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Carried Interest in the CROSSHAIRS

As Congress considers tax reform in 2013, private equity comes under fire

By Danielle Fugazy

With the start of a new year and the presidential campaign finally in the rearview mirror, the government is getting back to business. So what's on the agenda? Well, of course no one knows for sure, but there's a pretty good indication that policy makers will be looking more closely at the private equity industry this year. The presidential election brought unprecedented attention to the industry and the enormous personal wealth it can generate, thanks to Bain Capital co-founder Mitt Romney's failed bid for the White House. Now the government needs to raise money, and policy makers may view private equity as a cash cow. On a macro-economic level, the U.S. is deleveraging and there's massive debt hanging over the nation's head. In fact, government spending is projected to outpace revenues by more than 25 percent over the next decade, unless something changes, according to the Congressional Budget Office, a nonpartisan agency that analyzes costs. The federal government is looking for ways to close that gap. Could private equity be the answer? Here's a look at some of the policies and tax issues likely to affect the private equity industry during 2013.

Reform Anyone?

In the broadest sense, most industry experts believe tax reform will be on the agenda during the 2013 Congressional session. The so-called "fiscal cliff" threatening the U.S. at the end of 2012 underscores the need for tax reform. Historically, substantive tax reform has only taken place three or four times in the U.S., most recently in 1986, which was more than 20 years ago. Every constituency has a stake in the outcome, which makes it challenging for policymakers to reach an agreement. Successfully implementing tax reform is difficult, so most of the time, it gets ignored. But with the recent fiscal cliff fiasco, everyone has realized tax reform is long overdue. That said, no one likes his or her taxes increased. But, unlike the recent picture that's been painted in the mainstream media, it seems that private equity dealmakers welcome tax reform at the highest level as a better alternative to Congress' haphazardly targeting the private equity industry year after year to generate revenue.


Gary LaBranche

"If tax increases to private equity aren't part of a larger tax reform, dealmakers feel, and perhaps rightfully so, that lawmakers will just come back and ask for more at a later date. If an increase in taxes is part of a real tax reform, it shows the industry that Congress has really looked at the industry, considered the implications and that it's not just being used as this year's revenue raiser," says Mel Schwarz, a partner and director of tax legislative affairs in Grant Thornton's national tax office. "The industry has to feel that the deal that's struck will be in place for some extended period of time. If it's not part of a larger tax reform package, the industry will feel like it's always on the table."

What's more, people in the industry recognize tax reform is necessary. "We can't continue to be in a tax crisis, year after year. Businesses can manage business risk, not political risk," says Brett Palmer, president of the Small Business Investor Alliance (SBIA), which lobbies Congress on behalf of the small-to-middle-market private equity industry.

> "It's critical that middle-market private equity professionals remain vigilant and become engaged in the dialogue."

However, when the tax reform discussion heats up, nothing will be off limits, and industry associations, such as the Association for Corporate Growth (ACG), are urging private equity firms to stay abreast of the ever-changing situation. "It's critical that middle-market private equity professionals remain vigilant and become engaged in the dialogue," says Gary LaBranche, president and CEO of ACG. "There are so many items that will be on the table. It is critical that Congress understands the role private equity plays in building and growing middle-market companies.

Brett Palmer

Punishing PE will negatively impact middle market growth."

The challenge that private equity firms face is that most lawmakers don't truly understand the private equity model but do know of a few larger deals that went bust, say industry insiders. "Many legislators do not understand the amount of capital that private equity firms put into the economy, the number of jobs we create and the growth we produce," says Molly Simmons, a principal with Tonka Bay Equity Partners, a Minnetonka, Minn. firm investing out of its third fund, which raised $150 million in 2011. "Private equity isn't a four-letter word," quips Simmons, who serves as chair of the SBIA.

According to the Small Business Administration (SBA), private equity funds that are Small Business Investment Companies, or SBICs, invested more than $3.2 billion in small U.S.-based companies during 2012 and created more than 66,000 jobs, the third record-breaking year in a row.

What's more, according to a recent study released by John Paglia, a professor of finance at Pepperdine University, the average increase in net sales for companies with private equity financing during a five-year period is approximately $11.8 million, compared with a $4.9 million increase in sales for companies without PE financing. This suggests that establishments with private equity capital achieve 129 percent more net sales growth than their counterparts.

Private equity firms increasingly understand how important it is to educate Congress about the role it plays in the economy. According to ACG, in 2008, fewer than five percent of private equity professionals surveyed believed it was important to be engaged with politicians. Today 70 percent feel it's important.

Is it simply ordinary?

The fate of carried interest, currently taxed at the 15 percent capital gains rate, is by far the issue that's weighing most heavily on the private equity industry's collective mind. Carried interest is how private equity firms make money. It's in addition to a typically two percent management fee, and it's a share of the profits of an investment that is paid to a private equity firm, based on portfolio company performance. In order to receive carried interest, the manager must first return all capital contributed by the limited partners (LPs), and, often, must also return a previously agreed-upon rate of return to LPs, typically eight percent. The manager does not receive carried interest until and unless there is a successful exit, which may take several years. Carried interest is typically 20 percent of what remains in the private equity fund after the intial investment plus expenses have been returned, after the agreed-upon return has been delivered and after the PE firm's management fee has been paid.

Carried interest could become part of a larger tax reform, or simply become a non-issue, if Congress agrees to an increase in capital gains rate, which is a likely scenario. Either way, carried interest has long been an important part of the private equity model. As the whole world knows by now, private equity firms pay capital gains tax on the profits they make from their carried interest. There is a large constituency out there that believes private equity pros should pay ordinary income rates on their carried interest profits. For the past 10 years, the capital gains rate has been 15 percent, with talk now of hiking it to 28 percent. The highest tax rate for ordinary income (which most private equity professionals would fall into) has been 35 percent. Not surprisingly, the majority of the private equity firms disagree that there should be a reclassification. Proponents of changing carried interest taxation believe that taxing carried interest as ordinary income will be a more fair way to tax private equity professionals because it represents compensation for services, not a return on investment. Additionally, the current administration estimates that the change would raise an additional $13.5 billion through 2022, according to the Tax Policy Center.

The private equity industry believes there are misconceptions about carried interest. "The really big problem is that people do not understand what carried interest is," says Pam Hendrickson, the chief operating officer of the Riverside Co. and the vice chairman of ACG. "Carried interest is a share of the profit or loss in a long-term investment. There's a perception that it should be treated as ordinary income, because it is sweat equity rather than financial equity. In every other industry, sweat equity is treated as a capital gain, because there is no guarantee that you will get any money-- and the same is true with carry. Carry is at risk because of the clawback. If I make a profit on one of our deals and receive carry, but then I lose money on the next deal, I have to give the carry back to my investors. And, by the way, I don't get the taxes I paid on the received carry back."

After the heated presidential contest, many Americans may now believe that private equity professionals are simply getting rich off carried interest and not paying fair tax rates. But people in the industry point out that it is a tale of two industries. Most professionals do not reap the rewards that Romney and Bain Capital did. In fact, 90 percent of the private equity industry is comprised of middle-market firms, according to the ACG. Professionals at these firms do not bring in nearly as much in carried interest.

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"Carried interest is not inappropriately taxed," says Hendrickson. "If you make 10 times your original investment, that's great, but you can lose your money too. Deals can fail, and when they do, a private equity firm can wind up owing money. Private equity investors make and work on investments with no guarantees. The industry should be compensated fairly for taking risks on different businesses. However, the capital gains tax rate could be higher. It's been as high as 28 percent, and the world didn't end."

According to David Sterling, the leader of McGladrey's mergers, acquisitions and private equity tax services group, the rules concerning the taxation of carried interest were created by the courts to solve a problem, and this often gets lost in the discussion. "The courts decided carried interests were too hard to value upon receipt and decided that income from carried interests should be taxable when income from the carried interest was later realized. What's really happening is an executive receiving a carried interest is investing his sweat equity in a partnership. The executive is taxed on the income from his carried interest in the same way he would have been taxed if he received a cash bonus for his services and invested it in the partnership. However, with the receipt of a carried interest, the executive is not taxed currently on the value of his services, as he would with a cash bonus. The tax treatment of a carried interest is not perfect, but it's mostly correct."

If the carried interest rate increases to 20 percent, that would be a 33 percent tax hike. If carried interest gets reclassified as ordinary income and taxed at a 38.3 percent rate, it would represent a 155 percent increase from the current 15 percent capital gains tax.

Some tax experts believe a compromise could be reached. "How about taxing a portion of carried interest as capital gains and a portion at the ordinary income level?" says Grant Thornton's Schwarz.

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There can also be unintended consequences to legislation. Changing the treatment of carried interest changes the alignment between the private equity firms and their portfolio companies. "Having skin in the game, or carried interest, aligns the private equity partners with the limited partners who invest in the private equity funds, as well as the portfolio companies," says Simmons. "It is not a loophole. If the portfolio company investments do well and the limited partner investors do well, then the private equity fund manager should be able to share in the upside they created. If the carried interest tax treatment changes to ordinary income, the alignment goes down. Limited partners and portfolio company managers like knowing that our economic interests are all about maximizing value."

Changing the tax code may also lead to the private equity firms changing their entire fund structure. Some firms are already talking about making their firms holding companies and giving partners stock options. "Ultimately, having a carrot is good for everyone. If you take away the carrot, or cut it in half, the model doesn't work as it was intended," explains Simmons.

Capital Gains Hike

As Riverside's Hendrickson says, capital gains rates can go up, and they mostly likely will. So even if private equity profits do continue to be treated as capital gains, private equity firms face the likelihood of paying higher taxes. Capital gains rates are scheduled to increase from 15 percent to 20 percent in 2013. While the increase may seem steep, 23 percent is closer to the rate that has historically been paid on capital gains.


David Sterling

Incentives Unlikely

Any private equity firms that invested in a certain industry or made their investment model work with the help of government incentives will need to rethink their business model, say many observers. Policy makers typically enact stimulus through tax cuts and tax credits. For example, after the 2008 financial meltdown, The American Recovery and Reinvestment Act of 2009 encouraged investors to invest in renewable and alternative energy projects in the U.S. through tax credits. However, given the U.S.'s current fiscal situation there is a real possibility that reductions of tax incentives will be on the table. What's more, there will be no room for new tax incentives. These changes could influence where private equity firms invest going forward.

"No one should count on tax incentives in the future. This should concern all investors, but particularly anyone investing in oil, gas or mining. Their tax benefits are under attack already," says McGladrey's Sterling. "Manufacturers also get to deduct nine percent of their manufacturing income from their taxable income. This deduction may also be eliminated in future tax reform legislation."

Grant Thornton's Schwarz agrees tax incentives will no longer play a large role in dealmakers' decision processes. "There will be no room for new tax incentives when the government is in such dire straits. That said, I don't know if it will stop people already investing in certain areas, but it will dissuade new investors from entering certain sectors where it's hard to make money, and tax incentives helped make the models work," says Schwarz.

Forget the Deductions

Interest is an operating expense that is incurred in the course of doing business, and it is deductible under the current tax code. Most small and middle-market companies use debt to finance growth. Under current tax law, interest on that debt is deductible as an operating expense. As tax reform gets underway, it seems that eliminating the deductibility of interest expenses will be on the table, meaning businesses may no longer be able to deduct the interest they've paid on business loans.

"This will have a huge cash impact on small companies, and Congress needs to be aware of that," says Hendrickson. "We looked at the impact on a few of Riverside's portfolio companies, and the elimination of this deduction caused their marginal tax rates to go up to 50 percent. The average tax rate for small companies in the U.S. is already the highest of any developed nation in the world, so the elimination of this deduction is likely to be a growth inhibitor, unless overall corporate rates are lowered at the same time."

Pam Hendrickson

That said, there's no question why the government is looking at this. This change has the potential to bring in as much as $167 billion in revenue. Obviously, the number leads to a fair amount of momentum. However, this is really expected to affect U.S.-based businesses that want to become international. Companies that are incurring debt in the U.S. and deducting the interest, but then using the funds to develop overseas business, will feel the impact.

"Lawmakers always seem to be proposing a denial of interest expenses, and it will be an issue and a problem for domestic businesses that are seeking to expand internationally," says Schwarz. "But the devil will be in the details.

Taking Care of All

On Jan. 1, as part of the Affordable Care Act, all or part of the net income, including long-term capital gains and dividends, collected by higher-income earners, will pay an additional 3.8 percent investment surtax. So capital gains tax is scheduled to increase to 20 percent, but it's really 23.8 percent when you include the investment surtax.

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"This is happening. It's not part of a maybe, it's done," says Hendrickson.

In the beginning of December, the government finally put out guidance as to how this tax will work. But questions remain, most notably what it will mean for LLCs, will they qualify for the exemption from the new tax, based on their partnership status? "We finally received initial guidance, but there are many questions that have been left unanswered," says Schwarz. "We need clear language, but I don't believe any tax staff has even looked at this, because there's no guidance."

Access to Capital

Private equity firms may not be affected directly by Basel III, but because they rely on banks for loans, they may feel an indirect impact. Basel is a set of rules agreed to by regulators throughout the world after the 2008 financial crisis. It requires banks to put aside more capital to cover losses, including unpaid loans, and tightens the definition for which assets a bank can use to meet the capital levels. Basel III was scheduled to go into effect in January, but U.S. regulators in November said there would be a delay, and European Union regulators may follow suit. Basel III faces many critics. In February, 2011, the Organisation for Economic Co-operation and Development (OECD) issued a report, concluding that Basel III will decrease the growth of the annual gross domestic product of the U.S., EU and Japan, by -.05 to .15 annually.

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"Basel III will impact small banks that invest into alternative assets and therefore it will impact businesses' access to capital. Many smaller banks will not be able to meet the stricter requirements, and many small banks will disappear or be merged into larger banks," says Palmer. "The spirit of Basel III is to ensure solvency, yet these regulations will result in fewer banks, thus leaving only larger banks, which then can pose the threat of becoming too big to fail."

If smaller banks do indeed get swallowed up or simply disappear, it will make it harder for PE firms and their portfolio companies to secure loans.

Capital Gains Tax Rates 1942-2012

Year	President	Capital Gains Rate
1942-67	F. Roosevelt	25%
1976	G. Ford	39.9%
1979	J. Carter	28%
1982	R. Regan	20%
1987	R. Regan	28%
1997	B. Clinton	20%
2003	G.W. Bush	15%
2012	B. Obama	15%

Source: Tax Policy Center

In general, recent regulations put in place to keep the financial system safe are hurting smaller firms, argue opponents. Smaller firms do not have the bandwidth to handle the cost of additional regulations.

"Regulations insuring a healthy and competitive market can be helpful; however, many regulations are designed for multi-billion dollar, multi-national entities, and not for lower-middle-market private equity funds," points out Simmons. "I don't think that small private equity funds present systemic risk and the burden of regulations is much more onerous for small funds. The costs seem to outweigh the benefits. We don't have a finance department of 20 people, nor a large budget, to deal with additional regulation. Congress has to understand what regulations mean to everyone in the industry, not just the larger players." M&A