

# Capital Gains On “Carried Interests”

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How did a fabulous birthday bash in New York City set off one of the most emotionally charged tax debates the US has seen in years?

On February 13, 2007, Stephen A. Schwarzman -- flamboyant co-founder and chief executive officer of the private equity giant, Blackstone Group -- celebrated his 60th birthday in a big way at the Armory on Park Avenue. Some reports placed the party's cost to Mr. Schwarzman at \$5 million, including \$1 million for a live performance by aging rock icon Rod Stewart. Even at \$5 million, however, the cost would have been trivial to the multi-billionaire merrymaker.

A few weeks after Mr. Schwarzman's highly publicized extravaganza, reports began circulating of a draft paper, by an obscure young law professor at the University of Illinois, which had captured the attention of the staff of the Senate Finance Committee. Professor Victor Fleischer's theoretical analysis drew attention to the favorable tax treatment of so-called “carried interests,” which were the source of much of Mr. Schwarzman's wealth and the wealth of other private equity titans. Although there was nothing new or ingenious about the carried interests of the kind Professor Fleischer dissected, reports in the popular press adopted the tone of exposés.

As if Blackstone needed to draw even more attention to its tax situation, in March 2007 it announced an initial public offering (IPO). The IPO was premised in crucial respects on the favorable tax treatment of carried interests. The IPO closed in June, netting more than \$4 billion for the Blackstone managers.

For reasons unrelated to the debate over carried interests, the party seems to be over for private equity. But the furor surrounding the tax treatment of carried interests continues.

## **Management Fees and Carried Interests in General**

Partnerships – including limited liability companies that are taxed as partnerships -- have often been the business entity of choice when investors who supply capital are brought together with managers who, through their services, add value to the capital. Innumerable deals in real estate, oil and gas, and other industries, have followed this time-honored pattern of pooling labor and capital. Private equity funds are no different.

In private equity funds, and many other partnerships, the general partner typically receives a management fee based on gross assets (often 2%) and a “carry” or “carried interest” based on future profits (commonly 20% of all profits, or 20% of profits above some minimum). The general partner is rarely an individual. Rather, it is another pass-through entity -- partnership or LLC – whose income is taxed to the individual managers who own it. Although the general partner will put in some capital – maybe even a lot – it

receives the carried interest for services and not for capital. Similarly, the individual managers receive a carried interest in the general partner. The capital of the investors thus “carries” this special interest given to the general partner (and given indirectly to the individual managers).

An additional complication is that the fee and the carried interest are typically split between two different, but affiliated, entities. The general partner may earn the 20% carry, while an affiliate of the general partner (sometimes referred to as the “manager”) may be getting the 2% management fee. This separation between general partner and “manager” often is expected to reduce local tax, but is of no particular significance to the federal tax controversy that we are discussing. This article will ignore such separation, and refer to the individual members of the general partner, and of any affiliate earning a management fee, as the “managers” or the “individual managers.”

### **Taxation of Management Fees and Carried Interests**

The management fee is plainly compensation for services. It is taxed to the individual managers as ordinary income (offset, however, by deductible expenses). Although it is universally conceded that the management fee is ordinary income, the fee certainly has not escaped controversy. Some managers have been deferring tax on fee income through offshore entities, and there have been proposals in Congress – not our focus here – that would greatly limit the potential for that deferral. In addition, there have been charges that in some instances managers improperly convert management fees into carried interests because of the favorable tax treatment of the latter.

In most instances, the Internal Revenue Service (“IRS”) allows the general partner (and individual managers) to report no income on the initial receipt of the carried interest, even if the interest is fully vested. See Rev. Proc. 93-27, 1993-2 C.B. 343, and Rev. Proc. 2001-43, 2001-2 C.B. 191. Although some commentators disapprove of this potential for “deferral” of tax, even many critics of current law recognize that the carried interest is typically so speculative and illiquid that tax should not be imposed immediately. Rather, what has so enraged a surprisingly diverse collection of critics is the potential for the carried interest to ultimately generate long-term capital gain for the managers.

If and when future profits of the partnership are allocated to the general partner, and from the general partner to the individual managers, these managers are taxed in accordance with the character of those profits in the hands of the partnership. If the partnership generates long-term capital gain – as private equity funds tend to do – that gain “flows through” as long-term capital gain for tax purposes, even if the individual managers and general partner supplied services rather than capital. The character of other tax-advantaged forms of income similarly flows through. For example, many corporate dividends are now taxed to individual shareholders at favorable long-term capital gain rates. When such dividends are earned by a partnership and allocated to the general partner, the individual managers can enjoy such favorable tax treatment.

## The Debate

The debate has captured attention as few tax issues ever do. Few observers would have anticipated public expressions of outrage from hundreds of nonprofit organizations – churches, unions, and others – over this heretofore esoteric issue. The tax revenue at issue cannot begin to account for the emotional tenor of the debate. Official estimates from Congress placed the tax revenue from a change in law at a total of \$25.6 billion over ten years. Two or three billion dollars a year is a great deal of money by normal standards, but barely noticeable as a percentage of the federal budget (expected to top three trillion dollars next year).

The criticism is driven by distrust of the private equity industry and also by the perception of inequity. While individual managers pay tax on their long-term capital gain at a maximum federal rate of 15% (and no employment or self-employment tax), wage earners are subject to rates up to 35% (plus employment tax). Even a secretary, police officer, or teacher, with taxable income of perhaps \$50,000 a year, would be in the 25% federal tax bracket. Deriding the disparity as a “quirk in the partnership tax rules,” Professor Fleischer’s complains that “some of the richest workers in the country ... pay tax on their labor income at a low effective rate. While the high pay of fund managers is well known, the tax gamesmanship is not.”

Defenders of the current rules have several responses. One set of responses focuses on the blessings that private equity bestows on the world. While these responses do not respond directly to the contention that the fruits of personal services should be taxed as ordinary compensation, they attempt to assuage the critics’ animus by depicting private equity in a favorable light. Private equity creates value and jobs, and helps align the interests of shareholders and management. Mr. Schwarzman recently told the Confederation of British Industry that “Private equity is here to stay as a significant force and *as a force for good* within much of the world economy.”

The private equity industry has even tried to defuse critics by stressing the harm that a tax change could inflict on disadvantaged groups. The Access to Capital Coalition, a consortium of minority and women business leaders, was established specifically to oppose legislation to increase the tax rate on carried interests. The Coalition argues that current law attracts top talented minorities and women to the private equity industry, and that a change could discourage investment in small business and ethnically diverse communities. Earvin “Magic” Johnson, the basketball legend turned CEO, reportedly shares the Coalition’s view that changing the tax treatment of carried interests would hurt minorities and women. Professor Fleischer’s blunt assessment of Mr. Johnson’s position, as quoted in the New York Times, October 3, 2007: “That’s ridiculous.”

A more direct response to the charge that carried interests confer unfair tax benefits on fund managers arises from a comparison between fund managers and other contributors of “sweat equity” to businesses -- who in fact do routinely recognize their rewards in the form of capital gains. Whether an entrepreneur borrows to build a business, takes in equity from other investors, or puts up his or her own capital, a sale of

an interest in the business nearly always results in capital gain. Corporate founders and other shareholder/employees are taxed at capital gain rates on the sale of stock, even if all or most of the value is attributable to their efforts. Bill Gates – wealthier by far than any private equity fund manager – has always been entitled to capital gain on a sale of Microsoft stock, even though he and Paul Allen created Microsoft with nothing but their own remarkable abilities. Even in the case of “S corporations” -- which are not subject to corporate-level tax – employee/shareholders are virtually assured of capital gain when they sell stock. Should fund managers be singled out for worse treatment than corporate shareholder/employees?

A critic might respond that the treatment of corporate shareholder/employees may or may not be fair, but not every issue must be tackled at once. For at least some critics, creating an unwarranted tax disparity between fund managers and shareholder/employees would be justified, if doing so eliminated what the critic considers an even more inequitable tax benefit that fund managers enjoy relative to ordinary wage earners.

A more technical argument for the status quo starts from the observation that ordinary compensation income to one person is normally accompanied by an ordinary deduction to someone else. The critic’s paradigm is the case of a wage earner who performs services and is taxed, at ordinary income rates, on whatever he or she earns. The critic presumably accepts that the employer is entitled to deduct the compensation paid. In the critic’s mind, the reality is that the private equity funds are paying compensation to the managers for services. If one adopts that perspective, then the funds should report all the capital gain, and the managers none. By the same token, however, the funds should be entitled to deduct the compensation. Both the capital gain income and the compensation deduction would be passed through to the investors in the fund.

If the compensation is deducted against ordinary income on which an investor otherwise would pay tax, the investor would simply trade ordinary income (under current law) for capital gain (under the critics’ paradigm). Similarly, the managers would trade capital gain for ordinary income. The total amounts of capital gain and ordinary income available for the government to tax are identical in both cases. Assuming everyone pays tax at the same rates on the same kind of income, the government would not collect more revenue than it does now even if it could transform the fund managers into wage earners.

Critics will pounce, however, on that last assumption. They will insist that in many cases, although not all, investors and individual managers are taxed at different rates. To take an extreme but common example, pension funds and other tax-exempt investors are effectively taxed at a zero percent rate in many circumstances. They may be more than happy to accept ordinary income in place of capital gain, unless the ordinary income constitutes unrelated business taxable income. Individual managers, by contrast, badly want capital gain. If tax-exempts can shift capital gain to managers, with managers in turn shifting ordinary income to tax-exempts, the fisc loses.

But the technical argument put forward in defense of current law still may offer a useful perspective. First, it shows that the loss of tax revenue from any substitution of

carried interests for wages is likely far smaller than a simplistic analysis would have predicted. Second, it overcomes any misimpression critics may have that fund managers are somehow creating capital gain where none would otherwise exist. At worst, current law shifts capital gain between taxpayers.

### **Will the Law Change?**

The current tax treatment of carried interests is hardly a recent development. In many respects it follows from remarkably stable principles. The Treasury and IRS in 2005 proposed some changes to the current system, and could introduce others. REG-105346-03, 70 Fed. Reg. 29675 (May 24, 2005); Notice 2005-43, 2005-24 I.R.B. 1221. The changes proposed so far, however, would have a limited impact. To the extent that the 2005 proposals depart significantly from current law, their impact would nevertheless be muted because the proposals would permit many partners and partnerships to “elect” into a regime closely resembling current law.

It would be possible for the US Treasury and IRS to propose deeper changes, but any such radical proposals are unlikely in the absence of some signal from Congress. Moreover, without new legislation, Treasury and the IRS probably lack authority to implement the changes most desired by critics. One basic rule seems inviolate unless Congress takes action: when service partners are allocated a share of partnership profits, their income has the same character – ordinary income or capital gain – as the profits earned by the partnership.

Several pieces of legislation have been introduced, although so far none has been enacted. H.R. 3996, as passed the House of Representatives on November 9, 2007, included a brand new section of the Internal Revenue Code -- Section 710 -- which generally would characterize income from carried interests in “investment services partnerships” as “ordinary income from the performance of services.” Since the income would be not merely ordinary income, but service income of a partner, it would be subject to self-employment tax on top of income tax at a maximum federal rate of 35%. Section 710 was stripped out by the Senate, and H.R. 3996 (the “Tax Increase Prevention Act of 2007”) was enacted without it. Prospects for passage in 2008 are uncertain.

Although Section 710 is primarily a reaction to reports of private equity manager excesses, this new Code section would not be limited to private equity funds or to high-income individuals. Roughly speaking, it would catch any person who supplies substantial services with respect to investing in, purchasing, selling, managing, acquiring, disposing of, or arranging financing for “specified assets” of a partnership, or activities in support of the foregoing. “Specified assets” include securities (broadly defined), real estate, commodities, and options or derivative contracts on any of the foregoing.

Section 710 would not apply to the extent the service provider contributes invested capital, and the partnership makes a “reasonable allocation” to the service provider with respect to that capital. Although “reasonable allocation” appears to be a flexible standard, the appearance is belied by a rule that an allocation is not reasonable if

it “would result in the partnership allocating a greater portion of income to invested capital than any other partner not providing services would have been allocated with respect to the same amount of invested capital.”

While Section 710 would cause the managers to recognize ordinary compensation income, the new provision would not allow the partnership a corresponding compensation deduction. In this respect, Section 710 would actually penalize the parties for structuring a deal using carried interests instead of ordinary compensation for services.

The proposal is retroactive in two respects. Most importantly, it would apply to income earned on carried interests regardless of when the carried interest was granted. Thus carried interests granted years before this legislation was ever contemplated will be adversely affected. In addition, as passed by the House, it would apply to tax years ending after November 1, 2007, but doubtless this 2007 effective date would have to be postponed if the legislation is ever enacted.

Commentators catalogued numerous flaws in Section 710, and Congress may decide to scrap this proposed Code section. But even if Section 710 is abandoned, other legislative techniques for taxing a larger portion of carried interests as ordinary income are sure surface soon.

Some observers wonder whether Section 710 presages broader legislation that would not merely recharacterize selected capital gains as compensation income, but would impose an across the board increase on otherwise tax-favored capital gains. There has been relatively little talk so far, however, about such a general increase in capital gain rates.

Some narrower proposals would close the “loophole” that allows Blackstone to be treated as a partnership for tax purposes, and to thereby avoid corporate-level tax. A publicly traded partnership – such as Blackstone now is -- must be taxed as a corporation unless it derives at least 90% of its gross income from passive sources. Under current law, capital gains and other investment-type income earned by Blackstone qualifies as passive, even if it is in some sense derived from providing investment advice and asset management services. Thus under current law -- but not under some of the proposals that have been floated -- Blackstone can continue to enjoy tax classification as a partnership. Only a handful of companies, including Blackstone, would be affected by this proposal.