Editor's note: Although Amin is a member of UKSA's Policy Team, he writes for The Private Investor in a personal capacity. He is a retired PricewaterhouseCoopers tax partner.

How private equity executives pay less tax on their earnings than the rest of us

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While it is always a mistake to look for logic in tax law (to paraphrase Donald Trump, "Tax law is what it is"), there are some general principles seen most of the time. For example:

- What you earn by actively doing things, whether blue collar work or white collar work, is subject to income tax, with rates currently running from 20% to 45%.
- When things that you own go up in value and you make a gain from selling them, that gain is subject to capital gains tax, with the rates being 10% or 20%. (The higher rates which apply to gains on residential property are not relevant for this article.)

When you work as a private equity executive, you do the same white collar work as many of us: reading things, attending meetings, writing reports, making phone calls, writing emails etc.

So how do you manage to pay tax on much of what you earn at capital gains tax rates instead of income tax rates?

I have set out a simplified illustration below. In practice, private equity funds usually have very complex organisation charts. I have ignored that to make the principles easier to understand.

A private equity fund is normally structured as a limited partnership:

- The limited partners are outside investors who supply most of the capital.
- The general partner is typically a company owned by the private equity house that has sponsored the fund. It normally provides some capital to the fund, but not necessarily very much.

The general partner is typically entitled to make two charges to the fund:

- An annual management fee of, say, 2% of the size of the fund.
- A participation charge, called "carried interest", whereby once the fund has achieved a specified overall rate of return, say 10% per annum, the channel partner is entitled to, say, 25% of the excess return.

The income from the annual management fee is used by the general partner to pay for the running costs of the private equity house. This includes the salaries of the employees who are the key deal makers. These salaries suffer regular income tax.

The key deal-making employees normally also have fractional ownership stakes in the general partner company, either directly or indirectly.

When the fund is eventually closed out at the end of its life, assuming it has been successful, on the above numbers 25% of the excess return of the fund will be in the form of cash inside the general partner.

When the general partner is wound up, the key deal-making employees will make gains on their shares since the general partner company is liquidated and the cash inside it is paid out.

The key question is what rate of tax should apply to the gain made on this liquidation.

There are many complicated rules in UK tax law applicable to shares which have some connection with your employment. These rules normally have the effect of taxing gains on such shares as ordinary income, where the top rate of income tax in the UK is 45% as stated above.

However, in the case of private equity and carried interest, UK tax law allows such gains to be taxed at the normal capital gains tax rate. That capital gains tax rate is currently 20% for higher rate taxpayers.

Accordingly, the continuation of this favourable tax treatment of carried interest, taxation at 20% instead of 45% at top rates, is of great importance to the private equity industry in the UK.

Their threat is that if the UK eliminates this favourable tax treatment, they will emigrate, just as sports stars tend to emigrate once they become successful. Whether or not they are bluffing is a political question which I cannot answer.