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Another side of the carried-interest debate

Changes being mulled in Congress would affect taxes paid by fund investors, as well as managers

By Robert N. Gordon | March 24, 2013 - 12:01 am EST

Most of the debate over carried interest focuses on whether managers of hedge funds, leveraged-buyout funds, venture capital funds and other private investment partnerships are paying their fair share of taxes.

But if Congress changes the carried-interest rules, they could affect investors in these funds, as well.

Managers of these funds usually get paid both a base management fee and a performance fee. The performance fee is a percentage of the profits earned by the fund.

Many times, the performance fee isn't paid in cash but instead is paid to the manager as an allocation of profits, a “carried interest.” This method of payment can carry a possible tax benefit both to the manager and indirectly to the individual investors in the fund.

If a manager receives performance fees in cash, the taxable income from that activity would be taxed to the manager at his or her highest marginal tax rate on ordinary income, up to 39.6%. If a manager instead takes his or her performance fees as an allocation of profits, the taxable nature of the income realized by the fund is passed through to the manager.

If the fund earned all long-term capital gains, all the manager's income from performance fees would be taxed instead at long-term gains rates, or 23.8%.

Investment management fees paid by individuals are miscellaneous itemized deductions. Many high-income taxpayers can't deduct miscellaneous itemized deductions.

This is the case with any managed account, as well as for investment partnerships. It applies both to the base management fee and to any performance fees paid, not allocated.

The problem isn't present in funds that have enough portfolio turnover to qualify as “traders” instead of being taxed as “investors.”

There is nothing anyone can do about the base fee being a “useless” deduction. However, if the performance fee is a carried interest, then it is thought that the cost of the performance fees are no longer miscellaneous itemized deductions.

Instead, these allocations lower the taxable income flowing through from the fund to the investor. Thus the manager's choice of a carried interest instead of a cash fee also helps investors.

So what are the ramifications if Congress finally passes carried-interest legislation?

The increased tax burden will fall most heavily on managers of partnerships whose profits are composed chiefly of long-term capital gains. Their tax rate would go from 23.8% to 39.6%, up from last year's 15%.

The effect on a hedge fund manager's tax bill would depend on the taxable nature of the income the fund earns. The 3.8% Medicare tax is imposed only on investment income, not on ordinary income.

Performance fees that a manager receives in cash are taxed at 39.6%. Performance fees earned on short-term gains allocated through a carried interest are taxed at 43.4%.

One Big Four accounting firm has suggested that managers of “investor” hedge funds consider giving up carried interest to avoid the 3.8% tax and not bother waiting to see what happens in Washington.

If the income of a fund is predominantly interest and short-term gains, we would agree with that logic. Why should the manager pay 43.4% instead of 39.6%?

If carried-interest legislation is passed, it might make sense for all investment partnerships to go to a cash fee. The problem created is that the investor could wind up with more “useless” miscellaneous itemized deductions stemming from a cash performance fee and a tax bill on phantom profits.

Hedge funds that trade enough to be classified as “traders” have been spared the phantom income inequality because they are allowed to deduct the fees before calculating taxable income. A lot rides on whether a fund is a “trader” or an “investor,” and thus this issue belongs in the due-diligence questionnaire of any taxable-hedge-fund investor.

The 3.8% Medicare tax is meant to be applied only to net investment income. There would be major inequitable distortions if taxpayers, especially rapid-turnover traders, had to pay 3.8% on their gross gains instead of their net gains.

But if you work your way through the proposed regulations implementing the Medicare tax, that is exactly what would happen to investors in a “trader” fund. It seems that there is nowhere to hide.

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