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Helping Clients Understand Carried Interest

BY **ROBERT GORDON** October 28, 2015

Presidential candidates Hillary Clinton, Jeb Bush and Donald Trump have declared a dislike of carried interest, which they condemn as a means for allowing hedge fund managers to pay very little in taxes.

The legislative movement to close this so-called loophole has been going on for years; congressional proposals date back as early as 2007.

President Obama has tried to change the carried interest rules in every budget he has proposed.

Your clients may be asking you what all the political noise is about. You should explain that, in reality, hedge fund managers probably enjoy few tax savings from carried interest; it is actually the private equity and venture firms that traditionally have reaped the most tax benefit.

Most partnerships (sometimes these vehicles are LLCs) charge a base management fee and a performance fee to their clients.

The management fee is usually paid in cash from the partnership to the manager. The manager takes in this money as ordinary income taxed at the highest rate for ordinary income, 39.6%.

For the clients, the base management fee (which they see on their K1s) is a miscellaneous itemized deduction.

WORST OF BOTH WORLDS

In this way, investment management fees can create phantom income. A 2% base management fee thus is taxed at the highest rate to the manager and is not deductible to the client; this is the worst of both worlds.

When partnerships also charge a performance fee, the manager can set up the fund to be paid either in cash or as an allocation of profits — a carried interest. A cash performance fee would be taxed to the manager as ordinary income, just like the base management fee. A cash performance fee would also be a miscellaneous itemized deduction for the clients, creating even more phantom income. Again, the worst of both worlds.

THE RIGHT STRATEGY

If, instead, the manager waives his right to getting paid yearly in cash, these costs will not be miscellaneous deductions to the clients.

What the candidates don’t like is that, if the manager does not take a cash performance fee, the manager’s performance fee income will be taxed in the same manner as a client in the fund would have been taxed.

If the fund has all short-term gains, then the carried interest performance fee income will then be taxed as short-term gains as well.

If the fund has lots of long-term gains, then the carried interest performance fee is taxed as such.

There are many hedge funds that invest in short-term trading strategies or debt instruments. The managers of these types of hedge funds enjoy no benefit from carried interest (although their clients still do).

MORE USELESS DEDUCTIONS

A cash performance fee would have been taxed to the manager at 39.6%, the highest tax rate on ordinary income; short-term gains and interest income would demand a 43.4% tax as investment income that is liable for the additional 3.8% Medicare tax.

This fact has not been lost on the advisors to the hedge fund community. Ever since the introduction of the Medicare tax, accountants and attorneys have pointed out to their fund clients that these managers could avoid this 3.8% tax by taking a cash performance fee instead of a carried interest.

Of course, making that change would create more useless deductions and more phantom income to the fund's clients, so many managers have not acted on the observation and keep charging their performance fee as a carried interest.

LONG-TERM CAPITAL GAIN

On the other hand, private equity and venture capital funds usually garner only long-term capital gains, and thus allow great savings to the fund's managers when tax time rolls around.

What would have been earned as ordinary income taxed at 39.6% is instead taxed as a long-term capital gain at 23.8%. Leveraged buyout funds, real estate partnerships and commodity funds can also enjoy varying amounts of tax savings, depending on each one's tax attributes.

This is the loophole that the Obama administration and the 2016 candidates are aiming to close.

COLLATERAL ISSUES

If Congress does change the taxation of carried interest, there are some collateral issues that need exploring: 1) If carried-interest legislation passed in Washington and there were no longer any possible tax benefits to the manager to receive his performance fees as a carried interest, would all of the managers switch to a cash performance fee?

This could create big tax increases to clients in those entities that are limited in their use of miscellaneous deductions. If a fund made 15% on its investments and then charged 2 and 20, the client would be left earning 10.4% but paying tax on 15%.

2) There are publicly traded investment management organizations that might flunk the test they need to pass in order to continue to operate as non-taxpaying entities.

Private equity firm KKR, as an example, is a publicly traded partnership. To qualify as a partnership for federal income tax purposes, KKR has to be earning investment profits, not management fees. A change in the carried interest rules could prove troublesome to this structure.

PASS OR FAIL?

If KKR flunked this test, it would go from being a non-taxable flow-through entity to a taxpaying corporation.

Corporations pay 35% on all types of income; there is no tax break for long-term gains to corporations. A $1 profit earned today by KKR attracts only a long-term gains tax at the individual client level.

If KKR flunks this test, there will first be a 35% tax at the corporate level and another tax at the shareholder level. KKR would then have 65 cents to pay to holders as a dividend. The income received by the shareholder should conceivably be in the form of a qualifying dividend income taxed at a favorable rate. If KKR were not a publicly traded partnership but instead a taxable corporation, that $1 gain attracts 35 cents in tax from the company and another 23.8% tax at the holder level on the dividends received.

This leaves the investor with 49.53% of gains, versus 76.6% today. How would this change in after-tax cash flow effect the valuation of such publicly traded partnerships?

From these numbers you can see why the recipients of these benefits are fighting hard to keep the status quo, or at least delay or water down the proposals as best they can.