



Win The Battle, Lose The War

Earlier this month, Washington wound up an ugly slugfest over deficit reduction that left approval ratings lower than at any time in history. Congressional Republicans appear to have blocked tax increases, at least until the end of 2012. So we're safe, right? Well, not so fast. Legislation isn't the only way for taxes to go up. We still have to keep a sharp eye out for everything else coming from Washington. Take, for example, the "carried interest" debate.

Hedge fund managers, venture capital fund managers, and private equity fund managers are the rock stars of the money management world. John Paulson, who first gained fame for betting against housing prices in 2007, made an estimated \$4.9 *billion* in 2010 alone. The top 25 managers as a group made \$22.07 billion combined. Based on IRS figures, that's as much money as 667,816 average taxpayers - a population greater than the entire city of Boston!

Fund managers don't just *make* more than the rest of us, they *keep* more than the rest of us. That's because of how they get paid. They typically charge investors a management fee ranging from 2% to 4% of assets under management. They classify those fees as ordinary income, taxed at marginal rates up to 35%. But they also charge an incentive fee ranging from 20% to as high as 50% of annual gains. They classify *those* fees as an investment producing capital gains, with tax capped at the 15% maximum for long-term gains.

It's no surprise that some legislators have spotted what they call oversized paychecks, combined with undersized tax bills, and cried foul. Critics of "carried interest," as it's called, have tried several times to pass legislation recharacterizing it as ordinary income. But Congressional Republicans have blocked these efforts along with efforts to raise any other taxes. Now a recent Tax Court decision suggests that the IRS might accomplish through regulations what Congress can't accomplish through legislation.

Todd Dages worked at Battery Management Company, a venture capital fund manager. From 1999 through 2003, he earned \$10.9 million in compensation and \$43.4 million in carried interest. In 2003, he deducted \$3.6 million for a loan he made to a business associate that went bad. The IRS disallowed Dages's deduction, arguing it was a personal loan not created in connection with his trade or business. As such, the IRS argued, it was deductible only as a short-term capital loss, and limited to the amount of any capital gain he reported for that year plus just \$3,000 per year. Dages's funds lost money in 2003 and he reported no capital gains for that year, so in the IRS's eyes, he was out of luck.

But the Tax Court disagreed. In [Dages v. Commissioner](#) Judge David Gustafson ruled that Dages's carried interest was compensation from a trade or business and the loan was "proximately related" to that business - therefore, Dages could deduct the loan against his ordinary income for the year. Since Tax Court opinions set binding precedent, some observers argue the IRS can use this one to write *regulations* characterizing carried interest as *ordinary income*. This means Dages could win his individual battle, but actually lose the bigger war.

We realize it's hard to feel much sympathy for an investment hotshot pulling down \$10 million per year! But the debate over the Dages decision illustrates how tax increases can come out of left field. That's why we spend valuable time monitoring the latest developments from *everywhere* in Washington, not just Capitol Hill. That proactive approach is the key to holding *your* taxes to the absolute legal minimum.