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# Debate on Carried Interest

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## Debate on Carried Interest

by Calvin H. Johnson, Jeffrey H. Kahn, and Douglas A. Kahn

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In this point-counterpoint article, Johnson argues that the rationales offered by the Kahns do not justify giving fund managers capital gain treatment. The Kahns respond to that contention and defend their position.

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### The Erroneous Defense of the Tax Treatment of Carried Interests

by Calvin H. Johnson

In their article, "Fallacious Objections to the Tax Treatment of Carried Interests,"<sup>1</sup> Douglas and Jeffrey Kahn, father and son, defend the tax treatment of carried interests. Under the law, hedge fund, equity fund, or venture capital fund

managers achieve capital gain for their compensation.<sup>2</sup> The Kahns explain how capital gain arises under current law and provide a fair description of the rationales for current law, but their explanation carries no normative weight. Capital gain for compensation is a loophole that should be fixed.

Under current law, the character of partnership income is determined only at the partnership level. The rule allows an employer with access to tax-preferred income, including capital gain, to pay service providers with tax-preferred income. The rule is silly. Compensation should not be stripped of its ordinary character and its run through the progressive tax brackets when the item is compensation to the service provider, even when the service provider has been made a partner in a partnership with tax-advantaged sources of income. Partnership taxation should not be a cover that hides ordinary-income compensation.

Giving capital gain to the managing partners, moreover, violates the tenets of the open transaction doctrine. Under the logic of open transaction, compensation is not taxed before income is earned based on mere speculation. Receipt of a partnership income interest is not a payment but a platform for compensation, with the amount of ordinary compensation to be determined later. For the service provider under

<sup>2</sup>"Venture capital" funds, "hedge funds," and "equity funds" all have capital gain they can share with their service partners. The funds have traditional spheres, but the borders are easily crossed. "Venture capital funds" provide money for start-ups that are trying to develop some speculative idea into saleable commercial product. Equity funds perform leveraged buyouts, buying out the equity capital of target companies and replacing equity with debt capital. Equity funds make their money by getting rid of corporate tax paid by their targets. Hedge funds identify some anomaly or mispriced security, and lay off their bet for all risks of the security except for the anomaly they are trying to take advantage of. The funds, however, poach on each other's traditional domain, and each are willing to make money by any good strategy outside the traditional borders.

<sup>1</sup>Douglas Kahn and Jeffrey Kahn, "Fallacious Objections to the Tax Treatment of Carried Interests," 20 *Fla. Tax Rev.* 319 (2017).

the open transaction doctrine, the cash or distributable share of accrued income and gain ultimately achieved by the service partner remains compensation.

The issue is at least symbolic of something deeply rotten about the tax base and tax equity. The top 25 hedge fund managers had aggregate compensation of 11 billion last year, a year in which the funds significantly underperformed the stock market as a whole.<sup>3</sup> The monkeys picking stocks at random did better last year than the hedge funds. Managers are paid 2 percent of assets per year under industry standard practice, even when the monkeys do better. They get 20 percent of profit, even if profit is under par. One should also never assume that this treatment is wise social engineering by Congress, exactly calibrating the cost of tax lost to purchase of what needs to be accomplished. The loophole is available for subpar performance.

The Tax Cuts and Jobs Bill of 2017<sup>4</sup> addresses carried interests with ambiguous language, which leaves current law largely intact however the ambiguity is resolved. The bill would adopt a new section 1061 of the code which says that the taxpayer's net long-term capital gain with respect to a partnership interests received for services shall be computed using a three-year holding period, instead of the current-law, one-year holding period. There are at least two interpretations of that language. The narrowest is that section 1061 does not affect passed-through capital gain. Under current law, holding period for portfolio stock the funds sell is determined at the partnership level<sup>5</sup> and the partner's holding period for the partnership interest has no impact on whether gain passed through from the partnership is long term or short term. A partner can get long-term gain immediately if the partnership has held the sold asset for the requisite holding period. Because section 1061 says nothing about the partnership's calculation of holding period, the service partner might get

long-term capital gain passed through under the old one-year holding period. Under that interpretation section 1061 would have an impact when the taxpayer, that is, the partner, has gain with respect to the partnership interest either by a sale of it or by a distribution with respect to the interest that is in excess of the partner's basis. Partners in the funds do occasionally sell their partnership interests or get distributions in excess of basis, but the in usual course, the sale or exchange of the partnership interest in a fund occurs only in liquidation. By that time, all of the gain from the fund has been recognized by pass through on sale of portfolio assets and there is no further gain. The interpretation that section 1061 does not affect passed-through gain makes section 1061 almost an empty gesture. It will come up some, but not often.

Section 1061 might also mean the service partner can get a pass through of long-term capital gain, to which the lower rate applies, only if the partnership has held its portfolio stock asset for more than three years. Section 1061 does not explicitly say anything about partnership calculations of short- or long-term status under section 701(a)(2), but it might be implied, so as to prevent long-term status for stock assets held for under three years. That is a more restrictive interpretation of section 1061, but not world changing. Many of the funds either can and do hold their portfolio stocks for three years, or turn over assets so quickly they do not even try to qualify for even the current one-year holding period. Under either interpretation of section 1061, this debate about the propriety of current law's treatment of carried interests remains an important issue, beyond the modest reach of new section 1061, however modest that reach is.

### I. The Defining Heritage

Under the defining heritage responsible for capital gain treatment, compensation is not supposed to be capital gain, regardless of the form by which it is achieved. Capital gain arises from British conceptions of capital under which the castle and manor (that is, capital) belonged to the next male heir, even if the capital had appreciated

<sup>3</sup>Kathryn Dill, "Top-Earning Hedge-Fund Managers Raked in \$11 Billion Last Year, Despite Disappointing Returns," CNBC (May 17, 2017). The two highest-earning hedge fund managers were paid a total of \$4 billion. *Id.*

<sup>4</sup>H.R. 1, 115th Cong., 1st Sess. section 3314, enacting IRC section 1061.

<sup>5</sup>See section 702(a)(2).



in value. Income arose as the interest accessible to living persons, encompassing “the annual produce, the grass, the apples and things of that sort.”<sup>6</sup> The term “property” in section 1221, defining capital asset, comes directly from the British concept of capital. Property for capital gain means capital under the tradition. If something is income, it belongs by right to the income interest under the tradition and income tax gets a share of it at ordinary tax rates. Thus, the courts appropriately have held that income items including rent, royalties, interest, ordinary business income, and compensation are not capital gain under the traditional meaning even when they arise from the sale of something that in other contexts might reasonably be called property.<sup>7</sup> Not all property, as the term might be understood in other contexts, qualifies as capital and thus does not qualify as capital gain.<sup>8</sup> Compensation under the tradition is the earner’s own money, and it did not have to be preserved as capital exclusively for the yet-unknown male heir. Those who earn the compensation may use it.

Capital gain is also the gain from the appreciation of capital. For compensation there is no capital that explains the gain. The traditional term, “capital,” has evolved into the tax term “basis.” Under current law, without basis, the gain from compensation is not the appreciation of capital, and is not capital gain.<sup>9</sup> Compensation requires the investment of hard work, but work does not create basis; if it did, no wages could ever be taxed. Compensation is the product of work, not basis, and thus is never appropriately considered to be capital gain produced by capital.

Consistently, capital gain is also a relief from double taxation or double distortion under which

both the investment in capital and the yield from capital are subjected to tax.<sup>10</sup> The relief is partial: Much of the yield from capital, including rents, royalties, and interest, are ordinary income. Capital gain yields a reduction of tax not an exemption from double tax. Still, without an investment of capital, there is no yield from capital, no double distortion, and no capital gain. Compensation is not attributable to the investment of capital and so never qualifies as capital gain, once one understands the tradition and the meaning of the term.

Capital gain for compensation is always a loophole. Ordinary income, the Supreme Court has said, “is broad enough to include in taxable income any economic or financial benefit conferred . . . as compensation, whatever the form or mode by which it is effected.”<sup>11</sup> Section 1221(a)(3) now provides that artistic or literary property is an ordinary asset in the hands of the creator. Under prior law, when General Dwight D. Eisenhower sold the rights to his book, *Crusade in Europe*, for instance, he reported capital gain from his efforts.<sup>12</sup> The subsection was adopted specifically to close what the committee report called a “loophole.”<sup>13</sup> Section 83 was enacted first against a loophole under which restricted stock given as compensation was taxed as compensation neither when the stock was transferred to the executive nor when the restriction lapsed.<sup>14</sup> We may appropriately call capital gain for compensation a loophole, under ordinary English usage.

Capital gain has been allowed to expand beyond its tradition. It originally applied only to interests that were preserved for the yet-unknown male heir, that no living person had access to, and that no living person could consume. Congress

<sup>6</sup> Walter Strachan, *A Digest of the Law of Trust Accounts, Chiefly in Relation to Lifeowner and Remainderman* 25 (1911) (footnote and citations omitted).

<sup>7</sup> See, e.g., *United States v. Midland-Ross Corp.*, 381 U.S. 54 (1965) (gain from sale of bond was interest); *Commissioner v. Gillette Motor Transport*, 364 U.S. 130 (1960) (proceeds from sale of carveout was rent); *Burnet v. Harmel*, 287 U.S. 103 (1932) (periodic royalties on oil and gas lease were like business-operating income although considered a sale of property under state law), superseded by statute, section 613A.

<sup>8</sup> *Gillette Motor Transport*, 364 U.S. at 134.

<sup>9</sup> *Vestal v. United States*, 498 F.2d 487, 494 (8th Cir. 1974) (sale of partnership interest with zero basis was compensation not capital gain); *Bryan v. Commissioner*, 16 T.C. 972, 981 (1961) (sale was compensation not capital gain). Cf. reg. section 1.83-3(a)(6) (indication that no transfer has occurred is that employee does not bear risk of loss).

<sup>10</sup> Joseph Bankman and David A. Weisbach, “The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax,” 58 *Stan. L. Rev.* 1413, 1418 (2006).

<sup>11</sup> *Commissioner v. Smith*, 324 U.S. 177, 181 (1945) (options were compensation even if intended to give employee an ownership interest in the employer corporation).

<sup>12</sup> Associated Press, “Eisenhower to Pay Tax as an ‘Amateur’ Writer,” *The New York Times*, June 2, 1948, at 31 (reporting that the IRS ruled that Eisenhower had capital gain from sale of *Crusade in Europe* because he was an amateur).

<sup>13</sup> S. Rep. No. 2375, at 43-44 (1950).

<sup>14</sup> See Walter J. Blum, “Restricted Stock Arrangements Reconsidered,” 46 *Taxes* 598, 604-605 (1968).

has also used the lower capital gains rates as a honey pot for specially connected people. Still, capital gain is not an always-open-season free range without rules. As long as most people pay ordinary income tax on their compensation, that establishes the tax principle that everyone should.

## II. Step by Step to Error

The Kahns explain how capital gain for compensation of the manager of a fund arises under the logic of current law, step by step. Still, while their explanation fits current positive law, their explanation does not justify the capital gain normatively at the end of the steps. Each step, moreover, could and should have been contested and come out the other way, at least once you see the bad result. A bad step under current law is a self-inflicted wound by Treasury, prematurely closing off measurement of compensation under the open transaction doctrine. But more generally, compensation to a service provider remains compensation, even if the fund manager is made a partner in a partnership with tax-preferenced income.

The Kahns start by assuming that self-created property appropriately generates capital gain. They then argue that joint efforts at creating property also justify capital gain. They then leap to say that capital gain is fine for services performed for others. Or at least if that is not true generally, subchapter K makes it true. The Kahns say compensation must be measured when the manager gets an income interest in the partnership, and because the value of the interest then cannot reasonably be ascertained, it is deemed to be zero. The artificially deemed zero-value compensation is then the end of any compensation, and we switch over in full to partnership mode, rather than compensation mode of taxation. Because the profits from a hedge, venture capital, or equity fund are capital gain at the partnership level, the fund manager, post-compensation measurement, gets to treat the gain as capital gain with the character passed through from the partnership. Each of the steps is both the result reached by current law, and without normative value. Bad results do not have a normative penumbra — any more than say a boil generalizes to describe the beauty of the human body.

## A. Self-Created Property

The Kahns argue, first, that property created by labor — by sweat equity — is a capital asset. Courts have indeed held that the gain from building a house or a ship for a sale to a single customer will qualify as capital gain, as long as one is not also a distributor selling to customers (plural).<sup>15</sup> Still, the results are not as clean or as good as the Kahns describe. The courts say that a major factor in determining whether real estate falls within the section 1221(a)(1) ordinary-income exception from capital gain for holding for sale to customers is whether the seller has improved the property.<sup>16</sup> When Congress recharacterized artistic and literary property as an ordinary asset to the creator, it appropriately called the prior law — capital gain for books and art — a loophole. Compensation is income and does not need to be preserved for the male heir, even if compensation is achieved by making things. A taxpayer who makes and sells something is making compensation, not different in substance from ordinary wages.

Capital gain on self-created assets is a violation of tax principle, but self-created assets have secondary importance in a complex economy. In a complex economy, taxpayers are not typically self-employed, if artists and writers are disregarded. The rule also does not allow sales of the product to customers. Even if available and tolerable in an unimportant sector, sweat equity should not generalize beyond its strict borders. Bad rules have no penumbra.

## B. Services for Others

The fund managers are not building for themselves, however, but for others. The Kahns say that a group or joint creation of property

<sup>15</sup> *Commissioner v. Williams*, 256 F.2d 152, 155 (5th Cir. 1958) (allowing capital gain ship for one buyer); *Gangi v. Commissioner*, T.C. Memo. 1987-561 (allowing capital gain on sale of condos that taxpayer built).

<sup>16</sup> See, e.g., *Biedenbarn Realty Co. v. United States*, 526 F.2d 409, 422-423 (5th Cir. 1976) (listing factors yielding capital gain, including improvements); *Long v. Commissioner*, T.C. Memo. 2013-233 (developer hiring architect, applying for zoning relief, printing brochures, and taking deposits on 20 percent of units was enough development to make land an ordinary asset), *aff'd in part, rev'd in part, per curiam*, 772 F.3d 670 (11th Cir. 2014) (ostensibly reversing Tax Court on another issue, which was that taxpayer sold a judgment rather than the not-yet-purchased land); *Adam v. Commissioner*, 60 T.C. 996, 1003-1004 (1973) (holding that taxpayer was a passive investor, not improver).

should also get capital gain once it is assumed a single builder gets capital gain. That is a dicier conclusion. Long-standing and unbeatable regulations provide that when a taxpayer receives services in exchange for their services, the fair market value of the services received is gross income.<sup>17</sup> Thus, for example, if a tour guide organizes a trip to Europe and gets a free trip as a reward for the services, the value of the trip is income.<sup>18</sup> If a carpenter and plumber exchange services in building the house, both sides have ordinary income, and there is an added basis in the house for the amount included in income. Indeed, even if they are both carpenters, there is no tax exemption for like-kind exchanges of services.

Exchanges of services within a family are best understood as tax-exempt support. In a profound sense, our income tax is based on households and transfers within the household, whether or not in exchange for services, are properly ignored. Informal exchanges of services among friends and neighbors are — and reasonably should be — tolerated as outside the tax system, even though rewards for services are taxable in theory.

When informal exchanges of services get too formal, however, for instance in a barter club, the IRS can and will collect tax on both parties to the exchange, including with information returns and backup withholding of tax.<sup>19</sup> Billion-dollar hedge fund compensation is on the taxable side, neither informal nor small enough to be ignored as not worth the effort of enforcement.

Capital gain for self-service is sometimes an acceptable result, whereas capital gain for service to others is not. If, for instance, I spend 60 hours a week working on my investment portfolio, the value added by my services (if any) is not ordinary income under current law. The stock is the same and has not been created or improved. I have not built anything. I am buying and selling on the same market, so I am not performing a service of distributing the stock. The smart market

says that the price on a broad market already reflects all public information on value, which implies that gains I get above what a well-diversified portfolio would give is attributable to taking on too much risk or to sheer luck. There is well-based skepticism that I received compensation or built anything with my services.

It does not follow that financial advisers can get capital gain on compensation they earn by managing or advising others on what to invest in, even if the investment advice I give myself is treated as consistent with capital gain. Working for others as a financial adviser yields ordinary income both in theory and in practice. People providing financial services get no help from the rule that self-help does not turn capital gain into compensation.

The distinction between self-created property and working for others is unbridgeable. One indeed wonders why self-created property ever comes up in these discussions. Is the argument that because some compensation avoids ordinary tax, it all must?

### C. Partnerships

Under current law, a partnership with a tax-favored source of income may pay a partner who provides services by giving the service provider a share of the tax-favored income the partnership has achieved. Under subchapter K, governing taxation of partnerships, the character of an item as capital gain or ordinary income is determined exclusively at the partnership level.<sup>20</sup> If the item is long-term capital gain or tax-exempt income to the partnership, it is also capital gain or tax-exempt income to the partner. That the share is given to the service-provider partner only as a quid pro quo for the services provided does not matter as long as the services were performed in their “capacity as a partner.” The service-providing partner has ordinary income from the compensation for services only as if the services are performed, not in their capacity as a partner<sup>21</sup> — whatever that means. Subchapter K thus allows an alchemy turning lead into gold, that is, compensation for work done becomes not

<sup>17</sup> Reg. section 1.61-2(d)(1) (1960).

<sup>18</sup> Rev. Rul. 64-154, 1964-1 C.B. 72.

<sup>19</sup> See, e.g., IRS Publication 525, “Bartering,” Example 3 (member of barter club has ordinary income from claim on arising from services); Form 1099-B, “Reporting Income from Barter Exchange”; reg. section 31.3406(b)(3)-2 (providing for reporting of income and backup withholding by barter exchanges).

<sup>20</sup> Section 702(b) by reference to section 702(a)(2).

<sup>21</sup> Section 707.

ordinary income but tax-favored income if the partnership has a source of tax-favored income to share with the partner.

The alchemy of ordinary lead into capital gain gold or better is limited by tax-minimization tax planning, which is supposed to look at both parties to a transaction. A distributive share given to the service provider means the tax-favored item is diverted from other partners, so the alchemy is useful only if the other partners cannot use the tax favor as well as the service partner can. Corporate partners, for instance, pay the same tax on capital gain as on ordinary income so they do not usually mind diverting capital gain to a service-providing partner who will get a lower tax rate on capital gain instead of paying with tax-deductible cash. Tax-exempt investors also can give up capital gains character to service partners. If the services are capital expenditures, the compensation would be basis, not an immediate deduction, which limits the value of “compensation” characterization to the paying partners. Compensation can also be written up as for services “not in capacity as a partner,” or a guaranteed payment which would give the partnership a compensation deduction in computing its taxable income. The alchemy of converting compensation into capital gain is thus useful only because the other partners have limited use for a compensation deduction. Still, when giving tax-favored items to high-bracket service providers minimizes tax, the partnership can be used, like alchemy, to transform compensation from ordinary income (lead) into something better.

The ability of a partnership to turn ordinary compensation into capital gain or better is silly, or to use a technical term — *mashugana*. Subchapter K, governing partnerships, should never be able to put a blanket over compensation and hide it. Subchapter K is supposed to be the servant of substantive tax law. Except for minor administrative or procedural issues, where convenience is worth a (slightly) different result, if subchapter K and substantive law outside of subchapter K diverge, it is subchapter K that is in error.

There is nothing in the partnership relations that justifies a distinction from any other service provider. A partner performing services is an

agent of the partnership,<sup>22</sup> just as an employee, officer, or independent contractor is an agent of the business for whom the services are provided. We can create a spectrum of service providers: Some service providers are paid straight salary; some employees are offered a profit-sharing plan as a fringe benefit; some agents get substantial bonuses measured by performance; some get a trivial guaranteed salary and get almost all their pay according to outcome; and some service providers get paid only on commission or by a share in the output. Some service providers work under close supervision; some are independent; and some give orders to others. All have ordinary income for their compensation. At no place along the spectrum should it matter that the principal and agent cross off the “employee” label or “independent contractor” on their contractual papers and substitute “partner.” There is no substantive cutoff along the spectrum. Service partners are still service providers, with a profit-sharing plan, entitled to no special deal.

The right rule, in lieu of section 702, is that compensation is ordinary income as received if it is compensation at either the partnership or the partner level. Some partnerships, in law, accounting, architecture, or other services, make only compensation be judged either at partner or at partnership level. But the managers of venture capital funds, equity funds, or hedge funds work for funds that make capital gain from appreciation of stock purchased by the fund. The work they perform for the fund is rewarded by compensation even when the fund has only capital gain.<sup>23</sup>

It is not hard to identify compensation. The Kahns use examples of managers of funds who

<sup>22</sup> See, e.g., Uniform Partnership Act, section 301 (1997) (partner is agent of the partnership).

<sup>23</sup> If the partner has compensation income, the partnership should probably be treated as having a compensation expense at the same time and amount. See section 83(h). If the law did not give the partnership a deduction, the parties should ordinarily structure the payment as compensation for services not in capacity as a partner, deductible by the payer. Still, an alternative, asymmetrical treatment in which the service provider has ordinary income and the partnership has given up a share of capital gain should not be beyond the pale. The asymmetry would resemble other examples. Architect fees, for example, are capital expenditures, ordinary income to the recipient, but only basis to the payer. Section 264(a)(1) makes expenses otherwise deductible as business or production of income expenses into nondeductible expenses when the expenses are costs of tax-exempt interest, even when the expenses are ordinary income to the recipient.



contribute no capital. The managers in the examples have zero basis and zero capital for their share. All their return is explained by their services. In other examples, however, service managers might also contribute capital, as have prior earnings left in the partnership. Partnership shares having basis are different shares from compensation shares, and those shares should be able to participate in capital gain or other tax-favored income of the partnership just as other capital partners do. But partnership shares, like corporate stock, are divisible.

When the service partner has some capital shares with basis, there is danger of allocation to the service partner that is in fact compensation but falsely characterized as if it were a return of tax-advantaged income on the capital shares. It is not a difficult nor unusual enforcement problem. A service partner who is getting a larger share of tax-advantaged income of the partner, disproportionate to capital contributed or earnings left undistributed, and larger than what the partnership as a whole gets for the year as a percentage of capital is getting compensation and not a return on capital. These cases can be rooted out by the strong arm of the law.

There is also danger of an insider service partner claiming basis (that is, capital) for confetti debt used to acquire a capital share in the partnership. Debt is respected in the tax law only because payment of the debt has a discounted expected present value equal to the face amount of the debt; service-partner debt needs to be a cash equivalent. Service-partner debt for purchase of a partnership share might trigger an alert for special attention, because the debt does not have a value equal to the face amount paid, but it is not an insurmountable problem for ordinary enforcement of the law. Many transactions respected among arm's-length parties are recast when employer and service provider are involved. A bargain purchase between strangers is not a realization event, for example, but an employee has immediate income from a bargain purchase from his employer.<sup>24</sup>

#### D. Open Transition

A fund manager who receives an income interest in the fund has nothing upon which to be taxed. Nothing has been earned yet, and nothing has accrued. Receipt of the interest is an open transaction that avoids tax because value is not ascertainable. If the interest is traded on an established market, is sold soon enough for the sale to establish value, or consists of known future cash flows with a calculable net present value, then the compensation transaction is closed based on known value. Absent that, compensation is measured when the service provider achieves a distribution or at least a distributable share of partnership income. An open transaction has two sides: deferral, because taxing early does not work right, and ordinary taxation later when the results can be fairly measured. The general open transaction of current law was ruptured, however, because Treasury and the IRS stopped the second step.

Carried interests became a serious problem because the IRS ruled that the fund manager could get their interest in the partnership, taxing the interest as if it were worthless, and that that transfer of the deemed-worthless interest ended all future possibility of measuring compensation. The service partner thereafter got access to the *mashugana* section 702 rule that the compensation element is ignored if the partnership level has capital gain. A partnership profits interest is an interest that would give the partner no distribution if the partnership were liquidated immediately. In Rev. Proc. 93-27<sup>25</sup> the IRS held that it would not tax profits interests when issued, and would instead wait until partnership income (or capital gain) was passed through to the partner, conceding years of litigation in which the IRS had experienced mixed results. In 2005 the IRS also announced its intent to tax capital interests only as measured by the amount that would be paid to the partner on an immediate liquidation, at the time of issuance, even when a substantial risk of forfeiture of the interest lapses at a later date.<sup>26</sup> The fund managers under the industry standard

<sup>24</sup>Section 83(a)(1) and (2).

<sup>25</sup>Rev. Proc. 93-27, 1993-1 C.B. 343.

<sup>26</sup>Notice 2005-43, 2005-1 C.B. 1221, announcing proposed section 4.03 to Rev. Proc. 93-27.



practice get their interests in 20 percent of future fund profits, and a future 2 percent annually of fund assets at a time when there is no value to them from an immediate liquidation. The managers have not performed any services yet, and have not added any value to the investors' contributions. They have not earned anything. They always have zero liquidation valuation for their interest.<sup>27</sup>

It would be possible to find substantial value in the fund manager's interest at time of issuance by looking backwards from the result. Valuation, under the only available theory, is the net present value of the expected future cash flows. If we apply the known future cash flow retrospectively, that net present value can be substantial. If, for instance, an equity fund managers are given an interest at start of the tax year and has distributable cash of \$1 billion from their 20-2 share by the end of the year, we can discount the \$1 billion by a reasonable risk-free discount rate, say 5 percent, and the managers would then have net present value of \$952 million at the start of the year, which would be ordinary compensation income. The volatility or riskiness of results would be met by giving those managers who end up with nothing by year-end, a zero net present value at the start of the year. By taxing both the up leg and down leg of outcomes according to what happens, we can take account of volatile possible results and, overall for the industry, we will be taxing expected net present value at the start of the year, on average. Retrospective valuation both captures what happens to any one partner and captures the expected value.

Liquidation value, by contrast, is not value. Yes, before any performance of services or appreciation, the manager can expect no distributable cash on their interest from an immediate liquidation. They must perform, or at least ride the market to appreciation to earn anything. But that does not mean that manager would willingly leave the interest out on the curb on trash day as worthless. It is, after all, a platform

for making, for example, \$1 billion. Do not discard this opportunity!

Valuing compensation when the 20-2 platform is issued would be a bit like valuing a Stanford MBA upon graduation. Stanford MBAs make \$3 million on average in the 20 years after graduation,<sup>28</sup> but future salary depends on talent, work, and happenstance as well as on education. For those who go off to Fiji to beachcomb, die tragically, or bet on the wrong product, the MBA is not worth anything. Some will make much more than \$3 million. Just as it would be silly to tax the MBA on present value at graduation on what might be achieved, so the real value, discounted present value of the future cash flows, is not ascertainable on issuance of the 20-2 interests, except by retroactive taxation. The future income has not been earned and it is not ascertainable in amount. It has not accrued under generally accepted accounting principles. Trying to tax the unearned future income when the managing partner is given the platform for future profit would be premature and unreasonable.

Early taxation of a service interest is a terrible way to tax compensation. The fair market value of a service partner's interest when issued can be given value by the market, in bargaining between sellers and buyers, but the value so set will be systematically too low. Outsiders will make some sort of assumption about the contribution the service provider will add to the fund, but as outsiders they need to assume the risk the manager is a "lemon" and protect themselves by assessing value too low.<sup>29</sup> That means that every service partner who is slightly better than a lemon will add value to their share that cannot be captured at the outset. Indeed, even if there is some valuation for the partnership interest at the time the service partner receives it, the identification of compensation needs to tax some of the subsequent gain as service-caused gain. The initial tax cannot capture it.

<sup>28</sup> John A. Byrne, "The Most Lucrative Seven-Figure MBA Degrees," *Poets & Quants* (Oct. 13, 2014), reporting findings that Stanford MBAs make \$3 million in the 20 years following graduation. This is not an attempt to compute the value added by the degree. Stanford applicants start with talent and connections, and they might make as much going to Wharton or if they choose a different career.

<sup>29</sup> The argument is a variation of George Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism," 84 *Q. J. Econ.* 488 (1970).

<sup>27</sup> Even a profits interest or capital interest with no distribution upon immediate liquidation is taxable if the cash flows from the interest are certain; the interest is publicly traded; or the partner is taking the interest to sell it; but those exceptions never show up in the standard industry practices.

The only rationale for not taxing a partnership interest with no immediate liquidation value is the open transaction rationale. If the interest is traded on an established market, has such a predictable cash flow so that net present value of the cash flow is a reliable measure of value, or the partner sells the interest soon enough after receiving that the sale price is a reliable measure of the value of the interest when received, the partner has compensation from the receipt of the interest. Whatever else might be said in favor of not taxing partners on receipt of their interest falls away if the value of the interest is reasonably ascertainable. The open transaction doctrine, however, also has a second half, which is that when the value of the compensation is earned and becomes ascertainable, the compensation is still ordinary-income compensation.

It was an error for Treasury to say that the issuance of the partnership interest is the end of the effort to measure the manager's compensation. None of a manager's subsequent return on his partnership interest can be attributed to capital because the manager has not contributed any capital. Letting the manager into the status of partner and ending the compensation element means the manager thereafter has the lala rule of passthrough of partnership income, with a character of whatever it is to the partnership. The second step of the open transaction doctrine, taxation of the compensation when its value becomes clear, never happens. Letting the manager have zero compensation both at issuance of the interest and at distribution or allocation of a distributable share of the cash that gives the interest its value is like the loophole that section 83 was enacted to prevent, under which restricted stock compensation was taxed neither when transferred nor when the restriction lapsed.

Letting the executive get out of the compensation measurement with a zero-tax event is the sad end of an endeavor by Treasury, over at least two generations, to prevent premature compensation events taxed falsely at zero value from transforming the property from compensation into capital gain. For generations, compensation tax planners had asked Treasury to value compensatory tax options as the bargain that the option would give to the executive if the option were exercised immediately. For options

with no initial bargain, the gain the executive made at exercise would be capital gain and only if sold. Treasury resisted premature taxation of stock options, at zero "liquidation" value, for more than two generations so to prevent executives from paying tax zero tax on their stock options and then reporting subsequent gain as capital gain.<sup>30</sup> Then the partnership people found a way to get zero valuation by a premature taxable event, before anything was earned, with the errors of subchapter K partnership tax and so avoid all compensation. This is exactly what Treasury had resisted despite much hard lobbying for many years.

The zero-taxed carried interest is different from stock given as compensation when it has value. When stock compensation is included in income, the employee gets a basis equal to the FMV included in income. That basis, sometimes called "tax basis" or basis from being taxed, is like an investment and subsequent gain on the stock and is thereafter treated as capital gain. We treat the executive shareholder as if they had purchased the stock compensation for cash because the executive could have been paid compensation cash and purchased the shares for their value on the open market. For outside shareholders who have just invested the FMV for the stock, the gain is appreciation on basis, because of forces beyond the taxpayer's control. Corporate-level tax on the earnings the executive has created is also a fine rationale for letting subsequent shareholder gain, from the same earnings, qualify as capital gain, even if the shareholder-executive caused the gain.<sup>31</sup>

Partnership interests taxed at zero when issued are not the same. The partner comes out of

<sup>30</sup> See, e.g., reg. section 1.83-7 (2004) (stock options are taxable at issuance usually only if sold on established market); for other attempts to prevent premature taxation that gets into capital gain position, see reg. section 1.83-3(a)(6); reg. section 1.83-3(a)(7), examples 2 and 4 (employee must have capital to lose or the stock is not transferred yet).

<sup>31</sup> Sometimes stock appreciation is due at least in part to the effort of the employee who has been given the stock compensation. But we give shareholders capital gain on stock caused by their own efforts in part as relief from double corporate tax. See, e.g., Rev. Rul. 59-325, 1959-2 C.B. 185 (acquiescing in giving Jack Benny and Groucho Marx capital gain on sale of stock holding assets that amounted just to the comedians' services). Once the corporation has paid tax on the earnings the shareholder caused, it is reasonable to give lower tax on the stock to ameliorate double tax of corporate income at both the corporate and shareholder levels. See, e.g., section 1(h)(11) (giving capital gain for corporate dividends). For the fund manager, however, getting a partnership interest is not subject to double corporate tax.

the issuance with zero basis or capital. Zero basis cannot explain the future returns as a return on capital invested. The partner has no basis, no capital invested. It is all return to services provided — that is, compensation.

If the managing partner pays tax on interim distributable partnership income, but does not withdraw it, the managing partner does have a separate interest in the partnership, which is not a compensatory interest and not part of the ordinary-income closing of the compensatory open transaction. Taxed but undistributed income is like basis achieved by purchase. A partner has basis in distributable income not distributed.<sup>32</sup> Basis in the distributable but undistributed claim on earned amounts is justification for treating the subsequent income, if any, earned on that claim as return on capital, including if the return on the capital is tax-exempt bonds or tax-favored capital gain.

If a partner has both basis from a capital investment, or a basis from prior tax, and also a claim derived from services performed, one should worry that the manager in charge can claim too large a return of capital when the claim is really attributable to his continuing services. The investors would not object given the services. Still an agreement that gives the managing partner a return on capital accounts that is no larger than what the partnership has made overall for the year would not seem to be abusive, if nothing else is going on.

The principle that compensation is ordinary income is a strong one. Compensation is the normative heart of the income tax. Current law to the contrary needs to be fixed. The system for fixing it needs to be clean in theory and clear, but current law does need to be fixed. Finishing up the open transaction doctrine, as required by the logic of the doctrine, would reach the income — as it is earned — as ordinary income. Even better, section 702 needs to be amended so that capital gain on the partnership level will not mischaracterize compensation for partner services. The Kahns, while explaining rationales for current law, do not justify the capital gain result.

<sup>32</sup> Section 705(a)(1)(A).

## A Response to the Defense of Eliminating Capital Gains Treatment for Carried Interest

by Jeffrey H. Kahn and Douglas A. Kahn

We recently published an article demonstrating that the current tax treatment of carried interests, under which some partnership distributions to the holders of those interests are characterized as capital gains, is proper as a matter of good tax policy.<sup>33</sup> We contended that the widespread antagonism to that tax treatment was wrong and based on a failure to account for the nature of a partnership and the proper characterization of partnership distributions for federal tax purposes. We refer to that article as “Fallacious Objections.” Calvin H. Johnson has written an article in response (see above), which we refer to as the “Erroneous Defense article.” In that article, Johnson does not dispute that current tax law treats the distributions in question as capital gains, and he graciously acknowledges that Fallacious Objections provides a fair description of the rationale for the current law. However, Johnson maintains that the current treatment offends good tax policy and should be changed. As one might expect, we disagree and will seek to show in this article that Johnson’s thesis does not withstand scrutiny.

Before discussing the Erroneous Defense article, we briefly describe what constitutes carried interest and the basis of our contention that the current tax treatment of carried interests is consistent with tax policy. The support for our position is more fully set forth in Fallacious Objections.

### I. The Meaning of Carried Interest

A carried interest is the term used to describe a profits interest in a partnership that invests in equities. Typically, the partnership will be a limited partnership or a limited liability company to which several investors will contribute capital in exchange for a partnership capital interest. A “partnership capital interest” refers to a partnership interest that provides rights to both the properties that were contributed to the

<sup>33</sup> Kahn and Kahn, *supra* note 1.



partnership and to the profits earned by the partnership. A “partnership profits interest” refers to a partnership interest that provides rights only to the subsequent profits earned by the partnership and does not provide rights to the capital that was contributed by the investors. The partnership will invest in equities to be selected by one partner, called here managing partner, who has expertise in investing. The managing partner contributes little or no capital to the partnership. Instead, he contributes the right to his future services in managing the investments in exchange for which he receives a partnership profits interest. In many cases, the partnership invests in depressed companies, and the managing partner uses his expertise to turn those companies around so that they can be sold for a substantial profit. The profit from the sale of the stock of those companies will be treated as capital gains. Typically, the partnership profits interest that the managing partner receives in exchange for his promise to perform future services provides for a right to 20 percent of the partnership’s future profits.<sup>34</sup> The 20 percent partnership profits interest that the managing partner holds is referred to as a carried interest.

## II. The Thesis of Fallacious Objections

The distributions made by a partnership to its partners have the same character to the partners that the income from which the distributions were made had to the partnership.<sup>35</sup> To the extent that a distribution to a partner is attributable to what was long-term capital gain to the partnership, it will be characterized as long-term capital gain to that partner.<sup>36</sup> Because most of the amounts distributed to the partners of an equity investment partnership will be attributable to long-term capital gain income of the partnership,

most of the distributions to its partners will be treated as long-term capital gains. So, most of the distributions of 20 percent of the partnership’s profits to the managing partner will constitute long-term capital gains to that partner. It is that characterization of the managing partner’s distribution as capital gains to which Johnson and others object.

Our thesis in support of the current treatment of the partnership distributions to a managing partner rests on two elements. One element is that not all the income produced from a person’s labor is treated as ordinary income. In many cases, such income is treated as capital gains. An important example of that treatment arises when a person invests in an item and then expends considerable labor to improve the item before selling it (so-called sweat equity). The completed item is sometimes called “self-created property.” The gain on the sale of self-created property is partly attributable to the capital contributed by the seller in his purchase of the item and partly attributable to the seller’s labor. For example, Helen puts considerable time and effort into researching companies before investing in their stocks. She later sells the stocks for a sizable profit that is partly attributable to the capital she invested and partly to her labor. Yet, all the profit Helen earned on the sales is a capital gain.

The second element rests on how both state business law and federal tax law treat partnerships. For some purposes, a partnership is treated as an entity separate from its partners. For some other purposes, a partnership is treated as a fiction representing the aggregate interests of the several partners. For purposes of characterizing the income recognized by a partner because of an allocation to him of the partnership’s income, the partnership is treated as an entity and the partner’s income is characterized at the partnership level. The concept of a partnership is that several persons combine their capital and labor in the hope that the synergy will produce more income than their investments or efforts would produce if they acted alone. The profits that are earned are not income of each partner;

<sup>34</sup> Also, the managing partner usually receives an annual fee of 2 percent of partnership profits to compensate for his services. That fee will be treated as ordinary income to the managing partner.

<sup>35</sup> Section 702(b). It is not the distributions from the partnership that are taxable to a partner. The partnership’s income is allocated among the partners at the end of the partnership taxable year regardless of whether any distributions were received by the partner. Section 702(a). But, the source of the objections to carried interest is that the managing partner receives partnership distributions and is taxed at capital gains rates. For convenience, we refer to the partnership distributions as the source of the capital gains treatment.

<sup>36</sup> *Id.*

rather they are the partnership's income as a separate entity. Each partner is taxed on his share of the partnership's annual income regardless of whether it is distributed to him or her.<sup>37</sup> A partner is not taxed on a partnership distribution except to the extent that cash is distributed in excess of the partner's basis in his partnership interest.<sup>38</sup> So even if no distribution is made to a partner, he will be taxed on his share of the partnership's income for that year. For convenience, we refer to the distributions the managing partner receives as the source of the capital gains treatment.

The partnership income allocable to a managing partner is not compensation for work that she performed. The payment she received for her services was the receipt of the partnership profits interest she acquired on the formation of the partnership. The partnership income that is allocated to her is income earned by the property interest she holds (that is, her partnership profits interest). The partner acquired her partnership interest in exchange for her agreement to provide services to the partnership.<sup>39</sup> The partnership profits interest constitutes an advance payment for those services.

A proposed regulation promulgated in 2005 states that the receipt of a partnership profits interest is a taxable event to the recipient under section 83.<sup>40</sup> Previously, after some litigation, the IRS ruled in Rev. Proc. 93-27<sup>41</sup> that the receipt of a partnership profits interest for services is not income to the recipient unless one of several exceptions applied. While, if finalized, the 2005 proposed regulations would replace that ruling, the ultimate result reached by the 2005 proposed regulations would be similar. That is because the 2005 proposed regulations establish a safe harbor under which the value of a partnership profits interest will be deemed equal to its liquidation value if some requisites are satisfied.<sup>42</sup> Since the holder of a partnership profits interest has no

rights to the capital contributed to the partnership and since a newly formed partnership has not yet earned any profits, the liquidation value of the managing partner's partnership profits interest is zero. For that reason, under either Rev. Proc. 93-27 or the 2005 proposed regulations, the recipient of a carried interest will not incur any tax liability. As we will see, Johnson proposes that that rule be changed.

### III. A Critique of Johnson's Thesis

The principal targets of criticism of carried interests are hedge fund managers and equity fund and venture capital fund managers. Those who are successful in those fields receive large sums of money that are taxed at capital gains rates. Johnson and others consider this a loophole that should be closed. The sizable amounts involved incite their ire.

Johnson emphasizes that compensation for services should never be taxed at capital gains rates. We have no quarrel with that proposition. The difficulty is in determining what constitutes compensation for services. We will elaborate on that point later in this article.

#### A. Compensation for Services

The thrust of Johnson's position rests on his characterization of partnership distributions to managing partners as compensation for their services. Indeed, that is the common theme of all those who dislike the capital gains treatment for carried interests. As noted in our Fallacious Objections article, while that characterization has some superficial appeal, it is fundamentally wrong. The amounts received by the managing partners are a return on property they hold and are not compensation for their services. The following examples illustrate the error in characterizing those payments as compensation.

**Example 1:** Several investors form the XYZ limited partnership to invest in the stock of start-up companies and sell for a profit the stocks of those companies that succeed. Garry and Sheila are lawyers. The XYZ partnership hires Garry and Sheila to perform legal services for the partnership. As compensation for their services, the partnership gives limited partnership profits interests in XYZ to Garry and Sheila. Those partnership interests are not forfeitable. Shortly

<sup>37</sup> Sections 702(a), 704.

<sup>38</sup> Section 731(a).

<sup>39</sup> The arrangement often provides that the service provider will receive an additional amount for her services, but her primary compensation is the receipt of the partnership profits interest.

<sup>40</sup> Prop. reg. section 1.721-1(b)(1).

<sup>41</sup> Rev. Proc. 93-27, 1993-2 C.B. 343.

<sup>42</sup> Prop. reg. section 1.83-3(l). See also Notice 2005-43, 2005-1 C.B. 1221.

thereafter, Garry and Sheila form a partnership (the GS partnership) to invest in start-up companies. They approach Hilda and seek to hire her to manage their investments. The parties come to an agreement under which Garry and Sheila transfer to Hilda their partnership profits interests in the XYZ partnership in exchange for Hilda's agreement to manage the GS partnership's investments for 10 years. The value of the XYZ partnership interests that were transferred to Hilda is minimal because they provide no interest in contributed capital and the amount of the partnership's future income is speculative. Thus, the amount of Hilda's income from receiving those XYZ partnership interests is relatively small. The XYZ partnership proves to be successful and earns large amounts of long-term capital gains, which it distributes to Hilda and its other partners. Clearly, the distributions Hilda received from XYZ are not compensation for her services. She performed no services for XYZ. The compensation for her services was the receipt of the XYZ limited partnership profits interests. The distributions she received from the partnership are a return on her partnership interest and are taxed at capital gains rates. The same principle applies to the distributions to a managing partner. In the case of carried interest, the partnership that distributes its capital gains is also the one for whom the managing partner performs services, but just as in the XYZ situation, the payment for those services was the transfer of a partnership profits interest, and the subsequent distributions were returns on that partnership interest.

**Example 2:** Alex and Paul form a subchapter S corporation to invest in start-up companies. In exchange for their cash contributions to the corporation, they each receive stock and bonds of the corporation. The face amount of the bonds constitutes 85 percent of the amount contributed by the shareholders, and the value of the bonds equals their face amount. Thus, the value of the stock equals 15 percent of the amount that was contributed. The corporation wishes to use the services of Katherine to manage its investments. The corporation and Katherine agree that in exchange for her managing the corporation's investments, Katherine will receive stock in the corporation constituting 20 percent of the corporation's outstanding stock. The value of the

stock that Katherine receives is ordinary income to her; but because of the corporation's outstanding debt, the amount of her income is relatively small.<sup>43</sup> The investments are successful, and the corporation earns substantial capital gains from selling them. The capital gain income of an S corporation passes through to its shareholders at the end of the corporation's taxable year regardless of whether it is distributed.<sup>44</sup> Thus, Katherine's 20 percent share of the corporation's capital gains is taxed to her as capital gain income at the end of the year in which the gains are earned. Katherine's situation is almost identical to that of a managing partner except that Katherine will have ordinary income on the value of the stock when she receives it. But, the value of the stock is small so there is little practical difference in the situations. Indeed, if the 2005 proposed regulations are finalized, the receipt of a partnership profits interest will be income to the managing partner, but because of the zero valuation provided by the safe harbor rule, he would usually incur no tax liability. There is little practical difference between having a small value for the stock and a zero value for the partnership interest. In principle, both are included in income at their respective values. Johnson states that the receipt of stock is different because the service provider gets a tax basis in the stock equal to the amount of income (that is, the value of the stock). Having a tax basis is equivalent to making an investment, and so Johnson apparently agrees that the return on that investment when Katherine receives her share of the corporation's capital gains qualifies as capital gains. Therefore, if the IRS were to value a compensatory partnership profits interest at a figure greater than liquidation value, no matter how small, the managing partner would have a basis in his partnership interest. Johnson would agree that he would then qualify for capital gain treatment for partnership allocations to him. Johnson's proposal to have a substantial difference in tax consequences turn on the

<sup>43</sup> Katherine's stock represents 20 percent of the 15 percent of the amount contributed to the contribution by Alex and Paul. Thus, the value of her stock is 3 percent of the total amount contributed to the corporation. The reference to "contributed" in this footnote includes the amount paid by the shareholders to purchase bonds of the corporation.

<sup>44</sup> Section 1366(a), (b).



minuscule difference between having a zero basis in the appreciated property and having a minimal basis appears to us to be impractical and affords great consequence to insignificant differences.

It should be noted that Johnson buttressed his view for allowing capital gain treatment for the sale of stock in that it mitigates the double taxation that otherwise would apply. While double taxation does not occur in the case of S corporations, the principle the Erroneous Defense article espouses that having a basis in property is a justification for allowing capital gains treatment would apply to stock of an S corporation as well. Moreover, Johnson agrees that if the partnership profits interest were taxable to the managing partner when he receives it, the treatment of partnership distributions as capital gains would be appropriate. Ultimately, Johnson's position is that the qualification for capital gains treatment depends upon whether the managing partner has or is deemed to have an investment in the partnership interest. We discuss that issue later in this article.

It is noteworthy that if the 2005 proposed regulations concerning the receipt of a compensatory partnership interest are finalized, the adoption of Johnson's proposal would not make a significant change to the tax consequences of holding a carried interest. The 2005 proposed regulations provide a safe harbor in accordance with which the value of a compensatory partnership profits interest is deemed to be its liquidation value. But this safe harbor provision applies only if specific conditions are satisfied and if it is elected by the partnership and its partners.<sup>45</sup> Since Johnson's proposed open transaction approach does not apply if the receipt of the partnership interest is taxable, a partnership could simply not elect the safe harbor, and the partnership interest would then be taxable to the managing partner. The value of the partnership interest is likely to be small especially in light of the power of the investing partners to terminate the partnership and leave the managing partner with little or nothing. Thus, for a relatively small tax cost, the managing partner would continue to

qualify for capital gain treatment for his share of partnership income.

## B. Exchange of Services

Johnson correctly notes that the exchange of services for the services of another (or for property) is a taxable exchange in which both service providers can have ordinary income. From that rule, he concludes that a managing partner should have ordinary income because he is providing services for another and not for himself. He concludes that if subchapter K<sup>46</sup> provides otherwise, it is flawed. He states that "Subchapter K . . . is supposed to be the servant of substantive tax law." The problem with that approach is that the tax law operates in conjunction with property laws and other private laws. The nature of a partnership is a joint enterprise in which the individuality of the partners is merged to some extent in the entity. A partner who performs services in his partnership capacity is not considered to be performing it for the other partners. He is performing it for the joint enterprise of which he is a member. Consider the following example:

**Example 3:** John is an architect and Ralph is a builder. They form a partnership to construct an apartment building. John designs the building and creates blueprints for its construction. Ralph conducts the construction of the property. They are not treated as exchanging service with each other. Instead, they are treated as performing services in the joint enterprise of creating a building. They do not recognize income from the performance of their services. If, several years after completing the construction, they decided to sell the building for a gain, they would have section 1231 income, which likely will be treated as long-term capital gains. Even though much of the gain is attributable to the labor that they both contributed, their income may be taxed at capital gains rates. If the partners had managed the apartments so well as to increase the value of the building because of its positive reputation, the gain attributable to that labor also would be treated as section 1231 gain.

<sup>45</sup> Prop. reg. section 1.83-3(l).

<sup>46</sup> Subchapter K (sections 701-755) deals with partnership taxation.

Similarly, the services performed by a managing partner are for the joint enterprise of acquiring stocks for future appreciation. The services are not performed for the investors. It is common for some partners to contribute capital to a partnership, other partners to contribute services, and some partners to contribute both. The income from the partnership as an entity is divided among the partners and characterized as it is in the hands of the partnership. That aspect of partnership taxation conforms to the private business law view of a partnership as a joint enterprise.

In the *Erroneous Defense* article, Johnson states that, “The fund managers are not building for themselves, however, but for others.” He disregards the partnership’s significance and treats it as a mere arrangement to turn compensation income into capital gains which he refers to as a kind of alchemy. To the contrary, the carried interest partnerships are not mere devices to obtain favorable tax consequences. They are formed for legitimate business purposes. The investors believe and expect that the synergy of their investments and the expertise of the managing partner will produce greater profits than they would obtain if they invested alone. Not all those investments will be successful, but many are. It is not the function of the courts, the IRS, or academics to second-guess the business decisions that the investors made. Of course, the tax consequences of doing business in a partnership form is taken into account by the parties. That is commonly done in choosing the type of entity in which to conduct a business. If carried interest partnerships were not formed for legitimate business purposes, they would not qualify as a business entity for tax purposes and would not be treated as a partnership under the tax law regardless of how classified for local law purposes.<sup>47</sup>

Johnson states, “a partner performing services is an agent of the partnership, just as an employee, officer, or independent contractor is an agent of the business for whom the services are provided.” It is true that a partner is an agent for purposes of being able to bind the partnership to agreements

he makes on its behalf and in making the partnership liable for his negligence and poor decisions. But the partner is also a member of the partnership and is treated as self-employed. The partnership for whom he acts is an entity that consists of a melding of several persons, one of whom is the managing partner. When acting in his capacity as a partner, the partner is not treated as providing services for compensation but rather as performing his duties as a member of the partnership.

It is possible for a partner to perform services for a partnership for compensation. If a partner performs services that are not done in his capacity as a partner, the transaction will be treated as if it were between the partnership and someone unrelated to it.<sup>48</sup> For example, if Paula is an attorney and a partner in a real estate partnership that becomes engaged in litigation, and if the partnership hires Paula to represent it in the litigation, Paula would not be providing her legal services in her capacity as a partner. In that case, the payments made to her for her services would be treated as compensation. The payments would be ordinary income to Paula and, depending upon the nature of the litigation, could be deductible by the partnership. That provision does not apply to managing partners since they provide their services in their capacity as partners.

There is one situation in which the payments made for services provided by a partner in that capacity are treated as compensation for some purposes. If the payment must be made without regard to whether the partnership has income, it is referred to as a “guaranteed payment.” A guaranteed payment is ordinary income to the partner who receives it and, depending on the nature of the services, may be deductible by the partnership.<sup>49</sup> Guaranteed payment treatment applies only to payments to the extent that they are not dependent on the partnership’s income. For example, if the partnership agreement required that a partner be paid \$20,000 annually, regardless of whether the partnership has income in that year, that would be a guaranteed payment.

<sup>47</sup> Reg. section 1.7701-1(a).

<sup>48</sup> Section 707(a)(1).

<sup>49</sup> Section 707(c).

This provision does not apply if the payments to the service provider are based on a portion of the partnership's income. A managing partner has no guaranty of a specified amount of payment, but rather receives a percentage of the income earned by the partnership. The guaranteed payment provision does not apply to carried interests. Note that guaranteed payments do not treat the partner's services as having been performed for the other partners, but rather for the partnership as an entity.

The concept of a guaranteed payment was first adopted in the 1954 code. Before that, those payments were treated as partnership distributions rather than compensation.<sup>50</sup> The courts had difficulty dealing with that treatment when the partnership's income was less than the amount distributed. Congress adopted the guaranteed payment provision to clarify the treatment of such cases.<sup>51</sup> The concept is based on the fact that partners share in the income and losses of the partnership. If the amount that a partner receives is not determined by partnership income, it looks more like a payment for services than an allocation of partnership profits.

### C. The Scope of Capital Gains

There is no consensus on the function and purpose of capital gains treatment. It can be seen as serving multiple purposes. Johnson strongly adheres to the view that capital gain is restricted to appreciation of capital. Even if that is so, the managing partner's "capital" is his partnership interest. Regardless of whether he has any basis in that interest, it is an item of property and thus is capital that can appreciate. The investment of money is not a condition of having capital. For example, Ralph inherits the property of his grandmother upon her demise. Among her properties, there is an old baseball. From all facts known at that time, the baseball is worthless, and so Ralph has a zero basis in the ball.<sup>52</sup> Since Ralph

has no positive basis in the ball, Johnson would say that he has no investment in it. Five years later, it is discovered from records recently unearthed that the ball was the last home run that Babe Ruth hit. The ball then is seen as a collector's item, and Ralph sells it for \$100,000. There is no reason that the gain from that sale should not be capital gain. If Ralph had purchased the ball for \$1 at a flea market, the ball would not be more of a capital asset than it was as an inherited item.

Johnson appears to agree that if Ralph had purchased the ball at a flea market for \$1, he would have a capital gain of \$99,999 on its sale. But he contends that if he inherited the ball with a zero value, he would have ordinary income of \$100,000 on its sale. It seems also that Johnson would agree that if the ball were deemed to have a value of \$1 when Ralph inherited it, he would have had a basis of \$1 in the ball and so could have a capital gain of \$99,999 on its sale. His positions are based on his contention that capital gain can apply only if the taxpayer has an investment in the item. He equates a positive basis with an investment, and so the presence of a basis becomes the crucial element for capital gains treatment according to his theory. Even if one were to accept that view, it is wrong to equate a zero basis with no basis. If an inherited asset is valued at zero, it is still an asset with a basis of zero that can increase in value. Johnson's willingness to have a substantial difference in tax consequences turn on the minuscule difference between having a zero basis in the appreciated property and having a minimal basis appears to us to be more doctrinaire than principled.

In the Erroneous Defense article, Johnson states that, "Under current law, without basis, the gain from compensation is not the appreciation of capital, and is not capital gain." This statement is made in support of treating a property interest received for services as capital only if the property's value is taxable when received so that the recipient has a positive basis in it. In footnote 8, the article cites two cases for that proposition (*Vestal* and *Bryan*), and neither of those cases is apposite. The Erroneous Defense article states that *Vestal*<sup>53</sup> held that the sale of a partnership

<sup>50</sup> See *Lloyd v. Commissioner*, 15 B.T.A. 82, 84-85 (1929).

<sup>51</sup> Congress determined that the pre-1954 treatment of such payments was "unrealistic and unnecessarily complicated." H.R. Rep. No. 83-1337 at 68 (1954). See Douglas A. Kahn, "Proposed Regulatory Change of Treatment of a Guaranteed Payment from a Partnership to a Partner," 5 *Mich. Bus. & Entrepreneurial L. Rev.* 125, 130-131 (2016).

<sup>52</sup> Section 1014(a).

<sup>53</sup> *Vestal v. United States*, 498 F.2d 487 (8th Cir. 1974).



interest with zero basis was compensation, not capital gain. The case does not support that statement. In *Vestal*, the taxpayer had a contractual right to receive a transfer of a portion of the partnership interests that several limited partners held but only if specific conditions were satisfied. This contractual right was given as a fee for finding the investment. The conditions for transferring the partnership interests were never satisfied, and so the taxpayer never acquired a partnership interest. Instead, when the partnership interests of the partners were sold, the taxpayer received cash payments from those limited partners. The court held that the payments were made in accordance with a contract, not as a sale of a partnership interest. The *Bryan*<sup>54</sup> citation is even more puzzling. The case involved the sale of corporate stock, and the gain recognized on the sale was treated as capital gain.

Johnson contends that the profits from an item produced by a taxpayer's labor should be classified as compensation and, as a matter of tax policy, should be treated as ordinary income. He considers the failure to treat self-created property that way to be an exception that is allowed for administrative convenience. He points to the provision of the code treating gains from the sale of self-created literary and some similar items as ordinary income as evidence that taxing self-created property at capital gains rates is a loophole. Let us examine the current treatment of profits from a taxpayer's creations.

As Johnson notes, in the late 1940s, General Eisenhower sold the copyright to a book he authored, and the gain was taxed at capital gain rates. At that time, the sale of a self-created book or other composition by a person who was not a professional author could qualify for capital gain treatment. Congress later adopted section 1221(a)(3) excluding from capital asset classification a copyright, literary, musical, or artistic composition created by the taxpayer. Johnson maintains that the adoption of that

provision shows that Congress considered an allowance of capital gains treatment for any self-created property to be a loophole.<sup>55</sup> Conflicting with that view is the fact that Congress required ordinary income treatment only for several expressly listed types of self-created properties and left untouched all the others. If all self-created property should be excluded from capital gains treatment, why exclude only a few types? For example, a patent obtained for an invention is not included in the list in section 1221(a)(3) of items excluded from capital asset classification. Thus, a one-time inventor could sell the patent on his invention for capital gains. Not only did Congress leave patents off its list of excluded items, it left intact section 1235, a provision that allows a professional inventor (a modern-day Thomas Edison) to obtain capital gains treatment for a sale of his patents. Indeed, section 1235 applies capital gain treatment to the sale of patents far more liberally in several respects than is applied to the sale of items that are not self-created.<sup>56</sup>

In 2006 Congress added section 1221(b)(3), which grants taxpayers an election to have capital gains treatment for the sale or exchange of self-created musical compositions. Since that amendment was adopted, the composer of a musical composition can sell it for capital gains even if he is a professional composer.

Clearly, Congress considers one function of capital gains treatment to be to encourage specific behavior. When dealing with investments, capital gain treatment encourages more investment because some of the profits can be taxed at lower rates. It is false that Congress has no interest in encouraging labor in some areas. Apparently, Congress deems it desirable to encourage inventions and musical compositions, but cares little for literary works. Self-created works require an investment of labor. There are ample reasons to encourage the creation of goods from labor just as there are reasons to encourage the creation of goods from the contribution of capital. In the case of hedge funds or venture capital funds, the acquisition of a distressed business to restructure it into a successful and profitable operation can be

<sup>54</sup> *Bryan v. Commissioner*, 16 T.C. 972 (1951).

<sup>55</sup> The Erroneous Defense article cites a committee report that characterized the prior treatment as a "loophole."

<sup>56</sup> Section 1235(a)(1).

seen as a worthy enterprise to be encouraged. The change from a failing operation to a successful one benefits the public as well as those who invested in it.

In any event, in the case of carried interests, the capital gains are earned by the partnership as the product of the combination of the capital it acquired from its partners and the expertise of its managing partner. The gain resembles that of self-created property in that it is the product of the capital and labor contributed by its partners; there is no dispute that the partnership's gain is a capital gain. The partnership interest that the managing partner holds is not self-created property; it is property received as an advance payment for services to be performed.

The allowance of capital gain treatment for carried interests is not an outlier from the other properties that qualify. The treatment of carried interests comports with the partnership concept that was adopted by state laws and the federal tax law and is consistent with the capital gains treatment accorded throughout the tax law.

#### D. Income Exclusion of Partnership Interest

The Erroneous Defense article asserts that the core of the problem with the current treatment of carried interest is the failure to tax the managing partner on the receipt of a partnership profits interest. If the managing partner paid a tax on the receipt of that partnership interest, Johnson agrees that subsequent capital gain treatment is appropriate. Let us now consider the exclusion from income tax liability of the receipt of a partnership profits interest and its significance to the treatment of subsequent partnership distributions or allocations.

For federal tax purposes, the value of property is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts."<sup>57</sup> Johnson notes correctly that while the liquidation value of a carried interest at the time it is received is zero, the actual market value of the interest at that time is greater than zero. However speculative the success of the

venture may be, someone surely would pay something for the prospect of making a profit. However, the amount they would pay is likely to be small, not because the prospects of gain are poor, but because the other partners have the power to cause the termination of the partnership and leave the managing partner's interest with nothing more than the amount distributed on it in liquidation of the partnership (that is, a zero amount). It is unlikely that the other partners would promptly terminate the partnership, and so the carried interest does have value, but the transfer of that interest to a third party increases the risk that the partnership would be terminated, especially if, as often is the case, the carried interest is a general partnership interest. That risk of termination will reduce the market value of the carried interest, but it does not reduce it to zero.

In the 1931 Supreme Court decision *Burnet v. Logan*,<sup>58</sup> the Court dealt with the sale of stock for which payment was to be made in installments based on the amount of iron ore mined and sold under a lease arrangement. Because of the difficulty in determining how much ore would be mined, the Court agreed with the taxpayer that the sale should be kept open and the taxpayer should treat each subsequent installment payment as a return of her basis. Once her basis was fully recovered, payments received in excess of her basis would be treated as capital gain recognized from the sale of her stock. The Court determined that the taxpayer's right to installment payments had no "ascertainable fair market value" and so was not equivalent to cash. This treatment is sometimes referred to as the "open transaction rule," the "open transaction approach," or the "cost recovery method."

The IRS resisted the taxpayer's contention to keep the transaction open in *Burnet*. While it lost that case, the IRS has severely restricted the scope of the open transaction approach. The IRS's position is that the FMV of an asset can be ascertained in almost all situations, and so the open transaction approach will apply only in rare circumstances. Reg. section 1.1001-1(a) states, "The fair market value of property is a question of fact, but only in rare and extraordinary cases will

<sup>57</sup> Reg. section 1.170A-1(c)(2).

<sup>58</sup> *Burnet v. Logan*, 283 U.S. 404 (1931).

property be considered to have no FMV." The rare and extraordinary standard has been used by both the IRS<sup>59</sup> and the courts.<sup>60</sup> Courts usually adopt the IRS's position and assign value to items even though the amounts to be received are speculative. For example, in *Fleming*,<sup>61</sup> the court upheld a valuation of a right to receive payments based on a percentage of oil produced from wells — both existing and those planned to be built. In *Clodfelter*,<sup>62</sup> the court upheld the Tax Court's valuation of a right to receive a percentage of the income from the operation of a hotel. The Ninth Circuit went even further and held that the open transaction doctrine applies only if there is uncertainty regarding whether the taxpayer will recognize a gain; if it is clear that the taxpayer will recognize a gain, the court said, there is no requirement of ascertainable value.<sup>63</sup>

Treasury's resistance to the open transaction approach is appropriate and justified. The open transaction's use of subsequent installment payments as representing the FMV of the item at the time that it was sold is unrealistic. Congress illustrated its distaste for that approach when it adopted the Installment Sales Revision Act of 1980.<sup>64</sup> That act amended the code to permit installment reporting when the amount to be received by the seller cannot be readily ascertained because the amount is contingent.<sup>65</sup> In those cases, if the installment method of reporting is elected, the seller's basis is allocated ratably among the subsequent payments as contrasted to the cost recovery method used by the open transaction approach.<sup>66</sup> Because of that amendment, the open transaction rule applies to even rarer circumstances.

<sup>59</sup> Rev. Rul. 58-402, 1958-2 C.B. 15.

<sup>60</sup> See, e.g., *Estate of Marsak v. Commissioner*, 288 F.2d 535 (7th Cir. 1961) (in valuing patent rights, the court said that while ascertainment of value may be difficult, it is only in rare cases that no value can be found). But see *Dorsey v. Commissioner*, 49 T.C. 606 (1968) in which the Tax Court held that rights to the profits from exploitation of a patent had no ascertainable value.

<sup>61</sup> *Fleming v. Commissioner*, 153 F.2d 361 (5th Cir. 1946).

<sup>62</sup> *Clodfelter v. Commissioner*, 426 F.2d 1391 (9th Cir. 1970).

<sup>63</sup> *Tribune Publishing Co. v. United States*, 836 F.2d 1176 (9th Cir. 1988).

<sup>64</sup> P.L. 96-471.

<sup>65</sup> Section 453(f)(8)(B), (j)(2).

<sup>66</sup> Section 453(j)(2).

The *Burnet* open transaction rule does not apply to the carried interest situation. In *Burnet*, the taxpayer received the right to installment payments on the sale of her stock, and the amount of those installment payments was determined by reference to a percentage of iron ore that was mined. The taxpayer did not receive an interest in the mine itself or in a lease of the mine. In contrast, the capital gain income that is distributed to a managing partner does not constitute installment payments on a sale of his services; instead, the gains are a return on the property (the partnership interest) that the taxpayer acquired as an advance payment for his services. Similarly, in *Dorsey*<sup>67</sup> the taxpayer was entitled to installment payments from a sale of a patent, the payments measured by reference to a percentage of the income produced by the patent. The taxpayer did not have an interest in the patent itself. Even if the open transaction rule applied to carried interests, it would not affect the tax characterization of the managing partner's receipt of partnership distributions. The rule would not treat the managing partner's partnership interest as nonexistent. The distributions received on that partnership interest would be treated as such and not as deferred payments for the acquisition of the right to the partner's services.

Moreover, Rev. Proc. 93-27, which is still viable since the 2005 proposed regulations have not yet been finalized, provides that, with three exceptions, the recipient of a partnership profits interest for services does not recognize income. Thus, there is no basis for treating subsequent distributions from the partnership as gain recognized by the partner from his agreement to perform those services.

A finalization of the 2005 proposed regulations would not change that result. The 2005 proposed regulations do treat the receipt of the partnership profits interest as a taxable transaction, but those regulations allow an election to use the liquidation value of the partnership interest as its market value. As noted previously, the liquidation value is likely to be zero. That does not mean that the partnership interest has no readily ascertainable market value.

<sup>67</sup> *Dorsey*, 49 T.C. 606.



To the contrary, it has a market value, and that value is to be treated as zero.

The Erroneous Defense article notes that the IRS has sought to apply an open transaction approach to many stock options that were received as payment for services. Options, especially stock options, were previously used as a device to compensate employees in such manner as to minimize their tax consequences. The options were valued at a low figure when issued and then no gain was recognized if the option was exercised at a highly favorable strike price. The options might also be encumbered by restrictions and conditions designed to lower their market value. The IRS and Treasury took a dim view of that practice and took steps to prevent it. Also, Congress adopted section 83 to deal with a similar compensatory scheme.

The IRS's treatment of options is an exception to the its usual position. Reg. section 1.83-7(a) states that the granting of an option for services will be a taxable event unless the option does not have a readily ascertainable fair market value. Reg. section 1.83-7(b)(1) states that the value of an option "ordinarily" is not readily ascertainable unless the option is actively traded on an established market. Even if not traded on an established market, an option will have a readily ascertainable FMV if the conditions of reg. section 1.83-7(b)(2) are satisfied. If the option does not have a readily ascertainable FMV, a type of open transaction applies and the taxpayer is taxed under section 83 when the option is disposed of or exercised.<sup>69</sup>

The treatment of options has no bearing on how to treat the distributions received on a partnership profits interest. The amounts taxed to the holder of an option are amounts received on the disposition of the option either by a sale or by exercising it. The distributions received by a managing partner are not from a disposition of the partnership interest, but rather are a return on that property. The managing partner continues to own and hold the partnership interest, which is not diminished by the distribution. Also, as noted above, the open transaction rule does not apply to

those distributions because of Rev. Proc. 93-27 and the 2005 proposed regulations.

In his article, Johnson states, "The only rationale for not taxing a partnership interest with no immediate liquidation value is the open transaction rationale." That the liquidation value of a carried interest is zero when it is received does not of itself trigger the open transaction approach. The requirement for applying that approach is that the property not have a readily ascertainable value; it does not matter that the ascertained value is zero, \$1, or \$1 million. The regulations under section 83 eliminate any doubt that a zero value does not trigger the open transaction rule.

Section 83(a) provides that the FMV of property transferred to a service provider for the latter's services is taxable to the service provider at the first time that the property either is transferable or is not subject to a risk of forfeiture. Section 83 applies only to a transfer of property made to compensate for services performed. Section 83(b) grants the service provider an election to have the transferred property valued and taxed at the time of the transfer, in which case any restrictions on the property are ignored in valuing it. Neither section 83(a) nor 83(b) applies to a transfer at the time it is made if the transferred property has no readily ascertainable value.<sup>70</sup> The election under section 83(b) can be made even when the service provider pays FMV for the property so that there is no bargain element in the transfer.<sup>71</sup> In such a case, the transferred property effectively was partly sold and partly transferred as payment for services.<sup>72</sup> Since section 83 applies only if property is transferred to a service provider as compensation for services, the regulation's application of section 83(b) to the transaction means that Treasury considers there to have been a transfer of property to the service provider for his services. Because the recipient paid market value for the property, there was no distribution of that part of the property, and there

<sup>70</sup> Reg. section 1.83-7(a).

<sup>71</sup> Reg. section 1.83-2. The purpose of making the election is to prevent the application of section 83(a) to any appreciation of the property that is recognized on a subsequent disposition of it.

<sup>72</sup> Section 83(b) can apply only if there is deemed to be a transfer of property to the service provider as compensation for services.

<sup>69</sup> Reg. section 1.83-7(a).

had to be a deemed distribution of a portion of the property to the service provider. The value of the portion of the property deemed to have been distributed as payment for services was zero. Yet, the regulations provide that the section 83(b) election is available. The section 83(b) election is unavailable to a transfer in which the property has no ascertainable market value,<sup>73</sup> and so the regulation's statement that section 83(b) is applicable constitutes an acknowledgment that the compensatory transfer of property with a zero value does not cause the property to have no ascertainable value.

Johnson does not appear to contend that the open transaction rule applies to carried interests. Instead, he argues that the open transaction approach can be used to solve what he sees as the problem of allowing capital gain treatment for the partnership's distribution of its capital gain income. As we discussed earlier in this article, Johnson's view rests on his contention that the distributions should be seen as payments for the managing partner's performance of services. We responded to that contention earlier in this article and believe that we have shown that it is incorrect. The "solution" that Johnson proposes is to a problem that does not exist.

If the Erroneous Defense article's proposal to treat the distributions made to a managing partner as compensation for his services were adopted, it would have far-reaching consequences. Venture capital and equity and hedge funds are not the only partnerships that have partners who received a partnership profits interest as advance payment for their agreement to provide services. There are numerous partnerships in which some partners contribute property and some contribute their agreement to provide services. Many real estate partnerships have that arrangement. If the distributions to the partner who is the service provider are treated as compensation for services performed as an employee, the distributions would be subject to employment taxes. The imposition of those taxes would be inappropriate and costly.

Even if a carried interest were deemed subject to the open transaction rule (and we believe that it

is not), it would not apply because the partnership interest would not be deemed to have no readily ascertainable value. As noted, the open transaction rule applies only in "rare and extraordinary" circumstances.<sup>74</sup> The receipt of a partnership profits interest for an agreement to provide services is neither rare nor extraordinary. To the contrary, it is a common occurrence in the formation of new partnerships.

#### IV. Conclusion

A partnership's distribution<sup>75</sup> of a portion of its capital gain income to a managing partner is not compensation for the services performed by that partner. The managing partner received a partnership profits interest as an advance payment for his agreement to provide services to the partnership. The distributions received by the managing partner are his share of the partnership's income to which he is entitled because of his holding a partnership interest. The managing partner is treated by the tax law the same as any other partner is treated. His share of the partnership's capital gains is characterized as capital gains to him. There is no abuse to be cured.

### Johnson's Response — Last Words

by Calvin H. Johnson

Hard-fought debates tend to slide into less important details as they go on. Like a Mandelbrot fractal, as much energy and acrimony is spent on the increasingly trivial issues as on the broader scale. Readers, however, are less entertained by the warfare that gets into the trenches and smaller details.

Overall, Doug and Jeffrey Kahn offer a hypothetical in which the managing partner contributes no capital and has no basis in the

<sup>74</sup> Reg. section 1.1001-1(a).

<sup>75</sup> While we and other commentators refer to the taxation of "distributions" to a service providing partner, that term is used for convenience of discussion. As noted previously, the income recognized by a partner is not from a distribution of property to him but rather is from the allocation of the partnership's income at the end of the year in which it is earned by the partnership. If the income is not distributed in that year and is distributed to the partner in a subsequent year, the distribution typically will not be income to the partner.

<sup>73</sup> See reg. section 1.83-7(a).

fund. The manager takes out, for example, \$1 billion, attributable exclusively to managing. The managers have zero return from investment of basis, and all the return is a return to labor. The Kahns nonetheless advocate a tax accounting that makes all of the \$1 billion capital gain, and none of it compensation. Tax accounting has a sacred duty of describing the economics. The Kahns' accounting does not reflect the economic income. ■