

Have legislators in the US and UK closed the book on changes to carried interest taxation? A trio of tax experts provides PEO with perspective on the latest Capitol Hill and Westminster developments.

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Debates about carried interest taxation have been raging on both sides of the Atlantic for months. But in the past week, both US and UK legislative bodies have taken – or, rather, opted not to take – some significant steps.

“Although both countries have seriously debated the issues of whether carried interest is capital gains, neither country seems ready to move on it,” said Timothy Spangler, partner and chair of the Investment Funds Group in the London and New York offices of international law firm Kaye Scholer.

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There are a number of ways the simultaneous debates on both sides of the pond are linked to one another, Spangler said. “The two largest countries for private equity on the GP-side are the US and UK, so it’s not surprising that when you’re talking about questions of tax regulation, each is going to look to the other,” he says. “The shadow, as I always frame it, of Sarbanes Oxley looms large. People now realise that if you get it wrong, your competitors can win a tremendous advantage.”

Mel Schwarz

The UK government this week scotched speculation that it would reconsider its capital gains tax reforms, indicating it will go ahead with its plan to implement a flat rate of 18 percent. That effectively eliminates the need to broach what Spangler calls the “philosophical and public policy question” of whether carried interest is in fact capital gains.

“An enormous amount of effort has been exerted over the last 20 to 40 years supporting that assumption, that carried interest is capital gains,” Spangler said. “One of the interesting things about the last several months is that question is now being asked. All of a sudden an issue that had never been on the table is now on the table.”

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Similar to the UK, the philosophical and public policy debate on carry seems to have stalled in the US, as well. Last week, the US Senate passed a bill to temporarily fix an outdated tax act called the Alternative Minimum Tax (AMT). Unlike a similar bill passed by the House of Representatives, the Senate bill did not call for resulting lost revenue to be counterbalanced by treating carry as ordinary income rather than capital gains, thus more than doubling the tax, and by taxing hedge fund income deferred to offshore accounts. In order to generate a bill that both the Senate and House will approve, House Ways and Means Committee chairman, Charles Rangel, said it will draft new legislation without the controversial carry provision, but that it would “continue to pursue this issue”. Rangel’s statement indicated the House was more interested in pursuing the hedge fund/offshore accounts issue than the carried interest tax designation.

The events on Capitol Hill can be chalked up to “either a fortunate confluence of factors or brilliant lobbying – maybe both”, says Mary Kuusisto, a partner in the tax department of law firm Proskauer Rose and a member of its Private Investment Funds Group.

Mary Kuusisto



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“It was a given that Congress was going to pass something on the AMT political hot potato,” Kuusisto explains. “The only question was whether they would have to/be able to do it without ‘pay-as-you-go’ revenue offsets. The Republicans didn’t want offsets – to them, the government was never entitled to the AMT revenues from middle class taxpayers. To get the Democrats to pay for it with carry was attractive, but if AMT is a political hot potato, we saw that [maintaining capital gains treatment of] carried interest has even more powerful proponents.”

Offshore structures used by hedge fund are easier to attack – and are perhaps still in Congress’ sights – because it’s an issue that almost exclusively applies to hedge funds, whereas carried interest is used in partnership structures across all industries, Kuusisto says.

“It looks unfair to tax just those partnerships in the investment fund industry,” she said. “But even more important, the private investment funds lobbied hard and effectively. Some did that with dollars, others by instilling genuine fear that the US was risking its enviable position in the world economy.”

An informal tally of mid-year disclosure reports from lobbying firms found that from January to June, they’d been paid more than \$4 million to lobby on tax issues on behalf of some of the US’ biggest private equity players. But buyout firms were by no means the only ones hiring lobbyists – the National Association of Realtors, the International Council of Shopping Centers, and the US Chamber of Commerce are among the groups that have been knocking on Congressional doors with increasing vigor since introduction of the Rangel bill.



“The carried interest provision is probably the most lobbied tax provision that I have seen since 1986,” says Mel Schwarz, legislative affairs partner in the US National Tax Office of global accounting firm Grant Thornton. “There definitely has been an extraordinary effort.”

Spangler agrees. “We can’t underestimate how important the lobbying effort was,” he says. “The private equity industry [in the US] reacted in a constructive way. You look at the UK, and there was a great example earlier on in the year where the private equity industry, in the guise of the British Venture Capital Association, was seen to do a quite poor job of speaking for itself. I think one thing underlying a lot of the debate over the last year has been who are these private equity guys, what are they doing, what are they supposed to be doing, are they complying with all the taxes, rules, regulations and whatnot.”

Mel Schwarz

So has the carried interest tax question effectively been taken off the table, and swept under the rug? Kuusisto, Spangler and Schwarz won’t bet on it.

“This will continue to be a live issue if it’s not included in legislation this year,” Schwarz says. He and Kuusisto both note that the some \$25.7 billion in estimated revenue that would be raised by taxing carry as ordinary income is simply too large to ignore.

“The old joke is there’s nothing in the tax code that hasn’t been talked about for 10 years before they put it in,” Schwarz says. “Once one of these things comes on the table, it’s very difficult to get it off the table. You can beat it back, but anytime they’re looking to raise revenue, it’s going to come back.”

Kuusisto anticipates carried interest taxation will become a campaign issue in 2008; already many Democratic Presidential candidates have spoken out against carry being treated as capital gains.

“Whether it will pass – and I don’t think it will ultimately come to vote again until after the election – depends on who gets in office,” she says.