

CBO TESTIMONY

Statement of
Peter R. Orszag
Director

The Taxation of Carried Interest

before the
Committee on Finance
United States Senate

July 11, 2007

This document is embargoed until it is delivered at 10:00 a.m. (EDT) on Wednesday, July 11, 2007. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.



CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

Chairman Baucus, Senator Grassley, and Members of the Committee, thank you for inviting me to testify on the taxation of carried interest.

My testimony makes the following main points:

- A growing amount of financial intermediation is occurring through private equity and hedge funds, which are typically organized as partnerships or limited liability companies and now have at least \$2 trillion under management. Those organizational forms are growing rapidly for many reasons, including their tax advantages over traditional financial services corporations.
- A general partner of a private equity or hedge fund typically receives two types of compensation: a management fee tied to some percentage of assets under management and “carried interest” tied to some percentage of the profits generated by those assets. The management fee is taxed as ordinary income to the general partner. Taxation on the carried interest is deferred until profits are realized on the fund’s underlying assets, and any resulting profits to the general partner are taxed at the capital gains tax rate to the extent the fund’s profits reflect capital gains.
- Most economists, however, would view at least part and perhaps all of the carried interest as performance-based compensation for management services provided by the general partner rather than a return on financial capital invested by that partner. That perspective would suggest taxing at least some component of the carried interest as ordinary income, as most other performance-based compensation is currently treated, regardless of the nature of the underlying investments generating the profits of the fund.
- A variety of proposals have been put forward to alter the tax treatment of carried interest. Policymakers considering those changes need to evaluate many factors, including the potential distortions created by the current tax treatment of partnerships and carried interest relative to that of other organizational forms and types of income; the consequences for a broad range of industries, including real estate development, if a general solution is adopted, or the advisability of industry-specific rules, if a solution targeted to financial investment funds is pursued; the potential unintended effects, complexity, and perceived fairness of tax changes; and any net revenue effects. My testimony briefly reviews several recent proposals to change the tax treatment of carried interest in light of those considerations.
- Much of the complexity associated with the taxation of carried interest arises because of the differential between the capital gains tax rate and the ordinary income tax rate, which creates an incentive to shift income into a form classified as capital gains. Further widening of the differential between the taxation of ordinary income and of capital gains would create even stronger incentives to shift income into the tax-preferred capital form.

I would also emphasize that any revenue estimates associated with changing the tax treatment of carried interest would be undertaken by the Joint Committee on Taxation. My testimony therefore does not discuss specific revenue effects from proposed changes to that tax treatment.

Recent Innovations in Financial Services

Financial markets have experienced substantial innovation over the past several decades. Those innovations have affected the assessment and pricing of risk (including the development of credit derivatives and interest rate swaps) and the use of financial markets in supplying credit. The resultant changes in the allocation of capital and the pricing and dispersion of risk has probably contributed to continued economic growth. By increasing businesses' and households' access to capital, financial innovations probably also help explain the dampening of business cycles and the significant decrease in macroeconomic volatility over the past two decades.¹ The innovations also, however, have facilitated an ability by individual market participants to assume substantially greater degrees of risk and thus raised concerns about potential systemic risks to the financial system.

In addition to their effects on the allocation of capital and dispersion of risk, the financial innovations have been associated with substantial rewards to many people engaged in financial activities. The compensation of the top executives of investment banking firms are among the highest in the country. Recently, the pay of those top executives has, if anything, been surpassed by the compensation of people managing investments through alternative structures such as private equity and hedge funds. A recent study estimated that in 2004, almost nine times as many of those types of investors earned in excess of \$100 million as did public company chief executive officers.² According to one press account, the top 25 hedge fund managers earned \$14 billion in 2006, with one manager earning more than \$1.5 billion. The substantial income accruing to managers of private equity and hedge funds is one facet of and a contributor to broader income trends.

Private equity and hedge funds in particular have played an increasingly important role as financial intermediaries:

-
1. See Karen E. Dynan, Douglas W. Elmendorf, and Daniel E. Sichel, *Can Financial Innovation Help to Explain the Reduced Volatility of Economic Activity?* Finance and Economics Discussion Series, Working Paper No. 2005-54 (Washington, D.C.: Federal Reserve Board, November 2005). The decline in macroeconomic volatility, however, does not appear to have been associated with a reduction in the volatility of household earnings or income. See Statement of Peter R. Orszag, Director, Congressional Budget Office, *Economic Volatility*, before the Joint Economic Committee (February 28, 2007).
 2. See Steven N. Kaplan and Joshua Rauh, *Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?* Working Paper No. 615 (Chicago, Ill.: University of Chicago, Graduate School of Business, Center for Research in Security Prices, September 13, 2006).

- **Private equity** funds raise capital to purchase or invest in new and existing businesses. They are private in the sense that their ownership interests are not publicly traded. Instead, they raise investment capital outside public financial markets from sources such as pension funds, endowments and foundations, and wealthy individuals. With those funds, they make various investments, including in publicly traded companies. Private equity firms may acquire mature public companies with the intent of converting them to private companies, restructuring or reorganizing their activities, and then later reselling them to the public or another firm. The initial purchase of a public firm by the private equity fund can be done through a leveraged buyout (LBO), in which the private equity firm relies heavily on debt raised from third-party investors to finance the necessary purchases of the public company's shares. Venture capital is a type of private equity that specializes in investing in small start-up businesses.

- **Hedge funds** trade in a variety of financial markets and typically adopt complicated investment strategies, often involving financial derivatives. Some funds buy and sell stocks of publicly traded companies or derivative instruments based on stocks, such as options. Some specialize in debt instruments based on corporate loans, mortgages, and credit card debt. Many derivatives of subprime mortgages are held in hedge funds. Other hedge funds specialize in trading currencies, commodities, and derivatives based on them. Despite their name, hedge funds are not necessarily "hedged" in the traditional sense of being insulated from risk; many hedge funds take significant risks either knowingly or unknowingly. As with private equity funds, hedge funds do not raise funds through public issuance of securities; instead, they typically raise capital from institutions and wealthy individuals. Hedge funds' investments are often intended to be shorter term and typically do not involve management control, in contrast to the investments made by private equity funds, although the distinction between hedge funds and private equity can become blurred in practice.

The role of private equity and hedge funds has expanded substantially in the past 20 years. From 1980 to 1995, the amount of capital under management in the private equity market increased from roughly \$5 billion to over \$175 billion.³ In the past decade, the market has continued to experience rapid growth, and by some estimates, private equity funds now have more than \$1 trillion under management. Estimates also suggest that roughly 8,000 to 9,000 hedge funds now exist, with more than \$1 trillion in funds under management. In other words, private equity funds and hedge funds together have more than \$2 trillion under management.

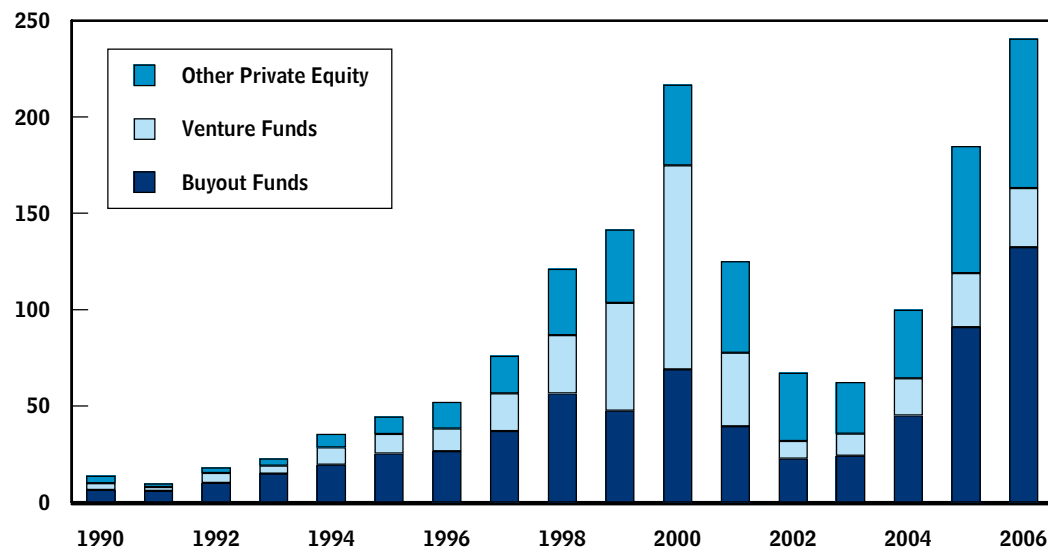
In 2006, private equity firms raised over \$240 billion in capital, up from less than \$25 billion a year in the early 1990s (see Figure 1). The private equity market is

3. See Stephen D. Prowse, "The Economics of the Private Equity Market," *Economic and Financial Policy Review*, Federal Reserve Bank of Dallas, Third Quarter (1998), pp. 21–34.

Figure 1.

Capital Raised by U.S. Private Equity Funds

(Billions of dollars)



Source: Congressional Budget Office based on data from Thomson Financial, Morgan Stanley Research.

dominated by a small number of major players. Over the past five years, the top five private equity firms have raised an average of \$30 billion in capital. The average amount raised among the next five largest firms was \$18 billion and among the next 40 largest firms, about \$8 billion.

The volume of private equity deals more than doubled in 2006, with LBOs accounting for almost 20 percent of the \$3.5 trillion in global mergers and acquisitions. This year, LBOs accounted for more than 17 percent of the \$2.26 trillion in deals through June 2007 and are on pace to break last year's record volume.⁴

Tax data provide another indication of the significant income that flows through entities such as private equity and hedge funds, along with other partnerships and S corporations. In 2005, capital gains from partnerships and S corporations were 22 percent of total current-year long-term capital gains reported on individual income tax returns, and 27 percent of the gains received by the 1 percent of taxpayers with the highest income (those figures do not include losses carried over from previous years).

4. Thomson Financial, as cited in "Who's Who in Private Equity," *The Wall Street Journal Online*, available at www.wsj.com.

Structure and Tax Treatment of Private Equity and Hedge Funds

Most private equity and hedge funds are organized as partnerships or limited liability companies; in most of this testimony, they are referred to simply as partnerships, because the tax characteristics of partnerships and most limited liability companies are essentially identical.

The partnerships typically consist of one or more general partners, who manage the partnership and determine the investment strategy, and limited partners, who contribute capital to the partnership but do not participate in management. General partners may also invest their own financial capital in the partnership, but such investments usually represent a small share of the total funds invested. (The general partner is itself typically a partnership, with the individual managers of the fund as partners.)

Several factors may motivate private equity and hedge funds to be organized as partnerships. For example, a partnership structure is often attractive because its flexibility can accommodate complex financial arrangements among those managing the fund and those contributing capital to it. It is likely, however, that tax law plays an important role in explaining why so much financial management activity is now occurring through partnerships. In particular, private partnerships (and limited liability companies electing to be treated as a partnership for tax purposes) do not pay a separate corporate income tax. Instead, they pass all income and losses through to the partners, who are liable for any income tax. As described below, the partnership structure is also attractive to investment fund managers because of the manner in which part of their compensation (the so-called carried interest) is taxed.

In contrast to private partnerships, publicly traded partnerships are generally treated as corporations for tax purposes and are subject to the corporate income tax. (The primary exception to this rule is that certain partnerships that derive at least 90 percent of their income from passive investments such as dividends, interest, rents, and capital gains or from mining and natural resources and that are therefore not required to register as investment companies under the Investment Company Act of 1940 do not pay the corporate tax.)

The taxation of the partnership entity itself is not the primary focus of my testimony, although it is worth noting that corporate income tax revenues have declined over the past several decades relative to the size of the economy, partly because of the effects of financial innovation and global integration and possibly because of the increased use of noncorporate forms of conducting business (which were created in part to avoid the potential distortions associated with corporate

taxation).⁵ Developments such as the growth of private equity and hedge funds may affect corporate income tax revenues in the future; a number of private equity firms, for example, are taking steps to go public without relinquishing their exemption from the corporate tax. Legislation introduced by Chairman Baucus and Ranking Member Grassley would tax as corporations publicly traded partnerships that derive income from asset management or as investment advisers.

Carried Interest

A general partner in a private equity or hedge fund is typically compensated in two ways: through a fixed management fee and a share of profits.

The fixed management fee, usually 1 to 2 percent of the assets under management, does not depend on the performance of the fund. For example, if the fund had \$1 billion in assets under management and a 2 percent management fee, the management fee would amount to \$20 million a year, and that amount would not depend on the return on the \$1 billion in assets. The \$20 million would be taxed as ordinary income to the general partner and would generate a deduction as an investment expense for the limited partners.

The second component of the general partner's compensation is a share of the profits on the assets under management. That component, which is often 20 percent of such profits, is usually referred to as carried interest, or, simply, carry.⁶ For example, assume the fund with \$1 billion in assets generated a 15 percent realized profit in a year. Of the \$150 million in profits, the general partner earning 20 percent carried interest would receive \$30 million. The other \$120 million in profits would be split among the investors in the fund (including the general partner if he or she owned some of the capital in the fund in addition to managing it). In many cases, the general partner earns carried interest only when profits exceed some threshold.⁷ For example, in many private equity funds, the general partner will

5. Corporate tax revenues declined from 3.6 percent of gross domestic product (GDP) in 1962 to 1.2 percent in 2003. A recent surge in corporate tax collections has temporarily reversed that longer-term trend—corporate tax revenues rose from 1.2 percent of GDP in 2003 to 2.7 percent in 2006, explaining the bulk of the overall increase in federal revenues over that time—but CBO projects a gradual decline in that share from current levels. See Congressional Budget Office, *Federal Tax Revenues from 2003 to 2006* (May 18, 2007) and *The Budget and Economic Outlook: Fiscal Years 2008 to 2017* (January 2007).

6. Managers of public mutual funds are not permitted to be paid in that fashion. Because private equity and hedge funds are exempt from the Investment Company Act of 1940, however, that form of compensation is permitted.

7. Such a preferred return for the limited partners is more common in private equity buyout firms than in venture capital firms. See Victor Fleischer, "The Missing Preferred Return," UCLA School of Law Research Paper No. 05-8 (February 2005).

receive carried interest only when profits exceed a “hurdle rate,” often an 8 percent return.⁸

Tax Issues Surrounding Carried Interest

Carried interest arrangements for partnerships raise two significant tax issues: the timing and the character of the income earned by the general partner. Both of those issues involve the same underlying question, which is whether a general partner’s carried interest should be treated as a quasi-investment in the partnership by the general partner, with the result that the carried interest would be subject to the same tax rules as apply to the limited partners’ partnership interests, or whether the general partner’s carried interest is more properly viewed as some form of contractual undertaking by the limited partners (or the partnership) to compensate the general partner for management services.

Deferral of Taxation

The first tax issue involves the timing of a general partner’s tax liability for the carried interest that he or she receives for managing the fund. Under current law and regulations, carried interest is not taxed at the time the right to the future profits is granted (for example, when the partnership is created) but rather when the partnership realizes profits that are allocated to the general partner.

At one level, deferral is a specific example of a more pervasive phenomenon, which is the tax code’s reliance on realization events—the sale of an investment, for example—to determine the timing of income from investments. Indeed, limited partners in a private equity fund also enjoy the benefits of deferral: They do not pay tax on unrealized gains but only on gains that have been recognized through a sale or similar event.

At another level, however, deferral as applied to a general partner’s carried interest effectively assumes the conclusion of the underlying technical and policy issue: whether the general partner’s carried interest should be treated as a simple investment by the general partner (albeit one that has no claim to the current capital of the fund but only to the future appreciation thereof), or whether, at least to some degree, the carried interest in substance is a form of compensation paid by the limited partners to the general partner for services in managing the fund. Most analysts believe that alternative characterization is more accurate.

8. If that 8 percent hurdle rate applied to the example, the general partner would receive the 20 percent carried interest on \$70 million (which is the \$150 million in profits minus the threshold of \$80 million that must be exceeded before carried interest applied), or \$14 million.

More specifically, carried interest can be viewed as a call option on a limited partnership interest, with a value equal to 20 percent of the future capital in the fund and a strike price equal to 20 percent of the initial value of the fund.⁹ Options pricing formulas, such as the Black-Scholes formula, can then be applied to valuing the carried interest. Although various complications arise in applying such options pricing techniques (including the requirement to estimate both the duration of the fund and the volatility of the underlying investments), it is clear that whatever the imperfections in the valuation process, an interest in future profits has some value greater than zero.

It is worth noting that deferral of taxation on carried interest generates a tax benefit to the general partner (who does not recognize income initially) but a tax cost to the limited partners (who do not enjoy a deduction or other reduction in taxable income at that point). Many limited partners are either tax-exempt entities in the United States or foreign institutions (see Table 1), however, so they may be largely unaffected by the lack of an immediate U.S. tax benefit. The net result is, therefore, the overall deferral of a net tax liability.

Treatment as Capital Gains or Ordinary Income

The second issue is the character of the income received as carried interest. Under current law and regulations, carried interest is treated in the same way as all other profits from the partnership for tax purposes. In particular, carried interest flows through to the general partner on the basis of the nature of the income from the underlying investments. Thus, if the carried interest arises from realizations of long-term capital gains on the investments held by the fund, the general partner is taxed on the carried interest at the long-term capital gains rate. In the paradigmatic private equity case, most profits arise from long-term capital gains, so the profit allocated to the general partner's carried interest will be taxed as long-term capital gains.¹⁰ For simplicity, the remainder of this testimony assumes that case and also assumes that no hurdle rate is applied to the carried interest. Such a hurdle rate would affect the precise examples and calculations but not the underlying substance of the issue.

9. A call option gives the holder the right to purchase an asset at the strike price. Consider a fund with \$1 billion under management and 20 percent carried interest. If the fund then grows in the future to \$1.5 billion, the general partner will be entitled to 20 percent of the \$500 million increase, or \$100 million. That outcome is equivalent to a right to receive 20 percent of the future value of the fund ($\$1.5 \text{ billion} \times 20 \text{ percent} = \300 million) in exchange for paying 20 percent of the initial value of the fund ($\$1 \text{ billion} \times 20 \text{ percent} = \200 million). This example assumes no hurdle rate is applied to the carried interest; the presence of such a hurdle rate would be reflected in the valuation of the option.

10. A hedge fund's income from securities trading, by comparison, usually constitutes a short-term capital gain or ordinary income, particularly if, as often is the case, the fund has elected to be taxed as a securities trader under section 475(f) of the Internal Revenue Code.

Table 1.

Percentage of Capital Investment in Private Equity by Type of Limited Partner

	2005 ^a	2006 ^b
Public Pension Funds	22	26.6
Corporate Pension Funds	10	12.3
Union Pension Funds	1	1.4
Banks and Financial Services	6	9.8
Insurance Companies	12	7.5
Endowments/Foundations	10	7.7
Family Offices	11	6.8
Wealthy Individuals	10	10.1
Funds of Funds	13	13.9
Other	5	3.9
Total	100	100

Source: Private Equity Council, *Public Value: A Primer on Private Equity* (Washington, D.C., 2007), p. 11.

a. Based on a sample of more than 75 global funds with total capital of over \$32 billion.

b. Based on a sample of more than 110 global funds with total capital of over \$44 billion.

To see how that system of taxation works, assume that a fund realized a profit of \$150 million in long-term capital gains and that the carry was equal to 20 percent of that profit, or \$30 million. The general partner would then pay capital gains tax on that \$30 million; at a capital gains tax rate of 15 percent, the tax owed would be \$4.5 million.

As an economic matter, the character of carried interest income should not depend on whether the compensation is performance-based. A wide range of performance-based compensation, including arrangements in which service providers accept the entirety of the risk of the success or failure of the enterprise, is effectively labor income and taxed as ordinary income for services. Contingent fees based on movie revenue for actors, for example, are taxed as ordinary income, as are performance bonuses, most stock options, and restricted stock grants.¹¹ So too are incentive fees paid to managers of other people's investment assets, when those fees are documented as such rather than as carried interest in a formal partnership. Instead, the key issue is whether the carried interest represents a fee for services provided or a

11. The tax treatment of nonqualified stock options, which are the most common type of options, is an example. Nonqualified stock options are generally taxed when they are exercised (although the tax can be delayed if the purchased shares are subject to a substantial risk of forfeiture), and the difference between the market price at the time of exercise and the strike price (multiplied by the number of shares) is taxed as ordinary income. The tax treatment of incentive stock options is more advantageous, but current law significantly limits the value of such options that can receive favorable tax treatment.

return of partnership long-term capital gains allocated to one partner (the general partner) under conditions that are not qualitatively different from the returns allocated to the other partners (the limited partners).

Most legal and economic analysis suggests that carried interest represents, at least in part, a form of performance-based compensation for services undertaken by the general partner. Although individual analyses differ slightly, there are two important themes with which most analysts concur. First, a general partner in a private equity or hedge fund undertakes a fundamentally different economic role from that of the limited partners, because the general partner is responsible (by virtue of his or her expertise, contacts and experience, and talent) for managing the fund's assets on a day-to-day basis. Second, the carried interest is not principally based on a return to the general partner's own financial assets at risk. If the purpose of the preferential rate on long-term capital gains is to encourage investors to put financial capital at risk, there is little reason for that preference to be made available to a general partner, whose risk involves his or her time and effort rather than financial capital.

Some observers view carried interest as a mixture of compensation for management services and capital returns. For example, one can think of carried interest as an interest-free nonrecourse loan from the limited partners to the general partner equal to 20 percent of the partnership assets, with the requirement that the loan proceeds be reinvested in the fund. (A borrower is not personally liable for a nonrecourse loan, beyond the pledged collateral, which in this case is the general partner's claim on future profits.) To see how this example works, imagine a fund worth \$100 million. With no direct capital investment, the carried interest entitles the general partner to the profits on \$20 million (20 percent of the profits on \$100 million is equivalent to the full profits on \$20 million). It is therefore as if the limited partners have contributed \$80 million to the fund and then lent the general partner \$20 million to invest in the fund too, but without charging the general partner interest on that loan.

This implicit loan perspective would result in treating carried interest somewhere between purely capital income and purely ordinary income. In particular, under current tax rules, the implicit interest on an interest-free loan would be taxed as ordinary income, with the interest rate set at the current rate on federal securities with the same duration as the loan. At the time the partnership sold its assets, any gain or loss to the general partner, after paying back the loan, would be treated as capital. In effect, then, this perspective would suggest that the component of carried interest attributable to implicit interest on the implied loan would be ordinary income and that the returns in excess of that implicit interest would be capital income.¹²

12. The presence of a hurdle rate on the carried interest would affect the calculation of the forgone interest on the implicit loan provided to the general partner.

The differential tax treatment of carried interest relative to the management fees earned by general partners has apparently led to efforts to transform management fees into carried interest. Consider the example of the \$1 billion investment fund with a 2 percent management fee, 20 percent carried interest, and a 15 percent realized profit on long-term capital gains. The general partner would then receive \$50 million in income: \$20 million in management fees and \$30 million in carried interest. With a 35 percent ordinary income tax rate and a 15 percent long-term capital gains tax rate, the general partner would pay \$11.5 million in income taxes. If the general partner was able to reduce the management fee to 1 percent and increase the carried interest to 26.7 percent, the income flowing to the general partner would remain \$50 million (\$10 million in management fees and \$40 million in carried interest). The taxes owed, however, would decline by \$2 million, to \$9.5 million. Such transformations of management fees into carried interest have apparently occurred, in some cases even after realized profits are known. Those types of transformations further highlight some of the similarities and, therefore, the interchangeability between management fees and carried interest. That those components of compensation are substituted for each other suggests, at least in part, that both types of income represent compensation to the general partner for management of the fund.

Finally, the issues of characterizing a flow of income as a return on capital or compensation for services provided are not unique to private equity or hedge fund partners and are not new developments. Many real estate development deals, for example, are structured as partnerships with essentially similar characteristics, in which an active manager or developer obtains a disproportionate share of partnership income or profits in return for his or her contributions of intangibles (contacts, know-how, and so forth) and management of the project. Nonetheless, the typical private equity firm presents the paradigmatic case for considering the appropriate tax treatment of carried interests.

Options for Modifying the Tax Treatment of Carried Interest

The tax issues described in the previous section have given rise to proposals to change the current tax treatment of carried interest. Policymakers considering such proposals may want to weigh the underlying substance of the tax issue at hand with various other considerations. For example, in general, changes in tax policy that have significant and potentially unexpected effects on particular industries should be approached with caution, because a broader policy objective may be served by stability and an associated perception of fairness. Furthermore, as noted above, carried interest arises not just within private equity and hedge funds; it is also a common feature of partnerships in other sectors. Many of the underlying tax issues that arise with regard to the taxation of carried interest in the financial services sector arise in those other sectors as well, and policymakers interested in changing the tax treatment of carried interest therefore need to evaluate the costs

and benefits of changing that treatment for all carried interest relative to restricting the change to the financial services industry.

Several proposals have been put forward to modify the tax treatment of carried interest. Under these proposals, some, if not all, carried interest would be treated as ordinary income regardless of the type of asset generating the fund's profits.¹³

Tax Carried Interest as Property When Granted. One alternative would be to tax the general partner on carried interest when granted. Under section 83 of the Internal Revenue Code, property (other than an option) transferred to a person in connection with the performance of services is generally taxed when that property is transferred. Under relatively unusual facts, the tax court held in *Diamond v. Commissioner* that the grant of a carried interest right “with determinable market value” constituted current ordinary income to the general partner.¹⁴ Because carried interest may be difficult to value, though, most practitioners continued to view the granting of carried interest as a nontaxable event. The Internal Revenue Service later embodied that view in Revenue Procedure 93-27. One possibility would be to alter that revenue procedure and apply section 83 to the grant of a carried interest. The valuation could then be done by Black-Scholes or some other method.¹⁵ The grant would be currently taxable as ordinary income to the general partner and generate a deduction for the limited partners.¹⁶

This approach would affect both the deferral component of carried interest and its character. For the reasons described above regarding the limited impact from a deduction granted to the limited partners, the result would be a net acceleration of revenues received by the federal government. Another result would be that the carried interest (its value determined at the time it was granted) would be treated as ordinary income. To the extent that the carried interest then appreciated or depreciated in value relative to the initial estimate, the changes would be taxed as capital gains or losses.

This approach would require some acceptable valuation methodology, however, which might be difficult to apply in the wide variety of circumstances in which carried interest arises. Furthermore, even with an accepted valuation methodology, modest changes in the assumptions applied may generate significant changes in

13. To implement any of these options, policymakers would also need to decide whether to treat the resultant ordinary income as labor income; if so, the income would also generally be subject to payroll taxation. The arguments in favor of viewing carried interest as ordinary income would tend to suggest that tax treatment.

14. *Diamond v. Commissioner*, 56 T.C. 530, (1971), (*aff'd*), 492 F. 2d 286 (7th Cir. 1974).

15. See, for example, Lee A. Sheppard, “Blackstone Proves Carried Interests Can Be Valued,” *Tax Notes*, vol. 115, no. 13 (June 25, 2007), pp. 1236–1243.

16. Although the valuation of the grant may be undertaken using options pricing methodologies, this tax treatment would differ from that applied to nonqualified stock options, which are typically not taxed when they are granted but when they are exercised.

valuation—creating opportunities to understate the value of the carried interest when granted. Finally, as noted above, deferral arises in a variety of settings across the tax code, and some observers believe eliminating deferral in this context but not others would not be justified.¹⁷

Tax Carried Interest as Ordinary Income When Realized. A second option would be to continue to allow deferral but to view carried interest as a fee for services provided and therefore tax the income distributed to the general partner as ordinary income. Carried interest would thus be taxable to the general partner as ordinary income and deductible as an expense incurred to earn investment income to the limited partners. As an example of this broad approach, consider the fund with \$1 billion in assets and 20 percent carried interest. If the fund earned a realized profit of 50 percent, the carried interest of \$100 million would be taxed to the general partner as ordinary income (rather than capital gains). At a 35 percent tax rate, the income tax owed would be \$35 million, rather than the \$15 million that would be due if the income were taxed at the 15 percent capital gains tax rate.¹⁸

H.R. 2834, introduced by Representative Levin and others, would implement this approach. Another approach proposed to accomplish the same objective is to modify section 707(a)(2)(A) of the Internal Revenue Code to require that carried interest be treated as a transaction between the partnership and a nonpartner; the result would be to treat the carried interest as ordinary income.¹⁹

This approach would most closely mirror the tax treatment of nonqualified corporate stock options, which share many characteristics with carried interest. As with the tax treatment of nonqualified options, this approach would not eliminate the deferral of taxation (because it would not impose the tax when the carried interest

17. For example, carried interest in the partnership context has much in common with employee stock options that a corporation might grant to valued employees. The tax code typically taxes those options as ordinary income only on exercise, in an amount equal to an employee's economic gain at that time (that is, the difference between the corporate stock's fair market value on the exercise date and the price paid by the employee under the terms of the option). Policy-makers may want to consider whether it is appropriate to create a timing rule for carried interest that would vary significantly from the general rule adopted for somewhat analogous nonqualified employee stock options.

18. Again, the limited partners would receive an ordinary income tax deduction, but the net effect would probably be a revenue gain for the reasons described earlier in the text.

19. See Lee A. Sheppard, "The Unbearable Lightness of the Carried Interest Bill," *Tax Notes*, vol. 116, no. 2 (July 12, 2007), pp. 15–21.

was granted) but it would impose ordinary income taxation.²⁰ This approach would also most directly reflect the view that carried interest fully represents performance-based compensation for services provided.

The approach might, however, create various tax planning opportunities, including the use of nonrecourse loans from the limited partners to the general partner, to attenuate its impact. Finally, although there is widespread agreement among analysts that at least some component of carried interest represents compensation for services provided, there is somewhat less agreement that the full amount of carried interest represents such compensation. To the extent that at least some component of carried interest is viewed as a return on capital invested, this approach could be viewed as overtaxing carried interest.

Tax Imputed Interest on the Implied Loan.²¹ A third option would be to explicitly treat the general partner's carried interest as a nonrecourse loan from the limited partners and tax the value of the implicit interest to the general partner as it accrued. As a result, that part of the carried interest would be treated as ordinary income, and part would be treated as a return on capital.

Consider again a private equity or hedge fund partnership that starts with \$1 billion in assets. The underlying assets are sold after three years for \$1.5 billion, generating a realized profit of \$500 million. With 20 percent carried interest, the general partner would receive \$100 million when the fund liquidated or sold the assets (20 percent of the \$500 million profit). Under current law, the general partner would pay a tax of \$15 million on his or her share of the profits (15 percent of \$100 million), under an assumption that the distributions qualified as long-term capital gains. If the carried interest was treated as ordinary income, as in the option above, the general partner would pay a tax of \$35 million (35 percent of \$100 million).

If, instead, the 20 percent carried interest was treated as a nonrecourse interest-free loan with the loan proceeds invested in the fund, the general partner would generally pay a higher tax than under current law but generally less than under the ordinary income option. In particular, in the example, the general partner would be treated as if he or she had received a \$200 million loan from the limited partners, which he or she then invested in the fund, obtaining a 20 percent interest in the fund. After three years, the general partner would be treated as if he or she

20. Apparently because of concerns about valuation, nonqualified stock options are generally not taxed when they are granted, but rather when they are exercised. Such valuation concerns are similar to those surrounding the value of a carried interest when granted, and the typical deferral of taxation on nonqualified stock options until they are exercised may suggest that the taxation of carried interests should also be deferred, as this option would entail.

21. One analyst describes this option as a cost-of-capital approach. See Victor Fleischer, "Two and Twenty: Taxing Partnership Profits in Private Equity Funds," University of Colorado Legal Studies Research Paper Series, Working Paper No. 06-27 (June 12, 2007).

received a 20 percent share of the \$1.5 billion in assets held by the fund, or \$300 million, and paid back the \$200 million loan. The general partner would thus have a realized gain of \$100 million (the underlying carried interest). The tax on that \$100 million would be \$15 million, again under the assumption that the fund's profits qualified as long-term capital gains. However, because the loan from the limited partners was interest-free, the general partner would be required by current law to count the forgone interest payments as ordinary income and pay tax on them each year.²² With a 5 percent interest rate, the implied ordinary income would be \$10 million per year, and the tax would be \$3.5 million per year.²³ The time value of money aside, the total tax bill would be \$25.5 million (\$15 million plus \$10.5 million). That tax liability, as expected, falls between the tax liability of \$15 million under full capital gains tax treatment and the \$35 million under full ordinary income tax treatment.

One advantage of this approach is that it may be more resistant to financial planning that does not change the underlying economics of the partnership arrangement. It also reflects the view that some analysts hold that carried interest is neither entirely a return on capital nor entirely labor compensation. However, the approach is clearly complex. The extent of the complexities involved may make this approach particularly difficult to implement in practice.

A Broader Issue: Differential Tax Rates on Capital and Labor Income

Much of the complexity associated with the taxation of carried interest arises because of the differential between the capital gains tax rate and the ordinary income tax rate. In particular, ordinary income for high-income taxpayers is typically subject to a 35 percent marginal income tax rate and, in the case of labor income, an additional 2.9 percent payroll tax for Medicare. Long-term capital gains for such taxpayers are typically subject to a 15 percent tax rate. The difference creates a strong incentive to shift income into forms classified as capital gains. Whether carried interest represented compensation for services provided or a return on capital invested would be largely irrelevant if the tax rates on labor and capital income were the same (although the issue of deferral would still remain).

22. This option assumes that the general partner would not receive a deduction for the imputed interest payments on the implicit loan. Under current law, imputed interest on actual loans may generate a deduction for the borrower. Advocates of this option, however, would not extend such a deduction to the general partner (the borrower of the implicit loan); they justify such a deduction in different ways.

23. The example follows the convention of using the federal interest rate on short-term securities. The choice of the proper interest rate is a significant issue in this approach, however. A 5 percent interest rate is arguably too low for a nonrecourse loan on a risky asset. The presence of a hurdle rate on the carried interest would also affect the calculation of implicit interest.

The Tax Reform Act of 1986 set the tax rate on capital gains at the same rate as the tax on ordinary income, but legislation since then has reintroduced differential tax treatment. A lower tax rate on capital gains and dividends than on other forms of income creates opportunities for tax avoidance and complicates the tax system. Income from sole proprietorships, S corporations, and other noncorporate entities is a mix of returns to capital and returns to labor, and a significant portion of the tax code is devoted to attempting to distinguish one type of income from another.

As the tax rate differential increases, the distinctions among different types of income assume greater importance. Proposals to reduce the tax on capital income (for example, by moving to a consumption tax) or to raise the tax on labor income (for example, by increasing the payroll tax) would increase the differential further and thereby create an even stronger incentive to shift income into a form classified as capital.

One motivation for differential tax treatment has been a desire to promote capital formation and economic activity. The empirical evidence suggests, however, that a low capital gains tax rate has only modest effects on such outcomes. Furthermore, the application of that broader motivation to carried interest in investment funds is unclear, because the financial capital that is gathered and invested in such funds is provided almost entirely by the limited partners, not the general partner.

Many considerations need to be taken into account in evaluating the appropriate tax rate on capital income. The income-shifting incentives and potential associated distortions created by differential rates on capital and income, which are highlighted by the debate over carried interest, represent one consideration.