

# Untangling The “Carried Interest” Controversy

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## ABSTRACT

*“Carried interest” is a form of deferred compensation payable to managers of hedge funds organized as investment partnerships. There are two tax components of this compensation that are favorable to the manager. First, income taxes are due only when amounts are received rather than when this interest is granted, and second, this income is eligible for the lower tax rates of capital gains and dividends. Special tax treatment has been criticized by some as being an unfair benefit for income that is essentially compensation for services, while proponents of continuing this special treatment point out policy reasons for continuing it, emphasizing characteristics of carried interest that warrant treatment such special treatment. Legislative changes have been proposed but not enacted into law, and there are different alternatives that warrant consideration for the future.*

**Keywords:** Tax; Carried Interest; Hedge Funds; Capital Gains; Dividends

## I. INTRODUCTION AND BACKGROUND

*I*n investment partnerships, as with mutual funds, the general partner of the partnership is often the investment manager. This individual charges a fee based on assets under management, typically in the range of 1 percent to 2 percent. However, when hedge funds are organized as investment partnerships, the investment manager will also charge an additional performance fee referred to as “carried interest.” This is an amount over and above the base management fee, and it is payable when the fund exceeds a predefined threshold. These fees are typically significantly higher than the management fees and could be as high as 20 percent or more. Also known as profits interests, they are the reward the manager gets for using his or her skills in obtaining superior performance.

Carried interest is a form of deferred compensation. Functionally, it is similar to a performance-based bonus, compensation ordinarily subject to ordinary income tax rates and payroll taxes. This paper discusses the various options of treating carried interest, the legislative history, and the pros and cons of taxing it differently.

Why is this an issue? A profits interest is a partnership interest other than a capital interest. If a person receives a profits interest for providing services to, or for the benefit of, a partnership in a partner capacity or in anticipation of being a partner, the receipt of such an interest is usually not a taxable event for the partner or the partnership unless the profits interest has an ascertainable fair market value at the time of receipt. The value of the future profits interest usually cannot be valued due to the speculative nature of the future profits. The partner has a taxable event only on distribution of the profits. The tax characterization of the profits interest depends upon the underlying characterization of the income. If it is ordinary income, short-term capital gains or dividends, the partner gets ordinary income treatment. However, if the underlying income character is capital gains, then the partner gets long-term capital gains treatment currently at a favorable maximum rate of 20 percent as opposed to a maximum ordinary income rate of 39.6 percent.<sup>1</sup>

<sup>1</sup> CCH Consultant Explanation PART: 12,104

Is this a fair treatment for performance-based compensation? Typically, as an employee, one pays payroll taxes and is taxed at ordinary income rates up to the maximum rate of 39.6 percent for a maximum total over 40 percent. If an employee receives a bonus, the same rules apply. On the other hand the fund manager of a partnership who receives a bonus for superior performance over a benchmark gets capital gains treatment of this "carried interest." There has been much publicity lately given to the fact that someone earning millions of dollars pays taxes at a much lower rate than someone earning less than \$100,000. Given the recent turmoil in the markets, which some analysts have attributed to the blatant risk taking of Wall Street and hedge fund traders, this inequitable benefit seems even more outrageous to many.<sup>2</sup>

In his report to Congress on their inquiry into key causes of the financial crisis of 2008, Senator Carl Levin attributed these causes to high-risk lending, inflated credit ratings and Wall Street firms engaging in massive conflicts of interest. He also pointed out that although the banks contended that their activities were mostly hedging activities, the report found that according to some of Goldman Sachs' own reports, these activities were not considered hedging.<sup>3</sup>

Although hedge funds seem not to have been as involved in the subprime mortgage crisis, the strategies used by bank traders closely resemble that of hedge fund traders.<sup>4</sup> In a 2007 report to the United States Senate Committee on Finance, Congressional budget office testimony included a statement that hedge funds trade in a variety of alternative and derivative investments and that many derivatives of subprime mortgages are held in hedge funds. In contrast to what their name suggests, hedge funds are involved in speculative trading rather than traditional hedging trading to reduce exposure and mitigate risk. Furthermore, a report by the International Monetary Fund analyzing the subprime mortgage crisis indicated that hedge funds which were largely unregulated had a substantial impact on the market as they were highly leveraged up to 500 percent in mortgage backed securities or its derivatives.<sup>5</sup>

## **II. RECENT LEGISLATIVE HISTORY**

In 2010 the House approved a bill, H.R. 4213,<sup>6</sup> that included a change in the taxation of carried interest. The bill generally treated net income from a partnership interest as ordinary income except to the extent it is attributable to the partner's qualified capital interest. A portion of the recharacterized income would be taxed at ordinary income rates and would be subject to self-employment tax. This bill would have taxed 50 percent of carried interest received in the years 2011 and 2012 as compensation, and 75 percent thereafter. This was also one of the means for the Obama administration to pay for the 2010 Unemployment and Tax Extenders Act. However the Senate rejected this provision. The provisions regarding carried interest were ultimately stripped from the bill before its passage in a substantially different form.<sup>7</sup>

Similar attempts at changing the taxation of carried interest had earlier been introduced in 2007 by Rep. Sander Levin to amend the Internal Revenue Code (IRC) to treat income received by partners for performing investment management services as ordinary income. This was followed by H.R. 3970, the Tax Reduction and Reform Act of 2007 introduced by Chairman of the House of Representatives Ways and Means Committee Charles Rangel that also included a provision to change the federal tax treatment of "carried interest." In 2009 again, the House passed the Tax Extenders Act of 2009 (H.R.4213) that included language wherein all carried interest income is taxed at ordinary income tax rates rather than lower capital gains rates

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<sup>2</sup> See, for instance, "Obama Tax Plan Would Ask More of Millionaires," Jackie Calmes, New York Times, September 17, 2011.

<sup>3</sup> April 13, 2010 Senate hearings on the causes of the subprime mortgage crisis

<sup>4</sup> July 11, 2007 Congressional Budget Office (CBO) director Peter Orzag's statement to the Senate Finance Committee

<sup>5</sup> International Monetary Fund (IMF) 4th Quarter 2007 Publication

<sup>6</sup> The American Jobs and Closing Tax Loopholes Act of 2010

<sup>7</sup> The Unemployment Compensation Extension Act of 2010

In his statement to the Senate in 2011 in regards to the debt ceiling debate, Senator Carl Levin again reiterated his position on carried interest. “One example of the kind of tax breaks and tax loopholes that we Democrats seek to change is the unconscionable tax break given to hedge fund managers.”<sup>8</sup>

New legislation was again been proposed within the Obama 2012 budget proposal that would include the carried interest provision. The budget proposed to designate a carried interest in an investment partnership as a services partnership interest (SPI) as elaborated further below. The Congressional Budget Office estimated that this would add revenue to the Treasury to the tune of about 20 billion dollars a year. However the 2012 budget lowered the revenue estimate to about \$14.8 million a year.<sup>9</sup>

### III. LAW AND ANALYSIS

The tax ramifications to the partner are governed under subchapter K of the Internal Revenue Code (the “Code”). Under Code §704(b), a partner’s distributive share of income shall be determined in accordance with such partner’s interest in the partnership as long as there is substantial economic effect per Code §704(b)(2) and taking into consideration all the facts and circumstances. Secondly, under Code §702(b), the character of any item of income, gain, loss, deduction, or credit included in a partner’s distributive share under paragraphs (1) through (7) of subsection 702(a) shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

The base percentage management fee is thus treated as ordinary income; however, the additional carried interest performance fee could be treated as capital gains if the underlying attribute of the profits interest is capital gains.<sup>10</sup>

Two major cases have been the determining factors in the issue of carried interest. One is *Diamond v. Commissioner*, 492 F.2d 286 (7th Cir. 1974). In this case, the petitioner received commissions for his part in securing loans. There were two issues presented to the court. In one, regarding a Monroe street property, the petitioner received a profits interest in the future sale of the property for his part in securing the loan for the property. The Tax court agreed with the Commissioner’s argument that the profits interest received by the petitioner was compensation for his services in securing the loan and that represented ordinary income. The 7th Circuit affirmed this decision. This was the first case determining that a profits interest was characterized as ordinary income for services rendered.<sup>11</sup> In this case the profits interest was sold back by Diamond within a year of its receipt. The court ruled that the profits interest had an ascertainable fair market value as determined by the subsequent sales price.

In another case, *Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991), a salesman received profits interest in the sale of partnerships by a syndicator. The IRS argued before the 8th Circuit that the interest received by the taxpayer was compensation between an employee and an employer and not by a partner. The court disagreed, reiterating that the profits interest should be treated like any other property received in exchange for services. Since the Tax Court did not directly address the issue in *Diamond v. Comm’r* as one pertaining to a partner’s profits interest, subsequent court cases and rulings have been inconsistent.<sup>12</sup>

The Treasury Department had since provided guidance in Revenue Procedure 93-27 (1993-27 C.B. 343) whereby 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 the anticipation of being a partner, the Internal Revenue Service will not treat the receipt of such an interest as a taxable event. However, it was made clear in the procedure that it would not apply: (1) If the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease; (2) If within two years of receipt, the partner

<sup>8</sup> Senate Floor Speech on Carried Interest and Offshore Tax Havens, June 30, 2011

<sup>9</sup> CCH Analysis of 2012 Budget Proposal, February 17, 2011

<sup>10</sup> Internal Revenue Code §§ 704(b) and 702(c)

<sup>11</sup> *Diamond v. Commissioner*, 492 F.2d 286 (7th Cir. 1974)

<sup>12</sup> *Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991)

disposes of the profits interest; or (3) If the profits interest is a limited partnership interest in a “publicly traded partnership” within the meaning of Code § 7704(b).

Some have raised the issue of the negative impact of legislation that would change the principles espoused by these cases and by the Treasury Department. There have been suggestions that treating carried interest as ordinary income and taxing it accordingly would be inefficient and would reduce entrepreneurial investment gains because the work of investment managers was of far more importance than that of other professions. In a statement to the U.S. Senate in 2007, the Assistant Secretary of the Treasury, Eric Solomon, stated that the current treatment of profits interests provides certainty for taxpayers in planning their transactions and encourages the pooling of capital, ideas, and skills in a manner that promotes entrepreneurship and risk-taking, while at the same time is administrable for the IRS. He cautioned against making significant changes to partnership tax rules that have worked successfully to promote and support entrepreneurship for many decades.<sup>13</sup>

The NAIOP, the Commercial Real Estate Development Association, is a group who typifies opposition to taxing carried interest at ordinary income rates. It takes the position that reducing the incentives for entrepreneurs to take risks inherent in development projects would have a pronounced negative impact on the real estate industry because investors would be less willing to support new construction and redevelopment projects.<sup>14</sup>

Although opposition by commercial real estate groups appeared to be widespread, much of the opposition was to changing the rule as it applied to real estate, and not to carried interest in general.

*While NAIOP supports Congress in going after fund managers who haven't paid their fair share, changes in tax policy typically apply broadly to legal entities structured as LLCs and LPs, not selectively targeted types of investors,* James V. Camp, chairman of legislative affairs for the Southern California chapter of NAIOP, tells CoStar Advisor.

*We wanted them to go after the hedge funds, to go after the bad Wall Street guys, but not to take the real estate industry down with the ship,"* Camp said. *"For whatever reason, [Congress] couldn't or didn't want to come up with a really creative way to go after who they were trying to go after."* *"We're just a casualty of war in this zest and zeal to penalize the evil Wall Street guys,* Camp said.<sup>15</sup>

While this kind of opposition may have been targeted, the ultimate result was that it contributed to the failure of legislative changes to existing treatment of carried interest.

Opponents of such changes further cite the fact that investment partnerships take on a lot more risk and that some funds even have a feature known as a “clawback” provision. Under this provision, if the fund in future years has diminished performance or does not exceed the preferred return threshold over the life of the fund, the fund may be obligated to repay some or all of the carried interest profits that the managing partner was initially entitled to back to the limited partners.

Another issue being brought up is that taxing carried interest at ordinary income rates would be a detriment to superior performance. This reasoning is questionable given the fact that employees routinely render superior performance with a view toward receiving a bonus, regardless of the fact that such bonuses are taxed at ordinary income rates.

There are questions as to whether treating carried interest as ordinary income would in fact be detrimental to risk-taking and entrepreneurship. Professor Joseph Bankman of Stanford University asks, “Why should a surgeon, a school teacher, or a CEO pay tax at twice the rate as a fund manager? Are the jobs of fund managers any more important than that of other professions?” In his rebuttal that taxing fund managers might hurt investors because investors indirectly benefit from the low tax rate, he stated that the same reasoning would imply that we then should

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<sup>13</sup> Testimonies to the Senate Committee on Finance at the July 11, 2007 U.S. Senate Hearings on carried interest

<sup>14</sup> NAIOP (Commercial Real estate development Association) – 2011 Government Affairs/ Carried Interest)

<sup>15</sup> Randy Drummer, “Real Estate Groups Warn That Carried Interest Tax Could Harm Recovery,” CoStar Group, June 2, 2010.

have the same low tax rate on other professions who help investors such as financial planners and 401(k) administrators.<sup>16</sup>

Yet another issue is whether or not the amount treated as compensation would be subject to payroll taxes. Beginning in 2013, Medicare tax has been increased to 3.8 percent for taxpayers with income over \$250k (\$200k single) as well as an additional Medicare tax of 3.8 percent on net investment income including carried interest.

#### **IV. ALTERNATIVE PROPOSALS**

##### **A. Treat All Carried Interest as Compensation**

One proposal is to tax at ordinary income rates all carried interest. This is based on the argument that if an employee or a sole proprietor were to provide the same kind of service, he or she would be subject to ordinary income tax and Social Security taxes.

President Obama's 2012 budget proposal contained a provision to tax carried interest as a services partnership interest (SPI). A partner's share of income from an SPI that is not attributable to invested capital would be taxed as ordinary income. This treatment would apply regardless of the character of the income at the partnership level and it would be subject to self-employment tax as well.

Treating all carried interest as compensation has tax policy appeal in simplification and consistency. Absent the court cases and the revenue procedure that established the current system of taxation, the Code already fully addresses the issue of value received as compensation, in Code §83.

With regard to the possibility of a clawback provision in a carried interest arrangement, the Code also addresses both property received with a substantial risk of forfeiture, in deferring realization until the risk lapses, or giving the taxpayer the option to report the compensation at the time and value of receipt.<sup>17</sup>

##### **B. Hybrid Approaches**

Several proposals involve hybrid treatment of income received. One such proposal is the taxation at time of income realization for the receipt of the profits interest at ordinary income rates and the rest at capital gains rates. Another such proposal is to impose annual income realization on the service partner. Since the general partner gets an interest in the partnership based upon unrealized gain, this is very similar to getting an interest-free loan from the other partners equivalent to his or her profits interest. Thus another proposal would be to treat the general partner's carried interest as a nonrecourse loan from the limited partners to the general partner and to tax the imputed interest on the loan as ordinary income and the rest of the profit as capital gains.

In another proposal during the 2007 Senate hearings on carried interest, it was suggested that the proposal to tax as ordinary income a portion of the carried interest should be subjected to large income partnerships only thereby not unduly burdening smaller partnerships with lower income.

Yet another proposal would be to use a simplified approach using a specific allocation percentage. This was the approach in the short-lived portions of H.R. 4213 that addressed carried interest, and perhaps has some viability even if in a modified form.

For example 60 percent of carried interest income could be taxed at capital gains rates, and 40 percent as ordinary income. This specific allocation strategy works with Section 1256 contracts.<sup>18</sup> Under Section 1256 market rules, all gains and losses for certain securities including futures and options are taxed at 60 percent capital

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<sup>16</sup> Fn. 13, *supra*.

<sup>17</sup> Code §83(b).

<sup>18</sup> Code §1256 includes regulated futures contracts, foreign currency contracts, non-equity options, dealer equity options, and dealer securities futures contracts

gains rates and 40 percent short-term capital gains rates (currently taxed at ordinary income rates) irrespective of the actual holding period of the underlying securities. Applying the same principles, we can tax carried interest using specific allocation percentages for capital gains and ordinary income at maybe a 60/40 or a 50/50 rate of allocation. This might be a fair compromise irrespective of how much of invested capital to partnership income that the general partner contributes. It would also have the advantage of reducing “taxpayer burden,” a concern that populates most discussions of IRS practices.

### **C. The “Buffett Rule”**

The so-called Buffett rule concept had its genesis in an op-ed piece by Warren Buffett in *The New York Times*. The piece was a criticism of the fact that wealthiest Americans paid taxes at a lower rate than working Americans, and singled out two abuses in particular:

*Some of us are investment managers who earn billions from our daily labors but are allowed to classify our income as “carried interest,” thereby getting a bargain 15 percent tax rate. Others own stock index futures for 10 minutes and have 60 percent of their gain taxed at 15 percent, as if they’d been long-term investors.*<sup>19</sup>

The words that resonated for the American audience were: “...what I paid was only 17.4 percent of my taxable income — and that’s actually a lower percentage than was paid by any of the other 20 people in our office. Their tax burdens ranged from 33 percent to 41 percent and averaged 36 percent.”<sup>20</sup>

In the wake of that piece, proponents of a smaller gap between the tax rate paid by someone like Warren Buffett and the tax rate paid by his staff have adopted the concept of the “Buffett Rule.” Although not a rule actually articulated by him, both the rule and the image of an overtaxed secretary have become a popular meme. Most recently, in the 2012 State of the Union address, President Obama stated:

*Right now, Warren Buffett pays a lower tax rate than his secretary... Tax reform should follow the Buffett rule: If you make more than a million dollars a year, you should not pay less than 30 percent in taxes... Now, you can call this class warfare all you want. But asking a billionaire to pay at least as much as his secretary in taxes? Most Americans would call that common sense.*<sup>21</sup>

As the State of the Union is by nature a statement of generalities, there was no indication of whether this Buffett rule would be instead of taxing carried interest as compensation, or on overlay on top of it. Either way, the Buffett Rule would make the distinction between dividend/capital gains income and ordinary income negligible, and the critics of the current system would likely be satisfied.

The Buffett Rule concept has had echoes elsewhere. In the United Kingdom, for instance, there were proposals to raise the capital gains tax from 18 percent to up to 50 percent for those earning over 150,000 pounds a year (approximately 250,000 dollars) according to a June 16, 2010 Bloomberg report. Considering that most “successful” hedge fund managers earn well beyond this income threshold, this proposal will mitigate the whole issue of treating carried interest as ordinary income or capital gains.<sup>22</sup>

In fact, what ultimately passed in the U.K. was far less dramatic. Effective as of June 2010, the United Kingdom has had a two-tier capital gains tax: a flat 18% tax for most taxpayers, and a flat 28% tax for higher earners, but the threshold for the higher tax is a more modest amount, originally £37,400, which as been criticized as not being adequate to close the disparity in taxes paid by the wealthy and the working class.<sup>23</sup> Whether the U.K. will eventually adopt a plan closer to the Buffett Rule remains to be seen.

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<sup>19</sup> Warren E. Buffett, “Stop Coddling the Super-Rich,” *The New York Times*, August 14, 2011.

<sup>20</sup> *Id.*

<sup>21</sup> Source used: [www.cnn.com](http://www.cnn.com)

<sup>22</sup> Fn 6, *supra*.

<sup>23</sup> David Teather, “Capital gains tax rises to 28% for higher earners,” *The Guardian*, June 22, 2010.

Where do things stand at the beginning of 2013? The issue of carried interest was not addressed in the “fiscal cliff” tax law changes enacted in January. However, further waves of tax changes are expected, and, as there will be considered cuts that hurt the middle class (such as home mortgage interest deduction and Social Security retirement benefits), it is likely that the favorable tax treatment of carried interest will also be scrutinized. “While few concede defeat publicly, the industry is rethinking its strategy. Rather than trying to stop the changes outright, lawyers and executives behind the scenes are trying to minimize the hit if it happens.”<sup>24</sup>

## **V. CONCLUSION**

There have been several debates and opinions on the debacle of carried interest, with some policymakers proposing to keep it as it is and some proposing to tax all of it at ordinary income rates, but most agree that at least some portion of the carried interest is deemed to be a sort of compensation. Aligning Wall Street tax rates with that of Main Street may itself be beneficial to revenue collection.

There is no clear-cut answer to the above issues, because the arguments appear to represent political rather than policy postures. Differences in opinion abound about how much accommodation should be given to financial firms and how much regulation of business the government should impose. Although the prior budget proposal plan on taxing carried interest as compensation subject to ordinary income and payroll taxes seems just and fair and more in line with economic and tax equity, some kind of political compromise may be necessary to get a bill passed through both the House and Senate. Finally, we could follow the Buffett Rule and tax all income over a certain income threshold at ordinary income rates thus making the carried interest debacle less of an issue.

## **AUTHOR INFORMATION**

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<sup>24</sup> Jane Sasseen, “With Tax Advantages Looking Shaky, Private Equity Seeks a New Path,” *The New York Times*, January 21, 2013.

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