Anchin Alert

Anchin, Block & Anchin LLP
Accountants and Advisors

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Tax Update: Proposed Bill Closing Tax Loophole Could be a Boon for Connecticut; IRS Recent Audit Targeting Management Fee Waivers

The Connecticut state legislature earlier this year proposed a bill that would slap a new 19 percent tax on investment management services fees, also known as "carried interest." Similar bills are planned, or have been introduced, in other states including New York, New Jersey, Massachusetts and Rhode Island. The Connecticut bill would only be effective if similar bills are passed in these other states. The investment community will also likely raise a strong opposition to this proposal as they have successfully done with similar bills that have been proposed in the past.

The loophole (or "carried interest") came about in the 1990's when hedge fund managers and private equity managers were allowed a tax break by paying the lower capital gains tax rate (generally 20%) versus the higher ordinary income tax rate (typically 39.6%) on certain income. Unlike management fees, which are taxed as ordinary income, the allocation of fund profits attributable to long-term capital gains are taxed at the lower rate applicable to long-term capital gains. Attempts by the federal government, dating back as early as June 2007, to tax carried interest as ordinary income have been unsuccessful. The Internal Revenue Service (IRS) served notice with the issuance of proposed regulations in July 2015 that it is willing to tax management fee waivers (as ordinary income in which managers reclassify management fees as carried interest), limiting the tax benefits of management fee waivers and other fee-waiver arrangements.

This is the first time the IRS has attempted to stop both hedge fund and private equity fund managers from reducing taxes of executives by reclassifying how management fees are treated. Specifically, the IRS is targeting the practice of converting management fees to shares of future profits of a fund—also known as "carried interest"—through the waiver of management fees. According to a BNA news report, the IRS has recently proposed adjustments and penalties to a private fund manager related to management fee waivers. Based on the report, this is one of the first cases to arise in connection with the IRS's effort to stop the practice.

With the issuance of the July 2015 proposed regulations and the more recent IRS target of management fee waivers on audit, the onus falls on registered investment advisers to determine whether their existing management fee-waiver arrangements are in compliance with current regulations lest they risk an IRS audit and potential penalties. The extent to which arrangements have significant entrepreneurial risk or fail to meet the other factors will need to be assessed for each such arrangement. Those arrangements that do not properly provide for a clawback of amounts upon subsequent losses appear to be at risk, as are arrangements where the provider of the management services (i.e., the management company) transfers the potential right to the waived fee amounts to another recipient, such as the general partner.

The recent IRS audit targeting management fee waivers comes less than three months after the proposed Connecticut legislation. And while a 2013 Congressional Budget Office (CBO) report estimated that taxing carried interest as ordinary income would raise federal revenue by $17 billion over a decade, (truly a drop in the bucket in terms of the Federal Budget), Connecticut State Rep. Robyn Porter told the *Wall Street Journal* the legislation could raise $535 million annually as the state tries to close a looming budget deficit of $1.5 billion.

Will there be a race to eliminating carried interest? Will the federal government be the ones to move first or will the states enact legislation before them? Anchin will continue to keep you informed as this story evolves in 2017.

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