the interest paid were received by a UK bank or UK individuals. That is because they would pay tax upon the receipt of these funds. But as the industry has itself acknowledged, that is not always the case. Indeed, it may well be the case that interest is rarely paid in this way. The reasons are twofold:

i. Some of that interest will be paid on an intra-group basis to the parent company that owns shares in the UK operating subsidiary that was formerly the quoted company. The parent company will, as has been noted above, be located offshore. As such there is almost automatically leakage in this respect as many such parent companies are either not taxed offshore (for example, the Isle of Man now has 0% corporation tax rates and Jersey and Guernsey are fast moving that way) or they can negotiate their own tax rates at will with the governments of the countries in which they are located;
ii. The funds may be loaned by offshore banks that can usually retain the benefit of untaxed income received offshore for very long periods without prejudicing their ability to pay dividends.

In combination this means that the offset of the interest against profit in the UK often completely eliminates a UK tax charge (as is for example almost entirely the case for the AA) with the result that this interest payment is effectively uplifted in value by 30% as a consequence of the one sided tax treatment it enjoys, the uplift being provided entirely by the UK Exchequer for the benefit of the owners of the offshore private equity fund.

To put this in context an example is needed. Suppose that a company makes a pre-tax and interest profit of £100 million. The UK tax rate is 30%. In that case logically if no interest is paid a dividend of £70 million can be paid to shareholders.

Now suppose £100 million of interest is paid, but to UK recipients. No tax is now paid by the company paying the interest but if the recipient is a bank tax will be paid at 30% and if the recipient is an individual the rate may be 40%. The net return to someone (if not the shareholders) will be between £60 million and £70 million. There has been no effective leakage from the UK economy.

Now suppose the interest is paid offshore to people who can keep the interest untaxed in that location. In that case there is no tax paid in the UK, but £100 million is received offshore with no tax due. In other words, the net benefit received from the company is now £100 million. Given that UK profits can be remitted in this way to offshore holding companies the result is that the effective loss of tax paid in the UK is transferred for the benefit of the investors in the private equity fund who own the offshore company that receives the interest. This effectively increases their return from £70 million to £100 million, an increase of 41% (calculated as 100/70 – 1). This again improves the rate of return for private equity over that available for conventional UK based companies and so, as was the case with capital gains, tax rules provide advantages that reduce private equities cost of capital and so provides them with additional, cheaper funds with which to raid the UK stock markets for targets who cannot enjoy this advantage. The detriment is similar to that arising on capital gains both for the City of London and long established UK businesses and the jobs that they provide.

## c. Carried interest

The taxation treatment of carried interest also provides private equity with an unfair advantage when accessing the market for people who can run corporate enterprises. By increasing those persons likely net pay from about 60% of salary to maybe 90% of salary these funds can effectively increase the pay of their top employees by 50% without bearing any of that cost themselves. The Exchequer bears that cost in the form of unpaid tax.

This has two consequences:

i. Tax is lost to the State;
ii. The pay of all executives is driven relentlessly upward beyond any reasonable market limit so distorting rewards and increasing the wealth gap in society which causes substantial harm in the form of inflated house prices, dissatisfaction with average pay which most can only ever hope to enjoy, and

disparity of social advantage. This is exaggerated still further if some of those owning the carried interest are not domiciled[14].

In either case unfair access to the market has again been provided to the market.

In all these cases the unfair access to the market that private equity enjoys and which it exploits to provide it with a significant competitive edge comes as a result of tax subsidies provided by the UK government, whether it be through the failure of the government to collect tax on capital gains, or on the subsidy it provides by allowing the payment of excessive interest offshore at the same time as allowing that payment to cancel UK tax bills, or by allowing the under taxation of the UK income of those owning the carried interests in these funds.

What must be noted is that these actions do not just represent a loss of tax: they also represent what is in effect a state subsidy to a business of unproven worth to the UK economy which has no record of adding value within it. If this subsidy were to be paid directly in cash to an ailing business the furore in the City and financial press would be considerable: consider, for example that which arose when small subsidies were given when Rover crashed. Likewise that subsidy might give rise to objection from the European Commission on the grounds of creating unfair competition. Because, however, it arises as a result of manipulation of tax laws and not because of cash paid, even though the net effect is identical, protest has not been heard. This paper argues that it is time that it was.

## 10. Means of tackling the abuse

Each of these abuses can be tackled. It is important to deal with each separately and this is done in turn with the relative ease of remedy being the indicator of order:

### a. Carried interest

If the return paid to carried interest is not a capital return, and that is considered true by almost all commentators, there can be no reason for that return to be taxed as capital. It should therefore be taxed as income.

[14] For an explanation of the domicile rules see http://www.taxresearch.org.uk/Blog/2007/07/11/domicile/ accessed 12-7-07

If this return were taxed as income it would help limit abuse of the domicile rule by this industry (although that rule does in any event need separate and urgent attention).

No compromise by way of a special rate of capital gains taper relief makes sense for this sector. It does not need tax incentives. What is needed is that it be put on a level playing field with other business sectors, including in its ability to attract employees, a process for which it does not need the tax subsidy it is currently enjoying when the market rates of pay it provides are already out of all proportion to salaries enjoyed by most people.

In addition an end must be brought to the process by which these people enjoy taxation by concession and not by legislation. This is iniquitous and undermines the credibility of the whole tax system with there being an apparent system of taxation by negotiated regulation for one small and well paid part of society that is quite different to that imposed by legislation for the majority.

The grounds for compromise on any of these issues is small. There is no economic logic or need for such compromise. Nor can the need to support an ailing market be used as justification for the subsidy given.

### b. Interest

Because of the tiny amounts of capital employed by the private equity sector and the distortion to the balance sheets of the companies that they own that they can apply almost at will due to the limited regulation that companies in the private sector are subject to the application of current proposals for reform of tax relief on the payment of interest are unlikely for the reasons noted above to impact seriously upon this sector. That means an alternative is needed.

The most effective way of tackling this is to strengthen the UK's thin capitalisation rules. These are, effectively a way of ensuring that the gearing of a company is not excessive for tax purposes, so preventing too much tax relief being given. These rules are effectively imposed through transfer pricing regulations. These have been subject to recent challenge in the European Court of Justice, from which challenge the private equity market has benefited[15]. This trend needs to be reversed, the thin capitalisation rules need to be reinforced and strict interest cover rules need to be introduced meaning that tax relief for the whole of operating profit is not available so that tax charges cannot be deducted in full.

Germany and France have such rules and negotiation of this outcome at a European level would be possible if the UK were to more fully interact with the EU on taxation issues.

In addition urgent consideration should be given to the disallowance of interest charges incurred as a result of loan obligations assumed by a UK company directly or indirectly as a consequence of a third party acquiring its shares. This reflects the principle of providing tax relief only for expenses incurred in the course of a trade which still underpins much of UK and European tax thinking but which is breached with regard to interest payments at present. These loans are not incurred for that purpose, having instead being accepted for the purpose of assisting a person to acquire the trade of the company, which is a quite separate and distinct endeavour. Such a change would also reflect the principle inherent in UK company law that a company should be barred from using its own assets to assist a third party to acquire its own shares, this rule being considered an essential protection for creditors and other stakeholders of the company. This protection is sorely absent in the case of private equity operations at this time and needs to be restored, using tax as a measure to do so if necessary.

### c. Capital gains

Companies have the right to incorporate where they like under EU law. This cannot be restricted. However, the right to collect tax in situations where a structure is adopted solely or mainly to secure a tax advantage has now been recognised by the European Court of Justice[16] but this has as yet not been considered in the context of the

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[15] See for example http://www.kpmg.co.uk/news/detail.cfm?pr=2561 where it was said by KPMG in 2006 as a result of an ECJ decision: "Although the UK thin cap rules employ an arm's length test, in practice, HMRC often applies and sticks rigidly to 'rule of thumb' tests of a 1:1 debt:equity ratio and 3:1 interest cover which relate back to some guidance issued in 1995 as if they were de facto fixed ratios. If the ECJ follows the AG's Opinion, it will strengthen the taxpayer's hand. This will be particularly welcomed by industries such as private equity where high gearing is normal."

[16] See, for example, commentary in http://www.internationaltaxreview.com/?Page=10&PUBID=35&ISS=21603&SID=622016&TYPE=20 accessed 12-7-07

taxation of capital gains in companies. Whilst the definition of what is and is not a controlled company is now under review in UK company law[17], a more extensive review is now needed to consider the ways and means by which capital gains earned on assets located in the UK but which have been artificially relocated outside the UK tax net might become charged to UK tax.

This is not the time and place to review possible changes to residence rules or the introduction of what would, in effect, be controlled company rules with regard to capital gains. Both possibilities do, however need future review by the UK Treasury and the Treasury Select Committee if this issue is to be resolved and the abuse of UK markets is to be prevented.

## 11. The consequences of action

It has been suggested that to tackle these issues is to risk the private equity market moving out of the UK. This is not true for the following reasons:

a. These activities are already not here for many purposes: they are paying little or no tax so the economic footprint they have here in terms of a return to society is already very low;
b. The companies they want to buy are here, and this will continue to be the case;
c. The support services they need are here and this will continue to be the case.

As such any change is not likely to be detrimental to the UK, the retention of profits here or on tax paid here.

In contrast the upside of the proposed changes is significant:

a. Some, and maybe significant amounts of, tax will be paid;
b. Taxation by concession will be stopped;
c. The UK will no longer be subsiding an activity that does not require state aid;
d. The effective assignment of significant amounts of UK taxation revenue for the benefit of those who are already amongst the wealthiest people in the world will be reduced;

[17] See http://www.hm-treasury.gov.uk/media/E/B/consult_foreign_profits210607.pdf paragraph 4.1 accessed 12-7-07

e. Substantial distortions in the UK market for corporate executives will be eliminated, so cutting their rewards, and reducing a cause of significant friction and inequality in society;
f. The cost of capital of private equity companies will be increased, so reducing their competitive advantage. This will mean that:
    i. they compete more fairly with existing corporate finance structures which are proven, are accountable and relatively (when compared to offshore) transparent;
    ii. stability will be enhanced, which has not been proven to be the case and is inherently unlikely of private equity,
    iii. jobs and markets will be protected as a result.
g. The role of the City will be supported in the face of competition from offshore with the inherent threat that poses to the world financial and taxation regulatory environment.

For these reasons the actions proposed in this report are recommended to the Committee.