

# The Real Problem with Carried Interests

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*The recent proposals to reform the tax treatment of private equity, venture capital, and hedge fund managers are misguided. Policymakers and commentators often take industry-focused, results-oriented approaches to the “carried interest” debate, thereby obscuring the real source of the policy objection to carried interests. Instead of starting with a result that is objectionable and trying to find a way to change the law to avoid the objectionable result, this Article begins with the law and facts relevant to carried interests and systematically unpacks the tax rules that combine to produce the current tax treatment of carried interests. As a consequence, this Article provides structure to the voluminous discourse about carried interests, identifies the key features of the tax law that are most likely to cause hostility toward carried interests, and analyzes how to design reform proposals that are most responsive to each objection. More generally, this Article redirects attention away from the narrow carried interest issue and toward the more fundamental aspects of the tax system that need reform.*

*Ultimately, the appropriate response to the carried interest controversy (assuming a response is warranted) depends on whether the crux of the problem is the use of equity compensation, one or more technical aspects of the partnership tax rules, revenue needs, distributive justice considerations, disapproval of the fund industry, or something else entirely. But the recent legislative proposals fail to respond effectively to any of these issues, and should be therefore abandoned. Instead, policymakers should uncover and fix their fundamental problem with carried interests.*

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## INTRODUCTION

The Cut Unjustified Loopholes Act, introduced by Senator Carl Levin on February 11, 2013, is one of the latest legislative attempts to

reform the tax treatment of private equity, venture capital, and hedge fund managers who receive interests in fund profits (“carried interests”) as compensation.<sup>1</sup> Senator Levin joins President Obama and many other policymakers and commentators in calling for carried interest reform.<sup>2</sup>

But these recent reform proposals are misguided. This is not because the current tax treatment of fund managers is necessarily appropriate. Rather, this is because recent commentators and policymakers have failed to systematically unpack the features of the tax law that combine to produce the current tax treatment of fund managers’ carried interests. This failure obscures the real source of the policy objection to the taxation of carried interests.

The recent discourse generally reflects an industry-oriented approach that focuses on the tax treatment of compensatory partnership interests primarily in the private equity fund, venture capital fund, and hedge fund industries.<sup>3</sup> This contrasts starkly with older literature on compensatory

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1. Cut Unjustified Tax Loopholes Act, S. 268, 113th Cong. (2013). Senator Levin reintroduced the carried interest legislation on February 11, 2013. See Senator Carl Levin, Levin Floor Statement on Cut Unjustified Tax Loopholes Act (Feb. 11, 2013), <http://www.levin.senate.gov/newsroom/speeches/speech/levin-floor-statement-on-cut-unjustified-tax-loopholes-act>. Similar proposals have been introduced over the past several years, but none has been enacted. See, e.g., Carried Interest Fairness Act of 2012, H.R. 4016, 112th Cong. §§ 2–3; Job Creation and Tax Cuts Act of 2010, S. 3793, 111th Cong. § 401; H.R. 2834, 110th Cong. § 1 (2007).

2. In the *Fiscal Year 2014 Budget Proposal*, President Obama renewed his call for carried interest reform. See OFFICE OF MGMT. & BUDGET, FISCAL YEAR 2014 BUDGET OF THE U.S. GOV'T 18 (2013) [hereinafter FISCAL YEAR 2014 BUDGET]; *Reforming the Tax Code*, THE WHITE HOUSE, <http://www.whitehouse.gov/economy/reform/tax-reform> (last visited Jan. 15, 2014) (President Obama calling for Congress to “close the carried interest loophole for investment fund managers”); see also *infra* notes 8–9, 39 (citing a wide variety of recent calls for carried interest reform).

3. See generally *Tax Treatment of Compensation Paid to Hedge, Private Equity and Venture Capital Fund Managers: Hearing Before the S. Comm. on Fin.*, 110th Cong. (2007) (statement of Darryll K. Jones, Professor of Law, Stetson University School of Law) [hereinafter Jones Statement] (focusing on the fund industry); STAFF OF JOINT COMM. ON TAXATION, 110TH CONG., PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS AND RELATED ISSUES, PART I (same); Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1 (2008) (focusing on the taxation of service partners in the fund industry); Lynn Forester de Rothschild, *A Costly and Unjust Perk for Financiers*, Op-Ed., N.Y. TIMES, Feb. 25, 2013, at A17 (focusing on “an already privileged sliver of financiers”); see, e.g., Adam H. Rosenzweig, *Not All Carried Interests Are Created Equal*, 29 NW. J. INT'L L. & BUS. 713, 723–24, 734 (2009) (explaining the general framing of the debate, not as a controversy over the “technical application” of the partnership rules, but rather as a question about whether managers of private equity funds should be able to be compensated with income that is taxed at preferential rates). But see generally *How to Tax Carried Interests: Hearing Before the S. Comm. on Fin.*, 110th Cong. (2007) (statement of Mark P. Gergen, Fondren Chair for Faculty Excellence, Univ. of Texas Sch. of Law) (recommending that the carried interest reform apply to all partnerships); Bradley T. Borden, *Profits-Only Partnership Interests*, 74 BROOK. L. REV. 1283 (2009) (considering the tax treatment, generally, of partners who receive interests in partnership profits). Cf. Philip F. Postlewaite, *Fifteen and Thirty-Five—Class Warfare in Subchapter K of the Internal Revenue Code: The Taxation of Human Capital upon the Receipt of a Proprietary Interest in a Business Enterprise*, 28 VA. TAX REV. 817, 890 (2009) (criticizing the “myopic focus upon a single industry”); Alan D. Viard, *The Taxation of Carried Interest: Understanding the*

partnership interests, which generally analyzed compensatory partnership interests more broadly regardless of industry.<sup>4</sup> But that older literature predates both the key revenue procedures regarding compensatory partnership interests<sup>5</sup> and the enormous growth of the fund industry that occurred over the past two decades.<sup>6</sup> Thus, today's debate is framed by the newer literature that generally adopts a narrow fund-focused approach.

Moreover, many recent political and popular commentators, and even some academic commentators, adopt a results-oriented approach. They often begin from the premise that carried interests should be taxed as ordinary income to a greater degree than under current law,<sup>7</sup> and they seek to design reforms that would achieve this goal.<sup>8</sup>

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*Issues*, 61 NAT'L TAX J. 445, 458 (2008) ("At a more fundamental level, it is not clear why partners providing investment services, however defined, should be treated differently from partners providing other forms of labor to partnerships.").

4. See generally Sheldon I. Banoff, *Conversions of Services Into Property Interests: Choice of Form of Business*, 61 TAXES 844 (1983); Martin B. Cowan, *Receipt of an Interest in Partnership Profits in Consideration for Services: The Diamond Case*, 27 TAX L. REV. 161 (1972); Laura E. Cunningham, *Taxing Partnership Interests Exchanged for Services*, 47 TAX L. REV. 247 (1992); Mark P. Gergen, *Pooling or Exchange: The Taxation of Joint Ventures Between Labor and Capital*, 44 TAX L. REV. 519 (1989) [hereinafter Gergen, *Pooling or Exchange*]; Mark P. Gergen, *Reforming Subchapter K: Compensating Service Partners*, 48 TAX L. REV. 69 (1993) [hereinafter Gergen, *Service Partners*]; Barksdale Hortenstine & Thomas W. Ford, Jr., *Receipt of a Partnership Interest for Services: A Controversy That Will Not Die*, 65 TAXES 880 (1987); Leo L. Schmolka, *Taxing Partnership Interests Exchanged for Services: Let Diamond/Campbell Quietly Die*, 47 TAX L. REV. 287 (1992). It is not, however, enough merely to refer back to the older literature, as that literature does not sufficiently address the carried interest issue. This is because those commentators generally wrote prior to the 1993 and 2001 revenue rulings regarding compensatory partnership interests, and prior to the enormous growth of the fund industry that occurred over the past two decades. Moreover, the older articles predate the industry focused discourse, so they could not argue against that narrow focus.

5. Rev. Proc. 93-27, 1993-2 C.B. 343; Rev. Proc. 2001-43, 2001-2 C.B. 191.

6. Assets under management by hedge funds and private equity funds recently hit new record highs at \$2.25 trillion and \$3 trillion, respectively. *Hedge Fund Assets Under Management Reach New Record*, MFA BLOG (Jan. 18, 2013) <https://www.managedfunds.org/2013/01/hedge-fund-assets-under-management-reach-new-record>; Press Release, Preqin, Private Equity Assets Hit \$3tn: Growth of Industry Continues as Performance Figures Show Recovery (July 30, 2012), [www.preqin.com/docs/press/2012\\_Performance\\_Monitor.pdf](http://www.preqin.com/docs/press/2012_Performance_Monitor.pdf). The older literature also predates the high-profile press about the excesses of fund managers who exemplify increasing income inequality. See, e.g., James B. Stewart, *The Birthday Party*, NEW YORKER, Feb. 11, 2008, at 100 (explaining how Stephen Schwarzman's lavish birthday party shortly following Blackstone's IPO made Schwarzman "private equity's designated villain").

7. See, e.g., Darryll K. Jones, *Sophistry, Situational Ethics, and the Taxation of the Carried Interest*, 29 NW. J. INT'L L. & BUS. 675, 675 (2009) (providing a "strident expression of indignation" and calling it "a patently offensive outcome" that "sometimes extraordinarily well-paid fund managers receive compensation taxed at capital gains rates" whereas all "other, usually very much lower-compensated, service providers are taxed at ordinary rates"); Alan S. Blinder, *The Under-Taxed Kings of Private Equity*, N.Y. TIMES, July 29, 2007, at 4(L) (calling it "hard to swallow" that "[s]ome people who are richer than Croesus are paying 15 cents in federal income taxes on the marginal dollar, while you may be paying 25 or 35 cents"); Warren E. Buffett, Op-Ed, *A Minimum Tax for the Wealthy*, N.Y. TIMES, Nov. 26, 2012, at A27 ("We need to get rid of arrangements like 'carried interest' that enable

Given the current industry-focused and results-oriented discourse, proposals to reform the taxation of carried interests are often ad hoc rather than measures that would be intellectually coherent within our existing tax regime and that would address the fundamental problem(s) behind carried interests. As a result, the recent legislative proposals regarding carried interests would make the tax code more complex, increase transaction costs, and further distort taxpayer incentives as to the structure of compensation for service partners. Even more problematic is that all of the attention on carried interest reform proposals diverts policymakers' time and energy away from the critical issues of fundamental tax reform and toward this narrow (but politically salient) issue that is merely a symptom of underlying problems that plague the tax system.

So rather than starting with a result that is objectionable and trying to find a way to change the law to avoid the objectionable result, this Article begins with the law and facts relevant to carried interests and systematically unpacks the tax rules that combine to produce the current tax treatment of carried interests. The benefits of this approach are threefold.

First, this Article provides much-needed structure to the voluminous discourse about carried interests. Second, by parsing the tax treatment of carried interests and identifying the features of the tax law that are most likely to be the sources of hostility toward carried interests, this Article helps policymakers devise reforms that are responsive to the root of that hostility. Of course, different readers may have different normative objections to carried interests. But our inability to agree about reform could be explained by these differences. Unless each of us understands what really troubles us about carried interests, it is difficult to have a

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income from labor to be magically converted into capital gains.”); *Romney Supports Retaining Tax Loophole That Keeps His Tax Rate Lower than Middle-Class Americans*, ORGANIZING FOR ACTION (Feb. 24, 2012), <http://www.barackobama.com/truth-team/entry/romney-supports-retaining-tax-loophole-that-keeps-his-tax-rate-lower-than-m> (reporting that during the 2012 election campaign, President Obama criticized Mitt Romney for supporting an “unjustified” and “unfair tax loophole for the wealthy”).

8. See, e.g., Fleischer, *supra* note 3, at 47–59 (explaining a variety of reform alternatives to tax all or part of the carried interests as ordinary income); Press Release, Senator Carl Levin, Levin Statement on Need to Close Carried Interest Loophole (Jan. 24, 2012), <http://www.levin.senate.gov/newsroom/press/release/levin-statement-on-need-to-close-carried-interest-loophole> (“Of all the tax loopholes that have tilted the tax code toward wealthy individuals, the carried interest loophole is one of the most egregious. It allows hedge fund managers and certain others to pay a special tax rate far lower than what they should owe on their income, lower than the rate millions of American families pay.”). A minority of commentators argue that the current manner of taxing carried interests should not be changed. See, e.g., Douglas A. Kahn & Jeffrey H. Kahn, *In Defense of the Current Treatment of Carried Interest*, 139 TAX NOTES 1203, 1203 (June 3, 2013); David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 VA. L. REV. 715, 719 (2008).

candid and productive conversation about how to proceed conceptually or concretely.<sup>9</sup> However, whatever one's fundamental problem with carried interests, the recent legislative proposals to change the tax treatment of carried interests are not likely to solve that problem. Thus, instead of resuscitating those proposals, policymakers should determine the crux of their problems with carried interests and then identify (or, if needed, design) reform that is both as responsive as possible to the core of the problem and as consistent as possible with the rest of the tax system. By parsing the law to identify the source of the fundamental problem with carried interests, this Article facilitates policymakers' abilities to fix what they really believe is broken.

Third, this Article redirects attention away from the narrow issue of carried interests toward the broader, more fundamental aspects of the tax system that are in need of reform. The underlying problem that motivates the uproar about carried interests is not carried interests per se. Rather, the objection is likely to a larger and more fundamental part of the tax system, such as the capital gains preference or our tax system's overall degree of progressivity.<sup>10</sup> Thus, this Article's systematization of the carried interest debate leverages the political salience of this debate to help policymakers identify which parts of the broader tax law they think are most in need of reform. Then, as our legislators embark on comprehensive tax reform,<sup>11</sup> they can try to focus their time and effort on addressing these bigger, more important problems that plague the tax system, rather than focusing on narrow issues such as carried interests.

A couple of caveats are warranted before proceeding. This Article does not purport to highlight every possible objection to carried interests.

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9. Of course, the political process can also seriously hinder the potential to reach an agreement on reform. But even where well-intentioned policymakers focus on substance rather than posturing, the failure to communicate effectively and the inability to understand the motivations of the other parties to the negotiation can impede the ability of policymakers to compromise. Admittedly, people sometimes agree on the same change for different reasons, and so it is possible that being more explicit about the reasoning could lead to more quarrels rather than less. On balance, however, I think it is preferable for people engaging in a discourse to have a clear understanding of their concerns and the possible concerns of others involved in the discourse. Moreover, given that the industry-focused, results-oriented political discourse regarding carried interests has not been fruitful even after six years of proposed legislation, more insight into the issues could help break the stalemate.

10. Indeed, the core concern may not even be a tax issue; rather, the problem could be the fund industry itself and the activities of the players in the industry.

11. Legislators are increasingly discussing the possibility of fundamental tax reform, but it is uncertain whether these efforts will ultimately lead to comprehensive reform. *See generally* Lindsey McPherson, *Ways and Means Members to Meet and Plan Bipartisan Tax Reform Process*, 140 TAX NOTES 422 (2013); Meg Shreve & Michael M. Gleeson, *Few Senators Willing to Make Tax Reform Suggestions Public*, 140 TAX NOTES 545 (2013); Press Release, Senator Max Baucus, U.S. Senate Comm. on Finance, Baucus Statement on the Public Calling for Tax Reform (July 25, 2013), <http://www.finance.senate.gov/newsroom/chairman/release/?id=893d0598-fd94-4493-b7b1-ae4635ba6619>.

Rather, it focuses on the objections that are most likely to arise from the major components of the analysis of the tax treatment of carried interests. Surely there are additional objections that could be levied. Moreover, the possible objections discussed below are not equally persuasive. While this discussion focuses on the objections that are most likely to generate hostility toward carried interests, some objections are clearly stronger than others. Nevertheless, each is certainly a legitimate basis on which someone could object to carried interests.

In addition, this Article does not advance an original proposal for carried interest reform, provide comprehensive discussions of the various reform proposals advanced in the literature, or endorse any particular proposal other than to oppose the recent legislative proposals. Further, this Article does not even argue that reform is necessarily needed. Rather, it leaves each reader to decide for herself whether and what reform is appropriate. But by methodically cataloging the potential objections and responses thereto, this Article imposes structure on the discourse, thereby improving each individual's ability to identify the source(s) of her concern about carried interests (and thus, about the tax system in general) and providing her with a deeper appreciation of how to create responsive and effective reform.

This Article begins by briefly explaining the current tax treatment of carried interests and the recent legislative proposals for reform. Then, for each major component of the analysis that contributes to the overall tax treatment of carried interests, this Article articulates why that portion of the analysis may be a source of an objection to carried interests. For each objection, this Article discusses the design and the scope of responsive reform. On the issue of the "scope" of reform, this Article pays particular attention to questions such as whether the relevant reform ought to apply to all compensatory partnership interests or only to carried interests. Further, as part of the discussion of responsive reforms, this Article explains why the recent legislative proposals regarding carried interests are less than ideally responsive to the identified concern. This Article concludes by recommending that policymakers think about more than class warfare and vilification of the fund industry; rather, policymakers should focus on implementing the reform that addresses the heart of the carried interest problem and that addresses the broader, more fundamental problems of the tax system.

#### I. UNPACKING THE TAX TREATMENT OF CARRIED INTERESTS

Compensation paid to managers of private equity funds, venture capital funds, and hedge funds is generally comprised of two economic entitlements. First, managers typically receive a management fee equal to

a percentage (often two percent) of the assets managed by the fund.<sup>12</sup> Second, managers receive a right to share in the fund's future profits (a "carried interest").<sup>13</sup> While the specific terms of carried interests vary from fund to fund, carried interests commonly entitle the manager to twenty percent of the profits earned by the fund.<sup>14</sup>

The value received by private equity and venture capital fund managers on account of carried interests is taxed, often to a significant extent, at the preferential long-term capital gains ("LTCG") rate.<sup>15</sup> This bottom line tax result, however, is the product of several different tax rules acting in tandem. In order to respond appropriately to the concerns about carried interests, we must first understand the different rules that contribute to the overall treatment of carried interests.

Thus, this Part provides a step-by-step analysis of the taxation of carried interests under current law and briefly describes recent legislative proposals for reform.

#### A. TAX ANALYSIS OF CARRIED INTERESTS UNDER CURRENT LAW

Many businesses, including private equity funds, opt to compensate service providers, in whole or in part, with ownership interests in the business. Of course, the specific ownership interest depends on the type of entity in which the business is operated. Private equity funds, venture capital funds, and hedge funds are generally operated by entities that are treated as partnerships for federal income tax purposes. Thus, a fund manager receives a partnership interest in exchange for services provided to the fund.

##### *1. Tax Treatment of Managers upon Grant of the Carried Interest*

A partnership interest granted in exchange for services is classified, for federal income tax purposes, either as a "profits interest," which only entitles the holder to an interest in future profits, or as a "capital interest," which also entitles the holder to a share in the underlying assets of the partnership at the time the interest is granted.<sup>16</sup> Capital interests are

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12. See generally JACK S. LEVIN & DONALD E. ROCAP, STRUCTURING VENTURE CAPITAL, PRIVATE EQUITY, AND ENTREPRENEURIAL TRANSACTIONS ¶ 1004 (2013).

13. See generally *id.* ¶ 1006.4.

14. See generally *id.* ¶ 1002.1.

15. Hedge fund managers, on the other hand, generally do not benefit from the preferential LTCG rate because of the type of assets held by hedge funds.

16. Rev. Proc. 93-27, 1993-2 C.B. 343 § 2. The regulations proposed in 2005 regarding compensatory partnership interests do not, on their face, distinguish between profits interests and capital interests. Partnership Equity for Services, 70 Fed. Reg. 29675 (proposed May 24, 2005) (to be codified at 26 C.F.R. pt. 1). These regulations have stalled likely pending resolution of the carried interest controversy.



generally taxable to the service provider upon grant.<sup>17</sup> In contrast, profits interests are generally not taxable to the service provider upon grant as long as certain requirements are met.<sup>18</sup> In the fund industry, profits interests are often referred to as “carried interests.” Thus, managers who receive carried interests (just like other service providers who receive profits interests) are generally not subject to tax upon receipt of the interest. As a result, taxation of fund managers is generally deferred.

## 2. *Tax Treatment of Managers During the Life of the Fund*

Partners, including partners who receive their interests in exchange for services, are taxed on their distributive shares of partnership income.<sup>19</sup> The timing of the partner’s inclusion of the income depends on the partnership; a partner includes her share of that partnership income in her taxable year that includes the end of the partnership’s taxable year.<sup>20</sup> And most taxpayers, including partnerships, are taxed on the gain from an asset only when that gain it is realized and recognized—as opposed to being taxable as the asset appreciates in value, like under a mark-to-market approach to taxation.<sup>21</sup> Thus, in the private equity and venture capital fund contexts, in which fund assets are usually held for a period of years before they are sold, the taxation of a holder of a carried interest is generally deferred until the fund disposes of fund assets.<sup>22</sup>

When partnership income is finally recognized, the character of the income (i.e., capital gain or ordinary income) is generally determined at

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17. *McDougal v. Comm’r*, 62 T.C. 720, 727 (1974).

18. Rev. Proc. 93-27, 1993-2 C.B. 343 § 4 (providing that the grant of the interest will be nontaxable if the service provider receives the interest “for the provision of services to or for the benefit of the partnership in a partner capacity or in anticipation of being a partner,” as long as the profits interest does not relate “to a substantially certain and predictable stream of income from partnership assets,” as long as the partner does not dispose of the interest within two years of receipt, and as long as the partnership is not a “publicly traded partnership” within the meaning of Internal Revenue Code of 1986, as amended, (“I.R.C.”) § 7704(b)). Further, if the profits interest is subject to a substantial risk of forfeiture, both the grant of the interest and the lapse of the forfeiture restrictions will be non-taxable. Rev. Proc. 2001-43, 2001-2 C.B. 191. The proposed regulations yield the same result, albeit through a slightly different analytical mechanism. Specifically, the proposed regulations provide a safe harbor that allows any compensatory partnership interest (whether profits or capital) to be valued at its liquidation value. *Partnership Equity for Services*, 70 Fed. Reg. at 29675. This approach to valuation results in the same tax treatment of these interests upon grant—a profits interest (liquidation value of zero) is not taxed upon grant, and a capital interest (positive non-zero liquidation value) is taxed upon grant.

19. I.R.C. §§ 702–04 (2012).

20. *Id.* § 706(a).

21. *Id.* § 1001.

22. If a holder of a carried interest sells her interest, that could also trigger the recognition of gain, even if the fund has not yet disposed of its assets. *Id.* § 741.

the partnership level.<sup>23</sup> This characterization determines the rate of tax paid by the partner on the income.<sup>24</sup> This partnership-level characterization of partnership income generally applies to all partners, without regard to whether the partner received her interest for a contribution of money, other property, or services. Further, this tax treatment of service partners applies both inside and outside the fund context. Thus, in the private equity fund context, where income is typically characterized as LTTCG, a holder of a carried interest is taxed on her allocable share of partnership income primarily at preferential LTTCG rates. As a result, fund managers often pay tax on income from a carried interest at a rate that is lower than the rate of tax that they would otherwise pay on salary, which is generally taxed at ordinary income rates.

### 3. *Bottom-Line Result*

The tax analysis above indicates that fund managers typically pay taxes on the income from their carried interests at a rate that is lower than their marginal ordinary income tax rate. This rate reduction is often the leading message about carried interests, at least in popular media and political discourse.<sup>25</sup>

## B. RECENT REFORM PROPOSALS

Many scholars, policymakers, and other commentators object to the bottom-line consequence of the fund managers' abilities to pay tax at a rate that is lower than the rate of tax that they would otherwise pay on salary.<sup>26</sup> These commentators argue that value received by fund managers on account of carried interests received for services should be taxed, at least in part, at ordinary income rates (recently raised from 35% to 39.6% for those in the highest marginal tax bracket),<sup>27</sup> rather than entirely at the preferential LTTCG rate (recently raised from 15% to 20% for high-income

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23. *Id.* § 702(b). One major exception to the entity-level characterization rule relates to contributed property, where the character of income earned by the partnership may be determined with respect to the contributing partner instead. *Id.* § 724.

24. *Id.* § 1.

25. See *supra* note 8; see, e.g., Peter Lattman, *Romney Disclosure Reignites Debate Over Carried Interest*, N.Y. TIMES DEALBOOK BLOG (Jan. 17, 2012, 4:13 PM), <http://dealbook.nytimes.com/2012/01/17/romney-disclosure-reignites-debate-over-carried-interest-tax>; *The Daily Show with Jon Stewart: Indecision 2012: I Know What You Did Last Quarter*, at 2:15–6:20 (Comedy Central television broadcast Jan. 24, 2012), available at <http://thedailyshow.com/watch/tue-january-24-2012/indecision-2012--i-know-what-you-did-last-quarter>.

26. See *supra* notes 2–4, 8, 9.

27. American Taxpayer Relief Act of 2012 § 101(b)(3)(A), I.R.C. § 1 (2013) (imposing a 39.6% tax bracket above the 35% bracket).

taxpayers<sup>28</sup>).<sup>29</sup> For these reasons, the President, legislators, and others have proposed reform.

Specifically, President Obama continues to advocate for taxing carried interests at ordinary income rates. President Obama's proposed budgets repeatedly include the change,<sup>30</sup> and he has continued to advocate reform since his reelection to a second term.<sup>31</sup>

Additionally, bills to add a new section 710 to the Internal Revenue Code of 1986, as amended (the "I.R.C." or the "Code"), which would change the tax treatment of carried interests, have been introduced multiple times in Congress,<sup>32</sup> including in 2013.<sup>33</sup> Some of the details of the legislative proposals have changed over time, but very generally, proposed section 710 would treat as ordinary income all or part of the income from a service partner's "investment services partnership interest."<sup>34</sup> Importantly, the recharacterization provision only applies to partners who provide certain types of services (e.g., investment, management, and financing advice) with respect to "specified assets" (e.g., securities, rental or investment real estate, partnership interests, and derivatives).<sup>35</sup> The recharacterization provision would not apply to a partner's "qualified capital interests," which very generally are partnership interests to the extent that the holder's entitlement is derived

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28. *Id.* § 102 (imposing a tax rate of twenty percent on certain long term capital gain income of high income individuals).

29. *See supra* note 8.

30. *See, e.g.*, OFFICE OF MGMT. & BUDGET, FISCAL YEAR 2013 BUDGET OF THE U.S. GOVERNMENT 40 (2012) ("This [carried interest] tax loophole is inappropriate and allows these financial managers to pay a lower tax rate on their income than other workers. The President proposes to eliminate the loophole for managers in investment services partnerships and to tax carried interest at ordinary income rates."); FISCAL YEAR 2014 BUDGET, *supra* note 2, at 18.

31. *See* THE WHITE HOUSE, *supra* note 2; *Obama Questions "Carried Interest" Tax Break*, CNBC (Feb. 3, 2013), [http://www.cnbc.com/id/100429960/Obama\\_Questions\\_039Carried\\_Interest](http://www.cnbc.com/id/100429960/Obama_Questions_039Carried_Interest); FISCAL YEAR 2014 BUDGET, *supra* note 2, at 18.

32. *See* Carried Interest Fairness Act of 2012, H.R. 4016, 112th Cong. §§ 2-3; Rebuild America Act, H.R. 5727, 112th Cong. §§ 341-42 (2012); American Jobs Act of 2011, H.R. 12, 112th Cong. §§ 411-12; Job Creation and Tax Cuts Act of 2010, S. 3793, 111th Cong. § 401; Tax Extenders Act of 2009, H.R. 4213, 111th Cong. § 601; H.R. 1935, 111th Cong. §§ 1-2 (2009); Alternative Minimum Tax Relief Act of 2008, H.R. 6275, 110th Cong. § 201; H.R. 2834, 110th Cong. § 1 (2007).

33. Cut Unjustified Tax Loopholes Act, S. 268, 113th Cong. (2013). Senator Levin reintroduced the carried interest legislation on February 11, 2013. *See* Senator Levin, *supra* note 1.

34. *See supra* note 33. Some of the details have evolved over time, but the core objective of the various iterations of proposed section 710 has remained constant.

35. *See generally* STAFF OF JOINT COMM. ON TAXATION, 111TH CONG., TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS CONTAINED IN THE "AMERICAN JOBS AND CLOSING TAX LOOPHOLES ACT OF 2010," FOR CONSIDERATION ON THE FLOOR OF THE HOUSE OF REPRESENTATIVES 259-87 (providing an explanation for the legislation). There are additional details, many of which are intended to prevent taxpayers from planning around the core objective of the section. However, for purposes of the discussion herein, the provisions described in the text are most relevant.

from contributions of money or property.<sup>36</sup> That is, proposed section 710 targets carried interests—situations where a manager provides investment advisory-type services to a fund that invests in securities and where the manager’s entitlement is not based on her contribution of property to the fund.

Practitioners and academics alike have critiqued the specific provisions of section 710.<sup>37</sup> In addition, scholars have proposed a wide array of alternative ways to reform the tax treatment of carried interests.<sup>38</sup> Although the technical tax proposals vary from proposal to proposal, most recommended reforms generally result in the taxation of part or all of the carried interests as ordinary income.

## II. DESIGNING REFORMS THAT ARE RESPONSIVE TO THE REAL POLICY OBJECTIONS TO THE TAXATION OF CARRIED INTERESTS

After parsing the analytical steps that explain the tax treatment of carried interests, we can identify the many different components of the analysis that could be the primary source of the hostility to carried interests. In turn, this allows a clearer identification of the reforms that are likely to be responsive.

This Part addresses potential objections to carried interests relating to the grant of the interest, the taxation of the interests during the operation of the partnership, and the big picture implications of the rules.

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36. *Id.*

37. *See, e.g.*, Howard E. Abrams, *A Close Look at the Carried Interest Legislation*, 117 TAX NOTES 961, 970 (2007); Jack S. Levin et al., *Carried Interest Legislative Proposals and Enterprise Value Tax*, 129 TAX NOTES 565, 566–69 (2010); Michael L. Schler, *Taxing Partnership Profits Interests as Compensation Income*, 119 TAX NOTES 829, 832–52 (2008); Letter from Charles H. Egerton, Am. Bar Ass’n Section of Taxation, to Senator Max S. Baucus, Senator Charles E. Grassley, Chairman & Ranking Member of the Comm. on Finance, Representative Sander M. Levin, Representative Dave Camp, Chairman & Ranking Member of the Comm. on Ways & Means, Comments on Carried Interest Proposals in Senate Amendment 4386 to H.R. 4213 (Nov. 5, 2010), available at <http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2010/110510comments.authchec.kdam.pdf>.

38. *See, e.g.*, Fleischer, *supra* note 3, at 52 (suggesting the “cost of capital method” and also discussing the “forced valuation” approach, among others); Samuel D. Brunson, *Taxing Investment Fund Managers Using a Simplified Mark-to-Market Approach*, 45 WAKE FOREST L. REV. 79, 82–83 (2010) (suggesting a modified mark-to-market approach); Noël B. Cunningham & Mitchell L. Engler, *The Carried Interest Controversy: Let’s Not Get Carried Away*, 61 TAX L. REV. 121, 128 (2008) (suggesting a modified interest charge approach that allows the service partner a deduction for the interest deemed paid); Borden, *supra* note 3, at 1286 (suggesting a “partnership disregard” approach); Gergen, *How to Tax Carried Interests*, *supra* note 3 (suggesting that all income from profits interests should be taxed as ordinary income); Rosenzweig, *supra* note 3, at 715–16 (suggesting an approach that focuses on holding periods); *see also* Paul Carman, *Taxation of Carried Interests*, 87 TAXES 111, 127–34 (2009) (providing an overview of various reform proposals).

A. OBJECTING TO THE TAX TREATMENT OF MANAGERS UPON GRANT OF THE CARRIED INTEREST

When a partnership grants a profits interest to a service partner, the grant is generally not a taxable event. Because a carried interest is merely a profits interest that is granted in the fund context, the grant of a carried interest to a fund manager does not result in current taxation.<sup>39</sup> Thus, focusing on the time the carried interest is granted, the root of the objection to carried interests could be the use of equity-based compensation (a profits interest) to compensate a fund manager or could be the non-taxation upon grant of that profits interest.

1. *Is the Problem with the Use of a Partnership Interest to Compensate Managers?*

Businesses often compensate service providers, at least in part, with equity interests in the business. When the business is operated in a corporation, the equity compensation typically takes the form of stock, restricted stock, stock options, stock appreciation rights, or phantom stock.<sup>40</sup> When the business is operated in a partnership, the equity compensation typically takes the form of a partnership interest.<sup>41</sup> Regardless of the specific form of equity-based compensation, compensating a service provider with an ownership interest in the business to which services are provided arguably reduces the agency problem between owners and managers.<sup>42</sup>

Equity compensation, however, does not provide a perfect alignment between the incentives of employees and owners, and many have criticized the use of equity compensation. For example, particularly in the public company context, scholars have argued that stock compensation can encourage managers to focus on short-term performance rather than long-term value generation,<sup>43</sup> and it can fail to

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39. See *supra* Part II.A.1.

40. See STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., PRESENT LAW AND BACKGROUND RELATING TO EXECUTIVE COMPENSATION 32–36, 42 (discussing forms of equity incentive compensation).

41. An alternative is the use of partnership options. However, while the Treasury Department recently promulgated final regulations articulating the tax treatment of *noncompensatory* partnership options, the regulations regarding *compensatory* partnership options (like regulations regarding compensatory partnership interests in general) remain in proposed form. T.D. 9612, 2013-13 I.R.B. 678 (promulgating the final regulations regarding non-compensatory partnership options); Partnership Equity for Services, 70 Fed. Reg. 29675 (proposed May 24, 2005) (to be codified at 26 C.F.R. pt. 1). The uncertainty with respect to the tax treatment of compensatory partnership options has impeded their use.

42. See generally Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 35 (1976).

43. See Lucian A. Bebchuk & Jesse M. Fried, *Paying for Long-Term Performance*, 158 U. PA. L. REV. 1915, 1922 (2010).

align incentives because managers can hedge away the risk inherent in the equity compensation.<sup>44</sup> In the carried interest context, scholars have noted that equity compensation increases the alignment of owners' and managers' interests. Depending on the design of the equity compensation, however, equity compensation can encourage managers to take on more risk than owners would want (e.g., where the terms of the carry make it akin to a very far out-of-the-money option) or could even encourage managers to take on less risk than owners would optimally want (e.g., where the carry is equivalent to an at-the-money or in-the-money option).<sup>45</sup>

There are many additional (and more nuanced) critiques of the utility and design of equity compensation,<sup>46</sup> and this discussion is not intended to provide a comprehensive summary. Instead, this discussion identifies that one source of commentators' objections to carried interests may be a fundamental objection to the use of equity compensation. That is, perhaps equity compensation, including carried interests, is not effective enough at reducing agency problems. If this is the concern, the appropriate response would deal with all equity compensation, or would at least try to ferret out which forms of equity compensation are least effective for aligning manager and owner incentives. Then, these types of equity compensation arrangements could be prohibited, limited in amount, or otherwise be regulated or disincentivized. But the legislative proposals to reform the tax treatment of carried interests are much narrower; they do not focus on all equity compensation, nor do they focus on all equity compensation in partnerships. They do not even focus on all partnership equity compensation granted in the form of profits interests.<sup>47</sup>

Rather, the carried interest tax proposal focuses only on profits interests within a particular industry. This focus might be justified if the use of equity compensation to align manager and owner incentives is particularly ineffective in the fund context, but this seems unlikely. In fact, carried interests have been identified as a good example of how

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44. See Eli Ofek & David Yermack, *Taking Stock: Equity-Based Compensation and the Evolution of Managerial Ownership*, 55 J. FIN. 1367, 1367-68 (2000).

45. See Victor Fleischer, *The Missing Preferred Return*, 31 IOWA J. CORP. L. 77, 97-108 (2005) (explaining the option analogy); Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1089-90 (2003).

46. See generally Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967 (2006) (providing a nuanced critique of the utility and design of equity compensation).

47. Moreover, if the objection is to the *tax treatment* of equity compensation (as opposed to the *use* of equity compensation), then an appropriate response would examine the taxation of all equity compensation, not merely carried interests. See Postlewaite, *supra* note 3, at 823-24 ("The narrowness of [the carried interest] inquiry precludes consideration of the overall proper tax treatment of human capital in compensatory transfers of equity interests in an enterprise. This exclusive focus on high-profile, recent developments in a single industry foreclosed an examination of the entirety of the issue of compensatory equity transfers across the continuum of business enterprise.").

equity compensation can reduce agency problems.<sup>48</sup> Moreover, the structure of fund manager compensation is a product of a contract, often heavily negotiated, between managers and sophisticated investors.<sup>49</sup> Given their level of sophistication, fund investors should be able to contract for the financial incentives that they want to create for managers. Thus, fund investors should be relatively well-positioned to protect themselves from agency problems. Indeed, the risk of misalignment of manager/owner incentives is likely more problematic when the owners are more dispersed and less sophisticated than typical fund investors. That would suggest focusing reform efforts (through the tax system or otherwise) on equity compensation *other than* carried interests.

Perhaps the concern about the use of equity-based compensation in the form of carried interests is not about protecting fund investors, but rather about protecting the public and the financial system. Some have argued that excessive risks taken by funds contributed to the financial crisis.<sup>50</sup> If carried interests create incentives for managers to take risks that impose externalities on the public, that could justify additional government intervention. Such intervention could involve prohibiting the use of carried interests, capping the portion of manager compensation that can be paid in the form of carried interests, or otherwise regulating the use of carried interests.

Alternatively, Congress could try to protect the public from excessive fund manager risk taking—not through regulation of fund compensation structure, but rather by disincentivizing the use of carried interests. However, encouraging people to do something (e.g., to stop using carried interests) is quite likely to be less effective than mandating a behavior change. Nevertheless, the use of disincentives is a viable approach to reduce the risk-encouraging impact of the use of carried interests. Disincentives, of course, can be designed in a variety of ways, including through unfavorable tax rules. However, the proposed reform to the tax

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48. Gilson, *supra* note 45, at 1072; Robert C. Illig, *The Promise of Hedge Fund Governance: How Incentive Compensation Can Enhance Institutional Investor Monitoring*, 60 ALA. L. REV. 41, 78 (2008).

49. See Heather M. Field, *The Return-Reducing Ripple Effects of the “Carried Interest” Tax Proposals*, 13 FLA. TAX REV. 1, 9 n.19–20 (2012) (highlighting several aspects of a manager’s carry that are often heavily negotiated).

50. *Hedge Funds, Systemic Risk, and the Financial Crisis of 2007–2008: Hearing on Hedge Funds Before the H. Comm. on Oversight and Gov’t Reform*, 110th Cong. 5 (2008) (statement of Andrew W. Lo, Harris & Harris Group Professor, MIT Sloan Sch. of Mgmt. & Chief Scientific Officer, AlphaSimplex Group, LLC), available at <http://papers.ssrn.com/sol3/papers.cfm?abstractid=1301217>; Jennifer S. Taub, *The Sophisticated Investor and the Global Financial Crisis*, in CORPORATE GOVERNANCE FAILURES: THE ROLE OF INSTITUTIONAL INVESTORS IN THE GLOBAL FINANCIAL CRISIS 188, 191–93 (James P. Hawley et al. eds., 2011); FINANCIAL CRISIS INQUIRY COMM’N, THE FINANCIAL CRISIS INQUIRY REPORT 28 (2011); INT’L ORG. OF SEC. COMM’NS, TECHNICAL COMM., HEDGE FUND OVERSIGHT: FINAL REPORT 6 (2009); THE JOINT FORUM, REVIEW OF THE DIFFERENTIATED NATURE AND SCOPE OF FINANCIAL REGULATIONS: KEY ISSUES AND RECOMMENDATIONS 4 (2010).

treatment of carried interests does not create an effective disincentive. The reform is not likely to curtail fund manager risk taking in an effort to limit the potential externalities for several reasons. First, hedge funds (not private equity funds or venture capital funds) have been the primary targets of those who argue that excess risk taking contributed to the financial crisis.<sup>51</sup> But the carried interest tax proposals are likely to have little impact on the hedge fund industry because very little of the income earned by hedge funds is typically characterized as long-term capital gain.<sup>52</sup> Second, if the carried interest tax proposals are enacted, private equity and venture capital funds may decide to restructure their compensatory arrangements with their managers as contingent fees.<sup>53</sup> This merely changes the form of the compensation arrangement to mitigate the adverse tax consequences of the tax reform, but it does not reduce (or does not significantly reduce) the incentive for risk taking. Third, the carried interest tax proposal may actually increase the incentive for managers to take risk rather than curtail it because of the way that tax reform could affect the operation of common fund agreement terms such as “clawbacks.”<sup>54</sup>

Ultimately, instead of trying to rein in manager behavior by modifying the compensatory relationships that create incentives for manager risk taking, there is a much more direct—and likely more effective—method for limiting the type of risk taking by funds that might have contributed to the financial crisis. Specifically, Congress could regulate funds and their investing activities directly. This possibility is discussed further in Part III.C.4 below.

2. *Is the Problem with the Failure to Impose Tax upon the Grant of Profits Interests to Service Partners?*

If a partnership interest is used to compensate a service partner, query how the grant of that interest should be taxed. Under current law, certain partnership interests, specifically “profits interests,” are not taxable to the recipient upon grant.<sup>55</sup> Because a carried interest is merely one type of profits interest, fund managers who receive carried interests

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51. See *supra* note 50.

52. Rosenzweig, *supra* note 3, at 733–34.

53. Field, *supra* note 49, at 30–31; see also Michael S. Knoll, *The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of Taxing Profit Interests as Ordinary Income*, 50 WM. & MARY L. REV. 115, 149–59 (2008) (discussing other possible industry reactions that could blunt the revenue impact of reform and result in very little change to the substantive economics of the compensatory arrangements).

54. Field, *supra* note 49, at 20–25 (explaining the possible impact of tax reform on the risk-taking incentives created by carried interests).

55. Rev. Proc. 93-27, 1993-2 C.B. 343.



in exchange for their management services generally do not have a taxable event when the interest is received.

Yet profits interests are not worthless. While profits interests by definition have a *liquidation* value of zero at the time of grant, profits interests have some positive *fair market* value.<sup>56</sup> This is, of course, because a profits interest has option value that comes from the possibility that the partnership might have future profits in which the profits interest partner would share. Thus, the grant of a profits interest is a compensatory transfer of property that has a positive fair market value.

Typically, when a taxpayer receives a compensatory transfer of property, the federal income tax law taxes the recipient on the fair market value of that property less any amount paid for the property.<sup>57</sup> Thus, the tax treatment of profits interests—non-taxable upon grant—is an exception to the general treatment of compensatory transfers. Perhaps this is the objection to the current tax treatment of carried interests—that it is unfair and inappropriate for the compensatory transfer of a profits interest to be nontaxable upon grant, particularly when the profits interest is granted for past or current services (as opposed to future services), while other unrestricted compensatory property transfers are generally subject to immediate taxation. Indeed, some commentators have advanced this critique.<sup>58</sup>

Of course, there are many exceptions to the general rule imposing tax on the fair market value of compensatory transfers of property. For example, amounts directed into qualifying retirement savings vehicles can be excluded from current taxation, and the value of qualifying incentive stock options are excluded from the recipient's current income.<sup>59</sup> These exclusions, however, are provided by Congress in the Code, whereas the favorable tax treatment for profits interest was neither enacted by Congress nor promulgated pursuant to notice and comment rulemaking;<sup>60</sup> the source of the authority is a mere revenue

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56. See Henry Ordower, *Taxing Service Partners to Achieve Horizontal Equity*, 46 TAX LAW. 19, 21 (1992) (arguing that using liquidation value to value profits interest is unsound).

57. I.R.C. §§ 61, 83 (2012). Assume cash method taxpayers for simplicity.

58. See, e.g., Cunningham, *supra* note 4, at 248 (arguing for immediate taxation when a profits interest is granted for completed or substantially completed services). See generally Lee A. Sheppard, *Massive Giveaway in Partnership Compensatory Options Regs*, 107 TAX NOTES 1487 (criticizing the IRS's willingness to allow taxpayers to use liquidation value to value profits interests, thereby avoiding any tax at grant).

59. See generally STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., PRESENT LAW AND ANALYSIS RELATING TO THE TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS AND RELATED ISSUES, PART II 24-33 (discussing ways that taxpayers can defer the taxation of services income).

60. The proposed regulations regarding compensatory partnership interests would have allowed the use of liquidation value for purposes of valuing the compensatory interest upon grant, but these proposed regulations have stalled. Partnership Equity for Services, 70 Fed. Reg. 29675 (proposed May 24, 2005) (to be codified at 26 C.F.R. pt. 1).

procedure.<sup>61</sup> This is not even a statement of the Internal Revenue Service's opinion about what the law is; it is merely a statement that the Service will not pursue this issue. Perhaps this issue is important enough that if profits interests ought to be nontaxable on grant, Congress ought to be the source of the authority for this treatment and impose appropriate limitations on such treatment, just as Congress has done with incentive stock options.<sup>62</sup> Moreover, other exclusions from income for compensatory transfers also (arguably) accomplish socially valuable policy objectives, such as encouraging people to save for retirement. In contrast, critics argue that profits interests are not sufficiently valuable—from a social policy perspective—to justify their favorable tax treatment. In particular, carried interests could be conceived of as a subsidy to encourage socially valuable “entrepreneurial risk taking,” but this subsidy justification has been heavily criticized.<sup>63</sup>

Then what is the policy justification for failing to impose tax upon the grant of a profits interest? Insight into the rationale is provided by the history of controversy about this topic, which was largely resolved in 1993 when the Service issued Revenue Procedure 93-27.<sup>64</sup> Without recounting the full history, key factors justifying the failure to impose tax upon the grant of a profits interest are the speculative value of a profits interest and the administrative difficulty of valuing a profits interest.<sup>65</sup> Indeed, even the proposed regulations regarding compensatory partnership interests demonstrate that valuation is a key issue; the

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61. Rev. Proc. 93-27, 1993-2 C.B. 343 (explaining that, under certain circumstances, “the Internal Revenue Service will not treat the receipt of such an interest as a taxable event”).

62. The tax treatment of carried interests is somewhat similar to the tax treatment for incentive stock options, and the favorable tax treatment for ISOs is provided by Congress by statute and is subject to significant limitations. I.R.C. § 442.

63. Arguably, the social policy benefit of subsidizing carried interests would be the facilitation of economic growth by preventing tax from standing in the way of efficient business collaborations between service providers and capital providers. See Fleischer, *supra* note 3, at 48 (explaining the argument that the tax treatment of profits interests can be understood as a subsidy for entrepreneurial risk taking). See generally Thomas J. Brennan & Karl S. Okamoto, *Measuring the Tax Subsidy in Private Equity and Hedge Fund Compensation*, 60 HASTINGS L.J. 27 (2008) (attempting to measure the subsidy). The subsidy argument as a defense of the tax treatment profits interests has been heavily criticized. Jones Statement, *supra* note 3, at 4 (criticizing the subsidy argument for favorable tax treatment of carried interests); Gergen, *Pooling or Exchange*, *supra* note 4, at 539 (describing as “preposterous” the argument that the favorable tax treatment of profits interest, particularly in the oil and gas industry, is justified as a subsidy).

64. See generally WILLIAM S. MCKEE ET AL., *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 5.02 (4th ed. 2007) (tracing the history that led to Rev. Proc. 93-27).

65. STAFF OF JOINT COMM. ON TAXATION, *supra* note 3, at 60 (acknowledging option value but explaining difficulty inherent in valuation). But see generally Ordower, *supra* note 56 (advancing a pricing formula to value compensatory partnership interests, and arguing that if the interest really cannot be valued, the interest should be taxed pursuant to the open transaction treatment). See generally MCKEE ET AL., *supra* note 64, ¶ 5.02 (explaining centrality of valuation issue to Campbell and other cases).

proposed regulations generally allow taxpayers to use the liquidation value of the interest as the value of the interest that is subject to tax, thereby enabling profits interests to avoid taxation upon grant.<sup>66</sup> In addition to the valuation concern, a variety of additional arguments have been employed to justify the non-taxation of profits interests upon grant. Such arguments include concerns about the risk of double taxation of future profits (i.e., if the value of the right to future profits is taxed upon grant, will tax also be imposed when the future profits are actually earned?),<sup>67</sup> and concerns about the ability of the service partners to have sufficient liquidity to pay the tax on the interest upon grant. Commentators have also asserted other, more theoretical, arguments in support of treating profits interests as nontaxable upon grant by arguing that a profits interest represents human capital that is not typically taxed,<sup>68</sup> and by arguing that non-taxation of profits interests upon grant is consistent with the fundamental idea that partnerships are intended to facilitate the pooling of capital and labor.<sup>69</sup>

So query whether these considerations remain persuasive reasons not to tax profits interests upon grant given the twenty years that have elapsed since the issuance of Revenue Procedure 93-27. The impact of the more theoretical arguments is largely unchanged; there remain reasons for considering reform of the way human capital is taxed, but this inquiry arguably should be made with respect to the taxation of human capital in general, and not merely with respect to the taxation of human capital in the fund industry.<sup>70</sup> And the liquidity concern, which was never particularly persuasive, should be surmountable.<sup>71</sup> As to the risk of double taxation, there is a remedy for this potential problem: amortizing the basis in the future profits as the future profits are earned.<sup>72</sup> Implementing this fix can be relatively complicated both because of the calculations and the careful partnership agreement drafting requirement. However, taxpayers and advisors are increasingly sophisticated, and

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66. Partnership Equity for Services, 70 Fed. Reg. 29675 (proposed May 24, 2005) (to be codified at 26 C.F.R. pt. 1). Both the proposed regulations and Revenue Procedure 93-27 lead to the imposition of no tax upon the grant of a profits interest, but the analytical approaches are quite different. The revenue procedure subscribes, at least to some degree, to the idea that grant of profits interest is nonrecognition event. In contrast, the proposed regulations take different view—that the grant of a compensatory partnership interest is clearly a taxable event, but the value of a profits interest happens to be zero.

67. *The Taxation of Carried Interest: Statement Before the S. Comm. on Fin.*, 110th Cong. 8 (2007) (statement of Peter R. Orszag, Director, Congressional Budget Office).

68. See, e.g., Gergen, *Pooling or Exchange*, *supra* note 4, at 544–50 (explaining this issue). See generally Postlewaite, *supra* note 3 (discussing the taxation of human capital).

69. Cunningham, *supra* note 4, at 259.

70. Postlewaite, *supra* note 3, at 887–89.

71. Gergen, *Pooling or Exchange*, *supra* note 4, at 545.

72. Cunningham, *supra* note 4, at 270–71.

technological advances may ease the burden of implementation, particularly with respect to the calculations.

This leaves the valuation issue. Profits interests today arguably have the same speculative value that profits interests had twenty years ago. So perhaps the valuation issue remains a meaningful impediment, in which case reform should focus on other issues, including the tax treatment of profits interests during the operation of the partnership.<sup>73</sup> But perhaps advances in financial sophistication over the past twenty years better enable profits interests to be valued, in which case responsive reform should impose taxation on fair market value of these interests upon grant.<sup>74</sup> And perhaps the valuation objections to taxing profits interests upon grant were never particularly persuasive except in the limited contexts where “there is no market for both the services and the capital involved in the exchange.”<sup>75</sup> Regardless, if the objection to carried interests stems from the failure to tax the service partners upon their receipt of the interest, the objection is equally relevant to profits interests inside and outside of the fund industry.<sup>76</sup>

Thus, any reform to impose taxation upon grant of the interest should also apply both inside and outside of the fund industry unless the justifications for non-taxation upon grant are significantly weaker in the carried interest context than in the context of other profits interests or unless the non-taxation of profits interests upon grant is particularly unfair and inappropriate in the fund context. Indeed, the fund industry has grown significantly in financial sophistication, number of firms, and in total value.<sup>77</sup> The growth of the industry availing itself of the favorable tax treatment of profits interests does not, itself, mean that profits interests are sufficiently easy to value such that they should be subjected to current taxation.<sup>78</sup> Perhaps critics could argue that the financial expertise of funds makes the funds uniquely placed to overcome the

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73. See *infra* Part III.B.

74. See Fleischer, *supra* note 3, at 52 (discussing “forced valuation” as a reform alternative).

75. Gergen, *Pooling or Exchange*, *supra* note 4, at 540–44, 560.

76. Moreover, the concern about taxation of the fair market value of the interest upon grant is equally applicable to capital interests as well as profits interests because capital interests, like profits interests, have option value. Thus, the total fair market value of a carried interest exceeds its liquidation value. See Ordower, *supra* note 56, at 19–25 (explaining why liquidation value is unsound in both the capital interest and profits interest context).

77. See *Taxation of Carried Interest: Hearing Before the S. Comm. on Fin.*, 110th Cong. 1–4 (2007) (statement of Eric Solomon, Assistant Secretary for Tax Policy, U.S. Treasury Department) (detailing the significant growth of fund industry).

78. Academic work acknowledges that fund managers should not be vilified because of their success; rather, there should be a solid policy justification if there is going to be a change to carried interest taxation. See, e.g., Brunson, *supra* note 38, at 122.

valuation difficulty<sup>79</sup> and that the sophistication of funds and their access to advice make funds particularly well-suited to deal with the risk of double taxation.<sup>80</sup> Thus, while it may remain largely untenable to require partnerships, in general, to value profits interests so that service partners can be subjected to tax upon grant of the interests, perhaps the Service should require profits interests to be valued when issued by partnerships with sufficient sophistication and financial expertise.

Ultimately, if the key concern motivating the uproar about carried interests stems from the non-taxation of the interests upon grant, then the recent legislative proposals regarding carried interests are not responsive to the core concern because the legislative proposals focus on the taxation of the service partner during the *life* of the partnership rather than upon the *grant* of the interest. Thus, if non-taxation upon grant of the compensatory interest is a powerful objection and responsive reform is viable, Congress and the Treasury Department should pursue reform and tax the fair market value of profits interests upon grant. If the objection is meaningful but responsive reform is difficult to implement, or if the objection is not particularly powerful, policymakers should then consider other potential objections to carried interests and try to respond to those objections.

#### B. OBJECTING TO THE TAX TREATMENT OF CARRIED INTEREST HOLDERS DURING THE LIFE OF THE FUND

Subchapter K of the Code imposes a single tax regime in which partnership income flows through and is taxed directly to the partners. Specifically, when a tax partnership realizes and recognizes income, that income is allocated among the partners, and each partner includes in her income the portion of partnership income allocated to her. The character of this income (and the rate at which the partner will pay tax on the income) is generally determined at the partnership level. These rules, regarding the taxation of partnership operations, apply both inside and outside of the fund context. Thus, when a fund recognizes primarily LTCG (as is commonly the case in private equity and venture capital funds), the partners (including managers holding compensatory

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79. See David J. Herzig, *Carried Interest: Can They Effectively Be Taxed?*, 4 ENTREPRENEURIAL BUS. L.J. 21, 23, 48 (2009) (suggesting that the initial public offering of Blackstone and other similar entities supports the conclusion that it is possible to value carried interests).

80. Additionally, perhaps critics could argue that there is greater risk that funds fail to comply with the requirements of the revenue procedure. For example, given that fund managers are so willing to accept carried interests in exchange for their services (and given that some fund managers are waiving their management fees in exchange for larger carried interests), perhaps we ought to be particularly suspicious that carried interests do not have liquidation values of zero. However, if this is the issue, then the responsive reform is better enforcement of the existing law.

partnership interests) generally pay tax on that income at the preferential LTCG rate.<sup>81</sup>

Given that funds are generally subject to the flow-through tax regime of Subchapter K,<sup>82</sup> a fund manager's ability to pay tax at preferential long-term capital gains rates on income derived from the manager's carried interest is a product primarily of (1) the way in which each partner's distributive share of partnership income is determined (i.e., the ability to make special allocations), (2) the rate preference applicable to LTCG, and (3) the entity-level characterization of partnership income.<sup>83</sup> Any of these rules could be the root of the problem with carried interests, and again, the appropriate response differs depending on which one (or more) of these rules is the source of the objection.

*I. Is the Problem with the Determination of a Partner's Distributive Share of Partnership Income?*

If partnership income is taxed directly to the partners, then it is critical to determine each partner's allocable share of the partnership income and loss.<sup>84</sup> So, perhaps the objection to carried interests relates to the way in which a partner's share of partnership income is determined.

Holders of carried interests and holders of any other profits interests are allocated partnership income/loss that is disproportionate to their financial contributions.<sup>85</sup> A partnership interest held by a profits interest partner builds up value because income that would otherwise be allocated to the partners who contributed capital to the partnership is diverted and allocated specially to the profits interest partner. That is, it is only through special allocations that profits interests build value.

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81. The mechanics of the tax treatment summarized in this paragraph are explained in greater detail above. *See supra* Part II.A.2.

82. Another possible objection to the taxation of carried interests may stem from the fact that funds are generally subject to taxation under Subchapter K. This issue is discussed further below. *See infra* Part III.C.1.

83. Arguably, the realization principle could also be viewed as a source of the objection to carried interests because, assuming that the interests are not taxed upon grant, the realization principle allows fund managers to defer paying tax on the value of their interests until the partnership actually recognizes income. Pure mark-to-market taxation could mitigate the deferral, but it would not change the character of the income. *Cf. Brunson, supra* note 38, at 105–07 (proposing an alternative that would tax initial allocations of carry as ordinary income, and thereafter taxing the service partners using a simplified mark-to-market approach).

84. Technically, partners are taxed on their “distributive” shares of partnership income. I.R.C. § 702(a) (2012). A partner's distributive share is the portion of the partnership income that is allocated to the partner. Colloquially, the term distributive share suggests distribution, so this discussion generally refers to the partners' allocable shares of partnership income in order to avoid confusion for any lay-readers.

85. *See Gergen, Service Partners, supra* note 4, at 106–08.

The partnership tax rules provide a tremendous amount of flexibility for partners to allocate income and loss in order to create the economic and tax arrangements that suit the partners' business needs.<sup>86</sup> These allocations need not be made in accordance with capital contributions or capital accounts. Rather, allocations will be respected for tax purposes as long as they have "substantial economic effect."<sup>87</sup> If an attempted allocation lacks substantial economic effect, the tax items will be reallocated among the partners in accordance with the "partners' interest in the partnership" ("PIP").<sup>88</sup>

Commentators have criticized the availability of special allocations in Subchapter K for a variety of reasons, including by arguing that special allocations allow inappropriate shifting of gains and losses among partners and that they enable taxpayers to circumvent substantively accurate taxation of the economic relationships they create.<sup>89</sup> Perhaps it is the objection to special allocations that underlies the concerns about carried interests—that partners, including service partners, should not be entitled to allocations of partnership income that are disproportionate to the partners' capital contributions or capital account balances.<sup>90</sup> If this is the concern, responsive reform would merely abolish special allocations and require that all partnership tax items be allocated in accordance with some measurement of PIP. Unless the problems with special allocations are particularly troubling in the specific context of profits interests or in the even narrower context of carried interests, the responsive reform would be appropriately targeted at all special allocations.

Query whether the argument opposing special allocations is particularly persuasive in the context of profits interests. Special allocations to a holder of a profits interest may be used to disguise a nonpartner compensation arrangement. Or special allocations to a holder

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86. I.R.C. § 704(a).

87. *Id.* § 704(b).

88. *Id.* See generally Bradley T. Borden, *The Allure and Illusion of Partners' Interests in a Partnership*, 79 U. CIN. L. REV. 1077 (2011) (explaining the difficulties of determining PIP).

89. Mark P. Gergen, *Reforming Subchapter K: Special Allocations*, 46 TAX L. REV. 1, 3–4 (1990); see Andrea Monroe, *Too Big to Fail: The Problem of Partnership Allocations*, 30 VA. TAX REV. 465, 471 (2011) (arguing that the benefits of allocation rules do not justify their complexity). Substantial literature criticizes particular aspects of section 704(b)'s limitations on special allocations, arguing for modifications to the economic effect rules and the substantiality rules in order to more effectively limit abuses. See, e.g., Gregg D. Polsky, *Deterring Tax-Driven Partnership Allocations*, 64 TAX LAW. 97, 100 (2010) (critiquing the substantiality rules as ineffective). However, it is not really the rigor of the definitions of economic effect or substantiality that implicate the treatment of profits interests, and thus are not likely to be the source of the objections to carried interests.

90. Several commentators have raised these concerns. See, e.g., Gergen, *supra* note 89, at 2; David Hasen, *Partnership Special Allocations Revisited*, 13 FLA. TAX REV. 349, 370 (2012); Darryll K. Jones, *Towards Equity and Efficiency in Partnership Allocations*, 25 VA. TAX REV. 1047, 1093 (2006); George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX REV. 141, 220 (1999).

of a profits interest may be used to disguise an arrangement in which the service partner's compensation entitlement is determined without regard to the partnership's income; this is particularly true if the partner's purported distributive share reflects special allocations of gross income items rather than of net income.<sup>91</sup> Section 707(a)(2) and section 707(c), respectively, are intended to prevent partners from disguising such arrangements as partnership allocations, but commentators have criticized both as ineffective.<sup>92</sup> And if special allocations were disallowed, at least with respect to service partners, there would be no need to try to patrol for these abuses in the compensatory context.

Are these potential abuses more prevalent in the context of carried interests than other profits interests? In general, I do not see a strong case that this is so; thus, reforms to limit or bar special allocations ought to apply equally to carried interests and other profits interests. But carried interests might raise a uniquely pressing risk of abusive use of special allocations with respect to one feature of carried interests that is common in the fund industry: management fee conversions. In a management fee conversion, a fund manager will waive all or a part of its entitlement to a management fee (typically a percentage of assets under management) and in exchange, the fund manager will receive a larger share of profits.<sup>93</sup> As Professor Gregg Polsky has argued, management fee conversion provisions may be particularly susceptible to arguments that they are not appropriately treated as distributive shares for the recipient of the additional carried interest.<sup>94</sup> If there is a high risk of a section 707(a)(2) or section 707(c) problem, with respect to management fee conversions or more generally with compensatory partnership interests, then those provisions should be more effectively enforced while special allocations remain allowed more generally.<sup>95</sup> In the absence of effective enforcement of these anti-abuse provisions, special allocations could be prohibited in the types of partnerships (e.g., private equity funds) where management fee conversions are common, or all compensatory special allocations could be barred.

That is, if the problem with carried interests is the opportunity to use special allocations to disguise the true substance of management fees, then the fund-industry-targeted scope of the carried interest tax proposals may be appropriate. The responsive reform would directly address the

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91. See generally Lewis R. Steinberg, *Fun and Games with Guaranteed Payments*, 57 TAX LAW. 533 (2004) (discussing factors that increase the risk that an entitlement will be treated as a guaranteed payment).

92. Gergen, *Service Partners*, *supra* note 4, at 74–84.

93. See Gregg D. Polsky, *Private Equity Management Fee Conversions*, 122 TAX NOTES 743, 749 (2009).

94. *Id.* at 762–63.

95. *Cf.* Schmolka, *supra* note 4.



allowability of special allocations. This approach would be both simpler and more intellectually coherent than the current legislative proposal.

2. *Is the Problem with the Existence of the LTCG Rate Preference?*

If income is allocated (through special allocations or based on PIP) to a partner (whether a service partner or otherwise) on account of her partnership interest, that income must be characterized in order to determine the rate of tax applicable to that income. Under our current rate structure for individual taxpayers, income that is characterized as ordinary is taxed at rates up to 39.6%, and income that is characterized as LTCG is subject to tax at preferential rates, generally 20% for high income taxpayers.<sup>96</sup> Income earned by private equity funds and venture capital funds is primarily from the sale of stock, and gains from the sale of stock held for more than one year generally benefit from the LTCG rate preference. Thus, perhaps the objection to carried interests stems from our rate structure that affords a rate preference to LTCG. Some commentators believe that the existence of the capital gains preference is the key issue in the carried interest debate.<sup>97</sup>

There is a vast, long-standing literature debating the policy merits of providing a rate preference for long-term capital gains.<sup>98</sup> Arguments in favor of a capital gains preference include concerns about lock-in, bunching, inflation, incentives for risk taking, and incentives for savings.<sup>99</sup> Arguments against a capital gains preference include concerns about accurate measurement of income, neutrality between different types of investments, encouragement of tax sheltering activity, simplicity, and distributional considerations.<sup>100</sup>

There is no need to rehash the capital gains preference debate here, but when thinking about the objections to the tax treatment of carried interests, it is useful to consider whether the LTCG rate preference is the root of the objection. If the objection to carried interests is to the application of the rate preference to gains from the sale of stock, then

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96. I.R.C. § 1 (2012). Higher rates apply to LTCG from collectibles and unrecaptured section 1250 gain, and lower rates can apply to LTCG of taxpayers who are not high-income earners.

97. See, e.g., Philip F. Postlewaite, *The Taxation of Compensatory Profits Interests: The Blind Men and the Elephant*, 29 Nw. J. INT'L L. & BUS. 763, 776 (2009) ("The true culprit which causes the heated debate [about carried interests] . . . is the presence of preferential treatment for a class of income, long-term capital gains."); Weisbach, *supra* note 8, at 763 ("The distributional problem with the taxation of wealthy private equity sponsors, however, should not be solved by changing the technical rules for the taxation of carried interests. The issue arises because of the capital gains preference more generally.").

98. See, e.g., Walter J. Blum, *A Handy Summary of the Capital Gains Arguments*, 35 TAXES 247 (1957); Calvin Johnson, *Seventeen Culls from Capital Gains*, 48 TAX NOTES 1285 (1990).

99. See STAFF OF JOINT COMM. ON TAXATION, 105TH CONG., TAX TREATMENT OF CAPITAL GAINS AND LOSSES 30–34 (summarizing the arguments for a rate preference).

100. See *id.* at 34–36, 45–46 (summarizing the arguments against a rate preference).

responsive reform would focus on the rate preference itself. Similarly, if the objection is to the ability of *any* fund investor, in general, to pay tax on their fund income at LTCG rates, then responsive reform would again focus on the rate preference itself. Because the current legislative proposals regarding carried interests only focus on the ability of certain individuals to benefit from the LTCG preference, these proposals are too narrow to be responsive. Rather, responsive reform should restrict the types of gains that can benefit from the rate preference<sup>101</sup> and/or should reduce the spread between LTCG rates and ordinary income rates.<sup>102</sup>

3. *Is the Problem with Entity-Level Characterization of Partnership Income?*

If it is not the existence of the LTCG rate preference per se that is troubling, the problem with carried interests may be that the eligibility of income for the rate preference is determined at the partnership level without reference to the identity of the partner to whom that income is going to be allocated and without reference to the economic relationship between the partnership and the partner to whom the income is allocated. That is, perhaps the concern is about the ability of *service partners* to avail themselves of the LTCG rate preference.

Partnership income is generally characterized with reference to the way in which the partnership earns the income.<sup>103</sup> Thus, if the partnership earns ordinary income, then the partners to whom that income is allocated will generally be taxed at ordinary rates. Because most income of private equity funds and venture capital funds (though generally not hedge funds) is characterized as LTCG, partners in these funds are generally taxed at LTCG rates on their fund income. This is generally true regardless of whether the partner received her interest in exchange for a contribution of cash or property or in exchange for a contribution of services.

Many commentators criticize this result, arguing that income earned by fund managers on account of their carried interests is, at least to a

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101. See, e.g., Samuel D. Brunson, *How to Tax Mitt Romney*, 135 TAX NOTES 1137, 1144 (2012) (drawing on justifications for the LTCG preference to argue that the rate preference should not apply to carried interest); Monte A. Jackel, *Replacing the Ugly: Alternative Proposals to Carried Interest*, 138 TAX NOTES 1253, 1255 (2013) (suggesting, among other alternatives, the possibility of applying “a special tax rate to some investment partnership capital gain”).

102. See, e.g., Solomon testimony, *supra* note 77, at 15–16. Recent changes to the top ordinary income rate and the LTCG rate for high income earners did, ever so slightly, reduce the spread between ordinary income and LTCG rates for the highest income earners (previously 35% ordinary income and 15% LTCG, now 39.6% ordinary income and 20% LTCG). American Taxpayer Relief Act of 2012 § 101(b)(3)(A), I.R.C. § 1 (2013). This reduction in the spread is, however, too small to respond to the concerns discussed in the text.

103. Section 724 provides a major exception to this general rule for the characterization of income earned by the partnership from unrealized receivables, inventory items, and capital loss property contributed to the partnership.

significant degree, labor income that should be taxed at ordinary income rates and that it is unfair for fund managers to benefit from a preferential rate on their labor income merely because the compensation is structured as a carried interest. The discourse on this issue is wide-ranging. Some commentators argue that income from profits interests should be characterized entirely as ordinary income, perhaps on the grounds that the income is entirely returns to labor.<sup>104</sup> Some argue that if a profits interest is not taxed upon grant, the interest is most appropriately taxed using an open transaction approach, which effectively taxes all income from the profits interest as income from labor taxable at ordinary income rates.<sup>105</sup> Even if some returns from profits interests constitute returns on capital rather than returns on labor, taxing all of the income from profits interests as ordinary income may achieve a “rough justice” given that profits interests partners are not taxed upon the grant of the interest and thus benefit from deferral; that is, imposing tax at ordinary income rates on returns to capital compensates the government for the time value of money lost when the profits interest partner was able to defer the taxing event. Others explicitly acknowledge that income from a profits interest is partly a return to labor and partly a return on capital,<sup>106</sup> and they conclude that the income should be taxed partly at ordinary income rates and should be characterized partly at the partnership level.<sup>107</sup> These commentators suggest a variety of ways to bifurcate the income from a profits interest into partly ordinary income and partly income characterized at the partnership level.<sup>108</sup> The details vary, but all of these positions essentially argue for “partnership disaggregation” pursuant to which characterization should depend, at least in part, on whether the partner acquired her

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104. See, e.g., Press Release, Representative Sandy Levin, Levin and Democrats Introduce Legislation to End Carried Interest Tax Advantage (June 22, 2007), <http://levin.house.gov/press-release/levin-and-democrats-introduce-legislation-end-carried-interest-tax-advantage> (quoting Rep. Levin as saying, “[t]hese investment managers are being paid to provide a service to their limited partners and fairness requires they be taxed at the rates applicable to service income just as any other American worker” when he introduced legislation to tax carried interests entirely as ordinary income). It is almost certainly wrong to assert that all income from profits interest is return to labor. As discussed in the rest of the paragraph in the text, there may, however, be other good reasons to tax as ordinary income all of the income derived from a carried interest.

105. See, e.g., Gergen, *Service Partners*, *supra* note 4, at 72; Ordower, *supra* note 56, at 37.

106. See, e.g., Christopher W. Livingston, *Finding the Right Balance: A Critical Analysis of the Major Proposals to Reform the Taxation of Carried Interests in Private Equity*, 62 *TAX LAW.* 241, 241 (2008) (grappling with the service/capital return dual nature of carried interests).

107. See, e.g., *id.*

108. See, e.g., Brunson, *supra* note 38, at 105 (suggesting a modified mark-to-market approach that would tax the initial allocation of the carry as ordinary income, and tax subsequent appreciation as capital gain); Cunningham & Engler, *supra* note 38, at 142 (suggesting a modified interest charge approach); Fleischer, *supra* note 3, at 54–55 (suggesting the “cost of capital” method); Livingston, *supra* note 106, at 242 (suggesting a “modified implied loan approach that allows for an interest expense deduction”).

interest for capital or for services.<sup>109</sup> As a result, where an interest is acquired entirely or partly for services, the income generated from that interest should be characterized, at least in part, as service income, on which tax is paid at ordinary income rates. Commentators contend that this approach reduces opportunities to use profits interests to convert into LTCG income that ought to be taxed as ordinary income.<sup>110</sup>

Still others defend the current rules that characterize income at the partnership level even if that approach results in taxing service partners at LTCG rates on the income generated from their labor. Some of these commentators argue that the line between ordinary income taxation of labor income and capital gains taxation of investment income is hazy; for example, goodwill of a business generated through the proprietor's labor generates capital gain when sold.<sup>111</sup> Other defenders of partnership-level characterization argue that it is most consistent with the premises underlying partnership taxation.<sup>112</sup>

If the defense of partnership-level characterization is not persuasive, then the concern articulated above remains—that income from a compensatory partnership interest is, at least in part, income generated from services that should be characterized with reference to the way in which the partner acquired the interest and should thus be taxed, at least in part, at ordinary income rates, just as other income from services is taxed. Unless this concern is particularly problematic in the context of carried interests, responsive reform would adopt one of the many proposed approaches to characterize all or part of the income from *all compensatory partnership interests* as ordinary income.<sup>113</sup>

If reform adopts some type of partner-level characterization of income allocated to service partners, query whether the reform should apply only to profits interests and not to capital interests.<sup>114</sup> Both profits interests and capital interests are granted in exchange for services, but perhaps they can be distinguished based on whether the compensatory transfer is taxed when the interest is granted. Profits interests are generally not taxed upon grant of the interest despite the fact that the grant does constitute a compensatory transfer of value. In contrast, when

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109. Borden, *supra* note 3, at 1302–15 (naming and critiquing the “partnership disaggregation” approach, and arguing in favor of the “partnership disregard” approach instead); *see infra* note 124.

110. *See, e.g.*, Fleischer, *supra* note 3, at 44–47.

111. *See* Howard E. Abrams, *Taxation of Carried Interests: The Reform That Did Not Happen*, 40 *LOY. U. CHI. L.J.* 197, 215–23 (2009).

112. *See* Schler, *supra* note 37, at 833; Schmolka, *supra* note 4; Weisbach, *supra* note 8, at 760–61.

113. This Article does not endorse any one proposal over another; rather it argues that, regardless of the proposal adopted, the scope of the reform's application should be carefully considered.

114. Cunningham, *supra* note 4, at 252–56 (discussing the economic identity between capital and profits interests); Ordower, *supra* note 56, at 30–31 (arguing that profits interests issues are also relevant for capital interests).

a partner is granted a capital interest for services, that partner is taxed upon grant at ordinary income rates.<sup>115</sup> Arguably, this tax event concludes the compensatory transfer. For tax purposes, the service partner is deemed to make a contribution of property,<sup>116</sup> and thereafter is treated in the same way as all other partners who make contributions of property. That is, she is entitled to have income allocated to her characterized at the partnership level. This argument for distinguishing capital interests from profits interests, however, is only persuasive if service partners receiving capital interests are taxed on the fair market value (and not merely the liquidation value) of the interest. If liquidation value is used (as is proposed in the proposed regulations on compensatory partnership interests),<sup>117</sup> then the recipient of the compensatory interest is not fully taxed on the value of the returns to labor—some option value inherent in the interest upon grant remains untaxed regardless of whether the compensatory interest is a profits interest or capital interest. This suggests that if a service partner is granted a compensatory partnership interest—whether capital or profits—and is taxed only on that interest's liquidation value at the time of grant, then at least some portion of the income later allocated to the service partner on account of the interest would substantively reflect returns to labor rather than returns to capital.

Even accepting that partner-level characterization of partnership income ought to apply only to profits interests, why apply such a reform only to profits interests issued in the fund industry? Is partnership-level rather than partner-level characterization of income allocated to profits interest partners more problematic for profits interest partners in funds than for other profits interests partners? Perhaps so because with profits interests in funds, partnership-level characterization enables more favorable tax treatment (capital gains characterization)<sup>118</sup> than partner-level characterization would allow (at least partly ordinary income treatment). In contrast, income allocated to service partners in many other partnerships would be characterized as ordinary whether the income is characterized at the partnership level or at the partner level. Yet, surely some partnerships outside of the fund context earn some income that would be characterized as LTCG if characterized at the partnership level. Thus, if the concern is that partnership-level characterization of income

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115. *McDougal v. Comm'r*, 62 T.C. 720, 724–27 (1974).

116. *Id.* at 726.

117. Partnership Equity for Services, 70 Fed. Reg. 29675 (proposed May 24, 2005) (to be codified at 26 C.F.R. pt. 1).

118. The more favorable treatment of partnership level characterization applies even to hedge funds because partnership-level characterization of hedge fund income results in a significant amount of short-term capital gain, which may be more favorable than ordinary income because short-term capital gain can be used to an unlimited extent to offset long-term capital loss.

could allow more favorable tax treatment than partner-level characterization of income allocated to service partners, responsive reform would apply not only to carried interests, but also to other profits interests in partnerships that earn at least some threshold amount of capital gain income.<sup>119</sup> This again suggests that the scope of legislative proposals to reform the tax treatment of carried interests is too narrow.

Notwithstanding the foregoing, perhaps reforms that focus on the level at which income is characterized (i.e., partner-level or partnership-level) ought to be limited to carried interests on the grounds that fund managers are more likely than other profits interest partners to be sophisticated enough to bear the additional complexity of the reform. But if this is the reason for focusing the reform only on profits interests in the fund industry, then we should explicitly acknowledge that, for simplicity reasons, we are deviating from reform that would be more responsive to the real problem.

### C. OBJECTING TO THE BOTTOM-LINE RESULT

Perhaps the source of the real problem with carried interests is not any particular tax rule and the way in which it applies to funds. Rather, the true concern might be about application of the partnership tax regime to funds in the first instance. Alternatively, the core source of the hostility toward carried interests could be about aggregate revenue, the overall degree of progressivity of the income tax system, or the fund industry itself.

#### *I. Is the Problem with the Application of the Partnership Tax Rules to Funds?*

As evidenced by the above discussion, the taxation of a compensatory transfer to a fund manager depends, to a large extent, on the tax regime to which the fund is subject. A significant part of the long-running debate about the taxation of businesses focuses on the appropriate method for determining which businesses are subject to which taxing regime, assuming that there are multiple tax regimes that apply to businesses.<sup>120</sup> Historically,

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119. See, e.g., Cunningham & Engler, *supra* note 38, at 139 (suggesting that the reform of the taxation of profits interests should exempt any partnership engaged in an active trade or business, i.e., exempting partnerships who earn a significant amount of ordinary income).

120. See, e.g., GEORGE K. YIN & DAVID J. SHAKOW, AMERICAN LAW INSTITUTE REPORTERS' STUDY, REFORMING AND SIMPLIFYING THE INCOME TAXATION OF PRIVATE BUSINESS ENTERPRISES (2000) (suggesting a different tax regime for private and public businesses); S. FINANCE COMM., TYPES OF INCOME AND BUSINESS ENTITIES 10-11 (2013) (discussing different ways to classify businesses). Debate also discusses the possibility of reducing the number of different tax regimes that can apply to businesses. See, e.g., *id.* at 5-6, 8-10 (discussing integration options). The debate also discusses whether businesses should be taxed using aggregate, entity, or hybrid theory, and discusses whether a flow-through tax regime should more closely resemble Subchapter S or Subchapter K. See generally

the tax law sought to distinguish businesses based on their substantive features, asking whether an entity closely resembled a corporation.<sup>121</sup> Today, entity classification is largely explicitly elective; unincorporated entities are generally taxed as disregarded entities (if the entity has one member) or partnerships (if the entity has more than one member) in each case unless the entity elects to be taxed as a corporation.<sup>122</sup>

Funds are generally taxed as partnerships subject to Subchapter K of the Code because they are typically organized as limited partnerships.<sup>123</sup> The partnership tax rules impose a single-tax regime in which income earned by a partnership is taxed directly to the partners. As a result of the application of partnership tax rules to funds, carried interests are subject to a number of favorable tax rules, which were discussed individually above. It may be that no one individual rule is the source of the objection to carried interests; rather, there may be a more fundamental concern driving the uproar about carried interests—that funds ought not to be able to avail themselves of the partnership tax regime.

Commentators objecting to the taxation of funds as partnerships generally fall into two categories. Some argue that the fund entity should be disregarded on the grounds that partnership tax should only apply to integrations of property and services; that is, where a business relationship is primarily a “hired service” relationship (such as where fund investors effectively hire fund managers to provide investment management services), the business relationship ought to be excluded from the definition of tax partnerships.<sup>124</sup> Other commentators argue that funds, or at least certain subsets thereof, should be taxed as “publicly traded partnerships” which are taxed very similarly to corporations.<sup>125</sup> They argue that this approach would reduce “regulatory gamesmanship,” curtail erosion of the corporate tax base, and provide at least a limited response to the carried interest problem.<sup>126</sup>

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Bradley T. Borden, *Aggregate-Plus Theory of Partnership Taxation*, 43 GA. L. REV. 717 (2009) (advancing the “aggregate plus theory of partnership taxation”); Philip F. Postlewaite et al., *A Critique of the ALI’s Federal Income Tax Project—Subchapter K: Proposals on the Taxation of Partners*, 75 GEO L.J. 423 (1986) (discussing which aspects of partnership taxation should reflect an aggregate theory and which should reflect an entity theory); Rebecca S. Rudnick, *Enforcing the Fundamental Premises of Partnership Taxation*, 22 HOFSTRA L. REV. 229 (1993) (defending the core of the partnership tax system and the conduit model for taxing business).

121. 26 C.F.R. § 301.7701-2(a) (1960) (the “Kintner regulations”); See *Morrissey v. Comm’r*, 296 U.S. 344, 357–59 (1935).

122. Treas. Reg. § 301.7701-3 (2006).

123. A limited partnership can, however, elect to be taxed as a corporation. *Id.*

124. Borden, *supra* note 109, at 1315–21.

125. S. 1624, 110th Cong. (2007) (proposing that funds whose interests are publicly traded ought to be taxed as corporations); see Victor Fleischer, *Taxing Blackstone*, 61 TAX L. REV. 89, 92–93 (2008).

126. See *id.* at 92.

Indeed, the debate about carried interests may suggest that the scope of tax “partnerships” ought to be refined. However, to the extent that the source of the outrage created by carried interests is caused by the application of the partnership tax regime to funds, we should think more broadly about the appropriate scope of Subchapter K. For example, given the reasons for excluding funds from Subchapter K, are there likely to be other types of enterprises that also ought to be excluded from (or included in) Subchapter K? Some existing literature, particularly articles by Professor Bradley Borden, takes a more comprehensive approach to defining the scope of Subchapter K.<sup>127</sup>

## 2. *Is the Problem with Reduction in Aggregate Revenue?*

Perhaps the objection to carried interests is less about the details of the tax rules and more about the loss of revenue—that the tax rules applicable to carried interests allow fund managers to pay particularly low taxes at a time when the country has serious revenue needs. It is true that profits interest partners are taxed favorably, but this is primarily a shift of the tax burden from profits interest partners to other partners rather than a reduction in the total tax burden.<sup>128</sup> That is, from a joint tax perspective, the aggregate revenue collected from the partners in the relevant partnership should not be reduced as long as the non-service partners are subject to the same marginal tax rates as the managers and as long as the managers provide services that do not need to be capitalized.<sup>129</sup> To the extent, however, that fund investors are tax-exempt (as many are)<sup>130</sup> or that salary payments to the managers would be capitalizable rather than currently deductible, the aggregate revenue collected from fund owners under the existing tax rules would be less

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127. Bradley T. Borden, *The Federal Definition of Tax Partnership*, 43 Hous. L. Rev. 925, 982–84 (2006) (discussing extent to which federal tax partnership classification should depend on state law classification); Bradley T. Borden, *Policy and Theoretical Dimensions of Qualified Tax Partnerships*, 56 U. Kan. L. Rev. 317, 360 (2008) (arguing that investment partnerships should not be eligible for Subchapter K because they can directly trace income to property and investors).

128. In some situations, using a profit interest rather than salary to compensate a service partner may not even reduce the service partner's tax burden, but the conditions that enable this result (namely, allocations to the service partner of ordinary income where salary payments would be currently deductible) generally do not exist in the fund context. See Gergen, *Service Partners*, *supra* note 4, at 72.

129. Karen C. Burke, *The Sound and Fury of Carried Interest Reform*, 1 Colum. J. Tax L. 1, 3–7 (2010) (employing a joint-tax perspective); Knoll, *supra* note 53, at 127–28 (same); Chris William Sanchirico, *The Tax Advantage to Paying Private Equity Fund Managers with Profit Shares: What Is It? Why Is It Bad?*, 75 U. Chi. L. Rev. 1071, 1103–06 (2008) (same).

130. Solomon, *supra* note 77, at 8–9; see PREQIN, PREQIN SPECIAL REPORT: INSTITUTIONAL INVESTOR OUTLOOK FOR HEDGE FUNDS IN 2012 at 5 fig. 8 (2011) (reporting that more than half of hedge fund investors are foundations, endowments or pension funds); STAFF OF JOINT COMM. ON TAXATION, 110TH CONG., PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS 37 (reporting the same as to venture capital funds).



than the aggregate revenue that would be collected from fund owners if managers were compensated with regular salary payments, taxable at ordinary income rates.

If revenue reduction is the real concern motivating objections to carried interests, revenue expectations from legislative proposals for reforming the tax treatment of profits interests should take the joint tax perspective into account. When considered from that perspective, the legislative proposals for carried interests reform would not be particularly responsive to a core concern about revenue.<sup>131</sup> Moreover, if aggregate revenue is the key concern, reform could be narrowly targeted to those partnerships where there are most likely to be joint tax minimization opportunities. The complexity of reform need not be imposed on all service partners; rather, the reforms could apply only to partnerships with partners who are not in the highest marginal tax bracket—particularly where partners are tax-exempt—and to partnerships in which service partners perform capitalizable services. Reform of this scope would likely apply to some, but not all, carried interests, and would likely apply to some, but not all, other profits interests as well. Or said differently, if the real problem is revenue, reforms that target only carried interests are likely both over and under-inclusive. As a result, in order to ensure that the reform applies to all partnerships that can minimize joint taxes using profits interest, the reform must apply even to partnerships outside of the fund context. We ought not to limit reforms to carried interests merely because “private equity is a deep and politically expedient pocket” from which to collect additional revenue.<sup>132</sup>

### 3. *Is the Problem with the Degree of Progressivity in the Tax Rate Structure?*

Perhaps the concern with the bottom-line tax treatment of carried interests is less about the aggregate revenue collection and more about the distribution of the total tax burden among members of society. Commentary in political discourse and the popular press<sup>133</sup> often reflects the view that fund managers are quite wealthy and the very rich in our

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131. Knoll, *supra* note 53, at 161 (“[W]hatever the other merits of taxing carried interests at ordinary tax rates, it is very clear in the context of existing budget deficits and priorities that reforming the tax treatment of carried interests will provide relatively little tax revenue for other purposes.”).

132. Abrams, *supra* note 111, at 227 (framing the revenue issue in these terms).

133. See *supra* note 8. This was particularly true of the political discourse from the 2012 presidential campaign during which Mitt Romney’s tax situation focused attention on the distributional equity implications of the tax treatment of carried interests. See, e.g., *Romney Supports*, *supra* note 7; Pat Garofalo, *The Real Scandal in Private Equity? It’s the Taxes*, THE ATLANTIC (Jan. 17, 2012), <http://www.theatlantic.com/business/archive/2012/01/the-real-scandal-in-private-equity-its-the-taxes/251463>.

society do not pay their “fair share” of taxes.<sup>134</sup> But if this concern motivates the objections to carried interest, then the carried interest proposals are significantly under-inclusive; the proposals to change the tax treatment of carried interests only affect fund managers rather than all high-income individuals, and are likely to affect primarily private equity and venture capital fund managers (and not hedge fund managers, whose income is generally not characterized as LTCG). Moreover, an increase in the nominal tax burden on fund managers does not necessarily mean that the fund managers will actually bear the economic burden of the additional tax burden; contractual and behavioral changes can shift the incidence of the nominally increased tax burden to fund investors (and possibly others).<sup>135</sup>

Instead, to address concerns about the appropriate level of taxation of high-income individuals, more responsive reform would increase the degree of progressivity in the tax system through base broadening and/or raise the ordinary income and/or LTCG rates applicable to high-income individuals. This reform would be made applicable to all high income individuals and not solely those who work in the fund industry.

Indeed, the American Taxpayer Relief Act of 2012 recently increased the progressivity of the tax system by raising both ordinary income rates from 35% to 39.6% for the taxpayers in the highest marginal tax bracket and LTCG rates from 15% to 20% for high income taxpayers.<sup>136</sup> Are these rate increases sufficient to create the right amount of progressivity in our income tax system? Maybe, maybe not—but at least these rate increases apply to all high-income taxpayers and not merely high-income private equity and venture capital fund managers.

#### 4. *Is the Problem with the Fund Industry Itself?*

Alternatively, perhaps the concern implicated by carried interests is not about high-income people in general, but rather fund managers in particular. That is, the objection is not to the form of the compensatory transfer but instead to the fund industry and the people involved in the industry; fund managers fail to produce anything of social value, and they adversely affect the economy.

If the uproar about carried interests is primarily a condemnation of the fund industry, then changing the tax treatment of carried interests is a relatively weak response. Among other reasons, this is because hedge

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134. See Abrams, *supra* note 111, at 227 (noting the “class warfare” framing of the debate); Fleischer, *supra* note 3, at 5.

135. Field, *supra* note 49, at 11–12 (explaining that fund managers, the intended targets of the proposed reform, may not bear the economic burden of the reform because of the design of their contractual agreements with fund investors).

136. American Taxpayer Relief Act of 2012 § 101(b)(3)(A), I.R.C. § 1 (2013).

funds are not likely to be impacted by the reform to any significant degree, and because the reform fails to identify or limit the specific problems created by the industry. Direct regulation would be more effective<sup>137</sup> because it would better enable policymakers to affect all aspects of the fund industry, including hedge funds. Further, direct regulation of the particular undesirable activities undertaken by some parts of the industry would better enable policymakers to curtail more precisely those industry behaviors and transactions that are most problematic.

#### CONCLUSION

Many different issues could motivate the recent controversy about carried interests. The appropriate response to the uproar (assuming a response is warranted) depends on whether the crux of the problem is equity compensation, some technical aspect of the partnership tax rules, revenue needs, distributive justice considerations, disapproval of the fund industry, or something else entirely. Any reform should reflect an intellectually honest response to the fundamental concern.

Much of the popular and political discourse, and some of the academic discourse, displays a class warfare orientation. If the concern about carried interests is truly about progressivity and the allocation of the tax burden among people of different income strata, then the narrow proposed changes to the taxation of carried interests may be politically expedient, but the proposals are not responsive to the core concern about distributive justice, nor are the proposals particularly responsive to the need for revenue. Perhaps the framing of the carried interest issue in terms of class warfare and vilification of the fund industry is merely a convenient way to draw attention to a technical but important partnership tax issue or to a broader systemic problem inherent in the federal income tax system. If so, that is not terribly troubling as long as the ultimate reform proposals are broad enough to address the fundamental (even if less sexy) concern. I am not optimistic about this because, to date, the scope of legislative reform proposals has mirrored the narrow rhetoric about carried interests. There is no evidence that the tone of the carried interest discourse is likely to change, and there is only sparse evidence that legislators have any intention to design broader reforms that would tailor a solution to the real problem that motivates the hostility to carried interests.

Ultimately, policymakers struggling with the carried interest problem should focus their reform efforts on the fundamental concern that motivates their objection to carried interests. Once they have identified their real problem with carried interests, they should fix *that*.

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137. See Levin et al., *supra* note 37, at 578–79 (recommending regulation rather than tax changes).

Admittedly, our political process may prevent the enactment of broad reform that responds to the underlying problems in the tax system that led to the carried interest uproar. Even in this case, however, Congress should not enact the recent legislative proposals. Not only are these proposals nonresponsive to the fundamental concerns that led to the carried interest controversy, but the proposals are themselves problematic. This is because they will make the tax law more complex, will encourage funds and fund managers to restructure their compensation to avoid the adverse tax consequences that would result from the proposals (thereby further distorting incentives regarding the compensatory structure for service partners), and will increase transaction costs, all without addressing the underlying issues. It would be better to do nothing.

February 2014]

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