Statement of Charles I. Kingson

Recent discussion suggests that amounts received for managing capital assets constitute gain from their sale. The issue is spoken of as the correct taxation of a carried interest in a partnership. A carried interest attributes to its holder both ownership of the underlying assets and income from their sale.

But since the profits interest held by the managers is not a carried interest, the argument fails. The concept of a carried interest as ownership of underlying assets and income –on which capital gain treatment rests - comes out of oil and gas law. That law is long outdated, and even when in effect applied only to taxation of mineral interests.

Instead, capital gain should be determined by how tax law treats a derivative, a concept that comes out of the financial community. Derivatives mimic ownership without having it and mimic lack of ownership despite having it. The managers' interest is a derivative, since they are intended to receive the same amounts they would have received had they owned and sold the stock.

Someone with a 20 percent interest in the appreciation of a $100 pool of assets could be considered to have invested in them by obtaining a $20 loan that he contributed to the partnership. Interest on the loan would be paid by performing services.[1] But since the loan would be nonrecourse – the manager does not bear loss on the $20 – what the money manager receives constitutes equity: the equivalent of annual stock appreciation rights.[2]

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[1] Section 7872

[2] The interests are in fact a series of annually granted stock appreciation rights (SARs) or stock options. (A SAR is an option without need to make an investment.)

The advantage of a profits interest over SARs or options can be seen with a two-year example. If in year one the fund grows from $100 to $150, the managers are entitled to $10, 20 percent of the $50 appreciation. Someone exercising a SAR or option would also have $10, but the ride would be over. If the fund grew to

Clothing the arrangement as a partnership should not change the analysis. Evidence that the partnership form makes no economic difference is that when foreign investors are concerned about U.S. taxation, the same arrangement becomes a performance fee; and when the fund is structured as a corporation, investors get A shares with $100 liquidation preference while the 20 percent fee embeds in the B shares. [3] Nor does state law control classification as a partnership.[4]

The debate over carried interests should be seen as part of a derivative free-for-all, a sort of financial check-the-box regime, in which people can choose between the tax attributes of owning or not owning property. Examples include equity swaps, tracking stock, and transactions that led to sections 1258 and 1259.

The common law of taxation has not coped with this especially well, although it is doing a far better job than its detractors (and some people facing penalties) assume. For example, almost 50 years ago the Tax Court help that a money manager's share of profits constituted compensation. [5] And a case denying carried interest treatment for nonmineral property said what should apply today: "A taxpayer does not have an economic interest merely because his right to payments is linked to profits, dividends, farm produce or the like."[6]

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$250 in year two, the SAR or option holder would have no further benefit. By contrast, a manager would get an additional $20, as though he had been granted a second SAR.

The same $20 could be obtained by not exercising the SAR until the end of year two, but that delay entails risk of losing the $10. If the fund goes back down from $150 to $100, the holder gets nothing, but the manager retains his $10 from year one.

[3] Section 875

[4] Cf. reg. section 301.7701-2 and -3; S & M Plumbing, 55 T.C. 702 (1971) (acq.). Moreover, the profits interest does not share loss. If the partnership anti-abuse rule has any bite, use of a partnership to claim capital gain from performing services should have been high on the list. But conflicts apparently prevented even bar associations form raising this.

[5] Smith v. Commissioner, 33 T.C. 465 (1959).

[6] Bryant v. Commissioner, 399 F.2d 800, 806 (5th Cir. 1968).

Even if the partnership form is given effect, the managers should be considered to have received an interest in partnership capital rather than profits; and receipt of a capital interest for services is taxed as compensation. The partnership tax law distinction between capital and profits interests envisions the difference between operating income of a business and appreciation of its assets. For example, someone who becomes partners with a building owner and agrees to run a candy store there for 20 percent of the profits would not expect to share in gain from the building; and the interest is clearly a profits interest.

By contrast, for an investment fund the concept of profits runs the two together. In this context appreciation of assets **is** the operating income, and 20 percent of profits meant just that. This leads to inconsistent approaches. For compensation purposes, investment managers look to the candy store model of an income interest. For characterization, the profits interest becomes the ownership of capital assets. The managers have acquired an interest in the partnership's capital assets without ever having received an interest in its capital. For compensation to be consistent with characterization, the interest received by the managers for their services should be considered an interest in partnership capital.

The essence of tax law is to define what words mean. For example, a large proportion of Supreme Court tax cases turn on the meaning of everyday words like gift, income, dividend and sale. This hearing is about the meaning of the word "compensation," amounts received for services. Investment managers perform services. The medic in the movie "*Battleground*" knew the difference. Called out to defend Bastogne, he told the infantryman who handed him a rifle, "I want you to teach me to shoot it, not sell it to me."