Focus on Funds

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Incentive Compensation: Allocation or Fee?

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In light of recent federal tax changes — especially the new 3.8% tax on net investment income — hedge fund managers should review the way they are compensated. In some cases, it may be advantageous to structure incentive compensation as a fee rather than an allocation.

What's the Difference?

Incentive fees are taxed as ordinary income. On the other hand, incentive allocations, or "carried interests," generally retain the character of the underlying fund's income and profits. Thus, managers typically receive a portion of their compensation in the form of capital gains and qualified dividends, which are taxed at lower rates. Also, while fees may be subject to self-employment (SE) taxes, allocations generally are not.

What's Changed?

This year, several tax changes took effect that have an impact on higher-income taxpayers. They include:

- A new 39.6% tax bracket, up from 35%, for individuals with taxable income over $400,000 ($450,000 for joint filers).
- An increase in the top capital gain and qualified dividend rates, from 15% to 20%, for taxpayers in the 39.6% bracket.
- An additional 0.9% Medicare tax on earned income above $200,000 ($250,000 for joint filers), bringing the uncapped Medicare portion of SE taxes up to 3.8% at this income level. SE taxes also include a 12.4% Social Security tax on the first $113,700 of net SE income (for 2013).
- A new 3.8% Medicare tax on net investment income (NII) to the extent a taxpayer's modified adjusted gross income exceeds $200,000 ($250,000 for joint filers). NII includes interest, dividends, annuities, rents, royalties, net capital gains, and income from passive activities and trading businesses. Certain active business income is exempt.

The NII tax has significant implications for fund manager compensation. Generally, the tax will apply to most if not all of a fund manager's share of incentive allocations, but not to incentive fees.

Previously, even if a fund's income consisted primarily of short-term capital gains taxed at ordinary income rates, incentive allocations still had an advantage over incentive fees because they avoided SE taxes. Now, however, the 3.8% NII tax essentially mirrors the 3.8% Medicare component of SE taxes for higher-income taxpayers, eliminating that advantage in many cases.

The NII tax will be particularly harsh for some fund managers who receive incentive allocations because, under currently proposed regulations, it may not be possible to offset trading or investment losses against trading gains subject to the tax.

Run the Numbers

Would you benefit by switching from incentive allocations to incentive fees to reduce the impact of NII taxes? The answer depends on a variety of factors, including your personal tax situation as well as the structure, portfolio makeup and investment strategies of your funds.

To determine the best approach, please call your Untracht Early advisor to discuss the alternatives available to you to maximize tax savings.

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Of significance to investment management firms, a noninvestment company parent retains the specialized accounting used by its investment company subsidiaries in consolidation. So, for example, a noninvestment company general partner that consolidates its investment funds would retain the funds' specialized accounting as per current GAAP guidance.

Investment companies should report noncontrolling interests in other investment companies at fair value. The ASU doesn't address controlling interests (although FASB may provide guidance on that issue in the near future). But under current practice, investment companies typically consolidate only wholly-owned investment companies.

Disclosures

An investment company must disclose in its financial statements that it is an investment company under ASU Topic 946 and also report any change in its status.

Evaluate Your Status

This article covers some of the highlights of the 78-page ASU. To assess its impact, ask your advisors to evaluate your firm's investment company status and determine whether you'll need to change your reporting practices.

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