

CARRIED INTEREST IS A CAPITAL GAIN

There has been a lot of commentary and political posturing lately on taxation of carried interest for hedge funds, venture capital firms, private equity firms and private real estate investment firms. Carried interest is the percentage ownership that accrues to the sponsor of the deal or fund. This ownership percentage is paid to the deal sponsor for structuring the deal/fund, raising the capital, acquiring the property or company, making the investment, managing and monitoring the deal or fund, communicating with the investor group, preparing various accounting/tax reports, selling the fund assets and distributing the proceeds. The carried interest is taxed at the capital gain rate, currently 20% (which was raised to this rate earlier this year by Congress from the prior rate of 15%) and not at higher ordinary income rates currently at a maximum of 39%.

Many politicians and pundits have been calling for an increase in the taxation of carried interest to the ordinary income rate of 39% for fairness, redistribution and to punish those rich and greedy investment firms. President Obama included raising the rate in his 2014 budget which was released a few months ago. They argue that many of these firms are not bearing any risk and therefore should pay a higher rate. Capital gains have been taxed at a lower rate than ordinary income since the early 1900's to encourage private sector investment and risk taking. This helps create job growth, new company formation, economic growth and entrepreneurship. It's also an incentive for people to take financial risk to generate profits and keep the US a robust and prosperous country.

I and many of my colleagues in the commercial real estate industry vehemently disagree with changing the taxation of this carried interest to ordinary income rates because it alters the historical characteristic of capital investment as discussed above and will not generate any significant revenues for the Treasury. If an investor buys 100 shares of McDonalds (currently at around \$99 per share) in a brokerage account, holds those shares for over one year and sells them, then the investor would pay tax at the capital gain rate of 20%. If this same investor buys all the shares outstanding of McDonalds and takes it private, holds those shares in a brokerage account or a fund with capital from outside investors for more than one year and sells them, then that investor should get the same capital gain treatment. Therefore I am perplexed and do not understand the argument of why this second transaction is any different? There is a risk of loss in both situations and capital is at risk. In the second transaction, the investor may not use his own funds due to the large size of the investment; however, he still bears all the risks associated with the deal from putting the fund together to finally selling the investment. In the first example, it

costs the investor for the 100 shares \$9,900 plus a broker commission, which can be paid for in cash or on margin. In the second example, buying out all the shares of McDonalds would take tens of billions of dollars and therefore must be structured with outside capital in a fund or pass-through entity format like a limited partnership or limited liability company. This is why all investment funds are structured in this manner. In both scenarios, the investor buys an asset, holds it for longer than one year and then sells that asset. In either case, this appears to me to be a straightforward capital gain transaction and should be taxed as such.

Author: Joseph Ori, President, Paramount Capital Corporation, a real estate advisory firm

© Copyright 2013 Paramount Capital Corporation