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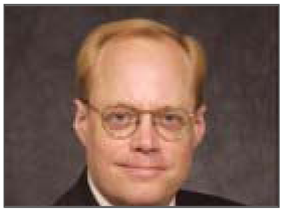

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THE TAX LAWYER

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Whistleblower Fingers Tax Tricks At Private Equity Firms

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If you feel like paying 15% would be a lot better than 35%, you might sympathize with the private equity firms hoping to hang on to their coveted carried interest perk. Even if they like Mitt Romney, they probably don't like the fact that Mitt's taxes stoke "carried interest" flames. The New York investigation into the secretive firms' tax practices? That doesn't help either.

New York's investigation includes subpoenas slapped on a dozen private equity shops including Mr. Romney's old firm. It concerns whether and how they converted ordinary management fees (35%) into carried interests (15%). The fact that many may have done it hardly seems surprising.

But now it turns out there was a mole in the private equity industry who triggered the investigation. See Whistleblower Is Key to New York Tax Probe on Buyout Firms. That's juicy. Plus, the timing of this story fits nicely with the revelation that UBS whistleblower Bradley Birkenfeld just got a whopping $104 million for his role in the Swiss bank rout. See UBS' Bradley Birkenfeld Gets $104 Million, Blows Doors Off IRS Whistleblower Program.

That may make queasy private equity fund mavens even more uncomfortable. Consider how how much money is at stake. Management fees are taxed as ordinary income. Carried interests—deemed fund investments—are taxed as capital gain. Like it or not, under existing tax law, carried interest is capital.

The issue seems unfair, has been attacked before, and could be changed by statute or even administratively. But that hasn't happened. Ways and Means Committee Ranking Member Sander Levin (D-MI) has twice authored legislation to tax carried interests as ordinary income. It has passed the House ***four times*** but never the Senate.

New York's investigation is focused on whether ***conversions*** of 35% management fees to 15% carried interests were legit or abused. New York can and should satisfy itself whether these deals pass muster. Although there are different ways of doing it, it is often called a "management fee waiver." 40% of U.S. based funds do it, according to a Dow Jones survey.

A comprehensive overhaul of the tax code is overdue and this is a good example of why. What is ordinary and what is capital is not always obvious. See Capital Gains, Ordinary Income and Shades of Gray. Plus, how partnership income is taxed is determined by how the ***partnership*** earns a profit, not by what the ***partners*** contribute.

Even with all of this, though, with this much attention, something seem's bound to give.

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