



DAUDS ADVISORY

The private equity debate : Tax

Cornwell Dauds

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Introduction

1. While it is often acknowledged that private equity transactions can contribute to economic growth in various ways, the tax benefits enjoyed by private equity fund managers sometimes come under attack. And, the question that often arises is whether the tax law that permits this favourable treatment should be reformed.

The way private equity funds operate

2. Private equity funds are often set up as partnerships which in turn comprise a number of investors, mostly institutional, such as pension funds, for example. If set up offshore, the fund will typically be organised as a limited liability partnership (LLP) and, if set up onshore, it is legally known as an *en commandite* partnership. Often the limited partnership will have a general partner (GP) who is responsible for the management of the affairs of the partnership. The GP is rarely an individual – in fact, in most cases it is itself a partnership consisting of a number

of individual partners. Alternatively, the funds of the partnership (the investors) may be managed by an investment management company (though this may be unwise as the same profits will be taxed twice – when they are earned and again when they are distributed). The brief of the GP or investment management company typically includes the identification, evaluation and negotiation of investment opportunities, and the monitoring and realisation of those investments on behalf of the fund. For this the GP or management company earns a management fee - typically 2% of the fund value.

3. To align the interests of the fund manager with those of the investors, the GP or investment management company may be required to co-invest with the investors in the fund. This requisite co-investment is typically as little as 1 - 2% of the total capital in the fund. In return, the fund manager usually becomes entitled to up to 20% of the total growth of the fund. However, 18 – 19% of this entitlement (the 20% of fund growth) is only triggered once the fund manager has achieved a certain agreed level of performance and the ordinary investors have received their specified return. Since the fund manager only contributes 1 – 2% of the fund's capital, yet gets a 20% share of fund growth, 18 – 19% constitutes what is often referred to as “carried interests” (the carry).
4. The fund manager does not receive the carried interests in return for any corresponding capital contribution. Rather, the carry is based solely on the fund manager's performance which – in several jurisdictions – enjoy favourable tax treatment in that it has attracted tax at the lower capital gains tax (CGT) rate instead of the higher normal rates for individuals. Fund managers often organise themselves into partnerships so that the carry is taxed in their hands as individuals at the effective CGT rate of 10%. This favourable tax treatment has unleashed vigorous debate worldwide with commentators taking very strong positions on both sides of the spectrum.

Is the carried interest private equity fund managers earn capital or revenue?

5. There appears to be agreement that the growth in the investment of the ordinary investors represents a capital gain and should be taxed in accordance with CGT rates since the shares purchased on behalf of these investors are typically held as capital assets. However, it is contended by some commentators that when 18 – 19% of these shares – which in many instances had appreciated substantially in value – are transferred from the investors to the fund manager as reward for the latter’s performance, the shares change character and become ordinary income in the hands of the fund manager and should accordingly be taxed as such. This treatment is supposedly supported by the argument that the shares, held as capital by the investors, actually represent compensation for services rendered by the fund manager, more specifically, they (the shares) represent performance fees.
6. A counter-argument is that these shares should not change character when they flow from the investors to the fund manager – even if the fund manager provided services rather than capital in exchange for the appreciated shares. To do so would, according to the counter-argument, amount to imposing an artificial re-characterisation on the shares. What was capital in the hands of the investors should remain capital in the hands of the fund manager, unless the latter clearly makes the decision to acquire and hold the share as trading stock (which points to income).

The use of debt in private equity deals

7. The interest on debt is, under most tax laws, an allowable expense and therefore deductible. Private equity deals have tended to involve a significant amount of debt. The deductibility of interest payments in these deals is often attacked by governments who often make it clear that they believe that some private equity deals, especially highly leveraged buy-outs, have the potential to undermine the

tax system.