[Florida Tax Review](https://scholarship.law.ufl.edu/ftr)

Volume 20 Article 5

2023

The Fallacious Objections to the Tax Treatment of Carried Interest

Douglas A. Kahn
University of Michigan Law School

Jeffrey H. Kahn
Florida State University College of Law

FLORIDA TAX REVIEW

Volume 20 *2017* *Number 5*

THE FALLACIOUS OBJECTIONS TO THE TAX TREATMENT OF CARRIED INTEREST

by

Douglas A. Kahn[*] *and Jeffrey H. Kahn*[**]

I. INTRODUCTION

The tax treatment of carried interest has become a notorious *bete noire* for many politicians and some academicians and practitioners.[1] Both 2016 presidential candidates denounced the current tax treatment and vowed to change it.[2] President Obama described the current treatment as a "tax loophole" which should be closed.[3] Others have also characterized the current tax treatment as an abusive loophole.[4] It is the thesis of this article that those

* Paul G. Kauper Professor of Law Emeritus, University of Michigan Law School.

** Harry W. Walborsky Professor of Law, Florida State University College of Law. The authors would like to thank Gregg Polsky for his helpful comments and suggestions.

1. *See, e.g.*, Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 NYU L. REV. 1 (2008); Jay Starkman, *Practitioner Argues for Taxing Carried Interest as Ordinary Income*, 2015 TAX NOTES TODAY 206-14 (Oct. 26, 2015).

2. *See* Wesley Elmore, *Clinton Would Ask Treasury to End Carried Interest Preference*, 2016 TAX NOTES TODAY 116-3 (June 16, 2016).

3. Kat Lucero, *Obama Criticizes Tax Break on Carried Interest*, 2015 TAX NOTES TODAY 180-5 (Sept. 17, 2015).

4. *See Democrats, Millionaires Group Oppose Carried Interest Preference*, 2016 TAX NOTES TODAY 122-23 (June 24, 2016). The cited report

criticisms are unfounded. To the contrary, the current tax treatment accords with sound tax policy and is proper and appropriate. Given the broad approval that attended the attacks on carried interest, a reader might well be skeptical of our claim; but if you will bear with us, we are convinced that we can sustain it.

Just what is carried interest? The term is used to describe a profits interest in a partnership that invests in equities. The typical arrangement is that a number of investors contribute capital to a partnership in exchange for a partnership capital interest.[5] The partnership will invest in equities to be selected by another partner who has expertise in investing and whose partnership interest is sometimes referred to as a carried interest. For convenience, we will refer to the partner who holds the carried interest as the "managing partner." The managing partner contributes little or no capital to the partnership. Instead, the managing partner contributes his services in selecting and managing the investments. The investments often are made in depressed companies, and the managing partner uses his expertise to try and turn those businesses around and make them profitable so that they can be sold for a large profit. The managing partner typically receives two different types of interests in exchange for his contribution. The managing partner usually receives a partnership profits interest of 20% in the partnership in exchange for his future services.[6] In addition, the managing partner receives a right to an annual fee of 2% of the invested capital of the partnership, and the payment of those fees will be ordinary income to the managing partner.[7] It is the managing partner's partnership profits interest that is referred to as a carried interest.

---

included a quotation from Representative Sander Levin that, "[t]he carried interest tax loophole is a vivid example of the unfairness in our nation's tax code." *Id.*

5. As used herein, a "partnership capital interest" refers to a partnership interest that provides rights to the contributed capital of the partnership as well as to its profits. A "partnership profits interest" refers to a partnership interest that provides rights only to the profits of the partnership, and provides no right to any of the capital contributed to the partnership. If a partnership profits or capital interest is received in exchange for services, it is referred to as a "compensatory partnership interest." A compensatory partnership interest can be either a profits interest or a capital interest. They are distinguished by referring to them as a "compensatory partnership profits interest" or a "compensatory partnership capital interest" respectively.

6. *See* Gregg D. Polsky, *Private Equity Management Fee Conversions*, 122 TAX NOTES 743, 744 (Feb. 10, 2009).

7. *Id.* Some managing partners have converted their management fee to a partnership interest in an effort to avoid ordinary income treatment. That raises additional issues that are not discussed in this article. For a discussion of that issue, see Polsky, *supra* note 6.

The typical form of entity employed for carried interest plans is a limited partnership in which the managing partner is the general partner[8] and the investors are limited partners. So, the managing partner would be liable to creditors for partnership losses. However, since the partnership's business is investing in equities, the only losses the partnership is likely to incur are losses of the capital contributed by the investing partners. As a result, even if the investments do badly, there will be no requirement for the managing partner to contribute to the partnership to satisfy partnership debts.

What are the current tax treatments of the carried interest that the managing partner holds? His receipt of a partnership profits interest in exchange for his future services will not cause him to incur any tax liability. We will discuss that feature later in this Introduction.[9] If the partnership earns net income, that income will be allocated among the partners at the end of the partnership's taxable year.[10] The income that is allocated to a partner has the same characteristics that it had in the hands of the partnership.[11] Consequently, if the partnership has ordinary income (such as dividends[12] and interest), the managing partner's share of that income is treated as ordinary income. If the partnership earns capital gains, the managing partner's share of that capital gain has the same character in his hands. If the enterprise is successful, the partnership will earn a large amount of capital gains from the sale of its equities, and the managing partner's 20% share of that gain will be taxed at capital gain rates. In successful ventures, the managing partner's share can be millions of dollars.

The complaint against the treatment of carried interest is aimed at the characterization of the managing partner's share of the partnership's capital gains as also being capital gains. The contention is that since the managing partner receives his share for services performed, he should be taxed at ordinary income rates rather than the preferentially lower capital gain rates. The contention is that the profits of one's labor are taxed at ordinary income rates, and so the managing partner's income from his labor should also be

8. A managing partner often forms a single member LLC to hold the general partnership interest. Since the LLC does not elect to be taxed as a corporation, it is disregarded for federal income tax purposes; and the managing partner, as an individual, is deemed to be the general partner of the partnership. *See* Reg. § 301.7701–3(a).

9. *See infra* notes 17–21 and accompanying text.

10. I.R.C. §§ 702(a), 706(a).

11. I.R.C. § 702(b).

12. However, currently most dividends received by an individual from a domestic corporation are taxed at capital gains rates. I.R.C. § 1(h)(11).

taxed at those rates. We will explore that contention in Part II of this article and demonstrate why it is incorrect[13].

To some extent, the complaint against the tax treatment of carried interests is grounded in a distaste for the preferential tax treatment of all capital gains.[14] The question of the proper tax treatment of capital gains is a much broader topic than the question of its application to carried interest. Suffice it to say, that the complaint against carried interest is much narrower, and this article will not deal with the question of whether there should be preferential treatment for capital gains. Currently, there is no significant political movement to dispense with preferential tax rates for capital gains. Instead, the discussion is confined to the application of capital gains to carried interests.

Different solutions have been proposed to the perceived problem of the treatment of carried interests. The most direct response is to adopt legislation that will tax the managing partner's share of capital gains at ordinary income rates. But an alternative suggestion is to tax the managing partner on the value of the compensatory partnership profits interest when he receives it.[15] If that change were the only one made, it would not likely satisfy those complaining of the current tax situation because it would not alter the capital gain treatment of the managing partner's distributive share of the partnership's gains. The value of the profits interest would be difficult to determine, and so the amount of tax imposed on the managing partner would not likely be large enough to satisfy those complainants. Moreover, if the managing partner were taxed on the receipt of a compensatory partnership interest, that would eliminate any possible justification for treating his share of partnership capital gains as ordinary income.[16]

---

13. *See infra* Part II.

14. For example, see Starkman, *supra* note 1. *See also* Heather M. Field, *The Real Problem with Carried Interests*, 65 HASTINGS L. J. 405, 410, 429 (2014).

15. Alan J. Wilensky proposed that Treasury revoke Rev. Proc. 93–27, 1993–2 C.B. 343, which provides, subject to several exceptions, that the receipt of a compensatory partnership profits interest will not cause income recognition to the partner. Alan J. Wilensky, *The True Story About the Taxation of Carried Interest*, 150 TAX NOTES 1173 (Mar. 10, 2016). It is noteworthy that a revocation of Rev. Proc. 93–27 would not necessarily result in causing the recipient of a compensatory partnership interest to incur a tax liability. *See* Douglas A. Kahn, *The Proper Tax Treatment of the Transfer of a Compensatory Partnership Interest*, 62 TAX LAW. 1 (2008).

16. If the managing partner were taxed on the receipt of a compensatory partnership profits interest, it would be equivalent to paying him cash, which he promptly contributed to the partnership in exchange for the partnership interest. In essence, he would have purchased his partnership interest just as the other investors had. There would be no justification for treating his allocations of income any differently from the allocations made to other partners.

The exclusion of the receipt of a compensatory partnership profits interest from income has a long history. For years, the courts wrestled with the question of whether it should be included in income and how to value it. In 1993, the Service promulgated Revenue Procedure 93–27 declaring that, with a few exceptions, the receipt of a compensatory partnership profits interest is excluded from income.[17] That Revenue Procedure was modified in 2001 by Revenue Procedure 2001–43,[18] but that modification need not concern us. In 2005, Treasury promulgated a number of proposed amendments to its regulations some of which apply to this issue. In its preamble to those proposed regulations, Treasury stated that compensatory partnership profits and capital interests would be treated the same and both would be subject to taxation under § 83.[19] However, in the event that the proposed regulations are finalized, Proposed Regulation section 1.83-3(l) and Notice 2005–43[20] provide a safe harbor under which a partner can utilize the liquidation value of his interest as its tax value. Under that safe harbor, the value of a managing partner's compensatory partnership profits interest would be zero since on the immediate liquidation of the partnership, he would receive nothing. Consequently, the managing partner would not incur any tax liability from the receipt of the partnership interest.[21]

II. THE CASE FOR CARRIED INTEREST

A. *Self-Created Property*

While it is true that the profits from an individual's labor often are treated as ordinary income, that is not always so. A major exception arises when an individual converts his labor into property and then disposes of the property. Gain from the sale of such self-created property can be a capital gain, and if it is not, there will be other reasons for that characterization that have nothing to do with the fact that the gain was the product of the individual's labor.

Consider this example. Alice purchased a building as an investment. Alice was not in the trade or business of improving or selling realty. Alice used her labor and a small amount of capital to improve the building. The

17. 1993–2 C.B. 343.

18. 2001–2 C.B. 191.

19. *See* Preamble to Prop. Regs. §§ 1.83–3, 1.83–6, 1.704–1, 1.706–3, 1.707–1, 1.721–1, 1.761–1, 70 Fed. Reg. 29,675 (May 24, 2005).

20. Notice 2005–43, 2005–1 C.B. 1221.

21. We will not discuss the proper treatment of the receipt of a compensatory partnership profits interest in this article. In a prior article by one of the co-authors, this issue was discussed in depth. *See* Kahn, *supra* note 15.

improvements were made over a period that is greater than one year. When the work was finished, Alice sold the building for a handsome profit. Most of that profit is attributable to the labor that Alice devoted to the project. Nevertheless, the entire amount of the profit Alice earned is treated as long-term capital gain.[22] The value that Alice created by her labor is sometimes referred to as "sweat equity."

If Alice had previously sold a number of buildings, she would likely be treated as selling to customers in the ordinary course of a trade or business. In that case, her gain from the sale would be ordinary income,[23] but the reason for that treatment would have nothing to do with her profiting from her labor. In that situation, even if she had put no labor into the project but had nevertheless sold the building for a profit, her gain would be ordinary income.

Let us now consider an example whose circumstances are similar to the carried interest situation. Alford has expertise and talent in making investments. Alford spends numerous hours reading and researching the market and examining the records of specific companies in which he might invest. Alford invests his capital in purchasing stocks, and he produces very large profits from the sale of those investments. The profits he earns are a product of both his capital investment and his labor in researching and choosing the best investments. Nevertheless, all of the gains he recognizes from the sale of those investments are treated as capital gains.[24]

What are the significant differences between Alford's situation and that of a managing partner's holding a carried interest? Those differences need to be examined when determining whether the self-created property exception is applicable to a carried interest.

There are two significant differences. One is that Alford invested his own capital whereas a managing partner benefits from the capital contributed

---

22. *Cf.* Rev. Rul. 75–524, 1975–2 C.B. 342 (§ 1231 asset constructed in stages treated as having bifurcated holding period).

23. Section 1221(a)(1) excludes from the category of a capital asset property that was held by the taxpayer primarily for sale to customers in the ordinary course of a trade or business. I.R.C. § 1221(a)(1).

24. Congress has imposed ordinary income treatment for gains from certain self-created works such as gain from the creation of literary or artistic compositions. I.R.C. § 1221(a)(3). However, no exception has been made for the labor put into investing in stocks, and so those narrowly defined statutory exceptions have no relevance to the carried interest situation. Note that the exclusion of self-created artistic compositions does not apply to most self-created musical compositions. I.R.C. § 1221(b)(3). This indicates that the opposition to capital gains treatment for self-created works is narrowly defined to specifically identified ventures. It is implausible that Congress would ever want to make an exception for the labor put into investing in equities.

by others. A related difference is that Alford bears the risk of a loss if the value of his investments declines, but a managing partner has little or no capital at risk. To see why these differences do not justify treating a managing partner differently, we need to examine the nature of fictional entities, especially a partnership, and how the tax law treats those entities and their members. Before turning to the treatment of entities, a few other points should be noted.

Professor Chris Sanchirico contends that the tax treatment of self-created property should not be applied to carried interests.[25] Professor Sanchirico claims that there is no revenue loss to the government and no overall tax benefit to the self-creating party when an individual converts sweat equity into property because the same person who receives the benefit of the labor is the one who performs the labor, and so there is no difference in marginal tax brackets.[26] If the seller of the self-created property were to pay compensation to a service provider who was in the same marginal tax bracket as the seller, the reduction of the seller's tax liability from deducting that payment would equal the increase in tax incurred by the service provider; and so the overall tax consequence would be a wash insofar as the government's collection of revenue is concerned.[27] In the context of self-created property, the seller performs both roles and so the treatment of the seller's gain from the sale as capital gain does not result in a revenue loss to the government.[28] In contrast, in the case of carried interest, the managing partner will be in a different marginal tax bracket than a number of the investors in the enterprise. From that observation, Professor Sanchirico concludes that an overall zero tax revenue consequence to the government is a required element for applying the self-created property principle.[29]

Among other problems with Professor Sanchirico's analysis, there are two that are dispositive in repudiating it. One is that it is not true that the application of the self-created property principle to non-carried interest transactions never provides a tax benefit to the person creating the property. To the contrary, there are numerous situations in which the creator of the property has a tax benefit and there is a resulting revenue loss to the government. Consequently, the contention that the government must not suffer any revenue loss for the self-created principle to apply is incorrect.

Professor Sanchirico's point is that the creator of property can be seen as operating in two separate roles. One role is as the person providing the labor, and the second role is as the person paying compensation for that labor. For

25. Chris William Sanchirico, *Taxing Carry: The Problematic Analogy to "Sweat Equity,"* 117 TAX NOTES 239 (Oct. 15, 2007).

26. *Id.*

27. *Id.*

28. *Id.*

29. *Id.*

the overall transaction to be a wash, the constructive payment of compensation for the labor must be a fully deductible expense. To the contrary, typically there would be no deduction for the payment of such compensation; and even if a deduction were allowed, only a portion of the payment would be deductible.[30] Consequently, Professor Sanchirico's asserted balance of a deduction matching the income from the constructive wage does not exist.

The payment for services to create property for use in the payor's business or for sale is not a deductible expense. Instead, such payments must be capitalized and added to the basis of the created property.[31] Moreover, even if such payments were not required to be capitalized, if incurred in the investment context, they typically would be miscellaneous itemized deductions and, as such would either not be deductible at all or only a portion of the payment would be deductible.[32]

Take the example above of Alice who used her labor to improve realty, which she then sold at a profit. Alice is not in the trade or business of selling or improving property. Consequently, if not required to be capitalized, any payment made by her for services to improve the building would be a nonbusiness expense under Code section 212 and would be a miscellaneous itemized deduction under Code section 67. As such, a part of that expense would not be deductible, and none of it would be deductible if Alice is subject to the Alternative Minimum Tax.[33] So, the treatment of self-created property provides a significant tax benefit to Alice, and her benefit is no different in principle from the tax advantage obtained because of the different marginal tax brackets of some investors and the managing partner. Similarly, the same tax benefit occurs in the example above in which Alford invested in stocks. The deduction for fees paid to manage stock investments is a miscellaneous itemized deduction.

Another problem with Professor Sanchirico's analysis is that it focuses on a comparison of the self-created property situation with the position of the managing partner.[34] As shown below, the question is not whether the self-created property principle applies to the managing partner but rather is whether it applies to the partnership. Under established and appropriate partnership tax rules, the characterization of the gain recognized on the partnership's sale of its equities is determined by reference to the partnership and not by reference to each partner separately.[35] Professor Sanchirico's

30. *See* I.R.C. §§ 263, 263A.

31. *See* I.R.C. §§ 263, 263A; Comm'r v. Idaho Power Co., 418 U.S. 1, 13 (1974).

32. I.R.C. § 67.

33. I.R.C. § 56(b)(1)(A).

34. *See* Sanchirico, *supra* note 25.

35. I.R.C. § 702(b).

analysis ignores how partnerships and partners are treated by the tax law and more importantly how they should be treated. It is only when the proper treatment of partnerships and partners is examined that it becomes clear that the current treatment of carried interest is correct.

Some might contend that the self-created property treatment typically applies to the performance of services by a single individual. In the case of carried interests, multiple parties are involved. Should the self-created property rule be inapplicable to multiple party situations? The answer is that the number of persons involved is irrelevant. For example, Harry and Laura decide to go together on building a boat, which they will sell. They contribute equal amounts to purchase the wood and other items they need, and they work together to build the boat. They have never sold a boat before, and so when they sell this one, they have a capital gain. The fact that two persons are involved in the creation of the boat does not require them to recognize imputed income on creating it nor does it prevent them from recognizing capital gain on the sale.

The application of the self-created property exception does not depend upon the taxpayer having invested a significant amount of capital. In Alford's case, he did; but that is not true for some other self-created properties. For example, Winston, who is a successful politician, does woodwork as a hobby. Winston created an especially beautiful and ornate china cabinet. Winston spent $100 in creating the cabinet. A visitor to Winston's home admires the cabinet and offers to purchase it for $3,500, and Winston accepts. While Winston had minimal capital invested in the property, his gain will nevertheless be a capital gain.

It is not true that a managing partner bears no risk of loss if the venture fails. He has little or no capital at risk. However, he is at risk that his labor will be for naught. He has invested his time and labor, and it will be lost if there is no return for it. The loss of one's labor is no less significant than the loss of one's capital. A managing partner's waste of his labor constitutes a loss of part of his human capital. While the loss of cash can be replaced, the lost labor can never be replaced.

More importantly, it does not matter whether a managing partner bears a risk of loss. As shown below, the self-created property treatment applies to the partnership as contrasted to its partners. Obviously, the partnership bears a risk of loss.

B. The Tax Treatment of Partnerships

A number of persons may wish to combine some of their resources in a joint enterprise. They can do so by utilizing a fictional entity such as a partnership or a corporation.[36] The contributions to the entity can take different forms. Some may contribute cash; some may contribute items of property, some may contribute future services, and some may contribute a combination of those. The parties' hope is that the synergy obtained from combining their contributions will produce greater income than otherwise could be obtained. In recognition that it would be undesirable for the tax law to impose impediments to the formation of partnerships, the Code has facilitated their use by permitting flexibility in the types of interests that partners can hold in a partnership.[37]

It is quite common for partnerships to have some partners contribute property and some contribute services. For example, Robert and Stephanie have capital to invest in a business that is for sale, but they lack the entrepreneurial and management skills to operate the business. Elizabeth possesses those needed skills. Elizabeth is unwilling to provide her services for a fee, and she will do so only if she is given an interest in the venture so that she can benefit from any profits she helps create. The three parties create the X partnership. Robert and Stephanie contribute cash to the partnership in exchange for a partnership capital interest. Elizabeth receives a compensatory partnership profits interest as payment for her future services in managing the

---

36. An equity investment entity can be a partnership or it can be an LLC. *See* Reg. § 301.7701–3(a). An LLC that has more than one member will be treated as a partnership for income tax purposes unless the entity elects to be treated as a corporation. *Id.* It is extremely unlikely that an equity investment entity would choose to be taxed as a corporation. Consequently, we have focused on the tax treatment of partners and partnerships. In any event, the carried interest issue arises only in the context of a partnership or an LLC. Since there is virtually no likelihood that an equity investment entity will need additional capital contributions to cover its losses, there is little benefit to adopting the LLC form of entity.

37. *See* I.R.C. § 704. Professor Cauble contends that the restrictions in the Code on the flexibility of allocating partnership tax items are not adequate to prevent what she perceives to be the carried interest problem. Professor Cauble advocates changing the current allocation rules. Emily Cauble, *Was Blackstone's Initial Public Offering Too Good To Be True?: A Case Study in Closing Loopholes in the Partnership Allocation Rules*, 14 FLA. TAX REV. 153 (2013). The allocation of the capital gain income to the managing partner equals the amount of dollars of that gain that will be distributed to that partner. The managing partner will receive 20% of the capital gains earned by the partnership, and it is perfectly consistent with tax policy to assign for tax purposes 20% of the capital gains to him. The only exception to that assignment treatment occurs with certain family partnerships (I.R.C. § 704(e)), and the rules there are designed to prevent the successful anticipatory assignment of income from one family member to another. The arrangement among the investors and the managing partner is a commercial one, and there is no effort to anticipatorily assign income to anyone.

business. Elizabeth is not taxed on the receipt of that partnership interest.[38] Subject to certain limitations, the partnership agreement can determine Elizabeth's share of each item of partnership income.[39]

It is possible to view a partnership in two distinctly different ways. One way is to treat a partnership as a separate entity in the same way that a C corporation[40] is treated. Alternatively, a partnership can be viewed as merely a representative of the aggregate interests of the partners. For some years, state and tax laws wrestled with the question of which of those treatments was more appropriate. When Congress first enacted Subchapter K[41] in 1954, it chose not to adopt either of those views exclusively. Instead, it treated a partnership as an aggregate of the partners' interests for some purposes and as a separate entity for other purposes.

As to the characterization of income earned by the partnership, the Code adopts a pure entity view. The character of the income is determined by its character in the hands of the partnership—i.e., it is determined as if it were earned directly by the partnership rather than determined separately for each partner's share.[42] The income with the character that is attributed to the partnership is then allocated among the partners at the end of the partnership's taxable year.[43] Consider the following example.

In the last month of its taxable year, the X partnership recognized a long-term capital gain on the sale of land. Part of that gain is allocated to Martin who has held his partnership interest in X for only 3 months. The gain allocated to Martin will be treated as long-term capital gain even though Martin did not hold his partnership interest for more than one year.[44] A part of the X partnership's gain is allocated to Martha who is in the business of selling land to customers. The gain allocated to Martha will be treated as long-term capital gain even though if Martha herself had owned and sold the land, she would have recognized ordinary income.[45]

---

38. *See supra* notes 17–21 and the accompanying text.

39. *See* I.R.C. § 704.

40. A C corporation is a corporation that has not made a valid election to be treated as a pass-through entity under Subchapter S. *See* Reg. § 301.7701–3.

41. Subchapter K is the principal part of the Internal Revenue Code that deals with partnerships.

42. I.R.C. § 702(b). In certain circumstances in which a partnership sells property that was contributed to the partnership by a partner, the character of the gain or loss recognized on the sale of that property may be controlled by the character the property had when it was held by the contributing partner. I.R.C. § 724. That provision is not applicable and has no relevance to the carried interest issue.

43. I.R.C. §§ 702(a), 706(a).

44. Rev. Rul. 68–79, 1968–1 C.B. 310.

45. I.R.C. §§ 702(b), 1221(a)(1).

In essence, the partners' contributions (whether in property or services) are amalgamated in the partnership, and the partnership is treated as a single person. Each partner has an interest in the partnership rather than in the individual items of property that the partnership holds. In this respect, a partnership interest is somewhat similar to stock in a corporation.

The critics of carried interest would treat a managing partner's share of partnership income as a payment for his ongoing services. That characterization is inaccurate. The partnership compensated the managing partner for his services by giving him a partnership interest. The subsequent allocation of partnership profits to him is a return on his partnership interest. The contention that the allocation to the managing partner is compensation for his services contravenes the approach to partnerships that the tax law has applied for more than 60 years. It is significant that many of the critics do not seek to change the way partnerships and partners are treated other than for equity investment partnerships.[46] They seek to make an exception exclusively for carried interests (i.e., generally only for equity investment partnerships) and would leave untouched the treatment of comparable compensatory partnership interests. Of course, Congress has the power to isolate carried interests and treat them differently. But, it cannot be said that it would be curing a loophole in the tax law. To the contrary, Congress would be subjecting carried interests to a tax scheme that is inconsistent with the established treatment of partnership interests. It would effectively constitute a penalty imposed on the managing partners. Congress has the power to exact penalties, but it is improper to falsely characterize one as a cure for a loophole that does not exist. A loophole refers to a glitch in the tax law that is inconsistent with tax policy. The current treatment of carried interests is perfectly consistent with established and proper tax policy. It is the proposal to treat carried interest as ordinary income that would constitute a departure from established and appropriate tax policy.

One of the benefits of the partnership vehicle is that it provides so much flexibility in choosing the types of interests that a partner can be given.[47] The managing partner receives a compensatory partnership interest for his promise of future services. The capital of his fellow partners and his services are combined in a single venture. The income from that venture is then divided

---

46. Some proposals, however, would reach the income received on any compensatory partnership profits interest. *See* Sanchirico, *supra*, note 25.

47. *See e.g.*, I.R.C. § 704. We discussed in note 37, *supra*, Professor Cauble's contention that the flexibility allowed to the allocation of partnership items is the source of the carried interest problem and should be changed. As explained in that note, we see no reason to object to the tax allocation to the managing partner of 20% of the partnership's capital gain when the managing partner will ultimately receive 20% of the partnership's capital gain income as a distribution.

among the partners. The managing partner does not receive payments from the partnership for his services. He received a partnership interest as payment for future services, and that partnership interest constitutes an item of property. The managing partner converted his services into property, and that property has the capacity to produce income just as any item of property is capable of doing. The managing partner's situation is akin to a shareholder who receives stock in a corporation in exchange for his future services. While the tax consequences to the shareholder for receiving stock are different from the consequences to a partner receiving a compensatory partnership interest, in both cases, the property, in the form of either stock or a partnership interest, is the source of the income that is paid thereon from the entity.

A partner can perform services in his capacity of being a partner. In so doing, he is not treated as an employee of the partnership or of the other partners. The Code expressly recognizes that there are circumstances where the services performed by a partner are performed in a non-partner capacity; and in such cases, the partner is treated as an employee of the partnership; and the payments made to him are treated as wages.[48] As shown below, that provision does not apply to the services performed by a managing partner since his services are performed in his capacity of being a partner.

The Code does provide that a partnership can make payments to a partner that are treated as compensation for services performed in a non-partner capacity. Section 707(a) treats services performed by a partner in a non-partner capacity the same as if the partnership were dealing with a third party, and so payments made to the partner will be treated as compensation. In certain narrowly defined circumstances, a purported partnership allocation to a partner can be characterized as a disguised payment for services to a person acting in a non-partner capacity. In 2015, Treasury promulgated a proposed regulation (Proposed Regulation section 1.707-2) that is designed to expand the application of § 707(a) to disguised payments. Even under the expanded approach of that proposed regulation, the allocation of income to a managing partner clearly is not a disguised payment for services. The proposed regulation lists six factors that are to be taken into account.[49] The proposed regulation states that the most important factor is whether the arrangement with the partner lacks significant entrepreneurial risk.[50] Entrepreneurial risk refers to a risk as to the amount of income that a partner will receive.[51] In the case of carried interests, both the amount of income that will be allocated to

48. *See* I.R.C. § 707(a).

49. Prop. Reg. § 1.707–2(c), 80 Fed. Reg. 43,652 (July 23, 2015).

50. *Id.*

51. Prop. Reg. § 1.707–2(d), Exs. (2) & (6), 80 Fed. Reg. 43,652 (July 23, 2015).

the managing partner and whether any income will be allocated to him depends upon how much income the partnership will earn on its investments, and that amount is unpredictable. The examples in the proposed regulations make clear that the normal carried interest arrangement will not be treated as a disguised payment.[52] Typically, none of the other five factors listed in that proposed regulation will apply to a carried interest arrangement.[53]

Since the managing partner's distributions and allocations from the partnership manifestly are not disguised payments, they are treated as partnership allocations and distributions. The distributions from a partnership to a partner will not be included in the partner's income except to the extent that the distributions exceed the partner's basis in his partnership interest.[54] So, the only income that a managing partner will have from the partnership is the income allocated to him under §§ 702 and 704. Even if a distribution were to exceed the managing partner's basis in his partnership interest, the gain he recognized would be a capital gain.[55]

When a partnership recognizes a gain from the sale of equities, the gain is attributable to a combination of capital investment and labor. Since the partnership is treated as a single person, the gain recognized by the partnership, like the gain recognized by Alford in an example above, is gain from self-created property. In the prior example, Alford provided all of the capital and labor; and in the case of the partnership, it is the partnership itself that provides all of the capital and labor. The fact that the partnership's assets and labor are derived from multiple persons is reflective of the essential nature of a partnership. The treatment of the partnership as a single person for purposes of characterizing its recognized gains is a fundamental principle of partnership taxation. It accurately reflects the purpose of the jural recognition of a partnership as an entity–namely to permit multiple parties to pool their resources in a single unit that itself is treated as a unique person.

III. CONCLUSION

The politicians and others who have attacked the current treatment of carried interest have done so on the ground that it is a loophole in the tax system. They suggest that an error was made in the design of the Code that results in gross unfairness in the allocation to the public of the costs of operating the government. As we have shown above, that is untrue, and the current treatment of carried interest accords with good tax policy. The actual basis of the objection to carried interest lies in contentions concerning

52. Prop. Reg. § 1.707–2(d), Ex. (6), 80 Fed. Reg. 43,652 (July 23, 2015).
53. *Id.*
54. I.R.C. § 731(a).
55. Reg. § 1.731–1(a)(3).

economic policy.[56] Whatever one thinks of the merits of the competing positions on the economic issues, the current tax treatment is not a loophole or a glitch. By labelling it so, the critics have attempted to change the nature of the issue to make their position appear so much more appealing to the public. They do a disservice to the debate on this issue by characterizing it as a loophole in the Code rather than as a question of economic policy and of whether the principles of the tax law concerning the treatment of partnerships and partners should be perverted in order to achieve a chosen economic goal. Relevant to that discussion is the amount of revenue that the government would acquire if it were to change the treatment of carried interest, and there are reasons to question whether the estimates of the amount of revenue at stake are realistic.[57]

Critics of the treatment of carried interest claim that only the partnership form of entity provides a vehicle for capital gain treatment to persons managing the investments.[58] While partnerships are the preferred form, the same consequence for income allocation could be obtained by forming an S corporation. In that case, the managing shareholder would recognize ordinary income on the value of the stock he receives, and that is one of the reasons that the partnership form is used. However, the capital gain income of an S corporation would be allocated to its shareholders, and the managing shareholder would treat his allocated income as capital gains just as a managing partner does.[59] Similarly, if a manager were to purchase a

---

56. *See e.g.*, Fleischer, *supra* note 1. Fleischer's arguments ultimately rest on his assumption that the allocation of partnership profits to a managing partner is compensation for his services. As previously shown, that is incorrect. The compensation that the managing partner received for his services was the receipt of a partnership interest. The profits of the partnership that are allocated to him are the products of that partnership interest.

57. If the income allocated to a managing partner were treated as compensation for his services, that would make them deductible by the partnership and that ordinary deduction would then be allocable to its partners. To the extent that the investing partners are in the same marginal tax bracket as the managing partner, the change would be a wash for the government. It is unlikely that those investors that are individuals or taxable corporations are in a much lower marginal tax bracket than the managing partner. However, a sizeable number of investors are tax-exempt organizations to which the deductions will be useless. The principal revenue gain to the government will be the amount of deduction that is allocated to tax-exempt organizations. *See* Fleischer, *supra* note 1, at 13–14. Several commentators have noted that changing the tax treatment of income received on a carried interest would not have a significant impact on the government's need for additional revenue. *See e.g.*, Field, *supra* note 14, at 436.

58. *See e.g.*, Fleischer, *supra*, note 1, at 3–4.

59. I.R.C. § 1366(a), (b).

partnership profits interest for its value, and were to provide his services without compensation or for low wages, the allocation of capital gain income to him as a partner would not be objectionable. This indicates that it is not the allocation of capital gain income that is the true object of the complaint; rather it is the combination of both the receipt of the partnership interest being free from tax and the capital gain characterization of the partnership's income that offends some persons.[60] There is no principled reason for treating the allocation of partnership income differently because of the decision not to tax the receipt of the partnership interest.

If the 2005 proposed regulations are finalized, the receipt of a compensatory partnership profits interest will be included in the managing partner's income, but if certain tests are satisfied, the value of the interest is deemed to be so speculative as to be treated as zero. That zero valuation is appropriate.[61] There is no principled justification for taxing the income from a compensatory partnership profits interest differently when the value of the partnership interest upon receipt was zero than it would be treated if the value of the partnership interest upon receipt was a small amount above zero.

The reason that carried interest has attracted so much attention and furor is that the amount of dollars obtained by managing partners has been so large. It is the view of the authors that legislative actions that contravene established and valid principles should not be undertaken merely because one is displeased with the amount of income obtained by some highly successful persons. The attack on carried interest has an element of envy of the success of those persons who benefit from it.

60. *Cf.* Field, *supra* note 14, at 416–417, 421.
61. *See* Kahn, *supra* note 15.