2007

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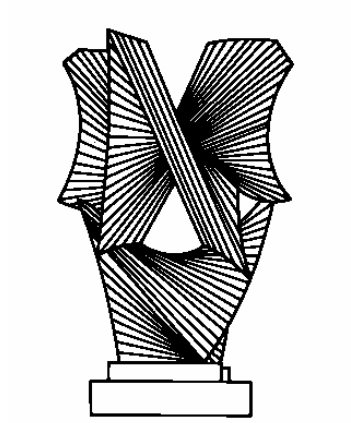
CHICAGO

JOHN M. OLIN LAW & ECONOMICS WORKING PAPER NO. 365
(2D SERIES)



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October 2007

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October 9, 2007

Forthcoming Virginia L. Rev., May 2008

Abstract

This essay analyzes the tax treatment of carried interests in private equity. It argues that there are two competing analogies: service income and investment income. Standard approaches are not able to resolve which of the competing analogies is better and often fail even to recognize that there are competing analogies. The best method for determining the proper treatment of carried interests is through direct examination of the effects of each of the possible treatments, known as the theory of line drawing in the tax law. From this approach, it is clear that the better treatment of holders of carried interests is as investors. Key pieces of evidence include the longstanding policy premises behind partnership taxation and the complexity and avoidance problems with attempts to tax carried interests as service income.

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David A. Weisbach[*]

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A carried interest in a private equity fund typically gives the sponsor of the fund the right to 20 percent of the profits. If the fund produces long-term capital gain, the sponsor is taxed on this gain at the capital gains tax rate when the gain is realized. The same treatment applies to a carried interest, also known as a profits interest, in any type of partnership: the holder is a partner and is taxed on his distributive share of partnership income.

A number of commentators have argued that returns to carried interests should be taxed as ordinary compensation income, and these claims have prompted close scrutiny from Congress.[1] The theory is that the sponsor performs services for the partnership in exchange for the carried interest. The sponsor is analogized to a money manager who determines how best to invest a client's funds. They argue, therefore, the carried interest should be taxed similarly to risky returns given to other service providers, such as stock, stock options, or royalties. In particular, the treatment of a carried interest is better than the treatment of other types of risky compensation

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[1]The two most prominent articles on the topic are Mark Gergen, *Reforming Subchapter K: Compensating Service Partners*, 48 TAX L. REV. 69 (1992) [Service Partners] and Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, *forthcoming*, NYU L. REV. (2008) [Two and Twenty]. There have been four congressional hearings on the topic. *Carried Interest Part I: Hearing Before the S. Comm. on Finance,* 110th Cong. 2007*; Carried Interest Part I: Hearing Before the S. Comm. on Finance*, 110th Cong. 2007; *Carried Interest Part III: Hearing Before the S. Comm. on Finance*, 110th Cong. 2007; *Hearing on Fair and Equitable Tax Policy for America's Working Families Before the H. Comm. on Ways and Means*, 100th Cong. 2007. Legislation has been introduced on a number of aspects of the issue including H.R. 2834, 100th Cong. 2007 (the Levin bill) and S. 1624, 100th Cong. 2007 (the Baucus Grassley bill). See Joint Committee on Taxation, Present Law and Analysis Relating to the Tax Treatment of Partnership Carried Interests and Related Issues, Part I (JCX-62-07), September 4, 2007; Joint Committee on Taxation, Present Law and Analysis Relating to the Tax Treatment of Partnership Carried Interests and Related Issues, Part II (JCX-63-07), September 4, 2007 for descriptions of the bills.

because taxation is deferred until the gains are realized and because the income is taxed as capital gain. These differences, they argue, are not justified, and commentators have proposed a number of different reforms.

An alternative way to view the activities of a sponsor of a private equity fund, however, is as raising capital and using that capital to make investments. The form used for raising capital is a limited partnership in which the sponsor is the general partner and the capital providers are limited partners. The limited partners get paid a market rate of return for their provision of capital and have no more involvement in partnership operations than any third party provider of capital. Under current law, anyone who makes an investment and holds it as a capital asset, even if made with third party capital, gets capital gain or loss on the investment. For example, anyone who buys stock through a margin account and profits on the sale is using in part someone else's money and their own effort and ideas about stock valuations to make money. Capital gains treatment is standard notwithstanding that the gains may be attributable to labor effort. Moreover, taxation is deferred until the gain is realized. The same holds for an entrepreneur whose business is financed by third parties. When the entrepreneur sells the stock of the company, he gets capital gain notwithstanding that most or all of the value is due to his labor effort.

Once we recognize that there are alternative analogies for the treatment of carried interests, the problem is which one to choose. Commentators arguing for treating carried interests like compensation arrangements rely on horizontal equity notions, of treating likes alike. It seems inequitable to allow sponsors of private equity funds to get capital gains treatment when other service providers, most of whom earn less money, are taxed at ordinary income rates. But any change in the treatment of holders of carried interests would itself violate horizontal equity by treating them less like individuals engaged directly in the activity, less like anyone else who uses third party capital to buy an asset. Given the underlying distinction between capital gains and ordinary income and between investors and service providers, carried interests cannot be taxed like both competing analogies. It is as if we

had to choose a color for three squares arranged in a line. The square on the right is red and the square the left is blue. If we must choose red or blue for the middle square, we cannot pick a color by noting only that the square to the right is red, ignoring the blue square on the left. Horizontal equity arguments fail entirely in this context.[2]

When faced with this dilemma, commentators argue that the analogy to a service provider is the better one. It is, however, never made clear why this is so. All of the features that commentators argue make holders of carried interests analogous to service providers are equally found in investors or entrepreneurs. For example, investors and entrepreneurs may use third party capital and may work very hard, so these features cannot be used to argue that carried interests are more like service providers – they do not distinguish the cases at all. Moreover, even if holders of carried interests had more features of service providers than of investors, this type of Sesame Street reasoning – which one of these things is more like the other – does not tell us the consequences of the choice. Whichever choice is made, service provider or investor, will influence behavior, such as how investments are structured. Without examining the consequences, we cannot make good policy choices.

As I have argued elsewhere, we should view problems of this sort as part of a generic class of line drawing problems.[3] The correct way to resolve this problem, is by directly examining the consequences of the various choices. In particular, we must examine the likely changes in behavior given a change in the rules, and in addition, the likely complexity and

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[2]There are many other, more fundamental problems with horizontal equity arguments. See Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 NATIONAL TAX JOURNAL 139 (1989).

[3]David A. Weisbach, *An Efficiency Analysis of Line Drawing in Tax Law*, 29 JOURNAL OF LEGAL STUDIES 71 (2000), David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL LAW REV. 1627 (1999).

administrative costs created. We want to minimize efficiency losses through the line drawing choices we make.

From this perspective the choice is clear: we should not change the treatment of carried interests in private equity partnerships. There are two key pieces of evidence. The first is that a longstanding and central premise of partnership taxation is that partners should be taxed as much as possible like they would be taxed if they engaged in the partnership activity directly. The major exception to this rule, found in both current law and reform proposals, is where a service provider is sufficiently distant from the partnership business that giving the same treatment as direct engagement in the activity does not make sense. Holders of private equity carried interests are not close to this line. Taxing holders of carried interests would, therefore, require reexamining this basic premise of partnership taxation, a premise that has underscored partnership taxation for more than 50 years. Commentators suggesting general, broad-based reforms of the partnership tax rules (as opposed to with respect to carried interests) almost uniformly attempt to strengthen this approach, to tax partners more like direct engagement in the activity rather than less. In fact, the current law measures abuse of the partnership tax rules based on large part on whether the results are different than direct engagement in the activity. Reform proposals for carried interests run directly counter to this view.

The second reason is that to treat holders of carried interests as receiving compensation income, we have to be able to distinguish service income from capital income. This is not feasible in many contexts and in cases similar to private equity partnerships, we do not even try. For example, if the sponsor were to borrow to make the investments, we would not try to distinguish service income from capital gain. Attempts to do so in the private equity context are not likely to succeed where years of experience show the problem is not amenable to solutions. The result will be complex and easily avoidable rules that raise little revenue while imposing costs on everyone.

This essay examines these arguments in detail. Part I provides background on private equity structures. Understanding how the structures are designed and their economic function is important for determining their tax treatment. Part I also discusses how carried interests are used in other economic contexts. Part II provides background on the current law tax treatment of carried interests and goes through the various proposals for change. Part III presents an analysis of how we should think about resolving dilemmas such as the one presented here, where there are competing analogies for the treatment of a given item and it cannot be treated the same as both. The theory I will develop I have previously called line drawing theory and applies generally, not just in this context.

Line drawing theory relies on evidence about relative elasticities of substitution. Without further empirical work, however, no direct data on these factors are available. To get a sense of the parameters, I look at two indirect pieces of evidence. Part IV discusses the history and policy behind the partnership tax rules, illustrating how a central premise of partnership taxation is that the existence of the partnership should matter as little as possible to the tax treatment of the partnership. An implication is that current law is correct in giving pass-through treatment to holders of profits interests. Part V turns to the key considerations of avoidance and complexity, arguing that because we cannot and often do not attempt to distinguish between labor and capital income in an entrepreneurial setting, we will not be able to do so in the private equity context. Part VI discusses other potentially relevant considerations, including the distributive effects of changing the law. Part VI also provides a conclusion.

I. Background: Private Equity 101

Private equity has experienced phenomenal growth in the last 10 years. Since 1999, capital committed to private equity funds has grown at an annual

rate of 23 percent.[4] The dollar volume of private equity merger activity has grown at 29 percent, and the private equity share of total merger activity has grown from under 5 percent to more than 25 percent.[5] In 2006, there were 151 sponsor-driven public-to-private transactions in the U.S. and Europe, up from 67 in 2000.[6] Understanding the structure of this activity and the reasons for the growth are central to determining the proper tax treatment.

What is Private Equity? The term private equity is used to refer to two types of investment funds: venture capital and leveraged buyouts.[7] Venture capital funds invest in start-up companies with the hope of a public offering sometime in the future. Leverage buyout funds purchase existing companies, taking them private, with the hope of restructuring the business and selling it at a profit. The leveraged buyout market is substantially larger than the venture capital market. The focus of this essay will be on leveraged buyout funds.

The Private Equity Sponsor. Private equity is driven by the sponsor, such as firms like Blackstone, KKR, and Cerberus. Private equity sponsors are

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[4]See The Blackstone Group L.P., Form S-1, June 11, 2007 at 147 (Blackstone Offering. For background on private equity, see Andrew Metrick, VENTURE CAPITAL AND THE FINANCE OF INNOVATION (2007); George Fenn, Nellie Liang, and Steven Prowse, THE PRIVATE EQUITY INDUSTRY: AN OVERVIEW (1997), James Schell, PRIVATE EQUITY FUNDS. BUSINESS STRUCTURE AND OPERATIONS (2006), Jack Levin, STRUCTURING VENTURE CAPITAL, PRIVATE EQUITY, AND ENTREPRENEURIAL TRANSACTION (2007), Steven Kaplan and Antoinette Schoar, *Private Equity Performance: Returns, Persistence and Capital Flows*, 60 JOURNAL OF FINANCE 1791 (2004), Andrew Metrick and Ayako Yasuda, *The Economics of Private Equity Funds*, available at __; Ulf Axelson, Per Stromberg, and Michael Weisbach, *Why are Buyouts Levered? The Financial Structure of Private Equity Funds*, (January 4, 2007) available at ___.

[5]Blackstone Offering at 148.

[6]Blackstone Offering at 148.

[7]See generally, Metrick note 4, chapter 1.

generally partnerships that specialize in purchasing large stakes in underperforming businesses, restructuring the business by improving the financial structure, management, or business plans, and selling the restructured business. They can profit from this activity because they have expertise, contacts, deal flow, valuation systems, methods of managing companies, and other intangibles. The individual partners in the sponsor often have experience working on Wall St. but may also come from industry or government. Sponsors are typically structured as partnerships with a relatively small number of partners, although they may have many employees, including analysts, industry specialists, financial experts, and other staff.

Initial Fund-Raising. Although the sponsors invest some of their own money, they need to raise outside funds to finance their activities. This is done in two stages. The first stage involves raising capital for the *private equity fund*. (A typical sponsor may have a number of funds.) The private equity fund is partnership that will invest in a number of portfolio companies over the first three to five years of its life. The fund raises money by issuing limited partnership interests. Investors include tax-exempt entities (such as pension plans and endowments), wealthy individuals, and taxable institutional investors.[8] The limited partners generally contribute between 90 and 97 percent of the capital in the fund, and the sponsors contribute the rest, in return for the general partnership interest.

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[8]According to data from the Private Equity Council, over 40 percent of investors are pension funds and other tax-exempt investors make up 7.7 percent of investors. Funds of funds comprise almost 14 percent of investors. Taxable investors (other than funds of funds) include wealthy individuals (10.1 percent), banks and financial services companies (9.8 percent), insurance companies (6.8 percent), and family offices (6.8 percent). Together, taxable investors other than funds of funds make up about 38 percent of investors. Private Equity Council, *Public Value: A Primer on Private Equity* (2007), available at ___. See also Joint Committee on Taxation, Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests, (JCX-41-07), July 10, 2007 [Partnership Carried Interests].

Under a typical arrangement, the limited partners are entitled to receive a return of their invested capital plus an additional return of up to a specified amount, usually 8 or 9 percent (the hurdle rate). If there are profits above this amount, the limited partners receive allocations so that they will get 80 percent of total profits. For example, if total profits are 15 percent, the limited partners get the first eight percent, none of the next two percent (bringing the allocation to the 80/20 split) and then 80 percent of everything thereafter.

When it forms the fund, the sponsor retains a general partnership interest which allows it to control the fund. It gets three types of returns. First, it gets a management fee, typically around 2 percent of total partnership capital. The management fee is a payment for the services performed by the sponsors on behalf of the fund. It is often limited in time, such as for the first five years to reflect the fact that the sponsor will be performing more intensive services during this period. After that time period, the fee is reduced, often to less than 1 percent. Second, the sponsor gets fees for providing services to the portfolio companies, sometimes known as transactions fees. These include items such as fees for sitting on the board or providing management consulting services.[9] Finally, they get any remaining gains after the limited partners have been paid their shares. These remaining gains, known as the carried interest, generally consist of 20 percent of partnership profits, subject to the hurdle rate allocation of the first eight percent to the limited partners. Industry-wide for buyout funds, roughly two-thirds of the payments to the sponsors are from the management fees or transaction fees and, correspondingly, roughly one-third is from the carry.[10]

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[9]The two percent management fee and the transactions fees sometimes partially offset, so that transactions fees reduce (in part or in whole) the management fees.

[10]See Andrew Metrick and Ayako Yasuda, *The Economics of Private Equity*, Table VI, available at ___. Joint Committee on Taxation, Partnership Carried Interests at 38, Table 4 (citing Metrick and Yasuda). This figure initially strikes many as implausible but

An important feature of the structure is that the fund invests in a portfolio of target companies as opposed to a single company. Losses on one company offset gains on others when computing the general and limited partnership shares. If distributions are made to the general partners early on, it is often subject to a "clawback" in which they must return the distribution if there are subsequent losses.[11]

The Leveraged Buyouts. The general partner or private equity sponsor controls the activities of the partnership and uses its expertise to determine which target companies to purchase. They generally purchase their targets at a premium of between 15 percent and 50 percent over their trading price. The goal is to sell the company at an even higher price, so the sponsors must restructure the business to increase its value. For example, suppose that a buyout fund purchases a company at a 50 percent premium over the trading price and sells it in five years for a 33 percent gain. This means that the value after the private equity fund has restructured the company is twice the value before the purchase.[12]

It appears that they are able to increase the value a portfolio company through a number of mechanisms. One mechanism used early on was simply to improve the capital structure of the target company, although it is not clear that there are significant gains from doing so in the current buyout

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it is easy to be blinded by the reports of very high returns, which show up in the newspaper, while not noticing the average or below market returns which do not. The Metrick and Yasuda study is an industry-wide study looking at a large number of firms over more than a decade.

[11]This feature differentiates a typical private equity fund from typical hedge funds. Hedge funds often have a 20 percent carried interest calculated on an annual basis with no offsetting of gains in one year for losses in another.

[12]If the stock was trading at $100 and the fund buys it at $150, it has to sell it at $200 to make a 1/3 profit on its investment.

wave.[13] They also have industry experts on their staff who are able to provide management expertise and guidance. Finally, private ownership may allow better monitoring of the senior managers of the company. In a sense, the managers of the target trade public shareholder activism, quarterly earnings demands, and regulatory compliance headaches for a stern task master watching over their shoulder. Managers may find private ownership more conducive to effective management. Improved financial structures, governance, and operational expertise appear to make a difference. Virtually all of the evidence finds that leveraged buyouts are associated with substantial increases in value.[14]

It is important to note, however, that private equity returns are very risky and there are long periods where their returns are not any better and often worse than the market. For example, one study of private equity returns shows that buyout funds did significantly worse than the market for substantial periods in the 1990's but better than the market during periods in the 1980's.[15] The Joint Committee on Taxation, in a recent study, concluded that 30 percent of private equity funds started during the period from 1991 through 1997 did not generate any payments on the carried interests.[16]

Note also that the success of private equity funds is a separate question from whether the target companies increase in value. Private equity returns

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[13]Current buyouts differ from those in the1980's in a number of important ways. First, current buyouts are largely friendly purchases, while hostile takeovers were dominant in the 1980's. Second, the leverage ratios today are lower than they were in the 1980's. Leverage ratios today are around 70 percent.

[14]See, Steve Kaplan and Antoinette Schoar, *Private Equity Performance: Returns, Persistence and Capital Flows*, available at ___.

[15]Steve Kaplan and Antoinette Schoar, *Private Equity Performance: Returns, Persistence and Capital Flows*, available at _____.

[16]Joint Committee on Taxation, Partnership Carried Interests, note __.

could be below the market return even if target companies substantially increase in value because the private equity returns depend on the price at which they purchase their targets. That is, when computing the value to the economy of private equity, one needs to consider not only the returns to the private equity investors and sponsors but also the returns to the former shareholders of portfolio companies. For example, suppose that a company is currently trading at $100 a share and that a private equity fund purchases it at $150 a share. If, after restructuring the company, the private equity fund sells it at $150 for no gain or loss, the value of the company has still gone up by $50, adding value to the economy. The gains in this example, were captured by existing shareholders.

There are important business reasons for the structures used by private equity sponsors. The private equity firm must be able to raise large pools of capital that are committed for a long period while retaining sufficient freedom to be able to negotiate deals. This creates an incentive problem. If sponsors are unduly constrained, they will not have the necessary freedom to negotiate or make decisions. The whole venture relies on their expertise, so they must be able to use it. If they have too much freedom, however, investors will not trust them with their funds. Nobody would irrevocably commit a large pool of capital to a fund sponsor who can do whatever they want.

Fund structure, including the use of the 20 percent carried interest calculated over a portfolio of companies, the hurdle rate, and the multiple rounds of financing, is thought to best solve these problems. One recent study argues that the initial round of financing should look very much like the limited partnership interests look: a fixed rate of return plus an equity stake.[17] The second round of financing – the debt issued to finance each particular portfolio company purchase – acts as a check on the sponsors to

[17]See Ulf Axelson, Per Stromberg, and Michael Weisbach, *Why are Buyouts Levered? The Financial Structure of Private Equity Funds* (January 4, 2007), available at __.

ensure that each purchase is desirable. That is, the limited partners, who commit their capital irrevocably to the fund, can use the market to help monitor sponsor behavior. Using pooled investments also helps in this regard because it reduces the "option" element given to the sponsor – the upside without the downside by measuring performance over a number of purchases.

To my knowledge, the structure of these funds is no more tax driven than any typical investment: within a basic structure, one wants to minimize taxes but taxes are secondary to business considerations. For example, it is my understanding that carried interests were commonly used even when there was no rate differential between capital gains and ordinary income.

Other types of funds. There are a number of other financial funds that engage in related but distinct activities. The most prominent are hedge funds. Traditional hedge funds engage in arbitrage – they attempt to find subtle mispricings in securities and enter into long and short positions to take advantage of the mispricing without exposing themselves to risk. They typically purchase public securities and hold them only for a short period.[18] As more money has been invested in hedge funds in the last decade, they have expanded their activities and now sometimes purchase companies or provide financing for the purchase of companies, blurring the line between hedge funds and private equity. Other funds include angel funds (investing in very early stage companies), mezzanine funds (providing risky loans to companies), and distress funds (focusing on troubled companies).[19]

Use of carried interests. Although the current discussion has focused on

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[18]For example, a convertible bond can be thought of as a straight bond and an option to purchase stock. If the convertible bond does not trade at the right price compared to the straight bond and option combination, a hedge fund can sell one side and buy the other so that when they ultimately converge, the fund makes a profit.

[19]For a description of these categories of investment, see Andrew Metrick, VENTURE CAPITAL AND THE FINANCE OF INNOVATION (2007), Chapter 1.

private equity partnerships or possibly financial partnerships more generally, carried interests (in other contexts called profits interests) are used in many different sectors, including oil and gas, real estate, and small businesses. Partnerships are generally private so it is not possible to get data on the full extent of the use of profits or carried interests. An indication of their widespread use is found in the huge number of articles written on the taxation of the receipt of a profits interest.[20] The leading partnership tax treatise, for example, devotes an entire chapter to the treatment of one aspect of profits interests, the receipt of the interest.[21] One article, written in 1991 has a half page footnote in small print listing articles on the subject and many more have been written in the intervening years.[22] There have been a number of courts decisions and a series of guidance documents from the

[20]A small sampling of articles includes Laura E. Cunningham, *Taxing Partnership Interests Exchanged for Services*, 47 TAX. L. REV. 247 (1992); Martin B. Cowan, *Receipt of an Interest in Partnership Profits in Consideration for Services: The* Diamond *Case,* 27 TAX. L. REV. 161 (1971); Henry Ordower, *Taxing Service Partners to Achieve Horizontal Equity*, 46 TAX. LAW. 19 (1992); Leo L. Schmolka, *Taxing Partnership Interests Exchanged for Services: Let Diamond/Cambpell Quietly Die*, 47 TAX L. REV. 287 (1991); Mark P. Gergen, *Pooling or Exchange: The Taxation of Joint Ventures Between Labor and Capital*, 44 TAX L. REV. 519 (1989); Susan Kalinka, *Rev. Proc. 2001-43 and the Transfer of a Nonvested Partnership Profits Interest*, 79 TAXES 12 (2001); William R. Welke and Olga Loy, *Compensating the Service Partner with Partnership Equity: Code Sec. 83 and Other Issues*, 79 TAXES 3 (2001); Terrence Floyd Cuff, *Campbell v. Commissioner: Is There Now "Little or No Chance" of Taxation of a "Profits" Interest in a Partnership*, 69 TAXES 642 (1991); Barksdale Hortensine and Thomas W. Ford, Jr., *Receipt of a Partnership Interest for Services: A Controversy That Will Not Die*, 65 TAXES 880 (1987). For a longer but now dated list of articles, see footnote 2 in Terrence Floyd Cuff, *Campbell v. Commissioner: Is There Now "Little or No Chance" of Taxation of a "Profits" Interest in a Partnership*, 69 TAXES 642 (1991).

[21]William S. McKee, William F. Nelson, and Robert L. Whitmire, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS (2006) Chapter 5.

[22]See Terrence Floyd Cuff, *Campbell v. Commissioner: Is There Now "Little or No Chance" of Taxation of a "Profits" Interest in a Partnership?* 69 TAXES 642 (1991).

Treasury, culminating in recently issued proposed regulations.[23] It is apparent from this that any change to the taxation of profits interests could affect a large number of sectors in the economy.

II. Tax Rules Governing Carried Interests and Proposals for Change

A. Current law treatment of carried interests

We can divide the tax issues with respect to the carry into the front-end or how the partner is taxed on the receipt of the profits interest, and the back-end, or how the profits interest is taxed with respect to partnership allocations or distributions. Before the current carried interest debate, virtually all of the attention was on the front-end issue.

Front-end. To the extent possible, current law provides that formations of partnerships or contributions to ongoing partnerships are tax-free.[24] For example, if a partner contributes appreciated property to a partnership in exchange for a partnership interest, no tax is imposed on the contribution. The issue raised by carried or profits interests is whether the receipt of a partnership interest in exchange for a promise to perform services in the future should be tax free. There has been perhaps more writing on this issue than on any other element of partnership tax law.[25] Although there have been a few deviations, the overwhelming consensus is that the receipt of a partnership profits interest is not and should not be taxable. The government has adopted this position in three separate pieces of guidance, including

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[23]The major court decisions include *Diamond v. Commissioner*, 56 T.C. 1971, aff'd 492 F.2d 286 (7th Cir. 1974), and *Cambell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991). Guidance includes Rev. Proc. 93-27, 1993-2 C.B. 343, Rev. Proc. 2001-43, 2001-2 C.B. 191, and Prop. Reg, 1.83-3(l).

[24]See section 721. See McKee, Nelson, and Whitmire, note __ for a detailed description of the partnership tax rules.

[25]See the sources listed in note __.

proposed regulations issued in 2005.[26]

The history is well known and not worth reviewing in any detail here. Following the courtroom skirmishes in *Diamond*, and *Campbell*, the government gave taxpayers a safe harbor. In particular, Rev. Proc. 93-27 provides that "if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner," the receipt of the profits interest will not be treated as a taxable event. This rule does not apply if the profits interest relates to a substantially certain stream of income, is disposed of within two years, or is a limited partnership interest in a publicly traded partnership. Rev. Proc. 2001-43 adds to this holding to cover the case where a profits interest is substantially nonvested at the time of receipt. It provides that under most circumstances, the service provider will be treated as receiving the profits interest at the time of the grant and not later when it vests. It is my understanding that taxpayers always structure partnerships to meet these safe harbors, so that profits interests are never taxed when received.[27]

The Service has recently proposed regulations which would provide a more formal basis for these conclusions and coordinate them with section 83.[28] Section 83 applies to any exchange of property for services. Because a profits interest is property, section 83 literally applies to the receipt of a profits interest. The proposed regulations confirm this conclusion but then provide a safe harbor (through an accompanying revenue procedure) under which taxpayers can treat the value of a profits interest as zero. Thus, the key result of Rev. Proc. 93-27 was retained, although some details differ (such

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[26]See Rev. Proc. 93-27, 1993-2 C.B. 343, Rev. Proc. 2001-43, 2001-2 C.B. 191 and Prop. Reg. 1.83-3(l). All three take the position that taxpayers can value a profits interest at zero (in all but abusive situations) and, therefore, the receipt generates no tax.

[27]See New York State Bar Association, *Report on the Taxation of Partnership Interests Received for Services and Compensatory Partnership Options*, January 23, 2004, p. 14.

[28]Propr Reg. 1.83-3(l).

as the requirements for the safe harbor valuation and the rules governing restricted interests and how they relate to elections under section 83(b)).

Back-end. Once a partner receives a profits interest, he is a partner for purposes of the tax law and is taxed like any other partner. This means that he is taxed on his distributive share of partnership items. The timing, character, and other attributes of the income are determined at the partnership level and passed through to the individual partners under the normal partnership rules. The capital account maintenance and substantiality requirements of 704(b) apply, with the profits partner initially getting a zero capital account.

This means in the private equity context, that if the partnership sells a portfolio company and has long-term capital gain, the sponsor gets taxed on his share of the long-term capital gain. This allocation of gain has no effect on tax revenues as long as all the partners are in the same tax bracket and account for the amounts in the same way.[29] To illustrate, suppose that all the partners are in the same tax bracket and that the partnership would get a deduction for paying a salary to the profits partner. To be concrete, suppose that there is $100 of long term capital gain, $20 of which is allocated to the sponsor. Under current law, the other partners would have $80 of long-term capital gain and the sponsor would have $20, for a total of $100 of long-term capital gain in the system and tax revenues of $15, assuming a long-term capital gains rate of 15 percent. Suppose instead that the partnership paid the sponsor $20 of salary. The sponsor would have $20 of ordinary income and the partnership would have a $20 deduction and a $100 long-term capital gain. The net result is still just $100 of long-term capital gain, and if the tax bracket of the sponsor and the other partners are the same, the tax revenue is the same. The only difference is that there are offsetting items of $20 of

[29]For a detailed explanation, see William Chris Sanchirico, *The Tax Advantage to Paying Private Equity Fund Managers with Profit Shares: What is it? Why is it Bad?*, U of Penn Inst. for Law & Econ Research Paper 07-14 (October 4, 2007), available at http://ssrn.com/abstract=996665.

income and $20 of deduction. This holds regardless of when the partnership pays the salary, so there are no deferral advantages either. This identity also holds for someone who works for himself, using so-called sweat equity to create an asset. The person does not pay himself a salary but this is the same as having the offsetting $20 of income and deduction.

There are two (and only two) circumstances where this treatment is better than the partnership paying the sponsor a salary. The first circumstance where this result does not hold is if the other partners are in a different (typically lower) tax bracket. If the other partners are in a different tax bracket, the $20 offsetting amounts do not offset in tax revenues, creating a net gain or loss to the government, the timing of which depends on the timing of the payment. According to a recent Joint Committee on Taxation study, about 60 percent of investments in private equity funds in 2003 were tax-exempt, so this situation is important.[30]

The second case is if the partnership has to capitalize the salary payment or otherwise cannot deduct it. Suppose, for example, that the partnership has purchased the property for $500 and sold it for $600, paying a $20 salary out of the proceeds. If the salary is capitalized into the purchase price, the partners do not get a deduction for that amount but increase their basis to $520. This means that capitalization eliminates the partnership's $20 deduction and reduces its long-term capital gain by the same amount. The net effect would be to convert the $20 to ordinary income: there would be $80 of long-term capital gain and $20 of ordinary income instead of $100 of long-term capital gain.

Section 707(a)(2)(A) was enacted to deal with this latter problem. Prior to the enactment of this section, partnerships would give profits interests to everyday service providers as a means of avoiding the capitalization requirements of section 263. For example, a real estate partnership might give an architect a profits interest. Using the numbers above, they might

[30]Joint Committee on Taxation, Partnership Carried Interests, note _.

want to pay the architect $20. If they pay him $20, they would have to capitalize the $20 into basis. If instead they give him a profits interest worth $20, they convert the $20 salary into capital gain. Section 707(a)(2)(A) provides that if the combination of services provided and allocation and distribution of income to the service provider together indicate that the service provider is not really acting as a partner, then the transaction will be recast as not between a partner and the partnership. That is, section 707(a)(2)(A) should be thought of as an anti-conversion provision that is based on whether the service provider is best thought of as separate from the partnership.

The language of section 707(a)(2)(A) does not provide any particular guidance on how this determination is to be made, and distinguishing "true" from "disguised" partners can be futile. To date, the Treasury has not issued regulations under this section, more than 23 years after enactment, reflecting the difficulty of making this determination. The legislative history, however, contains an extensive discussion along with examples. According to the legislative history, there six factors to be taken into account. The most important factor is whether the payment is subject to appreciable risk as to amount, reflecting the notion discussed above that we use entrepreneurial risk as a method of determining whether the partner should be treated as engaging in the activity directly and therefore get partner treatment. The Joint Committee on Taxation explained that "partners extract the profits of the partnership with reference to the business success of the venture, while third parties generally receive payments which are not subject to this risk." The other five factors are (i) whether the partner status of the recipient is transitory; (ii) whether the distribution and allocation to the partner are close in time to the partner's performance of services; (iii) whether the goal is to obtain tax benefits; (iv) whether the value of the recipient's interest in general and continuing partnership profits is small in relation to the allocation in question; and (v) a factor that relates largely to property transactions not relevant here.

A typical private equity carried interest easily passes all these tests. It

is highly risky compensation – indeed because of the hurdle rate, it is riskier than the overall returns to the partnership rather than less risky. It is not a transitory interest as it lasts the entire life of the partnership. The distribution and allocation are not close in time to the performance of services except by coincidence. One may argue about whether a goal is to obtain tax benefits, but as discussed above, there are clearly strong business reasons for the structure. Finally, the value of the sponsor's interest is not small in relation to the allocation in question. That is, there is simply no question under current law that a typical private equity sponsor would be treated as a partner with respect to the carried interest and would not be subject to recharacterization under section 707(a)(2)(A).

Moreover, even if payments to the fund managers were recharacterized under section 707(a)(2)(A), they would not likely have to be capitalized. Although the capitalization rules are complex and uncertain, if a fee is independent of whether a particular investment is made, it is generally deductible. [31] Because any payments to the sponsors are not dependent on making any particular investment, they would likely be deductible. Therefore, the only real difference between use of an explicit salary and the use of a carried interest relates to having tax-exempt investors.

Fees. The management fee is determined without regard to partnership profits. This means that it is taxed as ordinary income to the partner and generates a deduction or capital expenditure to the partnership under the principles of section 707.[32] Transactions fees received by the sponsor are taxed under general tax principals and are most likely taxed as ordinary compensation income.

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[31]See Sanchirico, note __ at 15-16, for a detailed discussion of the issue.

[32]They are likely guaranteed payments for services under section 707(c) rather than payments to a nonpartner under section 707(a)(2)(A). For our purposes, the two are essentially the same.

As noted, the fees represent around two-thirds of sponsor compensation. This means that roughly two-thirds of sponsor compensation is taxed as ordinary income under current law.

B. Proposals for Change

Front end. One possibility mentioned by some commentators is to impose taxation upon receipt of a profits interests based on an estimate of its value.[33] The overwhelming consensus is that taxing profits interests on receipt is not desirable and these proposals have received little attention in the current round of discussions.

The reasons for not wanting to tax the receipt of a profits interest are reasonably straightforward. One commonly cited reason is valuation. Although the right to a portion of future profits looks much like an option (upside but no downside), partnership profits interests are more difficult to value than options. Partnership interests are not traded which means that the price and volatility of the underlying asset, two key factors in option pricing, cannot be observed. Moreover, in many cases, the value of the profits interest depends crucially on the future services of the recipient – they are granted as an incentive for the profits partner to work. It is difficult to predict the value of the future services. To value the profits interest, therefore, one has to combine an option pricing methodology based on no or bad data, with a prediction on the value of someone's labor effort. Both tasks are difficult and combining them, often futile.

If we really wanted to, however, we could put a number on the value of a profits interest, and zero is clearly not the right number.[34] More fundamentally, however, taxing the receipt of a profits interest would violate basic tax principles, at least in most cases. The closest analogy to a profits

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[33]See Lee A. Sheppard, *Blackstone Proves Carried interests Can be Valued*, 155 TAX NOTES 1236 (June 25, 2007).

[34]See Sheppard, note __.

interest is a taxpayer who takes out a nonrecourse loan. In a nonrecourse loan, the borrower has no liability beyond the value of the secured property. This means that if the value of the property goes up, the borrower can pay off the loan and keep the profits, while if the value of the property goes down, the borrower can force the lender to settle for the depreciated value. It is equivalent to a normal loan along with a put option to the lender, or, equivalently, the right to call property from the lender. No one, however, suggests taxing the value of this option at the time of a nonrecourse lending. Instead, we wait to see if that value is realized.

Similarly, we do not tax other events that have clear value. We do not tax admission to a prestigious college, or a desirable club membership. We do not tax a promotion even if the promotion comes with an enforceable contract for increased pay. In the partnership context, we do not tax highly sought after admissions to law firms, accounting firms, or investment banking partnerships. We do not tax great inventions made while standing in the shower. In all these cases, the individual has immediate value and it is conceivable that we could place a number on it. For whatever reason, whether it is a reluctance to tax endowment, that the events are too hard to observe and value, or some other reason, we never have, and most assuredly never will, tax these sorts of events. One of the primary goals of partnership taxation is to tax the partners the same way they would be taxed without a partnership, which means that these basic principles must carry over to the formation of a partnership.[35] The exceptions found in Rev. Proc. 93-27, where we do tax the receipt of a profits interest, are all exceptions to this basic notion. For example, if the profits interest relates to a fixed stream of income, it is more like receiving a debt instrument than an inchoate right to earn money.[36]

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[35]See the discussion in note __ infra.

[36]Cunningham, note _, following this logic, would distinguish profits interests received for services performed in the past from those receives for services to be

Given the consensus on this issue, I will generally assume that profits interests will not be taxable upon receipt, at least on a mandatory basis. It is possible that back-end proposals will be combined with a section 83(b)-style election to tax the profits interest upon receipt based on its fair market value. I will not generally discuss how such an election would work but it is easy to see that the valuation issues would be substantial. Imagine a sponsor who raises $100 in limited partnership interest which have terms similar to the standard terms in the industry (hurdle rate, 80% of the profits, etc.) The value of the carried interest depends on how well the sponsor is able to perform over the next 10 to 12 years by identifying target companies, succeeding in the buyout, restructuring the companies and then selling them at a profit. The initial capital commitment indicates some confidence by the limited partners that the sponsor will be successful in this venture, but there is little to base a valuation on other than that.

Back-end. Back-end proposals would change the treatment of a holder of a profits interest over the life of the partnership. There are any number of possible proposals. I will discuss here the two that are the most prominent.

Mark Gergen has proposed to treat all payments with respect to profits interests as compensation for services and would grant the partnership a deduction (or capital expense).[37] Although he does not phrase it this way, we can think of the proposal as a super-sized section 707(a)(2)(A). He bases this proposal on the claim that otherwise service partners would receive compensation without paying social security taxes and possibly only paying

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performed in the future. For services performed in the past, none of the problems discussed in the text exist. Instead, it looks like the service provider has received a risky security in exchange for having performed services. Bittker and Lokken, in their tax treatise, make the same argument. See Boris Bittker and Lawrence Lokken, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS, ¶86.2.4 (Third Edition 1999)

[37]Gergen, Service Partnerships, note __. See also Fleischer, Two and Twenty, note __.

taxes at capital gains rates. For the same reasons discussed above concerning section 707(a)(2)(A), the proposal would only change the net treatment to partnerships if the partners are in different tax brackets or if section 263 or an equivalent section applies to capitalize the payment or otherwise disallow the deductions.[38]

It is not clear how Gergen would define a profits interest, but it appears that any allocation of partnership items other than a straight up allocation (pro rata to capital in every period) would be treated as a profits interest. Gergen notes that this is a crude measure but argues that most often it will understate service income.[39] He does not consider cases where allocations of pure returns to capital vary over time, by risk, or by region.

Congressman Levin (D-MI) introduced a proposal that is similar to the Gergen proposal. It would treat net income from an "investment services partnership interest" as ordinary income for the performance of services. An investment services partnership interest is a partnership interest held by a person who, in the course of the active conduct of a trade or business provides a substantial quantity of services to the partnership. If the partner also contributes capital to the partnership, the partnership must make a reasonable allocation of partnership items between the distributive share attributable to invested capital and the service element. Therefore, in comparison to the Gergen proposal, which seems to measure service income off of a baseline of straight-up allocations, the Levin bill merely requires taxpayers to make a reasonable allocation, leaving the standard for measuring whether the allocation is reasonable unspecified.[40]

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[38]For example, section 67 may limited the deduction in some cases.

[39]Gergen, Service Partnerships, note __ at 107 (giving examples of how a pro rata measure would understate service income).

[40]The Levin bill also differs from the Gergen proposal in that it would merely recharacterize the payment to a profits partner as ordinary income while the Gergen

The other proposal was initially put forth by Leo Schmolka and has been championed in the current context in a recent paper by Noel Cunningham and Mitch Engler.[41] This proposal would treat a profits interest as the temporary borrowing of capital from the limited partners. If a partner has a 20 percent profits interest, it is same as if he borrowed 20 percent of the partnership capital for the life of the partnership. The holder would either be required to pay interest on the use of capital or be taxed on the forgiveness of such a payment much like we impute interest on loans under sections 7872 and 1274. For example, if the partnership has $100 of capital and the profits partner has a 20 percent stake, the partner would be treated as borrowing $20. In each period, he would be required to include in income the applicable federal rate on this $20. For example, if the applicable federal rate were 5 percent, the profits partner would have $1 of interest income in each period. The underlying idea is that a profits partner has the right to the return on a portion of the partnership capital and, therefore, effectively has borrowed that portion.

This proposal would likely have no effect on private equity profits interests because of the hurdle rate. The hurdle rate gives the limited partners an 8 percent return on their entire investment plus 80 percent of all returns above 10 percent. At current rates, 8 percent exceeds the AFR (which is around 5 percent), which means that there would be no imputed interest

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proposal would create offsetting income and deductions similar to those created by section 707(a)(2)(A). This creates a tax difference if the deduction to the partnership under the Gergen proposal is capitalized or otherwise deferred or disallowed, with the Levin bill being more generous to the partnership than the Gergen proposal in these cases.

[41]Schmolka, note __. Noel Cunningham, and Mitchell Engler, *The Carried Interest Controversy: Let's Not Get Carried Away*, available at ___. Schmolka himself would prefer to do nothing and offers his implicit loan proposal only as a secondary option if something must be done.

income.[42]

Like with the Gergen proposal, this proposal would have to identify profits interests. We would need some baseline, such as pro rata allocations against which to measure internal borrowings and lendings. Moreover, the we would have to identify when adequate interest is paid on internal borrowings and lendings. We have a mechanism for this under the current law rules for loans with unstated interest,[43] but their application may be complicated if partnership allocations are complicated.

There are undoubtedly many other possibilities and proposals can be mixed and matched, or targeted at particular industries or income levels. All of the proposals have two basic ideas. The first is that a profits partner should not be taxed like other partners on their distributive share of partnership income. In other words, they are all based on the idea that a profits partner is not like other partners who are treated as if they engaged in the business directly. Second, they all have to be able to identify a profits interest. These are the two central questions examined in the analysis below.

III. Line Drawing in the Tax Law

As noted, there are two competing treatments of carried interest, service income and investment income. This section describes the competing analogies and discusses how to determine which treatment is better.

A. Service Income

One view of sponsors of private equity funds is as investment advisors. The limited partners provide funds to financial experts who make

[42]If the investment does not return 8 percent, the limited partners will not get paid their full return, but this is the same as in any nonrecourse loan.

[43]See sections 1274 and 7872.

investment decisions. The analogy would be to hiring an investment advisor, such as a mutual fund company, a bank or a broker. These companies provide investment advice and often directly make investment decisions for investors. The investors get back the profits, net of any fees, much like the limited partners do in a private equity fund.

Investment advisors fees are taxed as ordinary income. This is the case even if the fees are contingent on performance. For example, if investment advisors receive equity compensation, say in the company that employs them, they get ordinary income under the principles of section 83 or the principles governing options. The funds remain the investor's funds. The investor gets taxed on the gains or losses in the funds and potentially can deduct the fees paid to the advisor. The result is essentially the same as the result if section 707(a)(2)(A) were to apply in the partnership context – it only matters if the investor is in a different tax bracket than the advisor or if the fees would have to be capitalized.

The structure of a private equity partnership does not perfectly fit this analogy. Typically, an investment advisor is not treated as owning the funds that are invested. Instead, the investment advisor is merely the agent for the investor. In a private equity partnership, the partnership is the owner of the funds and not merely an agent for the investors.

B. Investment

The other competing analogy is to investment. The idea is that the limited partnership interests are a capital raising mechanism. Suppose that instead of using limited partnership interests, the sponsors issued debt. The debt could have terms similar to the limited partnership interests. It would be nonrecourse debt with a fixed rate of interest of 8 percent and an equity kicker of 80 percent of all profits above 10 percent. If this security would not qualify as debt, it would be relatively easy to structure a similar security or combination of payoffs that would. Or, even if such a security could not

qualify as debt, we can view the limited partnership interests as for the provision of capital: the tax treatment of carried interests should not depend on the debt/equity distinction as applied to the capital providers.

There would be no question that if the sponsor is viewed as an investor using third party capital, the sponsors would get capital gain or loss on the sale of the stock. Just like with any borrowing, the borrower is treated as the owner of the funds and is taxed accordingly. The costs of the funds would be deductible as interest.

C. Choosing between the competing treatments.

The policy question is how to choose between these competing treatments. I will first discuss arguments that have been made by various commentators that, in my view, should not or cannot be used to make the choice. I will then discuss how the choice can be made using a theory of line drawing that is based directly on the consequences of the choice and argue that this theory supports leaving current law as is.

1. Problematic theories

Horizontal Equity

The most common argument for treating carried interest as ordinary income is based on horizontal equity. The claim is that it is inequitable to allow carried interests to receive capital gain when other risky service payments are taxed as ordinary income.

Horizontal equity arguments have been widely criticized in the literature as conceptually baseless.[44] The problem is that one must have a criteria for determining who are equals and direct resort to that criteria is preferable to making horizontal equity arguments. For example, imagine

[44]Kaplow, note _; Peter Westen, *The Empty Idea of Equality*, 95 HARV. L. REV.537 (1982).

that individuals vary in two ways: suppose that they are either tall or short and either blond or brown hair. Someone who is tall with brown hair might be similar to a tall person with blond hair or a short person with brown hair. We need a criteria for determining equality. Horizontal equity is doing no work that direct reference to the criteria does not do.

Even leaving this problem to one side, horizontal equity fails in the carried interest context. The reason is that the treatment of carried interests cannot be the same as both that of a service provider and that of an investor. Regardless of which treatment is chosen, horizontal equity is equally violated. As discussed in the introduction, we can visualize the problem by imaging we have to color three squares either red or blue. The square on the right is red and the square on the left is blue. We cannot use equity arguments to determine which color to pick for the middle square because it will differ from a square immediately to one side regardless of which color we choose. We may argue that the right and left squares should not be different colors, but if that cannot be changed, the problem cannot be resolved by merely pointing in one direction and arguing based on horizontal equity.

Chris Sanchirico illustrates the same point with an analogy to passengers waiting to be let onto a platform to board an over-booked train.[45] He imagines one group of passengers waiting at the top of the stairs while another group has already been let onto the platform. If one person is arbitrarily allowed to advance from the stairs to the platform, we cannot use equality arguments to argue that this is unfair. Compared solely to those at the top of the stairs, the single person seems to have an unfair advantage, but compared to those already on the platform, that person is not more unequally.

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[45] Sanchirico, note __.

Analogical Reasoning

A closely related set of arguments rely on analogical reasoning. The claim is that returns on carried interests are "more like" service income than investment income. We might, for example, make this determination by comparing lists of attributes of each possible analogy and then weighing the various items. Analogical reasoning is standard in legal decisions, particularly those made by common law courts.[46]

There are two problems with using this approach here. The first is that virtually any attribute that can be used to argue for treating carried interest as service income equally applies to investment income. For example, we might argue that private equity sponsors show up at the office each day, indicating that they are performing services and are not merely passive investors. But many investors put in long hours choosing and managing their investments. Entrepreneurs, who can get capital gains on the sale of the stock of their companies, put in notoriously long hours.

Similarly, we might argue that holders of carried interests do not put in a substantial percentage of the capital, unlike an investor. But highly leveraged transactions are eligible for capital gains – there is no rule that requires investors to use a given percentage of their own capital as opposed to capital provided by third parties. The same holds for virtually any attribute: it cannot be used to distinguish investors and others who get capital gains from service providers.

The second and more fundamental problem is that we are never told why the various criteria matter. To illustrate, Mark Gergen argued that the analogy to an investor is not appropriate because an investor using third

[46]Edward H. Levi, AN INTRODUCTION TO LEGAL REASONING (1949)

party capital would have to pay interest.[47] Leaving aside that he has his facts wrong – there is an interest component because of the hurdle rate – the argument relies on the distinction between debt and equity. If private equity sponsors raised capital using debt, apparently, capital gains would be appropriate, but if they raise capital using equity, it is, according to this argument, not. There is no reason, however, why capital gains treatment should depend on whether third party capital is raised through debt or equity. I cannot think of any reason. Gergen offers none. It is simply a difference rather than a difference that matters. Analogical reasoning is prone to this sort of error because it merely looks at features without a theory of why a given feature matters.[48] More generally, reasoning by analogy does nothing to determine the consequences of changing the rules. Analogical reasoning should not be used unless it can promise good consequences. Directly examining consequences, however, is a superior method of determining whether this is likely to be the case.

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[47]Gergen Testimony of September 6, 2007, note 2.

[48]The arguments made by Joint Committee on Taxation, in its September 4, 2007 report on carried interests that the investment analogy is not sound suffer from the same problem. Joint Committee on Taxation, *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interest and Related Issues, Part I*, (JCX-63-07), September 4, 2007. It makes four arguments. First, it argues that it is not appropriate to treat the capital in the investment fund as owned entirely by the fund manager. Second, the Joint Committee argues that treating the limited partnership as a capital raising device is "inconsistent with the idea that the idea that the fund manager has only a profits interests." Third, the Joint Committee argues that it is inconsistent with the passthrough tax treatment to investors. Finally, the Joint Committee questions whether the interests could be characterized as debt. At the core of all of the Joint Committee's arguments is an adherence to the debt/equity distinction – financing comes in the form of debt not in the form of equity. The Joint Committee, however, does not provide any arguments on why the treatment of the carried interest should depend on whether it obtains financing in the form of debt or equity.

The Definition of Capital Gains

A third argument used to claim that carried interests should be taxed as ordinary income is based on the definition of capital gains. Unfortunately, there is little if any conceptual clarity governing the distinction between capital gains and ordinary income. Indeed, it is hard to come up with any sort of rationale whatsoever for the distinction. Courts have long struggled with this problem, and it is difficult to make sense out of the many conflicting opinions.[49] Without a solid rationale for the distinction (and one that roughly tracks current law), it is difficult to make principled arguments with respect to any given return. At best, we can try to observe where the tax law draws the lines.

The argument advocates for change make is that the capital gains rates at a minimum should not apply to labor income.[50] Under this theory, the analysis is straightforward: at least some portion of the return is attributable to labor income and should not get capital gains treatment. On the other hand, some portion represents labor income that is left invested in the fund and, therefore, could potentially get capital gain. One analogy that has been made is to restricted stock: absent a section 83(b) election, treating all of the stock gain as labor incomes does not measure labor income properly but the alternative is upfront valuation, which is also difficult. The argument would then proceeds on how best to identify labor income given the necessary imperfections.[51] An alternative analogy is to a loan from the limited partners

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[49]Compare *Commissioner v. Jose Ferrer*, 304 F.2d 125 (2d Cir. 1962) to *United States v. Dresser Industries*, 324 F.2d 56 (5th Cir. 1963).

[50]See Peter Orzag, *The Taxation of Carried Interest*, Testimony before the Committee on Finance, United States Senate (July 11, 2007).

[51]Note that under this approach, we might not change the treatment of private equity at all. Under current structures, approximately two-thirds of the returns to private

to the general partner, with the service component measured by foregone interest on the loan, if any.[52]

The capital gains distinction, however, does not track the distinction between returns to labor and returns to capital. In many cases, such as for investors and entrepreneurs, returns to labor get the capital gains preference.[53] To say that holders of carried interests should get ordinary income because they put in effort is to misapply the definition of capital gain.

More fundamentally, it ignores the line drawing nature of the problem,

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equity sponsors are taxed as ordinary income. This may very well represent a reasonable allocation between the labor and investment elements and, therefore, a reasonable tax treatment.

[52]Schmolka note __.

[53]There appears to be two key factors in when returns to labor get capital gains treatment. First, the more entrepreneurial the activity, the more likely the treatment will be capital. Second, the more that labor and capital are combined into a single return, the more likely it will be treated as capital. Consider some well-established cases. Everyday salaries that represent arm's length compensation for ordinary, non-entrepreneurial work are taxed as ordinary income. Employee stock compensation, pay for performance, and nonqualified options have a closer connection to entrepreneurial activity in the sense that they expose the employee to the risk associated with the success of the enterprise. These amounts are generally treated as ordinary income when they vest, subject to certain exceptions such as a section 83(b) election. Additional amounts are taxed as capital gains. On the other hand, self-created assets, including significantly patents under section 1235, get capital gain. An inventor who puts in many hours of labor gets capital gain when the invention is sold. A proprietor who raises capital to start a business and uses his expertise and labor to build the business receives capital gains when he sells the business. Similarly, founders of companies get capital gain when they sell their shares even if the gains are attributable to labor income. For example, most or possibly all of Bill Gates's fortune comes from his performance of services for Microsoft, but the overwhelming majority of his earnings from Microsoft will be taxed as capital gain. He engaged in entrepreneurial activity that combined labor and capital.

instead attempting to solve the problem by definition. Like with the red and blue square problem discussed above, there is a fixed category of items that are very similar to private equity activities that gets capital gain and another fixed category that gets ordinary income. Putting private equity on one side or the other because of a definition means that we do not examine the consequences of the choice – the policy choice is instead determined by parsing language.

An alternative way to try to use the definition of capital gains is to argue that none of the reasons for a capital gains preference apply to carried interests. This, however, cannot convince anyone. Those who believe in the reasons for a broad-based capital gains preference will also believe that it should apply to private equity activity. For example, for those who believe that the capital gains preference is needed because of problems of lock-in, to alleviate problems with the double taxation of corporate income, or the need for entrepreneurial subsidies will tend to equally apply these rationales in the private equity context. After all, private equity activity involves entrepreneurial investing, which falls in the bulls-eye of items getting the capital gains preference. Those who do not believe in a broad-based capital gains preference may believe that it should not apply to private equity but they should also believe that the problem is not particularly with this class of activity and that the best and only way to solve the problem is to fix capital gains rates generally.

2. The theory of line drawing

In general

As a substitute for these weak forms of argument – horizontal equity, analogical reasoning, and similar arguments – I laid out, in a series of papers, a very different theory for resolving competing analogies in the tax law, the

theory of line drawing.[54] The claim is that problems like the potentially differing analogies for the taxation of carried interests is a pervasive tax law problem that involves drawing a line between similar activities. It is the daily task of policymakers. For example, central to our tax system are lines between selling and holding an asset, between taxable compensation and fringe benefits, between employees and independent contractors, between debt and equity, and between capital and ordinary income. Policymakers are regularly confronted with transactions that fall in the difficult grey areas and must decide which of two treatments is more appropriate.

To illustrate, we can imagine any of these problems as involving three items: Item A is taxed at a low rate, item C is taxed at a high rate, and item B must be taxed as either A or C. We must draw a line somewhere in the middle, determining whether B is more like A or more like C. For example, Congress had to decide whether a short-against-the-box transaction was more like holding an asset or selling an asset.[55] Selling is the high-taxed category and holding is the low-taxed category. Congress had to place a short against the box into one of the two categories. It had to tax the middle category, B (hedged ownership), like A (holding) or C (selling). It decided that it was more like selling, but then delegated to the Treasury the decision on more complex strategies.[56] The Treasury must decide for these more

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[54]See Weisbach, *Efficiency Analysis of Line Drawing*, note _ and Weisbach, *Line Drawing, Doctrine, and Efficiency*, note __.

[55]In a short-against-the-box transaction, a taxpayer who owns stock borrows identical stock and sells it short, using the original shares as collateral for the short sale. The transaction completely eliminates the risk of gain or loss on the stock or from variable dividends with respect to the stock, and allows the taxpayer to withdraw substantially all of the cash invested.

[56]See section 1259 (treating a short against the box and similar transactions as sales).

complex strategies whether they will be treated like sales or like holding an asset. The same is true for numerous areas of the tax law, including the capital gains/ordinary income distinction relevant here.

The question is how policymakers should draw these lines. A key observation is that we cannot use consistency or horizontal equity as a criteria. The reason is that regardless of how B is taxed, it will be taxed inconsistently with either A or C. Merely pointing out that, say, B and A are taxed inconsistently does nothing to establish that B should be taxed like A. In the case of carried interests, for example, pointing out that they are taxed differently from compensatory options says nothing about how they should be taxed because changing their tax treatment would cause them to be taxed differently from self-constructed assets. Inconsistency cannot be eliminated (or even reduced) and, therefore, it is not a guide to policy.

Instead, the right way to determine how items in the middle should be taxed is to look at the economic consequences. The goal is to draw a line that raises revenue while minimizing economic distortions. There are two types of distortions: the costs of shifting activities into the lower-taxed category and the complexity costs of drawing the line.

The complexity costs are fairly straightforward: if putting B with either A or with C is more complicated, the additional burden of this complexity must be added to the calculus. Complexity costs impose compliance costs on taxpayers and increase the administrative burden on the government.

The shifting costs are more subtle. Regardless of how B is taxed, there will be an inconsistency in the tax law and taxpayers will shift across the line into the lower-taxed category. We need to compare the relative size of the shifts when B is taxed, alternatively, like A and like C. If B is taxed like C, (the high-taxed category), taxpayers will shift from the B category into A. If B is taxed like A, however, taxpayers will shift from C to B. Because there is a built-in inconsistency in the law, there are going to be shifts into the lower-

taxed category regardless of which choice is made, but the relative size of the shifts will vary. To measure efficiency, we must compare the relative size of these shifts.

One way to make this concrete is to examine costs of raising a given dollar of revenue in a given manner. Economists have labeled this the marginal efficiency costs of funds. We want this cost to be low. Raising revenue with a high efficiency costs means we get little revenue benefit and a high cost in terms of economic distortions, which is undesirable.

Joel Slemrod and Shlomo Yitzhaki have developed a very simple mathematical formula for estimating this number.[57] Suppose that we raise the tax rate on some individual or activity by a dollar. The individual can either pay the tax and be worse off by a dollar or change his activities to avoid or reduce the tax. The individual will be willing to lose up to a dollar of utility to save the dollar in taxes, so either way, we can estimate the cost to the individual is a dollar. That is, we can use the "static" revenue estimate in the sense of a revenue estimate assuming there is no behavioral change whatsoever to estimate the cost to individuals of increasing the tax by an increment. In addition, the individual must pay any unavoidable compliance costs associated with the tax change. Therefore, we need to add compliance costs to the static revenue estimate to get a total cost of revenue equal to X + C, where X is the static revenue estimate and C is the compliance costs.

The benefit of raising the tax on an item is the actual revenue raised less any administrative costs required to raise it. That is, the benefit is the net revenue raised, or MR - A, where MR is the marginal revenue from a tax change and A is the administrative costs.

The costs of raising a dollar from a tax change on an item can be

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[57] Joel Slemrod and Shlomo Yitzhaki, *The Social Cost of Taxation and the Marginal Cost of Funds*, 43 INTERNATIONAL MONETARY FUND STAFF PAPERS 172 (1996).

expressed as the ratio of these two factors, or

$$Cost\_of\_Funds = \frac{X + C}{MR - A}$$

We can use the short-against-the-box example to illustrate this theory. The issue was whether a taxpayer holding appreciated stock should be treated as realizing gain when he enters into an offsetting short sale of the stock or enters into any other similar hedge. The three categories are selling (high tax), holding (low tax) and hedging (the middle category). We have to determine whether the hedging is more like selling or holding.

If we treat a short against the box like holding, then individuals can shift from selling to the lower taxed category, short against the box. If we put short against the box into the selling category, there will be a shift from selling and perfect hedging to holding and imperfectly hedging. Regardless of which choice we make, taxpayer behavior is influenced, always shifting to the lower taxed category. The intuition behind efficient line drawing is to draw the line where shifting is minimized. If the cost of funds, as measured by the formula above, is high, the costs of drawing the line in that place is also likely to b high. The reason is that if X (the static estimate) is high and MR (actual revenue) is low, it is likely that there is significant shifting across the line.

Applied to private equity.

We need to apply this analysis to private equity. We have compare two possible treatments of private equity carried interests. The first is as capital gain under current law. As commentators have pointed out, there is an incentive for individuals to structure their activities as carried interests to get this benefit, resulting in economic distortions. The second is as ordinary income under one of the various proposals. The incentive would be to restructure carried interest to get around these proposals and retain capital

gains treatment.

Further analysis would require data regarding the relevant elasticities, but an understanding of the tax structure indicates that the shifting in the second case would be significant: as will be discussed below, under any of the existing proposals, private equity sponsors would simply restructure their operations to retain the capital gains preference. The marginal cost of funds is likely to be very high. We have to compare this to the shifting away from other arrangements into carried interests if current law stays as is. As discussed below, section 707(a)(2)(A) is intended to limit this shifting, but it is not clear whether it is successful. Nevertheless, we know that the marginal cost of changing the law is likely to be high, creating a strong indication that it is undesirable.

There is no direct evidence on the relevant elasticities.[58] Instead, we need to look at indirect evidence to get a sense of the right place to draw the line. I will look at two sources of evidence. The first, in the next section, will consider how partnership tax law has dealt with the line drawing issue, historically, under current law, and under various reform proposals. The second, in the subsequent section, will consider the complexity and avoidance opportunities in likely changes to the law.

IV. Partnership Taxation and Line Drawing

Since its inception, partnership tax law has had to draw the line between service providers and partners that is at stake here. Therefore, we might be able to look to our historical experience as well as various reform proposals to get a sense of the relevant parameters. This section engages in this task. Although we cannot take current law or reform proposals as

[58]There is some limited evidence that the revenue that might be raised would not be significant. See, Michael S. Knoll, *The Taxation of Carried Interests: Estimating the Revenue Effects of Taxing Profit Interests as Ordinary Income*, available at ___.

received wisdom (after all, the claim of those proposing to change the law is that current law is incorrect), there are two key lessons. First, absent administrability concerns, we should not get a fundamentally different result when using a partnership than when engaging in the activity directly. This premise is reflected in current law, the history of the partnership tax rules and in policy discussions of their reform.

Second, the relevant exception to this rule is if the structure of the transaction makes it inappropriate to treat the partner as engaged in the partnership business. The typical example given is of an architect with limited involvement in a project who receives a profits interest. The architect is best treated like a service provider rather than a partner. This means that commentators who argue for changing the treatment of carried interests because a distinction between service income and capital income are misreading the partnership tax rules. The lesson from history is that the right distinction is between a partner and someone who works for the partnership but is not properly treated as engaged in partnership business. Although this line is hard to draw, under both current law and reform proposals, private equity sponsors would clearly be treated as partners.

A. Direct Taxation

The starting place in examining the policy behind partnership taxation is the central premise of the regime: the tax results from operating in a partnership should vary as little as possible from the results that the partners would get if the engaged directly in partnership activity. As summarized by Alan Gunn and James Repetti, on the first page of their partnership tax book, "[t]he central principle underlying the taxation of partners is that the existence of the partnership should matter as little as possible."[59]

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[59] Alan Gunn and James Repetti, PARTNERSHIP INCOME TAXATION (4th edition, 2005), p. 1.

This basic principle is found in the first section of the partnership tax rules, section 701, which states

> A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.

The next section, section 702, carries out this approach by requiring each partner to separately account for his or her distributive share of the partnership's items.

The reason for this principle is that differences in tax results depending on whether a partnership is used create avoidance opportunities and tax shelters. As Bittker and Lokken note in their treatise, "[m]any tax shelter schemes using partnerships are structured to exploit the entity nature of partnership. The Treasury and the IRS, in attacking these schemes, have often characterized partnerships as aggregates, at least for particular purposes."[60] As these authors note, the use of entity notions in subchapter K is primarily for administrative convenience where a pure aggregate approach would be too complex.

This policy is made explicit in existing law in the partnership anti-abuse regulations. These regulations are based on the underlying notion that aggregate treatment clearly reflects income and, correspondingly, they measure abuse by whether the tax results produce a result that is different from aggregate treatment. They adopt this notion explicitly in the abuse of entity treatment rule found in 1.701-2(e). This rule holds that the Commissioner can treat a partnership as an aggregate in whole or in part where appropriate. It is also the basis of general subchapter K anti-abuse rule found in 1.701-2(a) through (c). For example, the first factor listed for

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[60]Boris I. Bittker and Lawrence Lokken, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS, ¶86.1.2 (Third Edition, 2003).

measuring abuse is whether "the present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's business directly."[61]

The anti-abuse regulation recognizes that there will often be results that differ from aggregate treatment, but, reflecting the logic in Bittker and Lokken, these results arise only for administrative convenience rather than because they clearly reflect income. Thus, Example 9 considers a case where failure to make an election under section 754 creates a disparity between inside and outside basis, resulting in a tax advantage because of the entity-type treatment given to partners' bases in their partnership interests. The regulation notes that the "electivity of section 754 is intended to provide administrative convenience for bona fide partnerships." Under the facts of the example, the failure to make a section 754 election was respected. The baseline for clear reflection, however, was aggregate treatment, treating the partners as if they engaged directly in the partnership activity.

The same policy is seen in the so-called "Brown Group" regulations. In *Brown Group* ,[62] the Eighth Circuit held that income that would have been subpart F income where it earned directly by the taxpayer was not when earned through a partnership. The government viewed this deviation from the aggregate approach as intolerable and issued regulations that overruled the case.[63] The underlying notion is the same as that underlying the partnership anti-abuse rule: when the tax treatment when using a partnership varies too much from the treatment when engaged directly in the activity, abuses will arise.

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[61]Treas. Reg. 1.701-2(c)(1).

[62]*Brown Group v. Commissioner*, 77 F.3d 217 (8th Cir. 1996),

[63]See 1.702-1(a)(8)(ii)

Not only does current law reflect the "direct engagement" notion; policy discussions on reform of the partnership tax rules start with the same premise, that treating partners as if they engaged in partnership activity directly is the best baseline. The proposal that best exemplifies this thinking is the 1984 ALI proposals on partnership taxation. As the ALI summarized, "the ideal mode for taxing partnership earnings is to tax each partner as though he were directly conducting his proportionate share of the partnership business."[64] The ALI recognized that in many cases, treating the partnership as a separate entity is desirable nonetheless, but the basic reason in each of these cases is administrative.

If this policy baseline of direct engagement is applied in the carried interest context, holders of carried interest would receive whatever treatment the partnership receives. Pass-through of capital gain, therefore, is mandated by this basic premise of partnership taxation. If the holders of carried interests were directly engaged in the activity of the private equity fund, they would be treated as investors exactly as the private equity fund is treated. We do not make investors segregate the portion of their return attributable to labor effort and, neither, therefore, would we make holders of carried interests if we treat them as directly engaged in the partnership activity.

B. Entity notions and nonpartners nominally acting as partners

There are many places where the partnership rules deviate from this aggregate approach. For example, partners have a basis in their partnership interests separate from the partnership's basis in its assets. Many elections are made at the partnership level, and partnerships can have taxable years different than minority partners. Also, within an aggregate notion of partnership taxation, many more recent tax rules are focused on shifting of tax attributes among the partners – that is getting the correct allocation of

[64] American Law Institute, FEDERAL INCOME TAX PROJECT, SUBCHAPTER K (1984) at 5.

items to each partner. Most of these are not relevant to the treatment of carried interests.

The rule that is relevant to the present discussion is section 707(a)(2)(A), which treats some service providers as non-partners even though they nominally hold a partnership interest. The underlying idea of this section is that if the partner had engaged in the activity directly, his payments would depend on the partnership business. If the payments instead are fixed, it not appropriate to treat him as if he engaged in the partnership business directly. Instead, he looks more like a service provider. Therefore, we carve out these cases and treat them similar to transactions between the partnership and third parties.

Historically, the aggregate approach predominated. Prior to 1954, partnerships could not pay partners a salary. Instead, all payments to partners were treated as distributions.[65] This approach was unworkable in many contexts because of the complexity of the capital account adjustments that were needed, and, as a result, in 1954, Congress added a rule that allowed a partnership to pay its partners so-called guaranteed payments for services. This rule treats payments made without regard to partnership income as payments to a nonpartner for purposes of sections 61, 162(a), and 263.

This approach, however, was insufficient. In particular, partnerships could pay service providers by calling them partners and allocating gross income to them. By doing so, they could avoid rules that would apply to payments to third parties for services, such as the rule that certain payments be capitalized under section 263. For example, payment for an architect's services must generally be capitalized. If the architect is given a partnership interest and is allocated the same income, the capitalization requirement is

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[65]See *Lloyd v. Commissioner*, 15 BTA 82 (1929), and Bittker and Lokken, note __ ¶89.1.1,

avoided. While the guaranteed payments rule, if it applied, would prevent this avoidance, taxpayers could base the payment on gross income and not run afoul of those rules.[66]

To prevent this avoidance, Congress added section 707(a)(2)(A). This section treats a payment as made to a nonpartner if a partner performs services for a partnership, there is a related allocation or distribution of income, and when viewed together they are properly characterized as between the partnership and a nonpartner. As noted, Congress listed six factors for making this determination and a typical carried interest easily passes all the relevant factors – carried interest in private equity partnerships have none of the factors that indicate that they are to be recharacterized as received by a nonpartner. That is, it is not even a close question, at least under current law, that the private equity sponsor is acting in its capacity as a partner with respect to a carried interest.

It is possible that the lines drawn in section 707(a)(2)(A) should be changed. In the 23 years since that section was enacted, compensation arrangements have changed significantly. Modern compensation is much more likely to depend on the success of the business than it was in 1984. This makes the problem posed by section 707(a)(2)(A) much more challenging. Nevertheless, absent a complete rethinking of section 707(a)(2)(A), which would have broad and unclear ramifications about who can and who cannot be treated as a partner, it is hard to see an argument that private equity sponsors are not properly taxed as partners. Not only are all six of the current law tests easily met but the economics indicate that the private equity sponsor is the primary partner. It is the general partner with all of the decision-making authority and residual risk. Given how far private equity sponsored interests are from where the line is currently drawn, moving the line to change their treatment would require wholesale examination of the

[66] *Pratt v. Commissioner*, 64 T.C. 203 (1975).

underlying premise. The long partnership tax history indicates, however, that it is unlikely that doing so would be desirable.

C. Summary

The long history of the development of the partnership tax rules and the many policy proposals for their reform indicate the strong preference for taxing partners as if they engaged in partnership activity directly. This is also supported by the partnership anti-abuse rule, which treats deviations from this baseline as potentially abusive. The major place where this treatment does not apply (relevant here) is when the partner is sufficiently remote from partnership activities that he is best not treated as a partner at all. There is no argument that this exception should apply in the private equity context.

Taken together this history is impressive evidence that the right place to draw the line between service provider and investor is to treat the private equity sponsor the same way that the partnership is treated. That is, this history strongly supports the notion that carried interests in private equity partnerships should get pass-through treatment and consequently, capital gains and losses on the sale of investments by the partnership.

V. Complexity and Avoidance

The second piece of evidence for the line drawing exercise is the likely complexity of any rule that attempts to tax carried interest as ordinary income and the ease of avoiding any such rule. Attempting to tax all or a portion of carried interests as service income will likely have the effect of simply making partnership tax more complex without actually changing the tax results of anyone who cares sufficiently to plan around the new rules.

The key problem with a rule that taxes carried interests as ordinary income is the need to distinguish labor income from capital income. There is simply no general method of making this distinction, and attempts to do

so are complex and avoidable. Moreover, even if we could devise a rule, the proposed changes would apply only in the partnership context, it would be easily avoidable. This section considers these points, first discussing the problem of identifying labor income and second analyzing likely avoidance possibilities.

A. Complexity and the problem of identifying labor income

Suppose that the law were changed to tax carried interest as ordinary income on the theory that they represent labor income. The question is how carried interests are to be identified.

The problem is that flows do not often come neatly labeled as capital or labor.[67] Current private equity structures use simple carried interests which are easy to identify because there is no reason to disguise them. As illustrated below, however, in many cases, the flows will be complicated and difficult to identify. Moreover, to the extent this is not the case now, it would become the case were there to be unfavorable rules for pure carried interests. If flows are complicated and mix up labor and capital, we have no method, not even a theory, for identifying the labor component and, therefore, no method of determining when a partner has a carried interest.

To illustrate the problems, suppose that there is a two person partnership with partners A and B, each of whom works for the partnership and contributes capital. They get paid equal salaries but their services may not be worth the same. They contribute equal capital, but their risk preferences may not be the same. To properly identify a profits interest, we

[67] Even in this case, we know that some portion, perhaps a substantial portion, is capital income in the sense that it represents returns that are left in the business rather than taken out each year as salary. Nevertheless, we might in this case, sensibly say that the best compromise is to treat it all as labor income exactly as we do in the case of restricted stock or nonqualified options.

have to be able to identify what portion of their return should properly be recast as additional salary.

Time variation. Suppose that A strongly prefers to get his money out soon, perhaps because he needs it soon or because risk increases with the length of an investment and he is more risk averse than B. Therefore, they agree that A gets 60 percent of the profits for the first five years and 40 percent of the profits thereafter. B gets the reverse. In addition, the partnership pays A and B equal salaries.

This may be a fair division of the returns to the capital and their service contributions may be equal, but it may not. Perhaps the present value of A's 60/40 split is greater than the present value of B's 40/60 split with the difference representing A's relatively greater contribution of labor income, or vice versa. Taking present values is difficult in this case because the returns are risky and the risk profile may change with time. There is no way to draft laws or regulations that identify any potential service component to the capital allocation. The government could attempt to challenge this on audit but any such challenge would be expensive and come down to a battle of experts with the IRS having little chance of winning except in egregious cases.

Risk variation. Alternatively, A may prefer to get the first returns from the venture in exchange for giving B all of the upside should it do very well. For example, A may be much more risk averse than B. Therefore, they may allocate, say, the first 6 percent of profits to A and give everything above that amount to B. Or, alternatively, A could get the first 8 percent, B get the next two, and then they could share everything beyond that with 80 percent going to B and the rest to A. Any degree of complexity is possible.

Just like in the time variation case, to determine whether A or B is hiding labor income in these capital returns, we would have to compare the present discounted value of each partner's share of the capital returns. In

this case, doing so would be particularly difficult because the returns explicitly have different risk profiles. Indeed, B's return may look very much like an option, and option valuation methodologies may be necessary instead of merely taking present values. Option valuation would, however, be very difficult because the underlying assets may not be traded, so volatility cannot be observed. Again, there would be no way to write legislation or regulations to capture cases like this, and the government would have no easy way of challenging this on audit.

Location variation. Finally, A and B may have different views about the returns from the venture in different locations. For example, if the partnership operates in both California and Illinois, A may prefer a relatively greater portion of the California returns and a correspondingly lower portion of the Illinois returns. Thus, suppose that A gets 70 percent of the profits from the California operations and 30 percent of the profits from the Illinois operations, and B gets the reverse. Like in the above cases, there would be no easy way to determine whether these allocations have equal value, and, therefore, no way to determine whether there is hidden labor income being taxed as capital income. Challenging this case on audit would require valuation of reasonable expectations of business returns in different locations, a task that would be far more difficult and subjective than present value or even option valuations.

Combinations. Any of the above cases can be combined with any of the other cases. For example, a may be the first 6 percent of returns from California and 30 percent of all returns from Illinois for some fixed period and then allocations could flip to a 50/50 allocation. Real economic arrangements could have almost any degree of complexity, as could arrangements designed solely or primarily as tax avoidance.

In each of these cases, it is entirely possible that the allocations have

equal present value and, therefore, do not contain hidden service income.[68] It is also equally plausible that they do not have equal value and compensation for service income, a profits interest, is hidden within these allocations. There is no easy formula for make this determinination. Without a method of making this determination, cannot readily enact a rule.

The basic approach of the partnership rules is to accept the economic allocations as real and require the tax allocations to follow. The limited exception to this rule is in the substantially requirement under 704(b), which attempts to find obvious cases of tax avoidance but nothing beyond that. That is, the 704(b) rules take the approach that there is, in general, no way of determining whether these various allocations are fair. Instead, they trust that if arm's length parties agree to the returns, they are likely to be close enough. If one wants to separate labor and capital returns, however, this approach cannot work. Instead, we must be able to examine the economic arrangements and find hidden returns to labor, a task that would likely prove impossible. In a sense, the task of those who would change the law is to revise the basic capital accounts rules of section 704(b) to reflect time value concepts, including making the proper adjustments for risk.

As noted, section 707(a)(2)(A) is the one place under current law where we come close to making this separation. It attempts to draw a line between where it is appropriate to treat the partner as in business for himself (and, therefore, we do not recharacterize capital gain as compensation even if it is due to labor income) and when the partner should be viewed as a third party service provider. Even this allocation, which seems likely to be easier than distinguishing between labor and capital, is too hard to implement. Twenty-

[68]The salaries could be below market and some portion of the returns could be service income equally to A and B. In the text, I am trying to see whether we can identify a profits interest – an allocation to one of the partners as a payment for services. The problem of undercompensation arises even with straight up allocations.

three years after the provision was enacted, there are no regulations or other guidance on the issue.

None of the proposals for changing the treatment of carried interests grapple with these problems. They simply assume that we can identify labor income when we see it. For example, the proposal introduced by Congressman Levin (D-MI) requires taxpayers to make a reasonable allocation between capital and labor with, effectively, a presumption that straight up allocations are the only appropriate allocations. Given that there is no way the government can determine whether the variously allocated returns to capital have equal risk-adjusted present value, there would be no way for it to determine whether an allocation is reasonable.

Similarly, Gergen would treat any payment that is not a straight-up, pro rata allocation of returns (to a partner that provides at least some services) as entirely for services. Essentially, he would require strict, pro rata sharing of all returns to capital regardless of the economic arrangement. Under this approach, none of the risk sharing arrangements considered above would work because none are pro rata, even if they were entirely driven by the underlying economic arrangement and even if there was no service element or tax motivation in the allocations. Gergen might defend his approach by arguing that there is no better rule, but given its inaccuracy, it is not clear that it is better than nothing (even if one were convinced that analogizing carried interests to service income is correct.) This is particularly true because, as will be discussed below, it is easily avoidable.

The imputed loan approach suffers from the same problem. To implement the approach, we would have to identify when one partner has implicitly loaned funds to another partner and then impute an appropriate cost of capital. If allocations are not straight-up, it would be impossible to identify implicit loans.

It is doubtful that there are any solutions to the problem that are not

complex, and regardless, any solution is likely to be inaccurate. The underlying problem is that outside of the employer/employee context, we do not have a method of distinguishing labor income from capital income, and without such a method, we cannot draft partnership tax rules to do so.

B. Avoidance

The exact avoidance strategies will depend on the precise legislation, if any, that is enacted, so it is difficult to make definite predictions. Nevertheless, it is clear that avoidance will be relatively easy because of the underlying theoretical problem: the difficulty of distinguishing labor and capital income.

The analogy to a debt-financed investor suggests that using debt could largely be successful in avoiding any change in the law; the proposed changes only apply to partnerships, so avoiding the use of partnerships avoid the changes. For example, the limited partners could lend the money to the sponsors with payments contingent on performance. Although tax planners would have to ensure that the resulting instrument qualifies as a debt instrument, our long experience with the debt/equity distinction shows that the government has a very hard time policing this boundary. Under the proposals being considered, dramatic tax consequences would depend on this distinction, giving taxpayers incentives to structure around it to their advantage.

Even within the partnership structure, there are a number of ways that the proposals could be avoided. The most obvious, suggested by the discussion of complexity above, is to make the returns complex and argue that what had been the 20 percent carry and is now a flow that is intertwined with other flows from the partnership, is a return to capital. Without a theory for measuring the return to capital, the government would have little ability to challenge this claim.

A second method of avoiding the various proposals while continuing

to use a partnership structure is to document the transaction as a loan between the limited and general partners consistent with the Schmolka imputed loan approach. The sponsor would borrow funds from the limited partners at a low interest rate, say the applicable federal rate, and then invest those funds. Partnership allocations would be made so that after the allocation of income to the various partners and payment of the interest on the loan, the net amounts are roughly the same as under current law.

The actual numbers would depend on the specifics of the transaction, but suppose that the structure is the one described above: the limited partners get the first 8 percent of the return, the general partners get the next two percent, and everything beyond that is shared 80/20. Suppose also that the applicable federal rate is 5 percent. Finally, suppose that total partnership capital is $100, all contributed by the limited partners.

Although it is commonly assumed that the imputed loan amount is $20, this is not correct. If the partnership does well, the general partners can end up with 20 percent of the partnership returns, but their return is riskier than the returns to the limited partners – the limited partners get the first 8 percent.[69] This means that someone contributing capital for that set of returns would contribute *less* than 20 percent of partnership capital, so that the risk adjusted return is appropriate.

Suppose, however, that we use the $20 number as a simple starting point. The general partner would have to borrow $20 from the limited partners, and suppose it does so at the applicable federal rate, 5 percent. This means that the general partners owe the limited partner $1 each year. There are many possibilities, but partnership allocations could provide that the limited partners receive the first 7 percent of profits, the general partners

[69] As noted by the Joint Committee, in 30 percent of private equity transactions (during the period they looked at), the carried interest got nothing. Joint Committee, note __.

receive the next 3 percent, and everything after that is split pro rata (80/20). Although the general partners would be getting more than a 20 percent return for their contribution of 20 percent of partnership capital, this return is riskier than the return to the limited partners, so that they could easily justify this difference. (At a minimum, the government would be hard pressed to challenge this valuation on audit.) The net payments would be substantially identical that those under the current structure with no additional payment of tax.[70]

There are many different versions that would also work. The loan amount from the limited partners to the general partners could be different from the $20 used in the illustration, the computation on the loan could different from a fixed AFR amount, or the partnership allocations could be different from those described. Howard Abrams suggests that the partnership could simply pay the general partners a fee sufficient to cover the interest payment due to the limited partners.[71] What is clear is that something very close to the current economics and current tax treatment could be achieved through a loan from the limited partners to the general

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[70]One potential tax difference is that the interest on the loan from the limited partners would be investment interest subject to the limitations under section 163(d). Either the general partners would have to have that much investment income otherwise in their portfolios or the private equity fund could ensure that the portfolio companies pay dividends sufficient to cover this amount.

An economic difference is that if the fund does not earn at least 8 percent, the general partners would owe the limited the interest on the loan without receiving an offsetting distribution from the partnership. This risk could be mitigated by using a different allocation scheme, where the general partners receive their first 1 percent earlier.

[71]Howard Abrams, *Taxation of Carried Interests*, 116 TAX NOTES 183 (2007). An advantage of this structure over the one described above is that it avoids problems created by section 163(d).

partner.[72]

A third method, suggested by Michael Knoll, is to have the portfolio companies pay fees to the sponsors equivalent the carried interest.[73] A deduction for these fees by the portfolio companies would offset the income inclusion by the general partners. This is simply an application of the idea that the treatment of carried interests does not matter unless the limited partners are tax-exempt or otherwise cannot deduct the fees. By shifting the payment of the carried interest to the portfolio company, this method ensures that it is deductible (or, at a minimum, capitalized and recovered over time).

Yet another method of avoidance is to capitalize the partnership with debt. For example, if the limited partners put in a substantial fraction of their investment in the form of debt, the allocations for the equity contributions made by the limited and general partners could be closer to straight up allocations, making it difficult to separate the returns to labor and to capital.

C. Summary

The analysis of avoidance strategies barely scratched the surface. Once rules are in place and a lot of money is at stake, many additional methods are likely to be available. Moreover, even if any one of these methods might be

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[72]Michael Knoll argues that this structure would not be respected because it implicitly relies on a below market interest rate on the loan from the limited partners. Michael S. Knoll, *The Taxation of Carried Interests: Estimating the Revenue Effects of Taxing Profits Interests as Ordinary Income*, available at ___. It will, however, be difficult for the government to challenge the interest rate on audit. The government would have to rely on section 482, which is rarely successful. Moreover, if this simple structure with a direct loan between partners can be challenged, the loan can be made through third party financial intermediaries, similar to the transactions described in Rev. Rul. 87-89, 1987-2 C.B.195.

[73]Michael S. Knoll, *The Taxation of Carried Interests: Estimating the Revenue Effects of Taxing Profits Interests as Ordinary Income*, available at ___.

challenged, complex structures will combine elements of each, making it very difficult, if not impossible, for the government to sort out.

These facts about complexity and avoidance show that the cost of funds from changing the tax treatment of private equity is likely to be high. The reason is that very little actual revenue is likely to be raised – MR is low. This will be because there is substantial shifting and avoidance, so the ratio of X/MR is likely to be high. Moreover, the administrative and compliance costs will be high, further increasing the cost of funds.

VI. Distributional Considerations and Conclusion

Distributional concerns are probably the underlying factor that is driving the discussion, not technical concerns about identifying labor income.[74] Many private equity sponsors are extraordinarily wealthy at a time when inequality has been increasing and at a time when the government is facing severe fiscal pressure, both immediate and in the future. Moreover, private equity sponsors are seen as financiers rather than inventors which makes the value they add to the economy harder for many to see. Bill Gates is many times richer than any private equity sponsor, earned all his money through labor effort, will be taxed on virtually all of his returns at the long-term capital gains rate and, to the extent he dies with built-in gains, will have his income tax entirely forgiven on the gains.[75] Because he is seen as inventing a product, however, these facts have not caused a clamor for change.

The distributional problem with the taxation of wealthy private equity sponsors, however, should not be solved by changing the technical rules for

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[74]For example, Victor Fleischer entice the reader with terms like "airplane rich" (you can afford your own airplane). Fleischer at note 33.

[75]Gates and private equity sponsors will equally be subject to the estate tax.

the taxation of carried interests. The issue arises because of the capital gains preference more generally. A special rule for private equity sponsors would not significantly change the distributional implications of the capital gains preference. To the extent it collected any tax at all, it would merely pick off one class of beneficiaries of the preference. A change to the capital gains rate, by contrast, would have far broader distributional effects. Moreover, it would be far less avoidable than technical changes to the partnership tax rules. That is, a technical change to the partnership tax rules leaves the capital gains preference generally available and relies on the ability of the government to distinguish labor income from capital income. This is not a promising approach, even if one is primarily concerned about the distributive consequences of current law.

The considerations discussed above indicate that the treatment of carried interests should not be changed. Under current law, private equity sponsors are treated the same way they would be treated if they engaged in the activity directly rather than through a partnership. There are sound reasons, many deeply embedded in partnership tax law for retaining this approach. Moreover, changes would likely be very complex and easily avoidable, imposing costs on the economy while raising little revenue. Distributional concerns are important but they are not centrally related to the taxation of carried interests. Instead, they arise because of the capital gains preference and if they are going to be addressed, should be dealt with directly.

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