THE REGULATORY FUNDAMENTALS GROUP LLC

Could Curtailing Carried Interest Hurt LPs?

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Congress is (yet again) focused on curtailing the ability of fund managers to benefit from "carried interest." Whether or not this effort will succeed is somewhat questionable, but if such legislation were to pass, investment advisors to hedge and other funds without a defined investment period may be prevented from recognizing long-term capital gains on partnership interests subject to Section 1061, and other advisors may enjoy long-term capital gains rates only if investments are held for at least five years. Funds might try to find a way to accelerate the start of the holding period by creating separate vehicles to hold investments, while leaving the fund economics tied together in a way that is similar to a current fund structure, writes the WSJ.

RFG reached out to lawyers with this question: What do you think the implications might be for LPs, limited partnership agreements, and the timing of realizations if (i) the holding period for carried interest to receive long-term capital gain treatment was extended to five years (which, as a practical matter, will result in a longer holding period), (ii) the scope of Section 1061 was extended, and (iii) other changes are made to the recognition of gains on partnership interests with respect to the Inflation Reduction Act of 2022? Their responses follow.

Anonymous: The proposed method for starting the 5-year clock will mean that hedge and private equity fund advisors practically will be barred from long-term capital gain rates in respect of their current carried interests allocations. Focus will turn to altering the current carry arrangements, for example, by using special purpose vehicles and new carry distribution waterfalls for assets or groups of assets that are expected to be held for at least five years. The IRS will focus on whether those altered arrangements have substance.

Irina Pisareva (Crowell & Moring): The longer holding period provisions will create substantial uncertainty around the amount of net incentive compensation an investment manager would earn. One of the challenges is that the 5-year holding period exception applies from the time the investment fund acquires "substantially all" of its assets. This means that in a typical scenario of a fund with a 5-year life, [some] investments … would not meet the 5-year threshold. It is even less clear how to apply this test in the case of large funds. The choice of a 5-year term seems arbitrary as most traditional PE assets have a life of 3-5 years.

From the tax-exempt investor's perspective, in certain scenarios, the new rules may bite into investment fund managers' desire to blend existing longer-term life assets with newer shorter-term but higher IRR assets within the same family of funds.

Another challenge would be whether the uncertainties related to incentive compensation would impact the private fund industry's ability to attract top talent. The tightening in carried interest taxation rules, combined with the ever-rising compliance and administrative expenses of running a fund could prompt the industry to consolidate under the umbrella of large investment management firms and the asset management "arms" of investment banks. Some managers may leave the private fund industry to join corporate acquisitions groups of large corporations. In all of these scenarios, the tax-exempt investors may have less choices of who to invest their money with. It is also possible that as a result of consolidation in the fund industry, investment management fees may increase.

Other comments. Other lawyers suggested that the industry may respond by making significant changes to fund structures and compensation models, including, in some instances, switching from an incentive allocation to an incentive fee structure. However one lawyer responded, "It seems unlikely that fund managers would try to change their compensation arrangements with existing investors, but new vehicles may be developed with compensation structures that reflect the changed economics of carried interest positions."