



CRS Report for Congress

Taxation of Hedge Fund and Private Equity Managers

Mark Jickling
Specialist in Public Finance
Government and Finance Division

Donald J. Marples
Specialist in Public Finance
Government and Finance Division

Summary

Hedge funds and private equity funds are investment pools generally available only to institutions and wealthy individuals. Private equity funds acquire ownership stakes in other companies and seek to profit by improving operating results or through financial restructuring. Hedge funds follow many strategies, investing in any market where managers see profit opportunities. The two kinds of funds are generally structured as partnerships: the fund managers act as general partners, while the outside investors are limited partners. General partners are compensated in two ways. First, to the extent that they invest their own capital in the funds, they share in the appreciation of fund assets. Second, they charge the limited partners two kinds of annual fees: a percentage of total fund assets, and a percentage of the fund's earnings. The latter performance fee is called "carried interest" and is treated as capital gains under current tax rules.

Several bills relating to the hedge fund issue have been introduced to date in the 110th Congress. S. 1624 would require private equity firms organized as publicly traded partnerships to pay corporate income tax. H.R. 2834, H.R. 3996, and H.R. 6275 would make carried interest taxable as ordinary income. H.R. 4351 and H.R. 6049 would include in gross income the portion of carried interest currently deferred offshore in foreign-chartered funds. In addition to summarizing the legislation, this report provides background on hedge funds and private equity and summarizes the tax issues. It will be updated as legislative developments warrant.

Background

Private Equity. Private equity firms buy and sell other businesses. The industry can be roughly divided into two parts: venture capital and buyout funds. Venture capitalists invest in small, startup firms, providing financing and management expertise. Their payoff usually comes when the firms are sold, either by selling shares into the

public stock market through an initial public offering (IPO), or by an outright sale to a larger company.

Buyout funds acquire ownership stakes in businesses of all sizes, from small concerns to industrial giants like Chrysler. The best-known form of transaction is the leveraged buyout (LBO), in which private equity investors use the proceeds of debt issued by the target company to acquire all the outstanding shares of a public company, which then becomes private. The LBO deal can be very lucrative for the private equity investors: they receive a premium above the going market price for their stake in the target, and at the end of the transaction they own the entire target company, even though they have sold their shares. After completion of the LBO, as owners of a private corporation, they can pay themselves fees, salaries, and dividends without having to answer to public shareholders or Wall Street analysts. An increasingly common practice is to issue debt and use the proceeds to pay a special dividend to the shareholders — who are the private equity investors themselves.¹ At the end of the process, usually several years after the acquisition, the company is resold, either to public investors through an IPO (in this case called a “reverse LBO”), or to another firm.

Hedge Funds. Hedge funds trade in all financial markets, employing a very broad range of investment strategies. Some take simple speculative positions on the direction of prices of financial assets — stocks, bonds, commodities, currencies, etc. — while others construct very complex portfolios based on price relationships across asset classes and across markets, designed to produce positive returns whatever the direction of prices in the underlying markets. Some funds follow high risk strategies; others are quite conservative. Hedge fund trading is not always based on short-term strategies, but in general their investment horizons are shorter than those of private equity funds, whose holding periods average six to ten years.

The line between private equity and hedge funds is often blurred. A significant subset of hedge funds, called “activist” funds, also operates in the corporate takeover market. Such funds typically buy a stake in a public company and then pressure the target firm to make changes in operations (such as spinning off underperforming units or assets), governance (e.g., replacing top executives or appointing a hedge fund designee to the board of directors), or financial structure (announcing a stock buyback or a special dividend) that will boost the share price. If these efforts do not succeed in the short-term, the funds may hold on to their investments for years, in essence replicating the strategy of value investors like Warren Buffett.

The Boom. Over the past several years, both private equity and hedge funds have grown rapidly in size and number, because of a number of factors that some call a “perfect storm.” When the bull market ended in 2000 and interest rates fell, institutional investors such as pension funds and foundations turned to “alternative” investments to make up for low yields in traditional asset classes. Hedge funds and private equity were the primary beneficiaries of this shift. Falling share prices and the availability of low-cost debt capital created an unusually favorable situation for private equity funds: they could borrow to finance acquisitions at relatively low cost, and expect to sell into a recovering stock market.

¹ Kate Kelly, “Executives Hedge Their Own IPOs,” *Wall Street Journal*, April 13, 2007, p. C1.

While there are no official or comprehensive statistics on the size of either industry, an often cited estimate is that there are now 8,000-9,000 hedge funds, with about \$1.2 trillion in investor funds under management. A decade ago, the comparable estimates were 2,500 funds and \$200 billion in capital. In private equity, firms have raised more than \$1 trillion in the past decade, with about \$200-250 billion in 2006 alone. In 2006, LBOs accounted for 18% of the dollar value of all corporate mergers, up from about 2% in the late 1990s.² In short, private equity and hedge funds, once marginal players, now exert significant influence in the markets where they operate.

Fund Structure and Compensation

While private equity firms and hedge funds may differ in their investment strategies, their structures are similar. Nearly all are organized as partnerships, which means that their earnings are not taxed at the firm level. Most partnerships are simply straightforward conduits of taxable income or loss and tax attributes to the individual partners. They can, however, also be used to manipulate the allocation of tax attributes and to shelter income and assets from taxation.

There are two kinds of partners. The fund managers, who guide the investment strategy, are general partners. Their background typically includes experience at a Wall Street investment bank, although two former Secretaries of the Treasury and a former Securities and Exchange Commission (SEC) chairman now run hedge funds.

Outside investors, who contribute capital but have no say in investment or management decisions, are the limited partners. They are generally institutional investors — public and corporate pension funds, insurance companies, foundations, and endowments — or wealthy individuals. The general partners often invest their own capital in the funds, but this is usually a small share of the total.³

Hedge funds typically establish multiple funds to accommodate the tax planning preferences of different investors. While they generally share a common pool of underlying assets, they are chartered in different jurisdictions to cater to different clientele. Foreign investors and U.S. tax-exempt institutions may prefer to invest in foreign-chartered funds, while other types of U.S. investors find it disadvantageous to invest in foreign funds. By one estimate, about 7,000 hedge funds, or about 80% of the total, are registered in the Cayman Islands as well as their home country.⁴

Excluded from the list of limited partners is the small public investor. Under U.S. law, the sale of shares, or interests, in an investment partnership constitutes an offering of securities, and must be registered with the SEC if the offering is public. In order to

² “M&A Almanac,” *Mergers & Acquisitions*, February 2007, p. 82.

³ According to media reports, general partners accounted for about 3% of funds raised by private equity firms in 2005. “Here’s Where the Capital Came From In 2005,” *Dow Jones Private Equity Analyst*, April 2006, p. 16.

⁴ James Eedes, “Special Supplement: Cayman Islands - Funds Flourish,” *The Banker*, July 1, 2006, p. 1.

avoid registration, and the associated disclosure requirements,⁵ most funds rely on exemptions in the securities laws that allow them to make unregulated “private” offerings. In order to qualify for these exemptions, prospective limited partners must meet various income and asset thresholds. (The most basic is the “accredited investor” standard — income of \$200,000 or more in the past two years and at least \$1 million in assets.)

Recently, a number of hedge funds and private equity partnerships have gone public, by selling shares (or units) in an IPO. Their securities are now traded on the New York Stock Exchange and other major markets, and may be purchased by anyone. These firms, which include the Fortress Investment Group and Blackstone, will operate much as before, but will be required to file quarterly and annual financial statements and make the full range of disclosures required by the SEC.

Types of Compensation. When the funds’ investments yield a positive return, both limited and general partners receive income, as the value of their share of the fund increases. This income, as mentioned above, is not taxed at the partnership level; only the individual partners pay taxes, usually at the capital gains rate.

In addition, the general partners receive compensation from the limited partners. Compensation structures may vary from fund to fund, but the standard pay formula is called “2 and 20.” That is, fund managers take 2% of the fund’s assets each year as a management fee, and 20% of the total profits as a kind of performance bonus.⁶

The percentage-of-assets management fee is usually paid in cash and is taxed at ordinary income rates.

The 20% performance fee is sometimes paid in cash, and sometimes credited to the manager’s account. Because the amount is often carried over from year to year until a cash payment is made, usually following the closing out of an investment, it is called “carried interest.” The carried interest is taxed at the capital gains rate.

Amounts of Compensation. Given the fact that these funds are private, no comprehensive figures on managers’ compensation are available, although a number of consultants and trade groups do publish estimates. According to *Alpha* magazine, the top 25 hedge fund managers earned \$14 billion in 2006.⁷ Comparable annual lists are not published for private equity managers, probably because cash distributions occur less frequently than in hedge funds, and there is greater year-to-year variation. One estimate is that managers earned \$45 billion over the past six years.⁸

⁵ Public offerors of securities must make public audited financial statements and detailed figures on executive pay, among other information.

⁶ The actual percentages may be higher or lower, but the fees charged by hedge funds and private equity are generally very high compared to other investments — public mutual fund fees, for example, average about 1.1%.

⁷ Andrei Postelnicu, “For Hedge Fund Head, Very Good Year; Simons Led Industry Again, Earning \$1.7 Billion in 2006,” *Washington Post*, April 25, 2007, p. D3.

⁸ Jenny Anderson and Andrew Ross Sorkin, “Hedge Fund Operators May Lose U.S. Tax Break: (continued...) ”

Tax Issues and Proposals

Several bills before the 110th Congress propose to change the tax treatment of fund manager earnings, or of the funds themselves. Fund manager compensation also raises other tax issues, which are set out below.

Tax Treatment of Carried Interest. As noted above, carried interest is the portion of fund managers' compensation that represents a percentage of the funds' total investment gains. Under current tax rules, it is generally taxed at the capital gains rate (generally 15%) when realized. Under proposals made in H.R. 2834, H.R. 3996, and H.R. 6275 carried interest "shall be treated as ordinary income for the performance of services" and thus taxed at rates up to 35%. Supporters of the proposals argue that carried interest is essentially a fee for investment advisory services, and that the appropriate treatment is to tax it like other ordinary income. Opponents maintain that since the source of carried interest is earnings on the fund's investments, it should be treated like any other investment income: capital gains if held for more than a year, ordinary income if the holding period is less. H.R. 6275 was reported out of the House Committee on Ways and Means on June 20, 2008.

Publicly Traded Partnerships. Publicly traded partnerships are partnerships whose interests are traded on an established exchange or in a secondary market. They are generally treated as corporations for tax purposes and subject to the corporation income tax with its 35% general rate, with two exceptions. One exception consists of partnerships with at least 90% of their gross income from passive investments, such as dividends, interest, rents, capital gains, and mining and natural resources income.⁹ These partnerships are not taxed at the corporate level.

S. 1624, introduced on June 14, 2007, by Senator Max Baucus, and others, with Senator Chuck Grassley as an original co-sponsor, would change the tax treatment of publicly traded partnerships that provide investment advisory and related asset management services: they would be taxed as though they were corporations. That is, they would pay the corporate income tax on their earnings, rather than pass those earnings through to be taxed only as the partners' individual income. In a news release, Senator Baucus stated that the bill was needed

to ensure that some corporations are not disadvantaged because they conduct business in the corporate form and pay taxes as a corporation. Asset management service and investment advisory partnerships provide the same types of active business services as their corporate competitors. Our tax system functions best when it is fair. The tax

⁸ (...continued)

Lawmakers Look at Private Equity Wealth," *International Herald Tribune*, June 22, 2007, p. 14.

⁹ A second exception consists of those partnerships that were publicly traded on December 17, 1987; these partnerships, originally grandfathered in for 10 years, may now elect to retain partnership treatment by paying a tax of 3.5% of gross income from the active conduct of business.

law ought to treat similarly situated taxpayers the same. Thus, these publicly traded partnerships should be taxed as corporations.¹⁰

The bill has been criticized by Henry Paulson, Secretary of the Treasury, on the grounds that tax policy ought not to single out one industry sector.¹¹ Chairman Baucus held a hearing on the bill in the Finance Committee in August 2007.

Deferral of Income. Along with its reduced tax rates, capital gains income receives another benefit — termed a tax deferral — because it is not taxed until realized. Carried interest shares this benefit. The concept of tax deferral relates to the timing of tax payments — with the idea that a taxpayer prefers to pay taxes in the future, rather than today because he or she can control the funds longer and use them in some other way. Deferral increases in value with both the length of the deferral period and the taxpayer’s marginal tax rate. Carried interest, discussed above, benefits from deferral since it is only taxed when realized — as is the case with capital gains.

In addition, hedge fund managers can amplify the benefits of deferral by electing to receive their compensation in shares of foreign-chartered funds. As mentioned above, these foreign-chartered funds may appeal to different types of investors than their U.S. chartered counterparts. In addition to deferring U.S. tax as long as the money is held offshore, and not related to the conduct of a trade or business, the returns on the investment can compound tax-free — resulting in a substantial tax advantage.¹² The advantage is such that the *New York Times* reported that a single hedge fund, Citadel, has deferred at least \$1.7 billion since it was founded in 1990.¹³ H.R. 3996, H.R. 4351, and H.R. 6049, all introduced by Chairman Rangel, would include compensation deferred through foreign-chartered funds in the gross income of the hedge fund manager. As mentioned above, H.R. 3996 was passed by both the House of Representatives and the Senate, though the Senate amended the bill to remove this provision. H.R. 4351, was passed by the House of Representatives and referred to the Senate Committee on Finance on January 22, 2008. H.R. 6049 was passed by the House of Representatives on May 21, 2008.

crsphpgw

¹⁰ Sen. Max Baucus, “Statement of Introduction on Publicly Traded Partnership Bill,” June 13, 2007.

¹¹ Brett Ferguson, “Paulson Objects to Senate Bill on Private Equity Firms,” *BNA Daily Tax Report*, June 28, 2007, p. G9.

¹² Deferred compensation arrangements are significantly less common in U.S. chartered funds, because they result in investors losing the deduction associated with compensation and facing higher tax liabilities.

¹³ Jenny Anderson, “Managers Use Hedge Funds as Big IRAs,” *New York Times*, April 17, 2007, p. A1.