

## The Taxation of Carried Interests In Private Equity Partnerships

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Over the past several months, there has been a great deal of discussion about the taxation of so-called carried interests in private equity partnerships. Congressman Levin (D-MI) recently introduced a bill that would treat income from carried interests as ordinary income from the performance of services, and the Senate Finance Committee staff has recently held a hearing to discuss the issue.

Carried interests, often called profits interests, represent interests in the profits of a partnership separate from an interest in the liquidation value or capital of a partnership. Carried interests are commonly used in private equity partnerships as well as other economic contexts, including real estate, venture capital, oil and gas, and small business. Under current law, holders of carried interests are taxed as partners on their distributive shares of partnership income. If the partnership has long-term capital gain, holders of carried interests are taxed on their shares of the long-term capital gain. The argument that some have raised and the apparent premise of the Levin bill is that this “pass-through” treatment of capital gains income from carried interests creates an anomaly because the sponsors of private equity funds perform services for the partnership, and most service income is taxed as ordinary income.

This argument is not consistent with basic principles of the tax law, including how capital gains are defined and how partnerships are taxed. The argument is misplaced for two reasons. First, the labor involved in private equity investments is the same type of labor that is intrinsic to any investment activity. Sponsors select the investments, arrange the financing, exercise control rights inherent in ownership of the portfolio companies, and eventually decide when to dispose of the assets. If the performance of these tasks were sufficient to deprive sponsors of capital gains treatment, capital gains treatment would not be available to any investor. For example, purchasing stock through a margin account involves combining capital, some portion of which is provided by third parties, and labor effort to make an investment. Notwithstanding that much of the value may be created by the efforts of the investor to identify good stocks or other investments, the investor gets capital gains treatment. The activities of private equity sponsors are similar. The only difference is that private equity sponsors

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raise funds by issuing limited partnership interests instead of debt, but there is no good reason for changing the treatment of private equity sponsors based on how they finance their activities or because they use a partnership.

Second, even if there were good reasons for changing the tax treatment of carried interests, the change would be complex and avoidable, imposing costs on all involved without raising any significant revenue. Any rule treating payments on carried interests as service income would require taxpayers and the government to accurately separate labor and capital income, a task which has proven difficult in other contexts. Moreover, because any change in the treatment of the current private equity fund structure would be based on the partnership tax rules, using a non-partnership structure, such as debt financing, would avoid those rules. The result would be less efficient economic structures and little or no change in tax revenues.

## **I. Background and Scope**

*Basic Structure.* Private equity funds are partnerships formed to acquire large stakes in underperforming businesses.<sup>1</sup> They create value by restructuring the business, aligning management and shareholder incentives, and providing better monitoring of managers. The goal is to sell the restructured and improved business at a profit in three to five years, though the holding period may vary depending on the circumstances. Although private equity funds have been profitable in the last few years, their investments are highly risky, and there have been long cycles where returns were low.

The funds are created by a sponsor or private equity firm, such as Blackstone, KKR, or Warburg Pincus. The sponsor firm has expertise, contacts, deal flow, valuation systems, methods of managing companies, and other intangibles that potentially allow it to profit from this activity. The sponsor retains a general partnership interest in the fund, which allows it to retain control of the venture, and raises capital from outside investors who receive limited partnership interests. The limited partners generally contribute between 90 and 97 percent of the initial capital and the sponsor contributes the remaining 3 to 10 percent. The sponsor determines which portfolio companies to invest in and then raises additional funds, typically through debt, on a company-by-company basis. After the investments are made, the sponsor helps to restructure the

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<sup>1</sup>Private equity structures are described in detail in many other sources. See, e.g., Jack Levin, *Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions* (May 2006).

businesses with the objective of maximizing value. A fund typically has a life of about 10 to 12 years and will invest in a number of portfolio companies during that time.

Under a typical arrangement, the limited partners are entitled to receive a return of their invested capital and expenses plus an additional return of up to a specified amount, usually 8 or 9 percent (the hurdle rate). If there are profits above this amount, the limited partners receive allocations so that they will get 80 percent of total profits. For example, if total profits are 15 percent, the limited partners get the first 8 percent, none of the next two percent and then 80 percent of everything thereafter.

The sponsor retains the right to all returns from the venture once the limited partners have been paid. This right to profits above the hurdle rate is known as the carried interest. In addition, the sponsor receives two types of fees. One is a management fee, typically around 2 percent of total partnership capital. The management fee is a payment for the day-to-day services performed by the sponsor on behalf of the fund. The second consists of fees for providing services to the portfolio companies, sometimes known as transaction fees.<sup>2</sup> (The 2 percent management fee and the transactions fees sometimes partially offset.) Recent research shows that industry-wide, roughly two-thirds of the payments to the sponsors are from management fees or transaction fees and, correspondingly, roughly one-third is from carried interests.<sup>3</sup>

There are important business reasons for the structure of private equity partnerships. The sponsors must have sufficient freedom to be able to negotiate deals when they arise but also must be able to raise large pools of capital that are committed for a long period. This creates an incentive problem. If sponsors are unduly constrained, they will not have the necessary freedom to negotiate or make decisions, but if they have too much freedom without the right incentives, investors will not trust them with their funds. Fund structure, including the use of the 20 percent profits interest calculated over a portfolio of companies, the hurdle rate, and the multiple rounds of financing, is thought to best solve these problems.<sup>4</sup> The structure of these

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<sup>2</sup>These services include sitting on the boards of the portfolio companies and providing consulting services to help restructure the companies.

<sup>3</sup>See Andrew Metrick and Ayako Yasuda, *The Economics of Private Equity Funds*, (July 1, 2007) Table VI, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=996334](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=996334).

<sup>4</sup>See Ulf Axelson, Per Stromberg, and Michael Weisbach, *Why are Buyouts Levered? The Financial Structure of Private Equity Funds* (January 4, 2007) available at <http://www.business.uiuc.edu/weisbach/lbo%20funds%20final%20version%20jan2007.pdf>.

funds is no more tax driven than any typical investment: within a basic structure, one wants to minimize taxes but taxes are secondary to business considerations.

*Use of Profits Interests.* Although the current discussion has focused on private equity partnerships, profits interests are used in many different sectors, including oil and gas, real estate, small businesses, hedge funds, and venture capital. I have not been able to obtain data on their overall economic value because the relevant partnerships generally are privately held. One indication of their wide-spread use is that there are hundreds of articles relating to only one aspect of their tax treatment, the treatment of the receipt of a profits interest. An entire chapter in the leading partnership tax treatise, is devoted to the issue (and was written long before private equity funds became prominent).<sup>5</sup> There have been a number of court decisions and a series of guidance documents from the Treasury, culminating in recently issued proposed regulations. It is apparent from this that any change to the taxation of profits interests would affect a number of sectors in the economy.

*Current Tax Treatment.* Although there have been occasional suggestions otherwise, the overwhelming consensus (including three separate pieces of guidance from the Treasury Department) is that the typical receipt of a profits interest is not and should not be taxable. For example, admission to a law firm partnership (entitling the new partner to a share of partnership profits) is not a taxable event even if admission is valuable and highly sought after. In the private equity context, the carried interest holder receives a zero capital account. Any gain or loss allocated to the holder is then taxed to the holder exactly as it would be to any other partner. The normal capital account maintenance and substantiality requirements of section 704(b) apply. The two percent management fee and the transactions fees are taxed as ordinary income. Because, as discussed above, approximately two-thirds of the earnings of private equity sponsors are from management fees or transactions fees, approximately two-thirds of the profits earned by private equity sponsors are taxed as ordinary income under current law.

*Proposals for Change.* A number of potential changes to the treatment of carried interests have been proposed, and it is not possible to consider them all. We can break them into two categories, front-end proposals and back-end proposals. Front-end proposals are concerned with the taxation of the receipt of a profits interest, with some

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<sup>5</sup>McKee, Nelson, and Whitmire, *Federal Taxation of Partnerships and Partners* (1997), Chapter 5.

suggesting that the receipt of a profits interest should be taxable like the receipt of stock or stock options, possibly under rules similar to those in section 83.

Back-end proposals would change the treatment of a holder of a profits interest over the life of the partnership. One such proposal, advocated in separate articles by Professors Victor Fleischer and Leo Schmolka, would treat a carried interest as the temporary borrowing of capital from the limited partners.<sup>6</sup> If a partner has a 20 percent profits interest, he would be treated as if he borrowed 20 percent of the partnership capital for the life of the partnership. The holder would either be required to pay interest on the use of capital or be taxed on the forgiveness of such a payment much like we impute interest on loans under sections 7872 and 1274. In effect, under this proposal, the general partner is treated as receiving a payment for services equal to the interest-free use of capital. A second proposal, advocated by Professor Mark Gergen, would treat any payment on a profits interest as ordinary income (and grant the partnership a deduction for the same amount, which would then potentially be capitalized under the rules of section 263).<sup>7</sup> The Gergen approach would treat all payments on a carried interest as in return for services, which is a very different measure of the payment for services from the measurement of service income in the Fleischer/Schmolka proposal. The approach taken in the Levin bill introduced last month is similar to the Gergen approach. The various approaches can be mixed and matched, such as combining the Gergen approach with a section 83(b)-type election to include the value of the interest when received.

The treatment of the receipt of a profits interest has been subject to numerous articles and discussions over the last 36 years, since the *Diamond* case first raised the issue to prominence. The overwhelming consensus is that taxing profits interests on receipt is not desirable. Doing so would raise intractable valuation issues,<sup>8</sup> complex questions about how capital accounts are to be kept, and deep philosophical issues about taxing services to be performed in the future. To avoid these issues, long

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<sup>6</sup>Leo Schmolka, *Taxing Partnership Interests Exchanged for Services: Let Diamond/Campbell Quietly Die*, 47 Tax L. Rev. 287 (1991); Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, *Legal Studies Research Paper Series*, Working Paper No. 06-27, March 11, 2007, revised June 12, 2007.

<sup>7</sup>Mark Gergen, *Reforming Subchapter K: Compensating Service Partners*, 48 Tax L. Rev. 69 (1992).

<sup>8</sup>The valuation problem in this case is more difficult than the standard option valuation problem. In the standard option valuation problem, one can observe the volatility of the stock and use this to price the option. In a partnership, there is no way to observe the price or volatility of the partnership interest. In part because of valuation difficulties, the Treasury has proposed regulations that treat the value as zero in most circumstances.

standing IRS policy, embodied in revenue procedures and proposed regulations, is to treat the receipt of a profits interest as the receipt of property with a zero value. Given the huge literature addressing the front-end issue, as well as the basic consensus on the right approach, I will not address it here. Instead, I will assume that the receipt of a profits interest is a nontaxable event. Below I focus on the back-end issue: how a holder of a profits interest should be taxed when income allocations or distributions are made.

## II. Analysis

There are two basic considerations. The first is whether taxing gains on profits interests on a pass-through basis is consistent with the underlying structure of the tax law. I will address this issue by asking how the sponsors would be taxed if they engaged in the activity directly, and then ask whether that treatment should change if the sponsors use a partnership structure. The second issue is, assuming that a change is otherwise desirable, whether the complexity and avoidance costs of a change are worth the benefits.

*Direct Engagement in the Activity.* If the sponsors engaged in private equity investing directly, there is little question that profits they receive from the sale of portfolio companies would be classified as capital gains. To illustrate, imagine that instead of raising funds by issuing limited partnership interests, they simply borrowed the funds from the investors. To keep things simple, we can imagine that the loan paid a fixed rate of interest, but it could also have interest based on the receipts from the sale of the portfolio companies and still likely be classified as debt.<sup>9</sup> The sponsor would then use the borrowed funds and its own equity contribution to make investments in portfolio companies. Gains from the sales of portfolio company investments, just like gains from any investment, would unquestionably be taxed as capital gain.

Value is created in this example by combining capital and labor. The underlying theoretical question is why this is treated as capital gain rather than a return to services. Unfortunately, there is little if any conceptual clarity governing the distinction between capital gains and ordinary income. Without a solid rationale for the distinction (and

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<sup>9</sup>The limited partnership interest could be restated as a nonrecourse loan that paid a fixed 8 percent interest rate plus a contingent return of 80 percent of all profits above 10 percent. Although further analysis of the details would be needed, this might possibly be treated as debt given the fixed minimum return, seniority, and limited term. If such a financial instrument were not treated as a loan, an instrument with similar features likely could be. See Example 2 in Treas. Reg. 1.1275-4(b)(4)(vi) (illustrating a debt instrument that has payment based on gross receipts).

one that roughly tracks current law), it is difficult to make principled arguments with respect to any given return. At best, we can try to observe where the tax law draws the lines.

There appears to be two key factors. First, the more entrepreneurial the activity, the more likely the treatment will be capital. Second, the more that labor and capital are combined into a single return, the more likely it will be treated as capital. The most closely related example is an investor who borrows money to purchase stock. This activity combines capital, some of which is supplied by third parties, and labor effort, in terms of arranging financing, identifying investment opportunities, and purchasing and selling the investments. Investors get capital gains and losses on their stock sales, and we make no effort to isolate the labor component of their gains. Similarly, entrepreneurs such as founders of companies get capital gains when they sell their shares even if the gains are attributable to labor income. For example, most or possibly all of Bill Gates's fortune comes from his performance of services for Microsoft, but the overwhelming majority of his earnings from Microsoft will be taxed as capital gain. Although one can come up with various rationales for this approach, such as subsidies for socially beneficial activities, to minimize lock-in, or because of the difficulty of separating labor and capital, perhaps the best thing we can say is that this approach is built deeply into the structure of current law. Any change in the treatment of a private equity sponsor engaged directly in their investment activity would require reexamination of these basic principles.

*Engagement Through a Partnership.* The sponsors do not engage in their investment activity directly, raising funds from the financing sources through loans. Instead, they use a partnership, raising funds from the financing sources by issuing limited partnership interests. The question is whether the tax treatment should change because of the use of limited partnership interests as a financing vehicle. From an economic perspective, the answer is straightforward: the tax result should not change when financing mechanisms change. The tax law, however, often makes uneconomic distinctions, and the question is whether there is some tax law reason for changing the treatment based on a change in financing mechanisms.

A central premise of partnership taxation is we should not get a fundamentally different result when using a partnership than when engaging in the activity directly. Partnerships generally determine the character and other attributes of income as if they were individuals, and pass through that treatment to the partners. The partners are then taxed on their individual shares of partnership income. Here, the partnership is

engaged in the entrepreneurial activity and determines its treatment just like any other taxpayer. It receives capital gain or loss when it sells a portfolio company.

There are a number of places where the partnership tax regime departs from this pure look-through approach, such as by giving partners a basis in their partnership interest separate from the partnership's basis in its assets. There are often conflicts between classification of an item at the partnership and partner levels. Thus, if a partnership holds a capital asset for more than 12 months, a partner gets long-term gain or loss even if the partner has been a partner for less than 12 months. This type of conflict is not at issue here: the partnership rules do not create a disparity between partner and partnership treatment in this case.

A second exception to the pure look-through approach is if the payments to the partner are sufficiently fixed that it is clear that the partner is effectively not engaged in the activity directly. The underlying premise is that if the partner had engaged in the activity directly, his payments would depend on the success of the partnership business. If the payments instead are fixed, it is not appropriate to treat him as if he engaged in the partnership business directly. Instead, he looks more like a service provider. Therefore, we carve out these cases and treat them as transactions between the partnership and third parties.

There are two relevant code sections. First, section 707(c) provides that "guaranteed payments" for services – payments which are determined without regard to the income of the partnership – are treated as ordinary income to the recipient and generate a deduction or capital expenditure to the partnership. Second, section 707(a)(2)(A) re-characterizes certain distributions to partners as payments for services if the facts indicate that the partner was not acting in his capacity as a partner. The purpose of this rule, enacted in 1984, was to prevent avoidance of the capitalization rules through allocations of income. If section 707(a)(2)(A) applies, partner-level activity (provision of services) controls the treatment of the distribution. According to the legislative history, there are six factors to be used in making the determination of whether a partner is acting in his capacity as a partner. The most important factor is whether the payment is subject to appreciable risk as to amount, reflecting the notion discussed above that we use entrepreneurial risk as a method of determining whether the partner should be treated as engaging in the activity directly and therefore get partner treatment. The Joint Committee on Taxation explained that "partners extract

the profits of the partnership with reference to the business success of the venture, while third parties generally receive payments which are not subject to this risk.”<sup>10</sup>

A typical carried interest easily passes all six factors – they have none of the factors that indicate that they are to be re-characterized as received for services. It is not even a close question, at least under current law, that the private equity sponsor is acting in its capacity as a partner with respect to a carried interest because the private equity sponsor really is the entrepreneur, using the limited partnership interests as a financing mechanism. Therefore, the section 707(a)(2)(A) rules sensibly do not recast the sponsor as someone not engaging in the partnership activity.

Proposals to abandon the pass-through treatment of carried interests are necessarily based on the theory that it is not appropriate to give a holder of a carried interest the same treatment he would have if he engaged in the partnership activity directly. The current lines are not written in stone and there is no reason to believe that they cannot be improved. Nevertheless, a typical private equity carried interest is so directly in the sphere of partnership activity, that it is hard to imagine a justification for changing current law unless the fundamental distinction between capital gain and ordinary income is revisited. This conclusion does not at all depend on a claim about whether the activities engaged in by the sponsor are more in the nature of labor or provision of capital. If the sponsor engaged in the activity directly, we would not make this distinction. Gains and losses would be capital, not ordinary even if the value were created primarily through labor. The only question then is whether there is some reason, because of the use of a partnership structure, that we would want to change this result.

Those seeking to change the result often analogize a carried interest to stock options, stock compensation, or payment for performance of services. The argument runs as follows: The traditional line drawn between partner and non-partner activity found in section 707 has eroded. It was previously based on the idea that service providers get fixed amounts. This is no longer true, as many employees now take risks associated with the success of the business through the receipt of stock, stock options or

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<sup>10</sup>The other factors relating to service income are whether the interest is transitory, whether the distribution and allocation to the partner are close in time to the performance of services, whether the goal is to get tax benefits, and whether the value of the recipient’s interest is small in relation to the allocation. There is a six factor relating to the capital account maintenance rules which is focused on property transactions. See Senate Comm. on Finance, 98<sup>th</sup> Cong., 2d Sess., Deficit Reduction Act of 1984, S. Prt. No. 169 at 227-228 (Comm. Print 1984).

performance-based pay. These forms of service payments are, to some extent, taxed as ordinary income. To create parity with these employees, they argue, partners who have carried interests should be treated as non-partners and get ordinary income on their returns to a similar extent.

The analogy to an employee performing services, however, is not appropriate. The tax law makes a fundamental distinction between an employee performing services and an entrepreneur creating or increasing the value of its business. There is little question that a sponsor of a private equity fund is more like an entrepreneur than an employee. The sponsor is the driving force, the individual with the ideas and the skill to make a project happen. The sponsor is the general partner of the fund with exclusive control over the fund's activity. As general partner, the sponsor bears all of the fund's residual risk. Limited partnership interests are merely a financing method.<sup>11</sup> Although taxing carried interest on a pass-through basis creates a distinction between employees and holders of carried interests, changing the treatment of a carried interest to be like employee compensation would create an even more inappropriate distinction between financing methods for entrepreneurial activity.<sup>12</sup>

One way to think of the problem is one of drawing a line. Regardless of which way the analogy is resolved, there will remain a tax difference between similar items. Thus, if one believed that carried interests were like employee stock options, taxing them that way would not eliminate the problem: there would still be a distinction between carried interest and direct engagement in the activity. The core distinction created by the capital gains regime cannot be eliminated.

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<sup>11</sup>Both Gergen and Fleischer recognize that their proposals are inconsistent with the treatment of self-created assets but neither has an answer to why this is appropriate. Gergen argues that looking to the profits-interest partner is inappropriate because the real issue is whether the other partners can avoid capitalization of payments for services by making a partnership allocation instead of a salary payment. While this issue may be important where other partners are the entrepreneurs giving a service partner a profits interest, it is not relevant for the taxation of private equity funds. Fleischer considers this issue only with respect to the treatment of the receipt of a partnership interest and does not mention how it affects the back-end taxation of a profits interest.

<sup>12</sup>Moreover, if we follow the stock option analogy, any entrepreneur who uses nonrecourse financing, even one who works for himself, would get ordinary income on all of their gains. The reason that any time nonrecourse financing is used, the entrepreneur has an option-like payout. For example, if an entrepreneur borrows \$95 on a nonrecourse basis and invests \$5 of his own money, he will get the upside of the project after the interest on the loan is paid off but not bear any of the downside beyond his \$5 contribution. The option analogy would treat this case the same as an employee getting options in his company, a result that is inconsistent with the basic structure of the capital gains preference.

Given that there will inevitably be a line between similar items, the question is how we should draw the line. I have argued elsewhere that we should do so by examining the efficiency effects of different lines, a process that is similar to but not exactly the same as reasoning by analogy.<sup>13</sup> To illustrate, suppose there are three items under consideration. Item A is high-taxed (ordinary compensation), Item C is low-taxed (self-created assets and founders shares), and we are trying to decide the treatment of B (carried interests). Suppose that under some theory of correctness in measuring income, we prefer to tax B like A. If, however, attempting to do so merely causes individuals to choose C, we should not tax B like A. We get little revenue or other benefits from treating B like A and we create enormous distortions because of this shifting. Economically, we want to examine whether B is a closer substitute for A or for C. We can show mathematically that the right way to measure this is to compare the ratio of amount of shifting to the revenue. If this is high – a lot of shifting to the low-taxed category and little revenue raised – the line is not desirable.

On these criteria, the choice is clear. As argued below, straightforward attempts to tax carried interests as ordinary income would simply lead to a change in the transaction structure, making them less efficient and raising little revenue. The reason is that a sponsor's carried interest is not like an employee stock option. It is like a return on an investment.

*Complexity and Avoidance.* The analysis above alluded to but did not directly address perhaps the most important problem in considering whether a change to the treatment of carried interests is desirable, which is the problem of complexity and avoidance. Changing the treatment of carried interests would be very complex because of the problems of defining carried interests. Moreover the complexity would be for naught because the change could be easily circumvented. Even if one were persuaded that the correct treatment of carried interests was as ordinary income, any benefits from changing the law would be swamped by the costs of complexity and avoidance.

The Gergen proposal would treat some distributions to partners as payments for services. The central problem is identifying which payments are for services. To do so, he would treat any payment to a service partner that is not pro rata with respect to capital accounts as entirely for services. This approach is vastly overbroad. Imagine a two person partnership where both partners provide an equivalent amount of services

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<sup>13</sup>David Weisbach, *An Efficiency Analysis of Line Drawing in Tax Law*, 29 *Journal of Legal Studies* 71 (2000).

and capital but have different appetites for risk and return on their capital. An allocation that reflected these different risk profiles might, say, give one partner all or most of the returns up to some fixed amount and the other partner everything beyond that. Gergen would treat all distributions in this case as for services even if the partners were each paid an arm's length salary.

The Gergen approach would also be easy to avoid. Using debt rather than limited partnership interests would make any such rules entirely inapplicable because there would be no partnership. If a partnership must be used, the transaction could be documented as the Fleischer/Schmolka structure. That is, if the profits interest were documented as a loan from the limited partners to the general partner (and a contribution of the loaned money), the general partner would unquestionably be receiving a return on contributed capital. The two-percent management fee would be their compensation for services. Thus, the significant complexity that the Gergen approach would introduce would be for naught, or at least very little.

The Levin approach is similar to the Gergen approach but rather than adopting a straight-up allocation rule, it would merely require a reasonable allocation between labor and capital. Similar avoidance mechanisms, such as the use of debt, would be similarly easy to use. Moreover, simply rearranging the labels on the current partnership structure would get around the Levin bill. For example, if the various returns paid to private equity sponsors are combined into a single return, the sponsors could allocate two-thirds of their returns as service income without changing their tax results at all. Auditors would have little basis to challenge such an allocation. More complex restructurings, such as loans from the limited partners to the sponsor who would then contribute the capital to the partnership would make a challenge to the allocations even more difficult. The result would be less efficient and transparent capital structures, an increase in tax controversies, and little or no additional revenue. More subtle rules that attempt to distinguish more accurately would be complex and yet remain inaccurate. This was the very problem faced by Congress when enacting section 707(a)(2)(A). Twenty-three years after passage of this rule, the Treasury has yet to issue regulations because there is no easy way to make the distinction between labor income and capital income. The Levin bill simply glosses over this central problem, hiding its complexities behind a rule that allocations must be reasonable.

The Fleischer/Schmolka approach suffers from similar problems. The underlying rationale is that uneven sharing of returns to capital represents implicit loans that should be recognized. This is a more accurate measure of the return to services than the

Gergen approach, but would likely be impossible to implement. It would be necessary to identify when one partner has implicitly loaned funds to another partner and then impute an appropriate cost of capital. If allocations are not straight-up, it would be impossible to identify implicit loans. At a deeper level, the capital accounts system required by the 704(b) regulations does not incorporate time value concepts (except to a limited extent in the substantiality test). Without time value concepts incorporated into capital accounts, there can be all kinds of internal loans among the partners. Attempting to revise the capital accounts rules to incorporate time value concepts, however, is a daunting prospect and would likely make the partnership tax rules entirely unworkable.

To illustrate, a typical private equity partnership uses a hurdle rate. The limited partners get the first 8 or 9 percent of the return. Once that return is achieved, the general partners get an allocation so that the overall return is split 80/20. This could be restated as a nonrecourse loan with a fixed return of eight percent and a contingent return of 80 percent of all profits above 10 percent. With a fixed return of eight percent, it would easily exceed any requirement of paying minimal interest as required by the Fleischer/Schmolka approach. Indeed, if we view the limited partnership interests as financial instrument issued to sophisticated third-party investors, there is no question that they are compensated for the use of capital. Tax rules that treat this return as inadequate would be ignoring the economic realities.

The Appendix includes some relatively simple examples of how partners might split up returns to both labor and capital. Any legislation should be able to address these simple examples. No proposal yet put forward can do so.

### **III. Conclusion**

Study of the tax treatment of carried interests remains important. In recent years, the returns in the private equity context have been significant, and a thorough understanding of whether current law is correct is worthwhile. Although many have analogized carried interests to fees earned for managing money, an understanding of the structure of the industry reveals that they are more like the returns that any investor or owner of a business receives, returns that are taxed as capital gains on their sale. The only difference between carried interest and direct investments is the use of limited partnerships instead of debt as a means of financing. It does not make sense to change

the tax treatment significantly based on this difference. Moreover, proposals to date would merely impose economic costs in the form of complexity and restructuring of the business without collecting any significant revenue. On this ground alone, the proposals would be undesirable.

## **Appendix: The problem of distinguishing capital from services in a partnership**

Any proposal to tax carried interest as ordinary income must be able to define when this treatment should apply. The problem is that capital and labor can be mixed in a partnership in ways that are virtually impossible to disentangle. The following examples illustrate some of the issues any such rule would have to face.

A and B form a partnership, each putting in \$100.

1. A and B each work for the partnership and their services are worth the same amount. They are paid a zero or minimal salary. The partnership produces long term capital gain, allocated equally to A and B.
2. A gets 60% of the profits and losses for the first 5 years and 40% thereafter. The parties anticipate that the present value of A's and B's return on capital are the same but have different risk profiles.
  - a.. The partnership hires a manager and pays an arm's length salary. Neither A nor B works for the partnership.
  - b. Same except that A and B each work for the partnership. Their services are worth the same amount.
  - c. Same except that the capital flows do not have equal present value. A's and B's services are worth differing amounts, offsetting the different in the present value of the capital flows.
  - d. Same except that losses are shared equally even as profit allocations shift, with each of the above three possibilities for services.
3. A gets the first six percent of profits and B gets everything beyond that. Losses are shared equally, or alternatively, B bears the first losses until his capital account is zero, then A bears any further losses. (Similar to A getting preferred stock and B getting common in a corporation.)
  - a. They hire a manager.

- b. They work for the partnership and the value of A's and B's services are the same.
  - c. They work for the partnership and the value of their services are different.
4. A gets 70 percent of the profits from stores in Illinois and 30 percent of the profits from stores in California while B gets the reverse.
- a. Neither A nor B work for the partnership. They hire managers at arm's length salaries.
  - b. A works in IL and B works in CA and each get paid a nominal salary. Their services are worth the same.
  - c. They both work for the partnership but their services are worth different amounts.
5. A has an idea but needs financing. B has \$100.
- a. B lends the \$100 to A at a 10 percent rate of interest (recourse or, alternatively, nonrecourse). A develops the idea and sells the resulting patent for \$200 the following year. He pays B \$110 and keeps \$90.
  - b. B lends the money to A in an "equity kicker" loan which entitles him to 10 percent interest plus five percent of any returns above 10 percent.
  - c. A and B instead form a partnership. B gets a limited partnership interest which pays a preferred return of five percent and 10 percent of gains beyond that. B bears all losses. A receives all remaining returns and works for the partnership. A works for the partnership and gets a minimal salary.
  - d. A gets a patent on his idea. A contributes the patent and B contributes \$100. They claim equal \$100 capital accounts. B gets a preferred return of five percent and 10 percent of gains beyond that. A works for the partnership and gets a minimal salary.

6. Fleischer/Schmolka:

- a. A has an idea and B has \$100. B lends A \$20 at a 10 percent rate of interest. A contributes the \$20 to the partnership and B contributes the remaining \$80. They share profits straight up. A works for the partnership and gets paid a minimal salary.
- b. Same except that A agrees to pay B a contingent rate of interest on the loan based on a market-place contingency.
- c. Same except that A agrees to pay B a contingent rate of interest on the loan based on the performance of the partnership.

One response to these examples is that the pure profits interest case, where there is a service partner and a capital provider, is easier than most of these examples. We can simply treat all of the allocations to the service provider as compensation for services. We can get this easy case right and worry about the harder cases later in regulations, perhaps with some guidance in the legislative history.

Even in the most straightforward case, where the carried interest contributes no capital, it is not easy to identify the service elements. As Examples 5 and 6 show, it is not correct to treat the entire payment on a carried interest as for services but identifying the service element is not straightforward. Moreover, unless a clear boundary can be drawn around the easy cases, this strategy would introduce substantial complexity and uncertainty into many other cases. Drawing a clear boundary, however, would likely mean easy avoidance and little revenue.