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Carried Interest Warning From Court May Be Trouble for Treasury

By Aysha Bagchi

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 - Future fights may lead to some funds changing investment strategy
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A recent court case meant to clarify the definition of a corporation intensifies questions about the tax treatment of carried interest, a prized perk for private equity and hedge fund managers.

The IRS argued for a broad definition of the term "corporation" in the case. But the legal issue that could come up in the future is whether it's reasonable for Treasury regulations to interpret the term more narrowly in the carried interest context, affecting who can qualify for the treatment.

That question is even more relevant because Treasury is planning guidance that could close what some see as an error created in the 2017 tax law's treatment of carried interest. The carried interest perk lets fund managers have much of their income taxed at 23.8% rather than at the top tax rate of 37%.

The tax law exempted corporations from having to hold assets for a longer time period before qualifying for the preferential tax rate. Treasury's forthcoming rules are expected to shut down the possibility that an S corporation could qualify for the exception. (An S corporation is an entity that isn't taxed at the corporate level, instead passing income through to shareholders for tax purposes.)

But the U.S. Court of Appeals for the Federal Circuit suggested it isn't so simple: it said the IRS

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If future regulations are challenged and invalidated by a court, it could leave open the potential for some private equity and hedge fund managers to take on S corporation status and get the preferential tax rate after just one year. To block that strategy, Congress would have to rewrite the provision in the tax law.

A Court's Question

The Oct. 17 appeals court decision in *Charleston Area Medical Ctr. v. United States* backed the IRS's broader definition of the word "corporation." The question in the case was whether the agency should treat a nonprofit incorporated under state law as a "corporation" when calculating the interest it owed on a tax refund.

In a point that wasn't central to its ruling, the court highlighted the contrast between the government's broad position in the case and its more narrow interpretation when it comes to carried interest, which Treasury laid out in a 2018 notice.

"While we question whether the regulations described in the Notice, if codified, would be proper in view of the government's position in this case that the Code incorporates the broad, common law meaning of 'corporation,' we leave that issue for another day," the court said.

That could mean trouble for the IRS—especially if future regulations were challenged at the Federal Circuit.

"I wouldn't want to be the government defending the regulation particularly in that type of case," said Monte Jackel, a tax expert and former special adviser to the IRS Chief Counsel. "And I'm not sure about defending the regulation generally."

Treasury and the IRS didn't return multiple requests for comment.

Looking Ahead

The exact impact of future carried interest regulations getting struck down in court is tricky to pinpoint, because of the nature of private equity and hedge funds.

Private equity funds typically hold assets for between four and seven years, although that can vary, according to Jason Mulvihill, COO and general counsel at the American Investment Council, a private equity advocacy group.

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Activist hedge funds that targeted companies in 2010 and 2011, for example, had a median holding period of 458 days, according to an article published in the International Journal of Disclosure and Governance.

Even some activist funds that hold assets for shorter periods may end up altering investment behavior to lock in tax benefits, said Yvan Allaire, one of the article's authors and executive chair of the Board of Directors for the Institute for Governance of Private and Public Organizations.

If future regulations are struck down in court, those hedge funds may decide to put carried interest into an LLC, which could elect S corporation status.

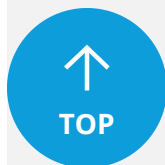
But being an S corporation comes with a lot of requirements.

"S corporations are just sort of a pain generally," said Scott Dolson, who heads the Private Equity Industry Team at Frost Brown Todd LLC. "I think you'd probably want to just set it up so that you would not have to convert everything."

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