CLIENT ALERT

Tax Reform in Small Bites: Restructuring General Partner Returns

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This is one in a series of articles analyzing the impact of tax reform on investment funds and their portfolio companies. Click here to see all articles in the series.

General partners in investment funds generally receive both a management fee (often calculated as a percentage of either commitments or assets) and a carried interest in the profits of the fund. Limited partners historically have had limited ability to deduct their share of management fees (as well as investment advisory fees, start-up expenses, and other investment related expenses related to their investment). Such amounts have been deductible (if at all) as miscellaneous itemized deductions. Under the Tax Cuts & Jobs Act (TCJA), these expenses are not deductible at all for the years 2018 through 2025. This change in law may incentivize limited partners to seek to shift the general partners' return from management fees to carried interest, and to change the way that operating and organizational expenses are paid.

Unless an investment fund is engaged in a "trade or business" for US federal income tax purposes, a limited partner's share of management fees, investment advisory fees, start-up expenses, and similar expenses are "investment expenses," which have been deductible as miscellaneous itemized deductions. In 2017 and earlier years, miscellaneous itemized deductions were deductible only to the extent they exceeded 2 percent of a limited partner's adjusted gross income, and deduction was also subject to certain other limitations. Under the TCJA, these expenses are not deductible at all, with the effect that limited partners could experience significant phantom income.

A carried interest, on the other hand, is a partnership allocation, and as such is effectively 100 percent deductible to the limited partners. A carried interest also generally results in better tax treatment to the general partner than the management fee. These facts (and the TCJA changes) make carried interest significantly more attractive from a tax point of view, both to the general partner and the limited partners in a fund. For years, funds have attempted to structure some or all of the "management fee" as a carry, which structuring led the IRS to propose regulations on carried interest in 2016. Under these rules, a carry must be structured carefully to qualify as such. Creative managers will look to optimize the way that fund expenses are charged and structured to mitigate the TCJA limitation on deductibility of expenses.

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