June 2010

Tax

A disappointing budget for private equity

The Chancellor announced in the Emergency Budget that capital gains tax will rise to 28% for higher rate and 50% income tax payers. This is not as great an increase as had been feared but the promised safeguards for "entrepreneurial business activities" will be of little help to carried interest investors or for private equity managers with shareholdings of less than 5%.

Announcements

The main announcements affecting private equity in the June 2010 emergency budget were:

- An increase in the rate of capital gains tax to 28% for higher rate and 50% income tax payers for disposals on or after 23 June
- An increase in the lifetime limit for capital gains tax entrepreneurs' relief (which effectively reduces the rate of tax to 10%) from £2 million to £5 million of gains
- 1% employer's and employees’ National Insurance Contributions (NICs) increases to go ahead but with threshold increases and a greater income tax personal allowance to protect lower earners
- A staged reduction in the rate of corporation tax to 24% by 2014

Implications for managers

Managers investing in shares in the private equity backed companies in which they are employed were subject to tax before 23 June at 18% on any gains they made on those shares but were able to claim entrepreneurs’ relief on up to £2 million lifetime gains if they owned at least 5% of the ordinary share capital and voting rights in the company and satisfied various other conditions. The effect of entrepreneurs' relief is to reduce the effective tax rate to 10%.

Although the rate of capital gains tax will increase to 28% for disposals of such shares on or after 23 June, entrepreneurs' relief will still be available for those owning at least 5% of the ordinary share capital or voting rights. In fact entrepreneurs’ relief will be more generous with the lifetime limit being increased to £5 million of gains.

This is good news for managers owning over 5% of the share capital who will continue to pay tax at 10% on their gains and will be able to get more gains into the 10% rate. However, managers owning less than 5% of the ordinary shares and voting rights will see an increase in their tax liability from 18% to 28%. The change therefore increases the disparity in tax rates for these two groups.

In addition managers are likely to suffer increased NICs on their salaries as a result of the 1% increase in employer’s NICs which will take effect from April 2011.

Implications for carried interest investors

The private equity industry had been hoping that the safeguards for entrepreneurs promised in the coalition agreement would extend to carried interest – the share of profits employees of private equity firms receive from successful investments. There was a concern that if carried interest investments were taxed at 40% or 50% this would drive private equity houses offshore.

The 28% increase in the rate of capital gains tax is not as bad as feared, but the industry will be disappointed that carried interest still does not qualify for the most favourable 10% rate of capital gains tax because executives are unlikely to be able to claim entrepreneurs’ relief as, in most cases, they will not own at least 5% of the ordinary share capital and voting rights.

The Budget confirms that a consultation will be undertaken on the tax treatment of employment-related shares and continued on reverse
securities offered under geared growth and similar arrangements. This was previously announced in the March 2010 Budget. It is still not entirely clear what arrangements will be affected by this review but there is a risk that it will cover carried interest investments. This will be a concern for private equity executives as taxing carry as income would bring in the 50% tax rate and an NIC cost.

In addition private equity executives are likely to suffer increased NICs on their salaries as a result of the 1% increase in employer’s NICs which will take effect from April 2011.

Implications for private equity houses

Although the trailed increase in capital gains tax is not as great as feared, private equity houses will be concerned that the return for their executives from carried interest investments will be reduced as a result of the increase in tax from 18% to 28% (especially as before April 2008 these investments qualified for business asset taper relief and were therefore effectively taxed at 10%).

The 1% increase in the rate of employer’s NICs from April 2011 will be a further increase in costs for private equity houses as although the increase in NIC thresholds eliminates the increase for lower paid employees, it will result in a real cost for employers of higher paid employees.

Implications for Newco

The reduction in the rate of corporation tax (ultimately to 24% by 2014) will be welcomed. However the most welcome news is that this will not be paid for by further restrictions on interest deductibility.

The rate of capital allowances for most plant and machinery will reduce from 20% to 18% from April 2012 but for most private equity owned companies this will not be a major concern and will be offset by the reduction in the rate of corporation tax.

The increase in the rate of VAT to 20% from 4 January 2011 will be a concern for private equity controlled companies in the retail industry who will either have to increase their prices to cover the increase in VAT or accept a reduction in profit margins if they absorb the increase.

Conclusion

Overall therefore the budget is not particularly good news for private equity but not as bad as it could have been had CGT been raised to 40% (or even 50%).