

Carried Interest And The Regulatory Landscape For Private Equity And Hedge Funds

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Despite the predominance of healthcare reform in the current legislative activities, it is likely that the Obama administration will rekindle the attention on various tax changes once the smoke clears. One such area that received a great deal of attention several months ago involves the treatment of carried interest for private equity firms. On a global level, the European community has also offered a new directive that will require registration of private investment funds (similar to the U.S. proposal) such as hedge funds. Many in the PE/Hedge Fund community feel that these two possibilities could clearly have a negative impact on the overall

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industry. Many in the industry feel that these new rules could clearly affect exit strategies and valuations in the underlying investments.

The likelihood of some move toward making carried interest ordinary income is supported by the need to fund the proposed healthcare bill and the revenue needed to support the current pace of post-economic crisis government spending.

In the case of carried interest, the advantageous tax treatment as capital gains (15 percent tax rate) could be changed and taxed at ordinary rates (more than double that of long-term capital gains income.) The basis for the Obama proposal is that the partners of the PE firms are really providing a ser-

vice for the carried interest income received, so, therefore, it should be taxed just like other wage income.

It is anticipated that there would be significant restructuring of the agreements that the private equity and venture capital firms have for the relationship with GP's and principals as they relate to the limited partnership investors. This would be expected to take the form of "equalizing" the general partners to change the terms of the deal in order to make up for the need to pay more taxes upon exit from the underlying investments (portfolio companies).

The likelihood of some move toward making carried interest ordinary income is supported by the need to fund the proposed healthcare bill and the revenue needed to support the current pace of post-economic crisis government spending. Supporters of the change suggest that it will result in an increase in tax revenue over the next ten years of as much as \$25 billion. Those who oppose this change, claim the tax revenue number is inflated and that the

effects on deal activity will be harmful to the private capital sector.

Given these likely developments, it will be important for PE firms and their principals to seek out appropriate tax advice to help mitigate the increase in the tax cost. Proper structuring of future deals and restructuring of existing ones may allow for greater tax efficiencies and a larger amount of capital upon exit to support subsequent deals.

It may be possible to address the new tax economics of private equity for the GP's by structuring deals in a manner that would reduce the effect of ordinary tax treatment. One way may be for GP's to take an upfront interest of the 20% normally paid out as carried interest. This potentially would give the GP's a capital asset in their hands from day one in the portfolio company. Another method would be a co-investment model with larger, non-pass-through entities. Exploration of all possible equity structures will greatly benefit the overall private capital markets and mitigate the inevitable negative effect on valuation.

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