

Carried interest: Whose ox is getting gored?

The burden will fall on venture capital and leveraged-buyout funds, not hedge funds

By Robert N. Gordon

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Managers of private investment partnerships usually get paid both a base management fee and a performance fee. Many times, the performance fee isn't paid in cash, but is instead paid to the manager as an allocation of profits. This method of payment can carry a possible tax benefit to both the manager and the individual investors in the fund.

Current proposals before Congress, however, would reduce any possible tax benefit that money managers might enjoy come 2011. The proposals have been bouncing around for a few years but are expected to get enacted this time.

The proposals shouldn't directly affect investors in a pooled investment partnership or corporate money managers, since corporations get no tax break for long-term capital gains. But they could affect investors indirectly, and here is how.

Investors' fees paid in cash are treated as "miscellaneous itemized deductions," and many investors get no benefit from such deductions. This is the case for the base management fee, which can result in investors' paying tax on more income than they actually realize.

Alternatively, performance fees can be paid as a "carried interest" in the entity. Adjustments in an investor's capital accounts made to compensate for a performance fee create no immediate deductions but instead lower the profit realized from the investment partnership.

Investment managers can possibly benefit by taking an allocation of profits, depending on the tax nature of any profits that the partnership realizes. As an example, if a fund

were to realize only interest income, a manager taking a carried interest would realize their performance fee as interest income.

The tax nature of the fee retains the form that the income was recognized in. For example, long-term capital gains are taxed at a rate less than half of that at which a cash fee is taxed — and that is what Congress dislikes about the existing benefit.

In its place, the proposals would re-characterize a proportion of the carried-interest long-term capital gains as ordinary income. The proposed changes also would deny capital gains treatment to the manager on the sale of the management entity if the manager ever received any tax benefits from the flow-through nature of the carried-interest rules.

Most hedge funds realize short-term gains and interest, so there would be little benefit to those managers. The proposed legislation, therefore, would create no negative effects on these managers' tax bills.

If, however, a pooled-investment partnership invested for long-term gains, there could be quite a reduction in the manager's tax bill.

Venture capital partnerships, leveraged-buyout funds and real estate partnerships historically have captured long-term gains. The taxes of the managers of these funds could be most affected.

Managed-futures managers who take an allocation of profits versus cash fees can also be hurt from this change in law because futures are taxed as IRC Section 1256 contracts where 60% of any gains are taxed as long term and could flow through as such.

If managers abandoned the carried-interest method in reaction to the new law, investors would have to start worrying if they could use miscellaneous itemized deductions. If they couldn't, the phantom-income problem would expand to include not just the base management fee but also any performance fee, which could easily overshadow the base management fee.

It isn't clear as to how the investor would treat a carried-interest performance fee that the legislation dictated to be ordinary income in the hands of the manager. It is feared that if the income is now ordinary taxable income to the manager, perhaps it should be a deduction to the investor at the time of payment.

If these deductions weren't limited by the miscellaneous itemized-deduction rules, this could be great news. For many, it could be a good reason to exit the partnerships.

Further, if the managers of these funds could no longer enjoy the benefits of long-term gains, their trading strategies might change, reflecting the equal tax treatment of gains, regardless of their duration. The possible tax benefit to investors of having a manager who used carried interest is that doing so would align the interests of the manager and the investor.

It is quite possible that Congress' two-pronged proposals will scare a few managers away from using carried interest, and that may wind up affecting investors' after-tax bottom line.

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