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Taxation of Private Investment Fund Manager Compensation: Why Managers and Investors Should Care

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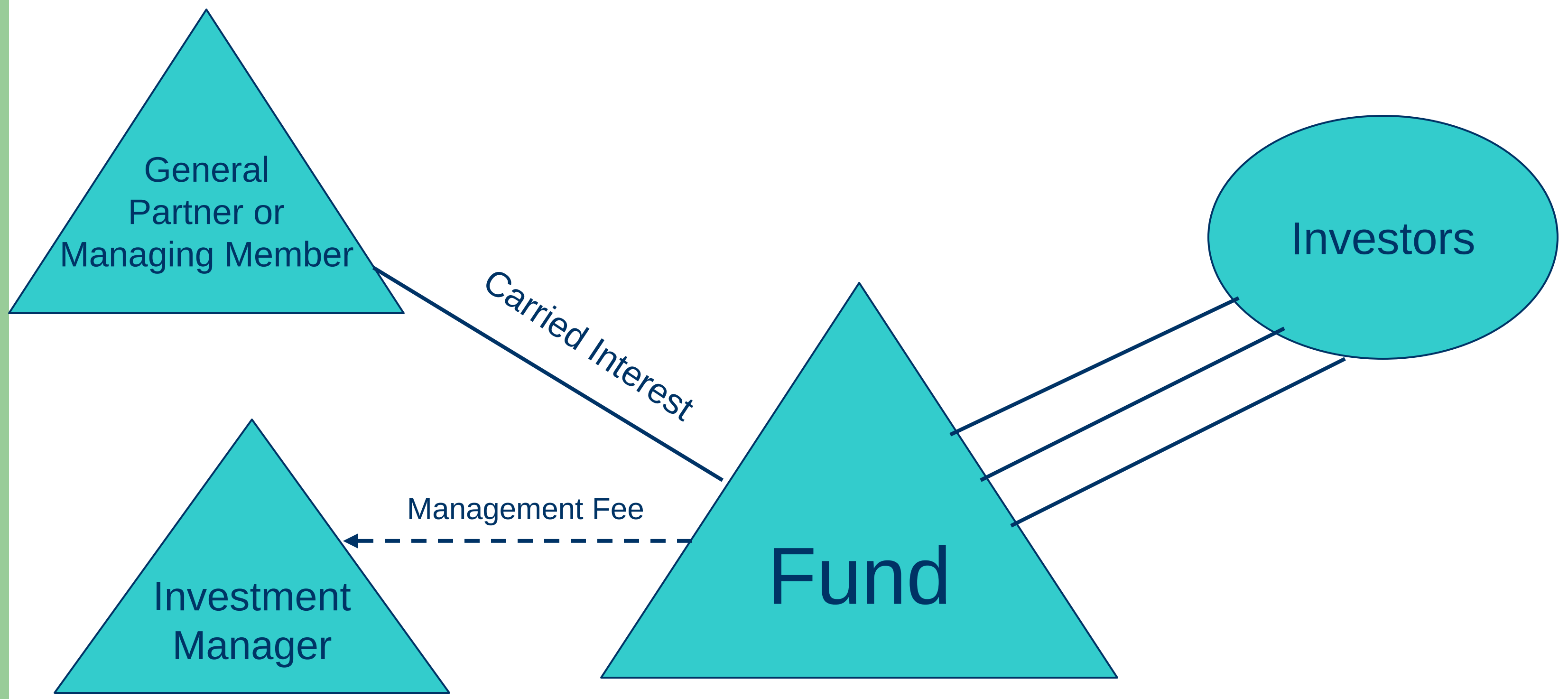
Tax attorney Peter J. Guy specializes in federal income tax law. Mr. Guy has extensive experience providing federal income tax advice to public and private companies with a particular emphasis on mergers, acquisitions, securities offerings and divestitures. He advises real estate funds, private equity funds, hedge funds, limited liability companies, partnerships, S corporations and similar entities on tax issues relevant to the formation and operation of such entities. He has experience advising real estate investors and developers on tax issues arising out of the ownership and operation of real estate, including certain tax credit advice. His experience includes advising domestic and international clients regarding cross border tax issues and certain New York state and local tax issues. Mr. Guy also has experience advising clients that have special tax considerations such as real estate investment trusts and tax-exempt entities. Prior to joining Ellenoff Grossman & Schole LLP, Mr. Guy was associated with the law firms of Paul, Weiss, Rifkind, Wharton & Garrison, LLP and Bryan Cave, LLP. Mr. Guy is admitted to practice in the state of New York and is a member of the American Bar Association's Section of Taxation. Mr. Guy received his Juris Doctorate from Harvard Law School where he graduated *cum laude* and his Bachelor of Science degree from Northeastern University where he graduated *summa cum laude.*

Typical Fund Entities

- Domestic Funds typically have one or two management-related entities.
- General Partner (for limited partnerships) or Managing Member (for limited liability companies)
- Investment Manager
- Typical Structure Chart on Next Slide

Typical Domestic Fund Structure



Carried Interest

- “Carried Interest” is a share of a Fund’s profits paid to a general partner or managing member of the Fund
- Typically 15% to 20% of the Fund’s profits
- Recipient of the Carried Interest must be a partner or member of the Fund to be eligible for capital gain treatment on some or all of shared profits

Management Fees

- Usually 1.5%-2% of the Fund’s assets under management from time to time
- Paid periodically – monthly or quarterly most common
- Paid without regard to Fund’s income or losses
- Typically used to fund manager overhead like rent, salaries, information technology, etc.

Example of Carried Interest and Management Fees

- Assume a Fund is formed on January 1, 2011 with $1,000,000 of investor money which it immediately uses to buy corporate stocks and that it charges a 20% carried interest and a 2% management fee
- On January 15, 2012 the Fund recognizes $150,000 of gains from the sale of some of the stock it purchased on January 1, 2011.
- For the tax year 2011, the Fund's Investment Manager will charge a $20,000 management fee ($1,000,000 x 2% = $20,000).
- On January 15, 2012, the Fund's General Partner or Managing Member will earn $30,000 attributable to its carried interest. That $30,000 will be long term capital gain, eligible to be taxed at reduced rates.
- The remaining $120,000 is allocated to the Fund's investors.
- Assume that the $150,000 of gains are distributed out of the Fund, so that on January 16, 2012, the Fund still has $1,000,000 of assets under management. On January 15, 2013, the Fund sells some of its stock for a $120,000 loss.
- On December 31, 2012, the Fund will still pay its $20,000 management fee, as the assets under management at that time are still $1,000,000. The amount of the loss does not reduce the management fee. However, the General Partner or Managing Member will not earn any carried interest on January 15, 2013, because the Fund has only losses and no income or gain at that time.
- Clawback?

Taxation of Receipt of Carried Interest

- Generally designed to mitigate risk of taxation upon grant
- General Partner or Managing Member may contribute a relatively small amount of capital in exchange for the carried interest (say, 1% of invested capital)
- Can also divide up "slices" of the carry and then grant "slices" to fund manager employees as incentive compensation
- Should avoid tax on grant of "slices" if structured as "profits interests"

Example of Profits Interest

- Assume a Fund's General Partner ("GP") or Managing Member ("MM") is entitled to a 20% carried interest
- Fund earns $100 in Year One, $20 of which is allocated but not paid to the GP/MM
- At beginning of Year Two, GP/MM wants to grant a "slice" of 1 percentage point of carried interest to new employee
- To reduce the risk of tax on grant, new employee should only be entitled to 1 percentage point of GP/MM carried interest in excess of the $20 carried interest already allocated to the GP/MM in Year One
- Assume at the end of Year Two the GP/MM earns $30 of carried interest on $150 of Fund income
- Of that $30, new employee is entitled to 1/20 x $30 = $1.50
- The remaining members of the GP/MM share the remaining $28.50 of carried interest from Year Two but retain the entire $20 of carried interest from Year One. New employee is not entitled to share in any of the $20 from Year One

Taxation of Carried Interest Allocated to GP/MM

- Since Carried Interest is paid to a GP/MM in its capacity as a partner or member of the Fund, profits passed through retain their tax “character”
- If all the Fund’s profits are derived from long term capital gains, recipients of the carried interest may be eligible for reduced tax rates on long term capital gains (typical for private equity and other non-hedge funds)
- Some Funds have little or no long term capital gains to allocate, so in that case profits would not be taxed at lower long term capital gains rates (this is the case in many hedge funds with short-term or hedged trading strategies)

“Performance Fees” vs. Carried Interest

- Some offshore investment funds (especially offshore hedge funds) pay a “performance fee” to investors in lieu of the carried interest
- Performance Fees are not paid to a GP/MM that is a partner or member of the Fund
- Performance Fees typically paid to an Investment Manager that has no equity ownership in Fund
- Since Performance Fees not paid to owner of Fund, cannot pass through tax character
- Recipient of Performance Fee pays tax on fee at ordinary income rates

New Legislative Proposals

- Numerous proposals have been introduced over the past few years to change the tax treatment of carried interest
- Most recent – H.R. 4213, now being considered in the Senate
- Proposals would require some or all of carried interest to be taxed as ordinary income
- Political “hot potato” because it is being proposed as part of larger tax bill to extend certain tax benefits
- Subject of intense industry lobbying

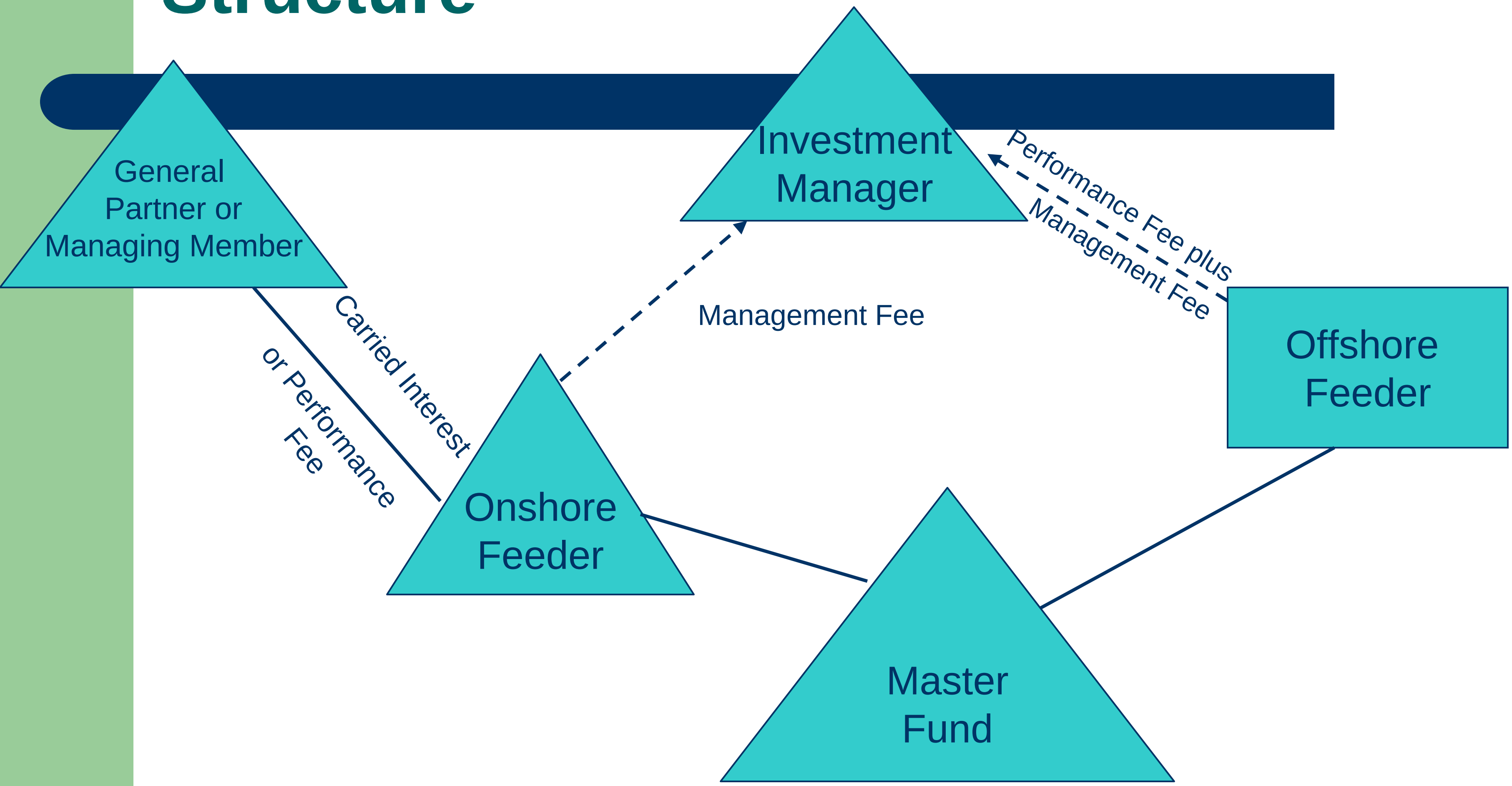
Tax Effects to Investors of Payment of Carried Interest

- Carried Interest is essentially a sharing of profits between Investors and Fund Managers
- From a tax standpoint this is a more efficient way for Investors to incentivize Fund Managers than the payment of fees, because every dollar of profits allocated to a Fund Manager is one less dollar of taxable income or gain allocated to Investors
- As discussed on next slide, fee payments may not be fully deductible by certain individual US investors
- Since the deductibility of performance fees or management fees may be limited, sharing of fund income through carried interest allows for full deduction of amounts paid to Fund Managers

Deductibility of Fee Payments by US Individual Investors

- Many private investment funds generate nothing but “investment income” for Investors (as opposed to income from a trade or business)
- Investing in Securities vs. Operating a Shoe Store
- “Investment expenses” are very difficult for US individuals to deduct fully
- Investment expenses are generally miscellaneous itemized deductions only deductible to the extent they exceed 2% of a US individual investor’s adjusted gross income and may be subject to other limitations

Typical "Master-Feeder" Hedge Fund Structure



Deferral of Offshore Fund Performance Fees

- Many investment funds have “offshore” feeder entities through which certain types of investors invest in the Fund (usually foreign and tax-exempt investors)
- In recent years Fund Managers structured these offshore feeder entities to pay performance fees, the receipt of which Fund Managers would elect to defer for a period of time (say, ten years)
- This allowed Fund Managers to defer the income from the offshore feeders until the performance fee was actually paid
- Recent changes to the tax law make fee deferrals from offshore feeder funds impractical

Typical Pressure Points Between Investors and Managers

- Payment of Management Fee generally necessary to fund Manager overhead, but Management Fee not fully deductible to US individual investors
- If make some or all of Management Fee a profit allocation instead, solves deductibility problem, but could cause cash flow problems for Fund Manager
- Managers prefer to defer fees if possible, but US taxable investors would prefer to pay fees currently (or even better, pay carried interest instead of performance fees).

Example of Problem of Fee Deferral

- Assume a Fund manager insists on a five-year deferred Performance Fee instead of a Carried Interest (meaning that although a performance fee might be earned in Year One, it will not be paid until Year Five).
- Assume the Fund earns $100 of income in Year One.
- Investors taxed on entire $100 of Fund income even though $20 of such income is attributable to the Performance Fee.
- When Fund eventually pays the $20 Performance Fee in Year Five, US individual investors may not be able to fully deduct that fee because it is a miscellaneous itemized deduction
- Combining the deferral feature with the nondeductibility of the $20 Performance Fee produces a net result that the Fund's US individual investors will have paid taxes on their share of the Fund's income attributable to the $20 performance fee without a corresponding current or future deduction
- Can be solved by paying current carried interest instead.

“Phantom Income” Issues

- Both Investors and Fund Managers want Fund to avoid making investments in securities that produce “phantom” income
- Phantom income is taxable income that is generated by an investment without a corresponding cash payment
- Examples – “zero coupon” bonds and similar preferred stock investments
- Any phantom income earned must be allocated to Fund’s equity owners, including the investors and the recipient of the carried interest
- Can be solved by making tax distributions but such distributions deplete Fund assets

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