

## How to Tax Carried Interests

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There is a fairly simple solution to the problem of the taxation of carried interests: amend Section 702(b) to treat a partner's distributive share as ordinary income when the partner receives the distributive share as compensation for services rendered by the partner to the partnership.<sup>1</sup> The capital accounts system, which is the core of modern Subchapter K, makes this fairly easy to do. This change would also solve some other substantive and technical problems under current law.

### The Carried Interest Problem

Managers of private equity funds typically are compensated for their services by being paid a base fee of 2 percent of the fund's assets plus 20 percent of the fund's profits. The 2 percent is ordinary income to the manager and an expense to the fund. The 20 percent is taxed as if it was an investment return. If the profits are in the form of capital gains, then this part of the manager's compensation is taxed at the capital gains rate (15%) and not at the ordinary rate (35% or more with phase outs). If it is interest income, then the manager avoids the self-employment tax (the 2.9% Medicare or Hospital Insurance tax has no ceiling). If it is tax exempt income, then the compensation is tax free. The unfairness of this is evident. It may also be inefficient as it may distort contract design and resource allocation.

### Current Law

The question of how to tax a partner who receives a profits share as compensation for services is an old one. It has long been settled that a partner who receives a capital interest in a partnership as compensation has ordinary income, generally when the interest no longer is subject to forfeiture. Regulations proposed in 2005 would settle two open questions.<sup>2</sup> One question regards the measure of income. The choices are between the market value of the interest (what a buyer would pay for the interest in an arms-length transaction) and the liquidation value of the interest (what the partner would receive if the partnership sold all of its assets for their fair market value, repaid its debts, and then liquidated). The market value of an interest may be lower than the liquidation value because of such factors as illiquidity or a minority discount. The other question regards the treatment of other partners. In particular, if the partnership has appreciated assets, then do the other partners recognize gain on the exchange of the interest for services, as they would have recognized gain had they exchanged the underlying assets for the services? The proposed regulations provide the service partner is taxed on the liquidation value (assuming an election is made) and that other partners do not recognize gain or loss on the underlying assets.

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<sup>1</sup> Section 1402 also should be amended to make this income subject to the self-employment tax.

<sup>2</sup> See Notice 2005-43, 2005-24 IRB 1221.

Debates over how to tax a partner who receives a profits interest for services generally have focused on the possibility of taxing the service partner on receipt of the interest. Two cases that are staples of the partnership tax course, *Diamond*<sup>3</sup> and *Campbell*,<sup>4</sup> hold that a service partner has income on receipt of a profits interest. In the odd circumstances of these cases, the result made sense. But there is little sentiment for generalizing the rule. It is not in Treasury's interest to try to tax profits interests on receipt because most such interests are of speculative value, and usually the right to profits is contingent on the performance of services during the period the profits are earned. The risk of forfeiture gives a taxpayer the right to elect whether to be taxed on receipt. The speculative value enables a taxpayer to assign a low value to an interest if she elects to be taxed. The combination invites strategic behavior.

Treasury responded to *Campbell* in 1993 with a ruling that a partner was not taxed on receipt of a profits interest for services, except in three limited situations not relevant here.<sup>5</sup> The 2005 proposed regulations maintain this position while integrating it with Section 83, which generally governs the taxation of compensatory transfers of property. Under the proposed regulations, to avoid tax on grant of a profits interest, the partnership agreement must provide for something called a "safe harbor election."<sup>6</sup> On the election the interest is valued based on its liquidation value at the time of grant, which is zero in the case of a profits interest. In addition, if the profits interest is subject to a substantial risk of forfeiture, which typically is the case, the service partner must make a Section 83(b) election so that the profits are not taxed as compensation when the right to them vests.

This is not a happy resolution of the matter for reasons independent of the problem of carried interests. It is not clear what tax consequences follow if people do not make the elections. If general Section 83 principles apply, then a service partner would have ordinary income equal to the market value of a right to partnership profits when her right to those profits is no longer subject to a substantial risk of forfeiture. The other partners would include the service partner's share of profits in their income and get a deduction equal to the amount of the service partner's income when her right to the profits vests. This may temporarily shift income from the service partner to the other partners if her right to the profits vests in year after they are earned. And, if the right to profits is valued at either a discount or a premium, this creates offsetting built-in gains and losses between the service partners and the other partners.<sup>7</sup> While it is hoped that

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<sup>3</sup> *Diamond v. Commissioner*, 492 F.2d 286 (7<sup>th</sup> Cir. 1974).

<sup>4</sup> *Campbell v. Commissioner*, 943 F.2d 815 (8<sup>th</sup> Cir. 1991).

<sup>5</sup> Rev. Proc. 93-27, 1993-2 C.B. 343. The exceptions were (1) an interest in a substantially certain and predictable stream of income; (2) the partner sells the interest within two years; and (3) a limited partnership interest in a publicly traded partnership. Under the proposed regulations, the safe harbor election is not available in these situations. Rev. Proc. 2001-43, 2001-2 C.B. 19, clarified that when a partner was granted a nonvested profits interest he would be treated as receiving the interest on the date of grant so long he was treated as a partner from that date.

<sup>6</sup> As an alternative to making the election in the partnership agreement the partners may make the election individually so long as all do so. A global election is required to prevent partners taking inconsistent positions.

<sup>7</sup> Consider an example. Assume A manages assets worth \$1 million and the partnership earns \$100,000 in year one. Her share of profits is \$20,000. Assume that her right to these profits is worth only \$15,000 (this

taxpayers will make the required elections to avoid these problems, it is odd to require taxpayers to make two elections to avoid a trap.

The proposed regulations also leave the carried interest problem uncorrected. Treasury is not to be faulted for it does not have the statutory tools to solve the problem.<sup>8</sup> But a solution is available within the general framework of Subchapter K.

### The Solution Available in the Capital Accounts System

Congress could take an important step towards solving the problem of carried interests by amending Section 702(b) to provide that a partner's distributive share shall be treated as ordinary income when it is compensation for services rendered by the partner to the partnership. Section 1402 also should be amended to make this income subject to the self-employment tax.

This is only a partial solution for it creates subsidiary problems. The capital accounts system in Subchapter K solves these problems. Under current law, the capital account measures the value of assets contributed by a partner to a partnership, plus the partner's distributive share of income, minus the partner's distributive share of losses, and minus the value of distributions to the partner. In addition, when there is a non pro rata contribution or distribution from a partnership, assets generally are booked up or down to their fair market value and partners' capital accounts are adjusted accordingly. The capital account system is a linchpin of the rules on special allocations, built-in gain or loss, basis adjustments, and more. It is the conceptual framework of modern Subchapter K.<sup>9</sup>

The capital account makes it possible to identify when a distributive share is compensation. A simple rule would characterize a distributive share as compensation if the partner performs services for the partnership to the extent the distributive share is in

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could well be the case if the profits are undistributed, A does not have the power to compel a distribution, and the interest is illiquid). Under general Section 83 principles, A would \$15,000 ordinary income and the other partners would have \$85,000 income (their share of profits, plus A's share, minus an expense equal to A's income). Comparing the basis of the interest and the capital account, A would have a \$5,000 built-in gain and the other partners a \$5,000 built-in loss. If A's right to the profits vested in a year after they were earned, then the other partners would have \$20,000 income on profits that probably would ultimately go to A and an offsetting deduction of \$15,000 when A's rights to the profits vests.

<sup>8</sup> Section 707(a)(2)(A) is not a reliable tool. It empowers Treasury to issue regulations to recharacterize allocations and distributions to a partner for the performance as services as a transaction with a nonpartner if they are properly so characterized. This rule is alongside and was enacted with the rules on disguised sales in 1984. The concern was that a partnership might avoid capitalizing an expense by giving a service provider a temporary, low-risk interest in partnership income. To solve the problem of carried interests using Section 707(a)(2)(A) Treasury would have to take the position that a fund manager was not truly a partner. This is untenable unless one is willing to take the position that to be a partner in a capital-based partnership a person must contribute and risk capital. See Mark P. Gergen, *Reforming Subchapter K: Compensating Service Partners*, 48 *Tax L. Rev.* 69, 75-81 (1992).

<sup>9</sup> I discuss the evolution of the system in Mark P. Gergen, *The End of the Revolution in Partnership Tax?*, 56 *S.M.U.L.Rev.* 343 (2003). Later I discovered that the principal creator of Subchapter K proposed a similar system to deal with pre-contribution gain and loss and related problems. See Mark P. Gergen, *The Story of Subchapter K: Mark H. Johnson's Quest*, *Business Tax Stories* 207 (Foundation 2005).

excess of the partner's pro rata share in partnership capital. There are more fine-grained ways to identify compensation that would enable partners who contribute both capital and labor to take a preferred return on capital without having it characterized as compensation.<sup>10</sup> The capital account system also supplies a mechanism for handling the sale or liquidation of an interest by a service partner when the interest bears unrealized profits that would have been taxed as compensation to the service partner when realized. The solution is to treat the partner as having compensation equal to the amount of compensation the partner would have had if the partnership had sold its assets for their fair market value immediately prior to the sale or liquidation. The handling of a sale follows Section 751(a). The handling of a liquidating distribution follows Section 737. The Section 704(c) regulations preserve the attribute of booked built-in gain as compensation through various events in the life-cycle of a partnership.

Different approaches are possible under the capital accounts system in the case of an asset revaluation. Assume A performs management services in a partnership with \$1,000,000 assets in return for 20 percent of the profits. The assets grow in value to \$1,500,000, which is unrealized appreciation. At this point \$500,000 new capital is contributed to the partnership. Under current law, the partnership may elect to book up its assets and give A a capital account of \$100,000.<sup>11</sup> At some point A should have \$100,000 income treated as compensation. One possibility is to recognize the income at the time of the revaluation. But this creates a troubling disincentive for non pro rata contributions and distributions, which generally trigger revaluations. Managers would become loathe to permit non pro rata contributions and distributions if it triggered a substantial tax liability to them. Another possibility is to tag A with that much built-in gain on the assets, which will be treated as compensation when A liquidates or sells the interest. It is a mistake to push recognition past when A receives a liquidating distribution for this would permit A to take property as compensation without paying tax. This violates Section 83.

At a deeper level, the capital accounts system is consistent in principle with recharacterizing a fund manager's share of capital gains as compensation. The capital accounts system embraces the aggregate theory of partnership tax. The carried interest problem exists because Section 702(b) follows the entity theory—the character of income is determined at the partnership level. From the perspective of the fund income is a return to capital. From the perspective of the manager it is compensation.

#### Other Ramifications

This solves some other problems. It makes it possible to exclude profits interests from Section 83. The receipt of a right to profits need not be treated as a receipt of property to be taxed as compensation when the profits themselves will be taxed as compensation when they are earned. This eliminates the need under the proposed regulations to make one or two elections and avoids the problems that arise in the

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<sup>10</sup> Any such rule should cap the amount of the preferred return and require that the yield on the service partner's capital account, including the preference, not be greater than the yield on other capital.

<sup>11</sup> Some think this is required. Such adjustments are standard in partnership agreements, which often are drafted to track tax law rules.

absence of an election. Remaining is the question of how to handle the case where retained profits are subject to a substantial risk of forfeiture. Consistent with Section 83, the partner could make a Section 83(b) election and be taxed on the distributive share<sup>12</sup> or the partner could forego the election and wait and be taxed on the value of the profits accumulated in her capital account when the interest vests. If the election is not made, then the distributive share would be taxed to the other partners, who would get an off-setting expense when the service partner takes the profits into income, bringing the other partner's tax position and capital accounts into line. This leaves some differences between the taxation of a compensatory grant of a profits interest and the taxation of a compensatory grant of an option, which can be economic equivalents. This is a more general problem that results from the reluctance to treat an option holder as a partner until the option is exercised. The option arrangement enables the service partner (or any other option holder) to defer recognition of income on its distributive share until the option is exercised.

The proposed changes foreclose some other troublesome possibilities under current law. In the 1980s I heard rumors of a film deal where an actor took a profits interest. The plan was that the partnership producing the film would buy property to be used in the production. When the film was done, the actor received the property in liquidation of his interest without paying tax. Current law on profits interests allows people to evade the rules on equity compensation. For example, if an employee is given a stock appreciation right, then he will have ordinary income on the amount of any appreciation. Instead put a block of the same stock in a partnership and give the employee a profits interest in its appreciation. After the stock appreciates, distribute to the employee stock equal in value to her share of the appreciation. The employee will be taxed on only part of the gain under Section 731(c) and it will be capital gain. Under the rules I propose the actor and the employee would have taxable compensation on the distribution.

Some of the problems addressed by Section 707(a)(2)(A) would not be solved. Section 707(a)(2)(A) is primarily directed at cases such as where an established partnership that develops and holds real estate gives an architect a short term interest in its rental income in return for services designing a new building. This allows the partnership to get a result equivalent to a short-term write off of the architect's fee and to avoid capitalizing the expense. Changing Section 702(b) would treat the rent as compensation to the architect. But it would not require the partnership to treat it as an expense and to include the architect's share of rents as income to the other partners.<sup>13</sup>

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<sup>12</sup> In the event the interest is forfeited, it is necessary to use either a deemed guaranteed payment or a side-agreement requiring the partner to forfeit his partnership interests to the other partners. From the perspective of the service partner, the deemed guaranteed payment is preferable because it provides an ordinary deduction to offset the ordinary income.

<sup>13</sup> A partnership would have the ability to treat the compensation as an expense by actually paying profits-based compensation or by making a guaranteed payment. If the profits are to be retained within the partnership, then the service partner would recontribute the payments.

In a forthcoming article,<sup>14</sup> Victor Fleischer explains a stratagem private equity funds may use under the rules I propose to ensure that above-normal returns to a manager are not taxed as compensation. The fund may make an interest-free nonrecourse loan to the manager to fund a capital account for the manager. The loan would be secured by the account. Interest imputed on the loan would be taxed as compensation under Section 7872. Returns above that amount would retain their character to the partnership. A partial answer to this possible stratagem is that a half a loaf is better than none—a portion of the manager’s return will be taxed as compensation. If this is deemed too small a portion, then increase the imputation rate.

### Scope

In principle, the rules I propose could be applied to all partnerships. They are easy to administer. A service partner who has no capital invested in a partnership will treat her entire distributive share as ordinary income (and self-employment income) whatever the character of the income at the partnership level. A partner who supplies labor and capital to a partnership will report income based on its character at the partnership level so long as distributions are in accordance with capital accounts. When partners negotiate a larger distributive share to a partner who provides services as well as capital, then presumably they understand this part of the distributive share is compensation. In principle, it would not seem to be asking too much to insist that people report what is negotiated as compensation as such.

In reality, much of Subchapter K is too complicated for the unsophisticated. This is a more general problem. While the proposed rules do not materially increase the complexity of Subchapter K, they do rest upon a body of rules that can be quite complicated in the application. Ideally, this problem would be fixed more generally. Several years ago an American Law Institute Project recommended creating a simplified body of rules (some call it K-Lite) that resemble Subchapter S and are less susceptible to abuse. This would be for individuals that do not want to deal with the complexity of Subchapter K.<sup>15</sup> In the meantime the changes I propose could be limited to partnerships in which capital is a material income producing factor with assets above a specified sum. There is no good policy reason to limit the changes to private equity funds, or even more oddly, to publicly traded partnerships.

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<sup>14</sup> See Two and Twenty: Taxing Partnership Profits in Private Equity Funds, forthcoming NYU L. Rev (2008). The paper is available on SSRN.

<sup>15</sup> Reporter’s Study, Taxation of Private Business Enterprises (July 1999).