OTHER VOICES

A Simple Tale of Carried Interest

A financial advisor explains the tax advantages of a private-equity partnership.

By DANIEL G. MAZZOLA
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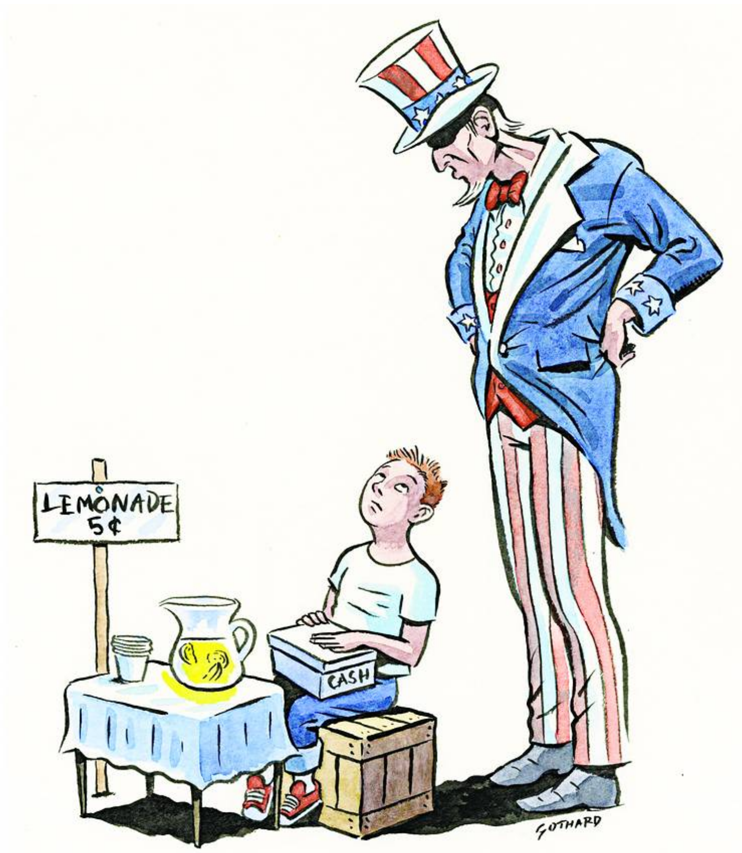

David Gothard for Barron?s

The U.S. government uses the tax code to promote business activity by taxing the gains on the sale of investment assets held for at least one year at a rate lower than the rate on income representing remuneration for services rendered. Capital is an important driver of economic growth, and without this favorable treatment, investors would be less inclined to stake risky ventures.

But one type of capital gains has become controversial, under the widely misunderstood name of “carried interest.” Let’s look at the topic from the point of view of two small-town, small-business ventures.

First, Jake owns a newsstand. His is a thriving business, and he is looking to make it grow by selling mobile phones. One of his daily customers, Tom, has been impressed by Jake’s industry and operational efficacy since he first encountered Jake running a lemonade stand when Jake was 9 years old. He has been helping him quietly ever since, and now Tom offers to lend Jake money to expand his business.

Jake’s expansion is successful, and Jake sells the newsstand after two years for a sizable gain, paying off Tom’s loan with interest, and of course paying capital-gains taxes.

Jake and Tom enjoy working together and are ready to move on to another project. Their activity will be restoring a neighborhood theater that has fallen on hard times. Tom will again be the financier; Jake will handle the day-to-day affairs of rebuilding and managing the theater to enhance its value. This time they will be partners.

In the new business arrangement, Jake receives wages for his daily services, and the two agree that he will collect a share of the sales proceeds if the business is sold after at least a year of operation and if the profit on the sale exceeds a specified threshold.

The profit on the sales of the newsstand and theater should be recognized for tax purposes as a long-term capital gain. The fact that Jake operated alone as a borrower in the first enterprise and as a partner in the second has no bearing on the fact that they both were capital gains. It also is irrelevant that Jake did not invest his own money in the theater renovation. With regard to partnerships, the tax code does not distinguish between financial capital and “sweat equity.”

Jake will pay ordinary income tax on his compensation as the theater manager. Jake's share of the profits when the theater is sold for more than a hurdle rate that was specified in advance is known as carried interest, and Jake will pay the capital-gains rate on it.

The tax treatment of carried interest is a hot topic these days, as politicians from both parties denounce it as unjust and a sop to the privileged elite and politically influential.

Critics of the present policy on carried interest argue that Jake should also pay the higher, ordinary income-tax rate on the profit on sale of the theater, reckoning it as an additional return on his labor and not capital, since he invested no cash.

A private-equity fund is typically structured as a partnership consisting of limited partners and general partners. Limited partners provide the money, usually have no say in daily operations, and cannot be sued for the debts of the partnership. The general partner manages the enterprise and is on the hook for partnership liabilities. He is paid a flat fee for his services and a percentage of profits that may be collected if the venture is successful and later sold.

THE SUCCESS OF PRIVATE-EQUITY ventures is presumed to be largely attributable to the general partner's endeavors, as he handles strategy, business development, management, and operational details. His responsibility is to return the company to profitability, and restructure so as to generate greater performance or unlock hidden value, and he does not receive profit on his carried interest unless he does so.

Carried interest is a less reliable source of income and only becomes available upon a liquidity event such as an initial public offering, recapitalization, or acquisition, normally three to five years after the operation began.

Opponents of the current carried-interest regulations contend that private-equity firms take the treatment of partnership taxation to an extreme. The work of a private-equity firm is a combination of investment banking and management consulting. Private-equity managers are not paid for starting new businesses from scratch, but for gathering and pooling the money of wealthy individuals and institutions and speculating on the future of an enterprise. (Critics often note that the efforts of private-equity firms rarely produce a positive outcome for the employees of the companies involved.)

Hedge fund managers are often painted with the same populist brush as private-equity managers when it comes to tax avoidance, but there are important differences between the two. Unlike private-equity managers, hedge fund managers rarely take a controlling interest in the companies they invest in, and few hold positions for more than a year. Thus, recognition of carried interest generally is not applicable to the profits of hedge fund managers.

President Donald Trump's one-page tax-plan outline issued recently did not mention carried interest. A White House official indicated, however, that the president intends to end the present treatment of carried interest, consistent with his economic blueprint released during the campaign. Democrats will no doubt try to hold him to this pledge.

Last year, an avowed socialist ran for president, attracting the disillusioned with philippics on income inequality and the 1%. But where is it written in our tax code that one individual has a rightful claim to the wealth of another who is more successful?

Taxes are necessary, but a system that applies discriminatory charges on income is not a mode of assessment for common needs of a community. It is a disguised expropriation from successful entrepreneurs, capitalists, and the affluent in general.

A sound tax policy should involve simple, transparent, low marginal, and rarely altered rates on a very broad tax base. The rights of Tom and other private-equity managers should be as inviolate as those of Jake and other citizens who earn their living from employment for wages.

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