Global Financial Private Capital

What Is Carried Interest?

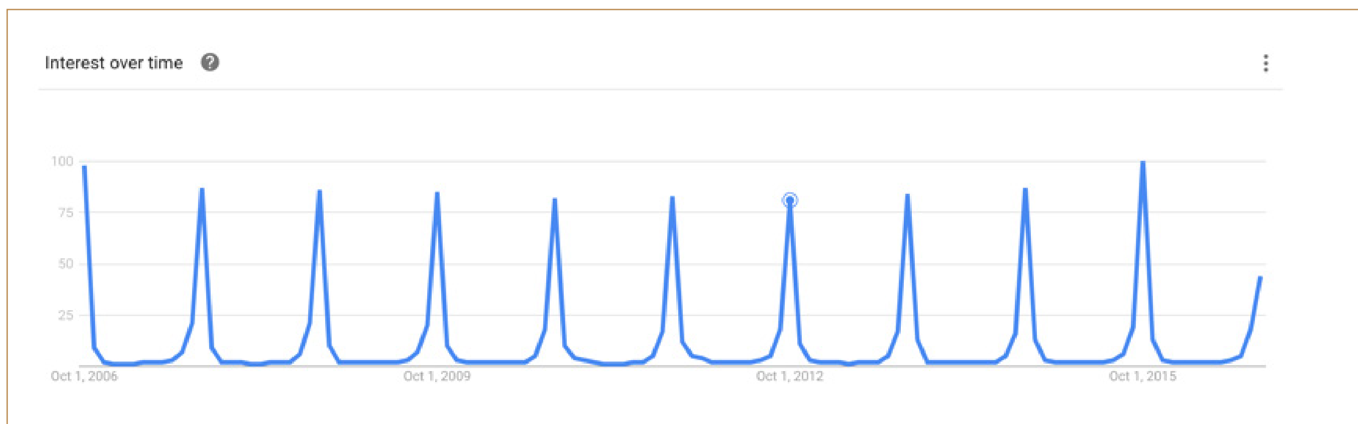
SYNOPSIS

- Google Trends is a website that allows a visitor to gauge the popularity of a search phrase over a given time period.
- "Carried Interest" is a term that has garnered a lot of attention from both sides of the presidential race, and investors want to know why it's become such a political hot button.
- As usual, politicians are doing nothing more than taking an irrelevant topic and blowing it up to avoid discussing the real issues that impact our country.

I have no intention of pushing investors to one side or the other, but rather make them aware that the carried interest debate is nothing more than politics at its worst.

INTEREST HAS SPIKED

Google hosts a website called Google Trends (https://www.google.com/trends/), which graphically displays how popular a search phrase has ranked over a period of time. For example, the chart below is a trend report on "Halloween" for the past decade.



Source: Google Trends

It should be no surprise that interest spikes around October but then promptly disappears after trick-or-treating has concluded. The chart below is another trend report on a topic that has spiked in popularity recently.

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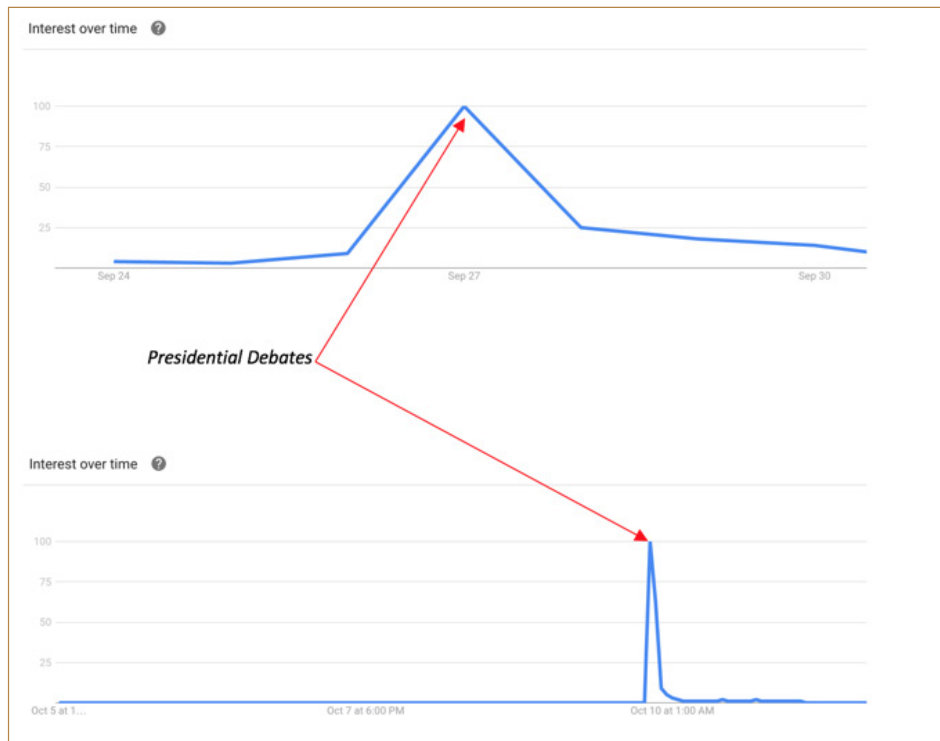

Source: Google Trends, Aviance Capital analysis

These trend reports are on "carried interest," and based on the reaction, people are curious about why it came up in both presidential debates.

Carried interest is a rather niche topic that pertains to private investment funds, but since it's taken center stage in the race to the White House, here are answers to some of the more common questions that investors have asked recently.

How do private investment firms work?

Let's say that a team of five seasoned executives from the manufacturing sector decided to partner and seek out small companies that exhibited the potential for success but were struggling through the challenges of growing their business.

They form a "private equity" fund and are considered "general partners," or GPs for short because they are going to be responsible for managing all aspects of the fund. Their next step is to find companies to put in their portfolio, so they conduct a search across the country for manufacturing companies that meet their criteria for investment.

These executives carry decades of manufacturing experience and are very confident that they can help companies grow significantly, but they also know that they cannot simply tell existing management what needs to be done. Instead, they need control over the day-to-day activities such as operations, financials, personnel, etc.

Few companies will just hand over the reins to outsiders, so the team is going to have to buy enough of each target company's stock to where they have control. These purchases can take hundreds of millions of dollars, so they raise money from two primary sources.

1. **Banks Loans**: Several banks will work together to fund the transaction, and the private equity fund will pay interest on these loans over time.
2. **Limited Partners**: The GPs will embark on fund raising activities to find investors who are willing to share in the risk for a piece of the return. They are called "limited partners," or LPs for short because they have very limited involvement in the fund.

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Once the GPs secure the capital, they need to hire personnel, rent office space, and do everything else a company needs to do to stay in business. In order to pay for it all and to compensate the GPs for doing the heavy lifting, they charge the LPs a management fee.

This fee ranges between 1% to 2% annually, so if the fund raised $100 million from its LPs, and the GPs charged a 2% management fee, then the GPs would use $2 million of the funds raised to pay its expenses in the first year.

The GPs do not assume so much liability and work as hard as they do for their investors just to earn a management fee. Instead, their goal is to profit from the sale of their investments. For example, if this fund invested $20 million of the capital raised into a small manufacturing company that was sold three years later for $200 million, then both the GPs and LPs will realize a big return on their investment.

What is carried interest?

Typically, the profit split between the two partners is 20% to the GPs and 80% to the LPs. If the profits from the sale in the example above were $100 million after the debt was paid back, that means the GPs take home $20 million, which in this case gets split amongst five people.

This percentage that GPs get to keep is called the "carry" or "carried interest," which can add up to huge amounts of money for those GPs who are successful over time. These gains are what is creating all the controversy.

What is the origin of carried interest?

The concept goes back to medieval times when sea captains would carry cargo on behalf of merchants to foreign ports and sell it. Upon safe delivery, a captain would get a cut of profits, which was his "carried interest" for carrying the cargo to some other port.

Why is carried interest such a hot topic these days?

Carried interest is considered a capital gain under the U.S. tax code and subsequently taxed at the more favorable capital gains tax rate. Both presidential candidates have advocated raising the tax rate, but there has been a tremendous amount of pushback from investors.

Those opposed to the change argue that any carried interest is by no means guaranteed. It is only created when the fund generates profits that exceed a predefined threshold, often referred to as a "hurdle rate."

For example, if the GPs in our example have a hurdle rate of 8% and their fund had a 6% return, they would not be able to collect their carried interest. The entire 6% would then be given to the LPs.

Since the carry is collected only when a profit from investment exceeds its hurdle rate, those who support the current tax treatment see carried interest as a capital gain in the same manner as selling a publicly traded stock or even a house.

Those advocating a change to a higher rate believe that the function of a GP is to generate returns for LPs. Therefore, any carried interest earned should be viewed as a stream of income rather than an investment gain.

It may sound like the advocates and opponents are splitting hairs, but the ramifications for GPs are huge. If either candidate were to follow through, the tax rate could rise 100% or more. This could dramatically increase the risk to being a GP if expected returns fell by so much.

However, the real reason why it's become such a hot topic is that it has now been politicized by officials and the media. They feel that treating carried interest as a capital gain is a loophole or deduction for wealthy investors to avoid paying higher taxes.

How will a rise in the tax rate of carried interest help our country?

Trump has said that he will get rid of the carried interest deduction by raising the tax rate from 23.8% up to 33%. Clinton has been less clear about her tax policy, but it is likely that she will try to reclassify carried interest as ordinary income, which could more than double the tax.

According to Congress's non-partisan Joint Tax Committee, taxing carried interest capital gains at ordinary income tax rates would raise taxes by $19.6 billion over the next decade. While this may sound like a big number, let's put this into context.

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The Congressional Budget Office, also non-partisan, projects that total federal tax revenues over the next decade will be $41.7 trillion over that same decade. Therefore, the reclassification to ordinary income would increase tax revenues by 0.047%.

In short, the gain in tax revenue is microscopic that barely classifies as a rounding error.

How will a rise in the tax rate of carried interest hurt our country?

This question is difficult to answer because it requires us to consider the law of unintended consequences. The GPs in a fund shoulder a huge amount of liability and risk, so lowering their expected return may make future investments less attractive.

If this were to happen then it could be bad for the country because private equity and venture capital are critical components to our economy. These industries not only create jobs but also provide access to capital to those companies who need it the most.

For example, Google, Facebook, Uber, and so many other companies that are changing the world got to where they are today due to private investments. If the government makes such ventures less profitable going forward, then investors may put their capital to work elsewhere.

IMPLICATIONS FOR INVESTORS

Trump has said that he will get rid of the "carried interest deduction," and Clinton has taken it a step further by proclaiming that she will completely remove carried interest from the tax code.

Both of these promised are equally confusing because carried interest is nothing more than a term used to describe the portion of investment returns for GPs. It is not a deduction, and it cannot be removed. All that can happen is reclassifying it from a capital gain to something else.

However, the politicians and mainstream media have latched on to this topic for reasons that truly baffle me. Think of all the issues that really matter at the moment. Does carried interest matter more than fixing the infrastructure in this country? Is getting it right somehow going to help the world defeat ISIS?

Decide for yourself if the tax should be raised or not. I have no intention of pushing investors to one side or the other, but rather make them aware that the carried interest debate is nothing more than politics at its worst.

The bottom line is that the future for the tax treatment of carried interest will have no material effect on your investments or the broader economy in the near future.

Sincerely,

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