

Taxing Matter: Will Your Carry Get Carried Away?



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In June of last year, far-reaching legislation was proposed in the U.S. House of Representatives that would have significantly changed the manner in which general partners and managers of private equity funds are taxed. H.R. 2834, proposed by Rep. Sander Levin, would have taxed income from an "investment services partnership interest" as ordinary income. The long accepted approach of taxing carried interest income at lower

capital gains rates (currently 15%) would be tossed out the window, and fund managers would be subject to ordinary income tax rates (reaching as high as 35%) on their carry.

While H.R. 2834 had support in the House Ways and Means Committee, and was ultimately passed by the U.S. House of Representatives, the changes proposed to the taxation of carried interest were not included in the Senate version of the bill. This means that for now, private equity fund managers are safe. During the last half of 2007, however, there was significant support behind some type of change to the existing regime, and it is unlikely that the status quo

will survive forever. While the efforts in the House have been described as somewhat of a knee-jerk reaction, it is fair to say that the general public and many in Congress do not view private equity with great sympathy. Changes in the US political landscape seem inevitable, and it will not be surprising to see Rep. Levin and other politicians push for reform in future legislative sessions. The massive amounts of capital raised and enormous economic successes in the private equity industry, combined with lavish spending by certain fund principals, are undoubtedly some of the main reasons for the current and anticipated efforts towards reform.

It is also clear, however, that the initial efforts to change the current landscape went too far. Not only would private equity be hit hard by the proposed changes but so would virtually every other investment partnership in the United States. This would have been true no matter how large or small the partnership, or whether it was closely tied or unrelated to private equity. Perhaps even more important, the proposed legislation ignored entirely the value of intangible investments and contributions made by fund managers to private equity vehicles. Fund principals bring their strategy and plans, networks and contacts, investment procedures and protocols to the funds they manage. The ever increasing size of and dollars under management by private equity funds is clear evidence of the value that investors place on these intangibles, as is the enormous share of profits given to fund managers in return for what they bring to the

table. The proposed legislation also ignored the fact that the existing structure creates an alignment of interest among managers and investors. Finally, despite the significant impact of the proposed legislation on private equity, the revenue effects would have been fairly minimal overall, generating approximately \$2 to \$3 billion a year between 2008 and 2012.

While the taxation of carry will certainly continue to receive attention, it is also worth noting that recent cuts to capital gains rates are currently scheduled to expire in 2010. With budget problems that do not show any sign of improvement, it remains unclear whether the historic low rates now in effect will continue indefinitely. This seems far off at the moment, but really is not considering the lifespan of typical private equity funds. And it is not improbable that alternatives to H.R.2834 will be considered between now and then as well. All of these factors should cause fund managers to consult with their tax advisors and prepare for the possibility of changes to the tax code in the future affecting their carry.

About the author: Scott Smith is a corporate and tax Partner at the Law Firm of Hanson Bridgett. He leads the firm's fund formation group and represents private equity and hedge funds in all aspects of their operations. Scott also represents institutional investors who invest in such funds. Scott can be reached at ssmith@hansonbridgett.com or 415/777-3200.

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