

ESSAY

THE TAXATION OF CARRIED INTERESTS IN PRIVATE EQUITY

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THIS essay analyzes the tax treatment of carried interests in private equity. It argues that there are two competing analogies: service income and investment income. Standard approaches are not able to resolve which of the competing analogies is better and often fail even to recognize that there are competing analogies. The best method for determining the proper treatment of carried interests is through direct examination of the effects of each of the possible treatments, known as the theory of line drawing in the tax law. Using this approach, it is clear that the better treatment of holders of carried interests is as investors. Key pieces of evidence include the longstanding policy premises behind partnership taxation and the complexity and avoidance problems with attempts to tax carried interests as service income. In particular, the longstanding policy behind partnership taxation is to tax partners as if they engaged in partnership activity directly. Current law, which gives holders of carried interests capital gains treatment follows this approach, and changing the law to tax carried interests as service income would require rejection of this historical trend. Because such an approach would mean taxing carried interests differently than if the partners engaged in the activity directly, it would be easily avoidable. Moreover, attempts to tax carried interests as service income will have to be able to distinguish service income from other types of income, a task which has proven to be difficult and complex.

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INTRODUCTION

A carried or profits interest in a private equity fund typically gives the sponsor of the fund the right to up to 20% of the profits.¹ If the fund produces long-term capital gain, the sponsor is taxed on its share of this gain at the capital gains tax rate when the gain is realized by the fund. The same treatment applies to a carried or profits interest in any type of partnership: the holder is a partner and is taxed on his share of partnership income.

A number of commentators have argued that returns to carried interests should be taxed as ordinary compensation income, and these claims have prompted close congressional scrutiny.² Their theory is that the sponsor performs services for the partnership in exchange for the carried interest. They analogize a sponsor to a

¹ A carried or profits interest in a partnership is a right to a share of the profits separate from an interest in the assets or capital of the partnership. For example, if a partnership has \$1,000 of capital and earns \$100, a 15% carried interest would give the holder the right to 15% of the \$100 profits and none of the \$1,000 of capital. A capital interest gives the holder the right to both profits and capital. A 15% capital interest in the same partnership would be entitled to both 15% of the \$100 profits and of the \$1,000 capital. Carried interests and profits interests are effectively the same thing and I will use the terms interchangeably.

² The two most prominent articles on the topic are Mark P. Gergen, *Reforming Subchapter K: Compensating Service Partners*, 48 Tax L. Rev. 69 (1992) [hereinafter *Service Partners*], and Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. Rev. (forthcoming 2008) [hereinafter *Two and Twenty*]. There have been four congressional hearings on the topic. See Carried Interest Part I: Hearing Before the S. Comm. on Finance, 110th Cong. (2007), available at <http://www.senate.gov/~finance/sitepages/hearing071107.htm>; Carried Interest Part II: Hearing Before the S. Comm. on Finance, 110th Cong. (2007), available at <http://www.senate.gov/~finance/sitepages/hearing073107.htm>; Carried Interest Part III: Pension Issues: Hearing Before the S. Comm. on Finance, 110th Cong. (2007), available at <http://www.senate.gov/~finance/sitepages/hearing090607.htm>; Fair and Equitable Tax Policy for America's Working Families: Hearing Before the H. Comm. on Ways and Means, 110th Cong. (2007), available at <http://waysandmeans.house.gov/hearings.asp?formmode=detail&hearing=584>. Legislation has been introduced on a number of aspects of the issue including the Levin Bill, H.R. 2834, 110th Cong. (2007), and the Baucus-Grassley Bill, S. 1624, 110th Cong. (2007). For background information and descriptions of the bills, see Staff of Joint Comm. on Taxation, 110th Cong., Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I (JCX-62-07, Sept. 4, 2007) [hereinafter *Partnership Carried Interests, Part I*, Sept. 4]; Staff of the Joint Comm. on Taxation, 110th Cong., Present Law and Analysis Relating to the Tax Treatment of Partnership Carried Interests and Related Issues, Part II (JCX-63-07, Sept. 4, 2007).

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money manager who determines how best to invest a client's funds. They argue, therefore, the carried interest should be taxed similarly to risky compensation given to other service providers, such as stock, stock options, or royalties. In particular, the tax law treats carried interests better than other types of risky compensation because it defers taxation until the gains are realized and because it taxes the income as capital gain. This preferential treatment, they argue, is not justified, and they have proposed a number of different reforms.

An alternative way to view the activities of a private equity fund sponsor, however, is as raising capital and using that capital to make investments. The form used for raising capital is a limited partnership in which the sponsor is the general partner and the capital providers are limited partners. The limited partners get paid a market rate of return for their provision of capital and have no more involvement in partnership operations than any third-party provider of capital. Under current law, anyone who makes an investment and holds it as a capital asset, even if made with third-party capital, receives capital gain or loss treatment on the investment. For example, anyone who buys stock through a margin account and profits on the sale is using in part someone else's money and their own effort and ideas about stock valuations to make money. Capital gains treatment is standard notwithstanding that the gains may be attributable to labor effort. Moreover, taxation is deferred until the gain is realized. The same holds for an entrepreneur whose business is financed by third parties. When the entrepreneur sells the stock of the company, he gets capital gains treatment notwithstanding that most or all of the appreciated value is due to his labor effort.

Once we recognize that there are alternative analogies for the treatment of carried interests, the problem becomes which one to choose. Commentators arguing for treating carried interests like compensation arrangements rely on horizontal equity notions of treating likes alike. It seems inequitable to allow sponsors of private equity funds to get capital gains treatment when other service providers, most of whom earn less money, are taxed at ordinary income rates. But any change in the treatment of holders of carried interests would itself violate horizontal equity by treating them less like individuals engaged directly in the activity—that is, less like

anyone else who uses third-party capital to buy an asset. Given the underlying distinction between capital gains and ordinary income and between investors and service providers, carried interests cannot be taxed like both competing analogies. It is as if we had to choose a color for three squares arranged in a line. The square on the right is red and the square the left is blue. If we must choose red or blue for the middle square, we cannot pick a color by noting only that the square to the right is red, ignoring the blue square on the left. Horizontal equity arguments fail entirely in this context.³

When faced with this dilemma, commentators argue that the analogy to a service provider is the better one. It is, however, never made clear why that analogy is better. All of the features that commentators argue make holders of carried interests analogous to service providers are equally found in investors or entrepreneurs. For example, both investors and entrepreneurs may use third-party capital and may work very hard, so these features cannot be used to argue that carried interests are more like service providers—they do not distinguish the cases at all. Moreover, even if holders of carried interests shared more features with service providers than with investors, this type of Sesame Street reasoning—which one of these things is more like the other—does not tell us the consequences of the choice. Whichever choice is made, service provider or investor treatment, that choice will influence behavior, such as how investments are structured. Without examining the consequences, we cannot make good policy choices.

As I have argued elsewhere, we should view problems of this sort as part of a generic class of line drawing problems.⁴ The correct way to resolve these problems is by directly examining the consequences of the various choices. In particular, we must examine the likely behavioral changes accompanying a proposed change in the rules, and any likely complexity and administrative costs created.

³ There are many other, more fundamental problems with horizontal equity arguments. See Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 *Nat'l Tax J.* 139, 140–41, 148–50 (1989).

⁴ David A. Weisbach, *An Efficiency Analysis of Line Drawing in the Tax Law*, 29 *J. Legal Stud.* 71, 72–73 (2000) [hereinafter Weisbach, *Efficiency Analysis*]; David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 *Cornell L. Rev.* 1627, 1631 (1999) [hereinafter Weisbach, *Line Drawing*].

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We want to minimize efficiency losses through the line drawing choices we make.

From a line drawing perspective the choice is clear: we should not change the treatment of carried interests in private equity partnerships. There are two key pieces of evidence that support this argument. First, a longstanding, central premise of partnership taxation holds that partners should be taxed as though they engaged in the partnership activity directly. The major exception to this rule, found in both current law and reform proposals, is where a service provider is sufficiently distant from the partnership business that giving the same treatment as direct engagement in the activity does not make sense. They are not, in such a case, properly treated as partners. Private equity sponsors, however, are central to the partnership activity. They are the managers of the partnership, making all of the investment decisions. Viewing them as anything other than partners would require reexamining this basic premise of partnership taxation, a premise that has underscored partnership taxation for more than fifty years. Commentators suggesting general, broad-based reforms of the partnership tax rules—as opposed to reforms focusing solely on taxation of carried interests—almost uniformly attempt to strengthen this historical approach, to tax partners more closely to the direct engagement model. In fact, the current law measures abuse of the partnership tax rules by looking, in large part, at whether the results are different than direct engagement in the activity. Reform proposals for carried interests run directly counter to this view.

Second, to treat holders of carried interests as receiving compensation income, we have to be able to distinguish service income from capital income. This is not feasible in many contexts, and in cases similar to private equity partnerships, we do not even try. For example, if the sponsor borrowed to make the investments, we would not try to distinguish service income from capital gain. Attempts to do so in the private equity context are not likely to succeed where years of experience show the problem is not amenable to solutions. The result will be complex and easily avoidable rules that raise little revenue while imposing excessive compliance costs.

This Essay will examine these arguments in detail. Part I will provide background on private equity structures. Understanding the design of the structures and their economic function is impor-

tant for determining their tax treatment. Part I will also discuss how carried interests are used in other economic contexts. Part II will provide background on the current tax treatment of carried interests and review the various proposals for change. Part III will present an analysis of how we should think about resolving dilemmas such as the one presented here, where there are mutually exclusive, competing analogies for the treatment of a given item. The theory I will develop I have previously called line drawing theory, and it applies both in this context specifically and more generally.

Line drawing theory relies on evidence about relative elasticities of substitution. Without further empirical work, however, no direct data on these factors are available. To get a sense of the parameters, I look at two indirect pieces of evidence. Part IV will discuss the history and policy behind the partnership tax rules, illustrating how a central premise of partnership taxation is that the existence of the partnership should matter as little as possible to the tax treatment of the partnership. An implication is that current law is correct in giving pass-through treatment to holders of profits interests. Part V will turn to the key considerations of tax avoidance and complexity, arguing that because we cannot and often do not attempt to distinguish between labor and capital income in an entrepreneurial setting, we will not be able to do so in the private equity context. Part VI will conclude by discussing other potentially relevant considerations, including the distributive effects of changing the law.

I. BACKGROUND: PRIVATE EQUITY 101

Private equity has experienced phenomenal growth in the last ten years. Between 1999 and 2006, capital committed to private equity funds has grown at an annual rate of 23%.⁵ The dollar vol-

⁵ See The Blackstone Group, L.P., Securities Registration Statement (Form S-1), at 147 (June 11, 2007) [hereinafter Blackstone Offering]. For background on private equity, see Jack S. Levin, Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions (2006); Andrew Metrick, Venture Capital and the Finance of Innovation (2007) [hereinafter Metrick, Venture Capital]; James M. Schell, Private Equity Funds: Business Structure and Operations (2007); George W. Fenn, Nellie Liang & Steven Prowse, The Private Equity Market: An Overview, *Fin. Markets, Institutions & Instruments*, Nov. 1997, at 1; Steven N. Kaplan & Antoinette Schoar, Private Equity Performance: Returns, Persistence, and Capital Flows, 60 *J. Fin.* 1791 (2005); Ulf Axelson, Per Strömberg & Michael Weisbach, Why are Buyouts Levered?

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ume of private equity merger activity has grown at a rate of 29%, and the private equity share of total merger activity has grown from under 5% to more than 25%.⁶ In 2006, there were 151 sponsor-driven public-to-private transactions in the United States and Europe, up from 67 in 2000.⁷ Understanding the structure of this activity and the reasons for the growth is central to determining the proper tax treatment.

What is Private Equity? The term “private equity” primarily refers to two types of investment funds: venture capital and leveraged buyouts.⁸ Venture capital funds invest in start-up companies with the hope of a public offering sometime in the future. Leveraged buyout funds purchase existing companies and take them private, with the hope of restructuring the business and selling it at a profit. The leveraged buyout market is substantially larger than the venture capital market. This Essay will focus on carried interest taxation in the context of leveraged buyout funds.

The Private Equity Sponsor. Private equity is driven by the sponsor, such as firms like Blackstone, KKR, and Cerberus. Private equity sponsors are generally partnerships that specialize in purchasing large stakes in underperforming businesses, restructuring the business by improving the financial structure, management, or business plans, and selling the restructured business. They can profit from this activity because they have expertise, contacts, deal flow, valuation systems, methods of managing companies, and other intangibles. The individual partners in the sponsor often have experience working on Wall Street, but they may also come from industry or government. Sponsors are typically structured as partnerships with a relatively small number of partners, although they may have many employees, including analysts, industry specialists, financial experts, and other staff.

Initial Fund-Raising. Although the sponsors invest some of their own money, they need to raise outside funds to finance their activi-

The Financial Structure of Private Equity Funds (January 4, 2007) (unpublished manuscript, available at <http://ssrn.com/abstract=676546>); Andrew Metrick & Ayako Yasuda, The Economics of Private Equity Funds (September 9, 2007) (preliminary draft, available at <http://ssrn.com/abstract=996334>).

⁶ Blackstone Offering, *supra* note 5, at 148.

⁷ *Id.*

⁸ See Metrick, Venture Capital, *supra* note 5, at 7–9.

ties. This is done in two stages. The first stage involves raising capital for the *private equity fund*. The private equity fund is a partnership that will invest in a number of portfolio companies over the first three to five years of its life, and a typical sponsor may have a number of funds. The fund raises money by issuing limited partnership interests. Investors include tax-exempt entities (such as pension plans and endowments), wealthy individuals, and taxable institutional investors.⁹ The limited partners generally contribute most of the capital in the fund, and the sponsors contribute the rest, in return for the general partnership interest.

Under a typical arrangement, the limited partners are entitled to receive a return of their invested capital plus an additional return of up to a specified amount, usually 8% or 9% (the hurdle rate). If there are profits above this amount, the limited partners receive allocations so that they will get 80% of total profits. For example, if total profits are 15%, the limited partners get the first 8%, none of the next 2% (bringing the allocation to the 80/20 split) and then 80% of everything thereafter.

When it forms the fund, the sponsor retains a general partnership interest which allows it to control the fund. It gets three types of returns. First, it gets a management fee, typically around 2% of total partnership capital. The management fee is a payment for the services performed by the sponsors on behalf of the fund. It is often limited in time, such as to the first five years, to reflect the fact that the sponsor will be performing more intensive services during this period. After that time period, the fee is reduced, often to less than 1%. Second, the sponsor gets fees for providing services to the portfolio companies in which the fund is invested, sometimes known as transaction fees. These include items such as fees for sit-

⁹ According to data from the Private Equity Council, in 2006 over 40% of investors were pension funds, and other tax-exempt investors made up 7.7% of investors. Funds of funds comprised almost 14% of investors. Taxable investors (other than funds of funds) included wealthy individuals (10.1%), banks and financial services companies (9.8%), insurance companies (7.5%), and family offices (6.8%). Together, taxable investors other than funds of funds made up about 38% of investors. Private Equity Council, *Public Value: A Primer on Private Equity* 11 Exhibit 6 (2007), available at http://www.privateequitycouncil.org/wordpress/wp-content/uploads/pec_primer_layout_final.pdf. See also Staff of the Joint Comm. on Taxation, 110th Cong., *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests* 2, 37 (JCX-41-07, July 10, 2007) [hereinafter *Partnership Carried Interests*, July 10].

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ting on the board or providing management consulting services.¹⁰ Finally, they get any remaining gains after the limited partners have been paid their shares. These remaining gains, known as the carried interest, generally consist of 20% of partnership profits, subject to the hurdle rate allocation of the first 8% to the limited partners. Industry-wide for buyout funds, roughly two-thirds of the payments to the sponsors are from the management or transaction fees and, correspondingly, roughly one-third is from the carried interest.¹¹

An important feature of the structure is that the fund invests in a portfolio of target companies, as opposed to just a single company. Losses on one company offset gains on others when computing the general and limited partnership shares. If distributions are made to the general partners early on, they are often subject to a “claw-back” provision that specifies they must return the distribution if there are subsequent losses.¹²

The Leveraged Buyouts. The general partner or private equity sponsor controls the activities of the partnership and uses its expertise to determine which target companies to purchase. They generally purchase their targets at a premium of between 15% and 50% over their trading prices. The goal is to sell the company at an even higher price, so the sponsors must restructure the business to increase its value. For example, suppose that a buyout fund purchases a company at a 50% premium over the trading price and sells it in five years for a 33% gain. This means that the value after

¹⁰ The 2% management fee and the transactions fees sometimes partially offset, so that transactions fees reduce (in part or in whole) the management fees.

¹¹ See Metrick & Yasuda, *The Economics of Private Equity Funds*, supra note 5, at tbl. VI. See also *Partnership Carried Interests*, July 10, supra note 9, at 38 tbl.4 (citing Metrick and Yasuda). This figure initially strikes many as implausible, but it is easy to be blinded by the reports of very high returns that show up in the newspaper, and not notice the average or below market returns that do not. The Metrick and Yasuda study is an industry-wide study that looks at a large number of firms over more than a decade.

¹² Private Equity Council, supra note 9, at 10. This feature differentiates typical private equity funds from typical hedge funds. Hedge funds often have a 20% carried interest calculated on an annual basis with no offsetting of gains in one year for losses in a future year. See René M. Stulz, *Hedge Funds: Past, Present, and Future*, 21 *J. of Econ. Persp.* 175, 178–79 (2007).

the private equity fund has restructured the company is twice the value before the purchase.¹³

It appears that buyout funds are able to increase the value of a portfolio company through a number of mechanisms. One technique used in previous decades was simply to improve the capital structure of the target company, although it is not clear there are significant gains from doing so in the current buyout wave. The funds also have industry experts on their staff who are able to provide management expertise and guidance. Finally, private ownership may allow better monitoring of the senior managers of the company. In a sense, the managers of the target company trade public shareholder activism, quarterly earnings demands, and regulatory compliance headaches for a stern taskmaster watching over their shoulders. Managers may find private ownership more conducive to effective management. Improved financial structures, governance, and operational expertise appear to make a difference. Virtually all of the evidence finds that leveraged buyouts are associated with substantial increases in value.¹⁴

It is important to note, however, that private equity returns are very risky, and there are long periods where their returns are not any better, and often worse, than the market. For example, one study of private equity returns shows that buyout funds did significantly worse than the market for substantial periods in the 1990s, but better than the market during periods in the 1980s.¹⁵ The Joint Committee on Taxation, in a recent study, concluded that 30% of private equity funds started during the period from 1991 through 1997 did not generate any payments on the carried interests.¹⁶

Note also that the success of private equity funds is a separate question from whether the target companies increase in value. Private equity returns could be below the market return even if target companies substantially increase in value because the private equity returns depend on the price at which they purchase their targets. That is, when computing the value to the economy of private equity, one needs to consider not only the returns to the private

¹³ For example, if the stock was trading at \$100 and the fund buys it at \$150, it has to sell it at \$200 to make a one-third profit on its investment.

¹⁴ See Kaplan & Schoar, *supra* note 5, at 1792–93, 1799.

¹⁵ *Id.* at 1801.

¹⁶ Partnership Carried Interests, July 10, *supra* note 9, at 39.

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equity investors and sponsors but also the returns to the former shareholders of portfolio companies. For example, suppose a company is currently trading at \$100 per share, and a private equity fund purchases it for \$150 per share. If, after restructuring the company, the private equity fund sells it at \$150 per share for no gain or loss, the value of the company has still gone up by \$50 per share, adding value to the economy. The gains in this example were captured by existing shareholders.

There are important business reasons for the structures used by private equity sponsors. The private equity firm must be able to raise large pools of capital that will be committed for a long period while retaining sufficient freedom to be able to negotiate deals. This creates an incentive problem. If sponsors are unduly constrained, they will not have the necessary freedom to negotiate or make decisions. The whole venture relies on their expertise, so they must be able to use it. If they have too much freedom, however, investors will not trust them with their funds. Nobody would irrevocably commit a large pool of capital to a fund sponsor who can do whatever he or she wants.

The design of the fund structure, including the use of the 20% carried interest calculated over a portfolio of companies, the hurdle rate, and the multiple rounds of financing, is thought to best solve these problems. One recent study argues that the initial round of financing should look very much like limited partnership interests: a fixed rate of return plus an equity stake.¹⁷ The second round of financing—the debt issued to finance each particular portfolio company purchase—acts as a check on the sponsors by ensuring that each purchase is desirable: the limited partners, who commit their capital irrevocably to the fund, can use the market to help monitor sponsor behavior. The use of pooled investments also helps in this regard because it reduces the “option” element given to the sponsor—the upside without the downside—by measuring performance over a number of purchases.¹⁸

¹⁷ Axelson, Strömberg & Weisbach, *supra* note 5, at 3–4.

¹⁸ Options give the holder the upside of an investment without exposing them to the downside. As a result, options benefit from volatility. They get the benefit of the increased upside without the cost of the increased downside. If a holder of an option has managerial control that allows him to increase the volatility of the company, there is a risk that the holder will act contrary to the interests of the company. Pooling in-

To my knowledge, the structure of these funds is no more tax-driven than any typical investment: within a basic structure, one wants to minimize taxes, but taxes are secondary to business considerations during selection of the structure. For example, carried interests were commonly used even when there was no rate differential between capital gains and ordinary income.¹⁹

Other types of funds. There are a number of other financial funds that engage in related, but distinct, activities. The most prominent are hedge funds. Traditional hedge funds engage in arbitrage—they attempt to find subtle mispricings in securities and enter into long and short positions to take advantage of the mispricing without exposing themselves to risk. They typically purchase public securities and hold them only for a short period.²⁰ As more money has been invested in hedge funds in the last decade, they have expanded their activities and now sometimes purchase companies or provide financing for the purchase of companies, blurring the line between hedge funds and private equity. Other funds include angel funds (investing in very early stage companies), mezzanine funds (providing risky loans to companies), and distress funds (focusing on troubled companies).²¹

Use of carried interests. Although the current discussion has focused on private equity partnerships and financial partnerships more generally, carried interests—called profits interests in other contexts—are used in many different sectors, including oil and gas, real estate, and small businesses. Partnerships are generally private, so it is difficult to get data on the full extent of the use of profits or carried interests. One indication of their widespread use, however, is the huge number of articles written on the taxation of

vestments reduces the incentive to create volatility—the option element—because gains from excessive volatility with respect to one company are likely to be offset by losses from excessive volatility on another company.

¹⁹ See Paul Gompers & Josh Lerner, *An Analysis of Compensation in the U.S. Venture Capital Partnership*, 51 J. Fin. Econ. 3 (1999) (analyzing the value of profits interests for years including the late 1980s when there was no capital gains preference).

²⁰ For example, a convertible bond can be thought of as a straight bond and an option to purchase stock. If the convertible bond does not trade at the right price compared to the straight bond and option combination, a hedge fund can sell one side and buy the other so that when they ultimately converge, the fund makes a profit.

²¹ For a description of these categories of investment, see Metrick, *Venture Capital*, supra note 5, at ch. 1.

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the receipt of profits interests.²² The leading partnership tax treatise, for example, devotes an entire chapter to the treatment of one aspect of profits interests: the receipt of the interest.²³ One article, written in 1991, has a half-page footnote in small print listing articles on the subject and many more have been written in the intervening years.²⁴ There have also been a number of court decisions and a series of guidance documents from the Treasury, culminating in recently-issued proposed regulations, relating to the taxation of carried interests.²⁵ It is apparent that any change to the taxation of carried interests could affect a large number of sectors in the economy.

II. TAX RULES GOVERNING CARRIED INTERESTS AND PROPOSALS FOR CHANGE

A. Current Law Treatment of Carried Interests

We can divide the tax issues with respect to carried interests into front-end issues—how the partner is taxed on the receipt of the profits interest—and back-end issues—how the profits interest is

²² A small sampling of articles includes Martin B. Cowan, Receipt of an Interest in Partnership Profits in Consideration for Services: The *Diamond* Case, 27 Tax. L. Rev. 161 (1971); Terence Floyd Cuff, *Campbell v. Commissioner*: Is There Now “Little or No Chance” of Taxation of a “Profits” Interest in a Partnership?, 69 Taxes 643 (1991); Laura E. Cunningham, Taxing Partnership Interests Exchanged for Services, 47 Tax. L. Rev. 247 (1991); Mark P. Gergen, Pooling or Exchange: The Taxation of Joint Ventures Between Labor and Capital, 44 Tax L. Rev. 519 (1989); Barksdale Hortensine & Thomas W. Ford, Jr., Receipt of a Partnership Interest for Services: A Controversy that Will Not Die, 65 Taxes 880 (1987); Susan Kalinka, Rev. Proc. 2001-43 and the Transfer of a Nonvested Partnership Profits Interest, 79 Taxes 11 (2001); Henry Ordower, Taxing Service Partners to Achieve Horizontal Equity, 46 Tax Law. 19 (1992); Leo L. Schmolka, Taxing Partnership Interests Exchanged for Services: Let *Diamond/Campbell* Quietly Die, 47 Tax L. Rev. 287 (1991); William R. Welke & Olga Loy, Compensating the Service Partner with Partnership Equity: Code Sec. 83 and Other Issues, 79 Taxes 94 (2001).

²³ William S. McKee, William F. Nelson & Robert L. Whitmire, *Federal Taxation of Partnerships and Partners* ch. 5 (4th ed. 2007).

²⁴ See Cuff, *supra* note 22, at 644 n.2.

²⁵ The major court decisions include *Diamond v. Comm’r*, 56 T.C. 530 (1971), *aff’d*, 492 F.2d 286 (7th Cir. 1974), and *Campbell v. Comm’r*, 943 F.2d 815 (8th Cir. 1991). The Internal Revenue Service has also promulgated and proposed rules applicable to partnership profits interest. See Rev. Proc. 93-27, 1993-2 C.B. 343; Rev. Proc. 2001-43, 2001-2 C.B. 191; Prop. Treas. Reg. 1.83-3(l), 70 Fed. Reg. 29,675, 29,680 (proposed May 24, 2005) (to be codified at 26 C.F.R. pt. 1).

taxed with respect to partnership allocations or distributions. Before the current carried interest debate, virtually all attention was focused on the front-end issue.

1. Front End

To the extent possible, current law provides that formations of partnerships and contributions to ongoing partnerships are tax-free.²⁶ For example, if a partner contributes appreciated property to a partnership in exchange for a partnership interest, no tax is imposed on the contribution. The issue raised by carried or profits interests is whether the receipt of a partnership interest in exchange for a promise to perform services in the future should be tax-free. There has been perhaps more writing on this issue than on any other element of partnership tax law.²⁷ Although there have been a few deviations, the overwhelming consensus is that the receipt of a partnership profits interest is not and should not be taxable.²⁸ The government has adopted this position in three separate pieces of guidance, including proposed regulations issued in 2005.²⁹

The history is well known and not worth reviewing in detail here. Following the courtroom skirmishes in *Diamond v. Commissioner*³⁰ and *Campbell v. Commissioner*,³¹ the government gave taxpayers a safe harbor. In particular, Revenue Procedure 93-27 provides that “if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner,” the receipt of the profits interest will not be treated as a taxable event. This rule does not apply if the profits interest relates to a substantially certain stream of income, is disposed of within two years, or is a limited partnership interest in a publicly traded partnership.³² Revenue Procedure

²⁶ I.R.C. § 721 (2000). See McKee, *supra* note 23, for a detailed description of the partnership tax rules.

²⁷ See sources cited *supra* note 22.

²⁸ See sources cited *supra* note 22.

²⁹ See Prop. Treas. Reg. § 1.83-3(l), 70 Fed. Reg. 29,675, 29,680–81 (May 24, 2005); Rev. Proc. 2001-43, 2001-2 C.B. 191; Rev. Proc. 93-27, 1993-2 C.B. 343. All three take the position that taxpayers can value a profits interest at zero (in all but abusive situations) and, therefore, the receipt generates no tax.

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

³¹ 943 F.2d 815 (8th Cir. 1991).

³² Rev. Proc. 93-27, 1993-2 C.B. 343.

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2001-43 adds to this holding to cover the case where a profits interest is substantially nonvested at the time of receipt. It provides that under most circumstances, the service provider will be treated as receiving the profits interest at the time of the grant and not later when it vests.³³ Taxpayers generally structure partnerships to meet these safe harbors, so that profits interests are never taxed when received.³⁴

The Service has recently proposed regulations that would provide a more formal basis for these conclusions and coordinate them with Section 83.³⁵ Section 83 applies to any exchange of property for services. Because a profits interest is property, Section 83 literally applies to the receipt of a profits interest. The proposed regulations confirm this conclusion but then, through an accompanying revenue procedure, provide a safe harbor under which taxpayers can treat the value of a profits interest as zero.³⁶ Thus, the key result of Revenue Procedure 93-27 was retained, with some details differing, such as the requirements for the safe harbor valuation and the rules governing restricted interests and how they relate to elections under Section 83(b).

2. Back End

Once a partner receives a profits interest, he is a partner for purposes of the tax law and is taxed like any other partner. This means that he is taxed on his distributive share of partnership items. The timing, character, and other attributes of the income are determined at the partnership level and passed through to the individual partners under the normal partnership rules. The capital account maintenance and substantiality requirements of Section 704(b) apply, with the profits partner initially getting a zero capital account.

In the private equity context, this means that if the partnership sells a portfolio company and has long-term capital gain, the sponsor gets taxed on his share of the long-term capital gain. This allocation of gain has no effect on tax revenues as long as all the part-

³³ Rev. Proc. 2001-43, 2001-2 C.B. 191.

³⁴ See Tax Section, N.Y. State Bar Ass'n, Report on the Taxation of Partnership Interests Received for Services and Compensatory Partnership Options 14 (2004).

³⁵ Prop. Treas. Reg. § 1.83-3(l), 70 Fed. Reg. 29,675, 29,676 (May 24, 2005).

³⁶ Id. at 29,680-81.

ners are in the same tax bracket and account for the amounts in the same way.³⁷ To illustrate, suppose that all the partners are in the same tax bracket and that the partnership would get a deduction for paying a salary to the profits partner. To be concrete, suppose that there is \$100 of long-term capital gain, \$20 of which is allocated to the sponsor. Under current law, the other partners would have \$80 of long-term capital gain and the sponsor would have \$20, for a total of \$100 of long-term capital gain in the system and tax revenues of \$15, assuming a long-term capital gains rate of 15%. Suppose instead that the partnership paid the sponsor \$20 of salary. The sponsor would have \$20 of ordinary income and the partnership would have a \$20 deduction and a \$100 long-term capital gain. The net result is still just \$100 of long-term capital gain, and if the tax bracket of the sponsor and the other partners are the same, the tax revenue is the same. The only difference is that there are offsetting items of \$20 of income and \$20 of deduction. This holds regardless of when the partnership pays the salary, so there are no deferral advantages either. This identity also holds for someone who works for himself, using so-called sweat equity to create an asset. The person does not pay himself a salary but it is the same as having the offsetting \$20 of income and deduction.

There are two—and only two—circumstances where this treatment is better than the partnership paying the sponsor a salary. The first such circumstance is if the other partners are in a different (typically lower) tax bracket. If the other partners are in a different tax bracket, the \$20 offsetting amounts do not offset in tax revenues, creating a net gain or loss to the government, the timing of which depends on the timing of the payment. According to a recent Joint Committee on Taxation study, almost 50% of investments in private equity funds in 2006 were tax-exempt, so this situation is important.³⁸

The second case is where the partnership has to capitalize the salary payment or otherwise cannot deduct it. Suppose, for example, that the partnership has purchased the property for \$500 and

³⁷ For a detailed explanation, see Chris William Sanchirico, *The Tax Advantage to Paying Private Equity Fund Managers with Profit Shares: What Is It? Why Is It Bad?*, 75 *U. Chi. L. Rev.* (forthcoming 2008) (manuscript at 12–24, on file with the Virginia Law Review Association), available at <http://ssrn.com/abstract=996665>.

³⁸ *Partnership Carried Interests*, Part I, Sept. 4, *supra* note 2, at 19–20.

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sold it for \$600, paying a \$20 salary out of the proceeds. If the salary is capitalized into the purchase price, the partners do not get a deduction for that amount but increase their basis to \$520. This means that capitalization eliminates the partnership's \$20 deduction and reduces its long-term capital gain by the same amount. The net effect would be to convert the \$20 to ordinary income: there would be \$80 of long-term capital gain and \$20 of ordinary income instead of \$100 of long-term capital gain.

Congress enacted Section 707(a)(2)(A) to deal with this latter problem. Prior to the enactment of this Section, partnerships would give profits interests to everyday service providers as a means of avoiding the capitalization requirements of Section 263. For example, a real estate partnership might give an architect a profits interest. Using the numbers above, they might want to pay the architect \$20. If they pay him \$20, they would have to capitalize the \$20 into basis. If instead they give him a profits interest worth \$20, they convert the \$20 salary into capital gain. Section 707(a)(2)(A) provides that if the combination of services provided and allocation and distribution of income to the service provider together indicate that the service provider is not really acting as a partner, then the transaction will be recast as not between a partner and the partnership.³⁹ That is, Section 707(a)(2)(A) should be thought of as an anti-conversion provision that is based on whether the service provider is best thought of as separate from the partnership.

The language of Section 707(a)(2)(A) does not provide any particular guidance on how this determination is to be made, and distinguishing "true" from "disguised" partners can be futile. To date, more than twenty-three years after enactment, the Treasury has not issued regulations under this section, reflecting the difficulty of making this determination. The Joint Committee on Taxation, however, has offered an extensive discussion along with examples. According to the Joint Committee, six factors should be considered.⁴⁰ The most important factor is "whether the payment is subject to an appreciable risk as to amount," reflecting the notion discussed above that we use entrepreneurial risk as a method of

³⁹ I.R.C. § 707(a)(2)(A) (2000).

⁴⁰ Staff of Joint Comm. on Taxation, 98th Cong., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 227–29 (Comm. Print 1984).

determining whether the partner should be treated as engaging in the activity directly and therefore get partner treatment.⁴¹ The Joint Committee on Taxation explained that “[p]artners extract the profits of the partnership with reference to the business success of the venture, while third parties generally receive payments which are not subject to this risk.”⁴² The other factors are (ii) “whether the partner status of the recipient is transitory,” (iii) “whether the allocation and distribution that are made to the partner are close in time to the partner’s performance of services,” (iv) whether the goal is to obtain tax benefits, (v) “whether the value of the recipient’s interest in general and continuing partnership profits is small in relation to the allocation in question,” and (vi) a factor that relates largely to property transactions not relevant here.⁴³

A typical private equity carried interest easily passes all these tests. It is highly risky compensation; indeed, because of the hurdle rate, it is riskier than the overall returns to the partnership. It is not a transitory interest as it lasts the entire life of the partnership. The distribution and allocation are not close in time to the performance of services except by coincidence. One may argue about whether a goal is to obtain tax benefits, but as discussed above, there are clearly strong business reasons for the structure. Finally, the value of the sponsor’s interest is not small in relation to the allocation in question. That is, there is simply no question under current law that a typical private equity sponsor would be treated as a partner with respect to the carried interest and would not be subject to recharacterization under Section 707(a)(2)(A).

Moreover, even if payments to the fund managers were recharacterized under Section 707(a)(2)(A), they would not likely have to be capitalized. Although the capitalization rules are complex and uncertain, if a fee’s incurrence is independent of whether a particular investment is made, that fee is generally deductible.⁴⁴ Because any payments to the sponsors are not dependent on making any particular investment, they would likely be deductible. Therefore, the only real difference between use of an explicit sal-

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Id.*

⁴⁴ See Sanchirico, *supra* note 37, at 15, for a detailed discussion of the issue.

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ary and the use of a carried interest relates to having tax-exempt investors.

3. Fees

The management fee is determined without regard to partnership profits. This means that it is taxed as ordinary income to the partner and generates a deduction or capital expenditure to the partnership under the principles of Section 707.⁴⁵ Transactions fees received by the sponsor are taxed under general tax principles and are most likely taxed as ordinary compensation income.

As noted, the fees represent around two-thirds of sponsor compensation. This means that roughly two-thirds of sponsor compensation is taxed as ordinary income under current law.

B. Proposals for Change

1. Front End

One possibility mentioned by some commentators is to impose taxation upon receipt of a profits interest based on an estimate of its value.⁴⁶ The overwhelming consensus is that taxing profits interests on receipt is not desirable, and such proposals have received little attention in the current round of discussions.⁴⁷

The reasons for not wanting to tax the receipt of a profits interest are reasonably straightforward. One commonly cited reason is valuation. Although the right to a portion of future profits looks much like an option (upside but no downside), partnership profits interests are more difficult to value than options. Partnership interests are not traded, which means that the price and volatility of the underlying asset, two key factors in option pricing, cannot be observed. Moreover, in many cases, the value of the profits interest depends crucially on the future services of the recipient; they are granted as an incentive for the profits partner to work. It is difficult to predict the value of the future services. To value the profits in-

⁴⁵ They are likely guaranteed payments for services under § 707(c) rather than payments to a nonpartner under § 707(a)(2)(A). For our purposes, the two are essentially the same.

⁴⁶ See, e.g., Lee A. Sheppard, Blackstone Proves Carried Interests Can Be Valued, 115 Tax Notes 1236, 1238 (2007).

⁴⁷ See sources cited supra note 22.

terest, therefore, one has to combine an option pricing methodology based on no or bad data with a prediction on the value of someone's labor effort. Both tasks are difficult, and combining them is often futile.

If we really wanted to put a number on the value of a profits interest, however, we could do so, and zero is clearly not the right number.⁴⁸ More fundamentally, however, taxing the receipt of a profits interest would violate basic tax principles in most cases. The closest analogy to a profits interest is a taxpayer who takes out a nonrecourse loan. In a nonrecourse loan, the borrower has no liability beyond the value of the secured property. This means that if the value of the property goes up, the borrower can pay off the loan and keep the profits, while if the value of the property goes down, the borrower can force the lender to settle for the depreciated value. It is equivalent to a normal loan along with a put option to the lender, or, equivalently, the right to call property from the lender. No one, however, suggests taxing the value of this option at the time of a nonrecourse lending. Instead, we wait to see if that value is realized.

Similarly, we do not tax other events that have clear value. We do not tax admission to a prestigious college or a desirable club membership. We do not tax a promotion, even if the promotion comes with an enforceable contract for increased pay. In the partnership context, we do not tax highly sought-after admissions to law firms, accounting firms, or investment banking partnerships. We do not tax great inventions made while standing in the shower. In all these cases, the individual has immediate value and it is conceivable that we could place a number on it. For whatever reason, whether it is a reluctance to tax endowment, a recognition that the events are too hard to observe and value, or some other reason, we never have, and most assuredly never will, tax these sorts of events. One of the primary goals of partnership taxation is to tax the partners the same way they would be taxed without a partnership, which means that these basic principles must carry over to the formation of a partnership.⁴⁹ The exceptions found in Revenue Procedure 93-27, where we do tax the receipt of a profits interest, are all

⁴⁸ See Sheppard, *supra* note 46, at 1238.

⁴⁹ See discussion *infra* Part IV.

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exceptions to this basic notion. For example, if the profits interest relates to a fixed stream of income, it is more like receiving a debt instrument than an inchoate right to earn money.⁵⁰

Given the consensus on this issue, I will generally assume that profits interests will not be taxable upon receipt, at least on a mandatory basis. It is possible that back-end proposals will be combined with a Section 83(b)-style election to tax the profits interest upon receipt based on its fair market value. I will not generally discuss how such an election would work, but it is easy to see that the valuation issues would be substantial. Imagine a sponsor who raises \$100 in limited partnership interests that have terms similar to the standard terms in the industry—hurdle rate, 80% of the profits, etc. The value of the carried interest depends on how well the sponsor is able to perform over the next ten to twelve years by identifying target companies, succeeding in the buyout, restructuring the companies, and then selling them at a profit. The initial capital commitment indicates some confidence by the limited partners that the sponsor will be successful in this venture, but there is little else upon which to base a valuation.

2. *Back End*

Back-end proposals would change the treatment of a holder of a profits interest over the life of the partnership. There are a number of possible proposals, and I will discuss the two most prominent.

Mark Gergen has proposed to treat all payments with respect to profits interests as compensation for services and would grant the partnership a deduction (or capital expense).⁵¹ Although he does not phrase it this way, we can think of the proposal as a super-sized Section 707(a)(2)(A). He bases this proposal on the claim that otherwise service partners would receive compensation without paying

⁵⁰ Following this logic, Professor Cunningham would distinguish profits interests received for services performed in the past from those received for services to be performed in the future. Cunningham, *supra* note 22, at 260. For services performed in the past, none of the problems discussed in the text exist. Instead, it looks like the service provider has received a risky security in exchange for having performed services. Bittker and Lokken, in their tax treatise, make the same argument. See Boris Bittker & Lawrence Lokken, 4 *Federal Taxation of Income, Estates, and Gifts* ¶ 86.2.4, at 86-22 (3d ed. 1999).

⁵¹ Service Partners, *supra* note 2, at 103–11. See also Two and Twenty, *supra* note 2, at 47.

social security taxes and possibly only paying taxes at capital gains rates.⁵² For the same reasons discussed above concerning Section 707(a)(2)(A), the proposal would only change the net treatment to partnerships if the partners are in different tax brackets or if Section 263 or an equivalent applies to capitalize the payment or otherwise disallow the deductions.⁵³

It is not clear how Gergen would define a profits interest, but it appears that any allocation of partnership items other than a straight-up allocation (pro rata to capital in every period) would be treated as a profits interest. Gergen notes that this is a crude measure but argues that most often it will understate service income.⁵⁴ He does not consider cases where allocations of pure returns to capital vary over time, by risk, or by region.

Congressman Levin introduced a bill that is similar to the Gergen proposal. It would treat net income from an “investment services partnership interest” as ordinary income for the performance of services. An investment services partnership interest is a partnership interest held by a person who, in the course of the active conduct of a trade or business, provides a substantial quantity of services to the partnership. If the partner also contributes capital to the partnership, the partnership must make a reasonable allocation of partnership items between the distributive share attributable to invested capital and the service element.⁵⁵ Therefore, in comparison to the Gergen proposal, which seems to measure service income off a baseline of straight-up allocations, the Levin bill merely requires taxpayers to make a reasonable allocation, leaving the standard for measuring whether the allocation is reasonable unspecified.⁵⁶

⁵² Service Partners, *supra* note 2, at 94.

⁵³ For example, § 67 may limit the deduction in some cases.

⁵⁴ Service Partners, *supra* note 2, at 106–07 (giving examples of how a pro rata measure would understate service income).

⁵⁵ H.R. 2834, 110th Cong. (2007).

⁵⁶ The Levin bill also differs from the Gergen proposal in that it would merely re-characterize the payment to a profits partner as ordinary income while the Gergen proposal would create offsetting income and deductions similar to those created by § 707(a)(2)(A). This creates a tax difference if the deduction to the partnership under the Gergen proposal is capitalized or otherwise deferred or disallowed, with the Levin bill being more generous to the partnership than the Gergen proposal in these cases.

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The other proposal would treat a profits interest as the temporary borrowing of capital from the limited partners. This proposal was initially put forth by Leo Schmolka, and a revised version has been championed in a recent paper by Noël Cunningham and Mitch Engler.⁵⁷ If a partner has a 20% profits interest, it is the same as if he borrowed 20% of the partnership capital for the life of the partnership. The holder would either be required to pay interest on the use of capital or be taxed on the forgiveness of such a payment, much like we impute interest on loans under Sections 7872 and 1274. For example, if the partnership has \$100 of capital and the profits partner has a 20% stake, the partner would be treated as borrowing \$20. In each period, he would be required to include in income the applicable federal rate (“AFR”) on this \$20.⁵⁸ For example, if the AFR were 5%, the profits partner would have \$1 of interest income in each period. The underlying idea is that a profits partner has the right to the return on a portion of the partnership capital and, therefore, effectively has borrowed that portion.

This proposal would likely have no effect on private equity profits interests because of the hurdle rate. The hurdle rate gives the limited partners an 8% return on their entire investment plus 80% of all returns above 10%. At current rates, 8% exceeds the AFR (which is around 5%), which means that there would be no imputed interest income.⁵⁹

Like the Gergen proposal, this proposal would have to identify profits interests. We would need some baseline, such as pro rata allocations, against which to measure internal borrowings and lendings. Moreover, we would have to identify when adequate interest is paid on internal borrowings and lendings. We have a mechanism for this under the current rules for loans with unstated interest,⁶⁰

⁵⁷ Schmolka, *supra* note 22, at 302–08; Noël B. Cunningham & Mitchell L. Engler, *The Carried Interest Controversy: Let’s Not Get Carried Away*, 11–15 (Sept. 4, 2007), <http://ssrn.com/abstract=1014974>. Schmolka himself would prefer to do nothing and offers his implicit loan proposal only as a secondary option if something must be done. Schmolka, *supra* note 22, at 312.

⁵⁸ The applicable federal rate is described in I.R.C. § 1274(d) (2000). It is, effectively, the Treasury rate for a loan of equivalent maturity.

⁵⁹ If the investment does not return 8%, the limited partners will not get paid their full return, but this is the same as with any nonrecourse loan.

⁶⁰ See I.R.C. § 1274 (2000); I.R.C. § 7872 (2000).

but its application may be complicated if partnership allocations are complicated.

There are undoubtedly many other possibilities and proposals that can be mixed and matched or targeted at particular industries or income levels. All of the proposals share two basic ideas. The first is that profits partners should not be taxed like other partners on their distributive shares of partnership income. In other words, the proposals are all based on the idea that a profits partner is not like other partners who are treated as if they engaged in the business directly. Second, they all have to be able to identify a profits interest. These are the two central questions examined in the analysis below.

III. LINE DRAWING IN THE TAX LAW

As noted, there are two competing treatments of carried interests: service income and investment income. This Section describes the competing analogies and discusses how to determine which treatment is better.

A. Service Income

One view of sponsors of private equity funds is as investment advisors. The limited partners provide funds to financial experts who make investment decisions. The analogy would be to hiring an investment advisor such as a mutual fund company, a bank or a broker. These companies provide investment advice and often directly make investment decisions for investors. The investors get back the profits, net of any fees, much like the limited partners do in a private equity fund.

Investment advisors' fees are taxed as ordinary income, even if the fees are contingent on performance. For example, if investment advisors receive equity compensation (say in the company that employs them), they get ordinary income under the principles of Section 83 or the principles governing options. The funds remain the investor's funds. The investor gets taxed on the gains or losses in the funds and potentially can deduct the fees paid to the advisor. The result is essentially the same as if Section 707(a)(2)(A) were to apply in the partnership context—it only matters if the investor is

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in a different tax bracket than the advisor or if the fees would have to be capitalized.

The structure of a private equity partnership does not perfectly fit this analogy. Typically, an investment advisor is not treated as owning the funds that are invested. Instead, the investment advisor is merely the agent for the investor. In a private equity partnership, the partnership is the owner of the funds and not merely an agent for the investors.

B. Investment

The other competing analogy is to investment, the idea being that the limited partnership interests are a capital raising mechanism. Suppose that instead of using limited partnership interests, the sponsors issued debt. The debt could have terms similar to the limited partnership interests: it would be nonrecourse debt with a fixed rate of interest of 8% and an equity kicker of 80% of all profits above 10%. If this security would not qualify as debt, it would be relatively easy to structure a similar security or combination of payoffs that would. Or, even if such a security could not qualify as debt, we can view the limited partnership interests as for the provision of capital: the tax treatment of carried interests should not depend on the debt/equity distinction as applied to the capital providers.

There would be no question that if the sponsor is viewed as an investor using third-party capital, the sponsors would get capital gain or loss treatment on the sale of the stock. Just like with any borrowing, the borrower is treated as the owner of the funds and is taxed accordingly. The cost of the funds would be deductible as interest.

C. Choosing Between the Competing Treatments

The policy question is how to choose between these competing treatments. I will first discuss arguments that have been made by various commentators that, in my view, should not or cannot be used to make the choice. I will then discuss how the choice can be made using a theory of line drawing that is based directly on the consequences of the choice and argue that this theory supports leaving current law as is.

*1. Problematic Theories**a. Horizontal Equity*

The most common argument for treating carried interest as ordinary income is based on horizontal equity. The claim is that it is inequitable to allow carried interests to receive capital gains treatment when other risky service payments are taxed as ordinary income.

Horizontal equity arguments have been widely criticized in the literature as conceptually baseless.⁶¹ The problem is that one must have criteria for determining who are equals, and direct resort to those criteria is preferable to making horizontal equity arguments. For example, imagine that individuals vary in two ways: suppose that they are either tall or short and have either blond or brown hair. Someone who is tall with brown hair might be similar to a tall person with blond hair or a short person with brown hair; we need criteria for determining equality. Horizontal equity does no work that direct reference to the criteria would not do.

Even leaving this problem aside, horizontal equity fails in the carried interest context because the treatment of carried interests cannot be the same as both that of a service provider and that of an investor. Regardless of which treatment is chosen, horizontal equity is equally violated. As discussed in the introduction, we can visualize the problem by imagining we have to color three squares either red or blue. The square on the right is red and the square on the left is blue. We cannot use equity arguments to determine which color to pick for the middle square because it will differ from a square immediately to one side regardless of which color we choose. We may argue that the right and left squares should not be different colors, but if that cannot be changed, the problem cannot be resolved by merely pointing in one direction and arguing based on horizontal equity.

Chris Sanchirico illustrates the same point with an analogy to passengers waiting to be let onto a platform to board an overbooked train. He imagines one group of passengers waiting at the top of the stairs while another group has already been let onto the

⁶¹ See Kaplow, *supra* note 3; Peter Westen, *The Empty Idea of Equality*, 95 *Harv. L. Rev.* 537 (1982).

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platform. If one person is arbitrarily allowed to advance from the stairs to the platform, we cannot use equality arguments to argue that this is unfair. Compared solely to those at the top of the stairs, the single person seems to have an unfair advantage, but compared to those already on the platform, that person is not treated unequally.⁶²

b. Analogical Reasoning

A closely related set of arguments relies on analogical reasoning. Supporters of horizontal equity claim returns on carried interests are “more like” service income than investment income. We might, for example, make this determination by comparing lists of attributes of each possible analogy and then weighing the various items.

Analogical reasoning is standard in legal decisions, particularly those made by common law courts,⁶³ but there are two problems with using that approach here. The first is that virtually any attribute that can be used to argue for treating carried interest as service income equally applies to investment income. For example, we might argue that private equity sponsors show up at the office each day, indicating that they are performing services and are not merely passive investors. But many investors put in long hours choosing and managing their investments. Entrepreneurs, who can get capital gains on the sale of the stock of their companies, put in notoriously long hours.

Similarly, we might argue that holders of carried interests do not put in a substantial percentage of the capital, unlike an investor. But highly leveraged transactions are eligible for capital gains—there is no rule that requires investors to use a given percentage of their own capital as opposed to capital provided by third parties. The same holds for virtually any attribute; it cannot be used to distinguish investors and others who get capital gains from service providers.

The second and more fundamental problem is that we are never told why the various criteria matter. To illustrate, Professor Mark Gergen argued that the analogy to an investor is not appropriate

⁶² Sanchirico, *supra* note 37, at 66.

⁶³ For a detailed discussion of analogical reasoning, see Edward H. Levi, *An Introduction to Legal Reasoning* (1949).

because an investor using third-party capital would have to pay interest.⁶⁴ Leaving aside that he has his facts wrong—there is an interest component because of the hurdle rate—the argument relies on the distinction between debt and equity. Apparently, if private equity sponsors raised capital using debt, capital gains treatment would be appropriate, but if they raise capital using equity, such treatment would not be appropriate, according to this argument. I cannot think of any reason, however, why capital gains treatment should depend on whether third-party capital is raised through debt or equity. Gergen offers none. It is simply a difference rather than a difference that matters. Analogical reasoning is prone to this sort of error because it merely looks at features without a theory of why a given feature matters.⁶⁵ More generally, reasoning by analogy does nothing to determine the consequences of changing the rules. Analogical reasoning should not be used unless it can promise good results. Directly examining the consequences is a superior method of determining whether this is likely to be the case.

c. The Definition of Capital Gains

A third argument used to claim that carried interests should be taxed as ordinary income is based on the definition of capital gains. Unfortunately, there is little if any conceptual clarity governing the distinction between capital gains and ordinary income. Indeed, it is

⁶⁴ Fair and Equitable Tax Policy for America's Working Families: Hearing Before the H. Comm. On Ways and Means, 110th Cong. n.2 (2007) (statement of Mark P. Gergen, Professor of Law, The University of Texas School of Law, Austin, Texas), available at <http://waysandmeans.house.gov/hearings.asp?formmode=view&id=6433>.

⁶⁵ The arguments relating to the unsoundness of the investment analogy made by the Joint Committee on Taxation in its September 4, 2007, report on carried interests suffer from the same problems. The Joint Committee makes four arguments. First, it argues that it is not appropriate to treat the capital in the investment fund as owned entirely by the fund manager. Second, the Joint Committee argues that treating the limited partnership as a capital raising device is "inconsistent with the idea that the fund manager has only a partnership profits interest." Third, the Joint Committee argues that it is inconsistent with the pass-through tax treatment to investors. Finally, the Joint Committee questions whether the interests could be characterized as debt. At the core of all of the Joint Committee's arguments is an adherence to the debt/equity distinction—financing comes in the form of debt, not in the form of equity. The Joint Committee, however, does not provide any arguments on why the treatment of the carried interest should depend on whether it obtains financing in the form of debt or equity. Partnership Carried Interests, Part I, Sept. 4, *supra* note 2, at 55–56.

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hard to come up with any sort of rationale whatsoever for the distinction. Courts have long struggled with this problem, and it is difficult to make sense out of the many conflicting opinions.⁶⁶ Without a solid rationale for the distinction—and one that roughly tracks current law—it is difficult to make principled arguments with respect to any given return. At best, we can try to observe where the tax law draws the lines.

Advocates for change argue that, at a minimum, the capital gains rates should not apply to labor income.⁶⁷ Their analysis is straightforward: at least some portion of the return is attributable to labor income and should not get capital gains treatment. On the other hand, some portion represents labor income that is left invested in the fund and, therefore, could potentially get capital gains treatment. One analogy is to restricted stock: absent a Section 83(b) election, treating all of the stock gain as labor income does not measure labor income properly, but the alternative is upfront valuation, which is also difficult. The argument then proceeds on how best to identify labor income given the necessary imperfections.⁶⁸ An alternative analogy is to a loan from the limited partners to the general partner, with the service component measured by foregone interest on the loan, if any.⁶⁹

The capital gains distinction, however, does not track the distinction between returns to labor and returns to capital. In many cases, such as for investors and entrepreneurs, returns to labor get the capital gains preference.⁷⁰ To say that holders of carried interests

⁶⁶ Compare *Comm'r v. José Ferrer*, 304 F.2d 125 (2d Cir. 1962), with *United States v. Dresser Indus.*, 324 F.2d 56 (5th Cir. 1963).

⁶⁷ See *The Taxation of Carried Interest: Hearing Before the S. Comm. on Finance, 110th Cong. 1* (July 11, 2007) (statement of Peter R. Orszag, Director, Congressional Budget Office).

⁶⁸ Note that under this approach, we might not change the treatment of private equity at all. Under current structures, approximately two thirds of the returns to private equity sponsors are taxed as ordinary income. This may very well represent a reasonable allocation between the labor and investment elements and, therefore, a reasonable tax treatment.

⁶⁹ Schmolka, *supra* note 22, at 302–08.

⁷⁰ Two factors appear to be essential in determining when returns to labor get capital gains treatment. First, the more entrepreneurial the activity, the more likely the treatment will be capital. Second, the more that labor and capital are combined into a single return, the more likely it will be treated as capital. Consider some well-established cases. Everyday salaries that represent arm's length compensation for ordinary, non-entrepreneurial work are taxed as ordinary income. Employee stock

should get ordinary income because they put in effort is to misapply the definition of capital gain.

More fundamentally, it ignores the line drawing nature of the problem, instead attempting to solve the problem by definition. Like with the red and blue square problem discussed above, there is a fixed category of items that are very similar to private equity activities that gets treated as capital gains and another fixed category that gets treated as ordinary income. Putting private equity on one side or the other because of a definition means that we do not examine the consequences of the choice—the policy choice is instead determined by parsing language.

An alternative way to try to use the definition of capital gains is to argue that none of the reasons for a capital gains preference apply to carried interests. This, however, cannot convince anyone. Those who believe in the reasons for a broad-based capital gains preference will also believe that it should apply to private equity activity. Those who believe that the capital gains preference is needed because of lock-in problems, the need for entrepreneurial subsidies, or to alleviate problems with the double taxation of corporate income will tend to apply these rationales equally in the private equity context. After all, private equity activity involves entrepreneurial investing, which falls in the bull's-eye of items getting the capital gains preference. Those who do not believe in a broad-based capital gains preference may believe that it should not apply to private equity, but they should also believe that the problem is not particularly with this class of activity and that the best and only way to solve the problem is to fix capital gains rates generally.

compensation, pay for performance, and nonqualified options have a closer connection to entrepreneurial activity in that they expose the employee to the risk associated with the success of the enterprise. These amounts are generally treated as ordinary income when they vest, subject to certain exceptions such as a § 83(b) election. Additional amounts are taxed as capital gains. On the other hand, self-created assets, including, significantly, patents under § 1235, get capital gains treatment. An inventor who puts in many hours of labor gets capital gains treatment when the invention is sold. A proprietor who raises capital to start a business and uses his expertise and labor to build the business receives capital gains when he sells the business. Similarly, founders of companies get capital gains treatment when they sell their shares, even if the gains are attributable to labor income. For example, most, if not all, of Bill Gates's fortune comes from his performing services for Microsoft, but the overwhelming majority of his earnings from Microsoft will be taxed as capital gains. He engaged in entrepreneurial activity that combined labor and capital.

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2. *The Theory of Line Drawing*

a. *In General*

As a substitute for these weak arguments—horizontal equity, analogical reasoning, and so forth—I have laid out a very different theory for resolving competing analogies in the tax law: the theory of line drawing.⁷¹ The theory of line drawing asserts that problems like the potentially differing analogies for the taxation of carried interests are pervasive tax law problems that involve drawing lines between similar activities. These are the daily tasks of policymakers. For example, central to our tax system are lines between selling and holding an asset, between taxable compensation and fringe benefits, between employees and independent contractors, between debt and equity, and between capital and ordinary income. Policymakers are regularly confronted with transactions that fall in the difficult grey areas and must decide which of two treatments is more appropriate.

To illustrate, we can imagine any of these problems as involving three items: item A is taxed at a low rate, item C is taxed at a high rate, and item B must be taxed as either A or C. We must draw a line somewhere in the middle, determining whether B is more like A or more like C. For example, Congress had to decide whether a short-against-the-box transaction was more like holding an asset or selling an asset.⁷² Selling is the high-taxed category and holding is the low-taxed category. Congress had to place a short-against-the-box into one of the two categories; that is, it had to tax the middle category, B (hedged ownership), like A (holding) or C (selling). It decided that hedged ownership was more like selling, but then delegated further decisions on more complex strategies to the Treasury.⁷³ The Treasury must decide whether these more complex strategies will be treated like selling or holding an asset. The same

⁷¹ See Weisbach, *Efficiency Analysis*, supra note 4; Weisbach, *Line Drawing*, supra note 4.

⁷² In a short-against-the-box transaction, a taxpayer who owns stock borrows identical stock and sells it short, using the original shares as collateral for the short sale. The transaction completely eliminates the risk of gain or loss on the stock or from variable dividends with respect to the stock, and allows the taxpayer to withdraw substantially all of the cash invested.

⁷³ See I.R.C. § 1259 (2000) (treating a short-against-the-box and similar transactions as sales).

is true for numerous other areas of tax law, including the capital gains/ordinary income distinction relevant here.

The question is how policymakers should draw these lines. A key observation is that we cannot use consistency or horizontal equity as a criterion. Regardless of how B is taxed, it will be taxed inconsistently with either A or C. Merely pointing out that carried interests are taxed inconsistently with compensatory options does nothing to establish that their tax treatment should be changed because changing their tax treatment would cause them to be taxed differently from self-constructed assets. Inconsistency cannot be eliminated (or even reduced) and, therefore, it is not a guide to policy.

Instead, the best way to determine how items in the middle should be taxed is to look at the economic consequences. The goal is to draw a line that raises revenue while minimizing economic distortions. There are two types of distortions: the complexity costs of drawing the line and the costs of shifting activities into the lower-taxed category.

The complexity costs are fairly straightforward: when putting B with either option is more complicated than the alternative, the additional burden of this complexity must be added to the calculus. Complexity costs impose compliance costs on taxpayers and increase the administrative burden on the government.

The shifting costs are more subtle. Regardless of how B is taxed, there will be an inconsistency in the tax law, and, as a result, taxpayers will shift across the line into the lower-taxed category. We need to compare the relative size of the shifts when B is taxed similarly to either alternative, like A or like C. If B is taxed like C (the high-taxed category), taxpayers will shift from the B category into A, and vice versa. Because there is a built-in inconsistency in the law, there are going to be shifts into the lower-taxed category regardless of which choice is made. The relative sizes of the shifts will vary, however, and to measure efficiency we must compare these relative sizes.

One way to make this concrete is to examine the costs of raising a given dollar of revenue in a given manner. Economists have labeled this the marginal efficiency cost of funds. We want this cost to be low. Raising revenue with a high efficiency cost means we get

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little revenue benefit and a high cost in terms of economic distortions, which is undesirable.

Joel Slemrod and Shlomo Yitzhaki have developed a very simple mathematical formula for estimating efficiency cost.⁷⁴ Suppose that we raise the tax rate on some individual or activity by a dollar. The individual can either pay the tax and be worse off by a dollar or change his activities to avoid or reduce the tax. The individual will be willing to lose up to a dollar of utility to save the dollar in taxes, so either way, we can estimate the cost to the individual as a dollar. That is, we can use the “static” revenue estimate—a revenue estimate based on the assumption that there is no behavioral change whatsoever—to estimate the cost to individuals of increasing the tax by an increment. In addition to this cost, the individual must pay any unavoidable compliance costs associated with the tax change. Therefore, we need to add compliance costs to the static revenue estimate to get a total cost of revenue equal to $X + C$, where X is the static revenue estimate and C is the compliance costs.

The benefit of raising the tax on an item is the actual revenue raised less any administrative costs required to raise it. That is, the benefit is the net revenue raised, or $MR - A$, where MR is the marginal revenue from a tax change and A is the administrative costs.

The cost of raising a dollar from a tax change on an item can be expressed as the ratio of these two factors, or

$$\text{Cost of Funds} = \frac{X + C}{MR - A}$$

We can again use the short-against-the-box example to illustrate this theory; the issue was whether a taxpayer holding appreciated stock should be treated as realizing gain when he enters into an offsetting short sale of the stock or another similar hedge. The three categories are selling (high tax), holding (low tax), and hedging (the middle category). We have to determine whether establishing the hedge is more like selling or holding.

If we treat a short-against-the-box like holding, then individuals can shift from selling to the lower-taxed category, short-against-the-box. If we put short-against-the-box into the selling category,

⁷⁴ Joel Slemrod & Shlomo Yitzhaki, *The Costs of Taxation and the Marginal Efficiency Cost of Funds*, 43 Int'l Monetary Fund Staff Papers 172, 186–89 (1996).

there will be a shift from selling and perfect hedging to holding and imperfectly hedging. Regardless of which choice we make, taxpayer behavior is influenced, always shifting to the lower taxed category. The intuition behind efficient line drawing is to draw the line where shifting is minimized. If the cost of funds, as measured by the formula above, is high, the cost of drawing the line in that place is also likely to be high. If X (the static estimate) is high and MR (actual revenue) is low, it is likely that there is significant shifting across the line.

b. Applied to Private Equity

We need to apply this analysis to private equity. We have compared two possible treatments of private equity carried interests. The first is as capital gain under current law. As commentators have pointed out, there is an incentive for individuals to structure their activities as carried interests to get this benefit, resulting in economic distortions. The second is as ordinary income under one of the various proposals. The incentive would be to restructure carried interest to get around these proposals and retain capital gains treatment.

Further analysis would require data regarding the relevant elasticities, but an understanding of the tax structure indicates that the shifting in the second case would be significant. As will be discussed below, under any of the existing proposals, private equity sponsors would simply restructure their operations to retain the capital gains preference. The marginal cost of funds is likely to be very high. We have to compare this to the shifting away from other arrangements into carried interests if current law stays as is. As discussed below, Section 707(a)(2)(A) is intended to limit this shifting, but it is unclear whether it is successful. Nevertheless, we know that the marginal cost of changing the law is likely to be high, creating a strong indication that it is undesirable.

There is no direct evidence on the relevant elasticities.⁷⁵ Instead, we need to look at other factors to get a sense of the right place to

⁷⁵ There is some limited evidence that the revenue that might be raised would not be significant. See Michael S. Knoll, *The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of Taxing Profit Interests as Ordinary Income* 7-14 (U. Pa. Law Sch. Inst. for Law & Econ., Research Paper No. 07-20, 2007), available at <http://ssrn.com/abstract=1007774>.

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draw the line. I will look at two sources of evidence. The first, in the next Section, will consider how partnership tax law has dealt with the line drawing issue, historically, under current law, and under various reform proposals. The second, in the subsequent Section, will consider the complexity and avoidance opportunities in likely changes to the law.

IV. PARTNERSHIP TAXATION AND LINE DRAWING

Since its inception, partnership tax law has had to draw lines between service providers and partners similar to the line drawing issue at stake here. Therefore, we might be able to look to our historical experience and various reform proposals to get a sense of the relevant parameters of the debate. This Section engages in this task. Although we cannot take current law or reform proposals as received wisdom—after all, the claim of those proposing to change the law is that current law is incorrect—there are two key lessons. First, absent ease of administration concerns, we should not get a fundamentally different result when using a partnership than when engaging in the activity directly. This premise is reflected in current law, the history of the partnership tax rules, and in policy discussions of their reform.

Second, the relevant exception to this rule is if the structure of the transaction makes it inappropriate to treat the partner as engaged in the partnership business. The typical example given is of an architect with limited involvement in a project who receives a profits interest. The architect is best treated like a service provider rather than a partner. This means that commentators who argue for changing the treatment of carried interests because of a distinction between service income and capital income are misreading the partnership tax rules. The lesson from history is that the right distinction is between a partner and someone who works for the partnership but is not properly treated as engaged in partnership business. Although this line is hard to draw, private equity sponsors would clearly be treated as partners under both current law and reform proposals.

A. Direct Taxation

The starting place in examining the policy behind partnership taxation is the central premise of the regime: the tax results from operating in a partnership should vary as little as possible from the results that the partners would get if they engaged directly in partnership activity. As summarized by Professors Alan Gunn and James Repetti on the first page of their partnership tax book, “[t]he central principle underlying the taxation of partners is that the existence of the partnership should matter as little as possible.”⁷⁶

This basic principle is found in the first section of the partnership tax rules, Section 701, which states, “[a] partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.”⁷⁷ The next section, Section 702, carries out this approach by requiring each partner to separately account for his or her distributive share of the partnership’s items.⁷⁸ The reason for this principle is that differences in tax results depending on whether a partnership is used create avoidance opportunities and tax shelters. As Bittker and Lokken note in their treatise, “[m]any tax shelter schemes using partnerships are structured to exploit the entity nature of partnerships. The Treasury and the IRS, in attacking these schemes, have often characterized partnerships as aggregates, at least for particular purposes.”⁷⁹ The use of entity notions in subchapter K is primarily for administrative convenience where a pure aggregate approach would be too complex.⁸⁰

This policy is made explicit in the existing partnership anti-abuse regulations, which are based on the underlying notion that aggregate treatment clearly reflects income; correspondingly, they measure abuse by whether the tax results produce a result that is different from aggregate treatment. They adopt this notion explic-

⁷⁶ Alan Gunn & James R. Repetti, *Partnership Income Taxation* 1 (4th ed. 2005).

⁷⁷ I.R.C. § 701 (2000).

⁷⁸ I.R.C. § 702 (2000).

⁷⁹ Bittker & Lokken, *supra* note 50, ¶ 86.1.2, at 86-5.

⁸⁰ See Am. Law Inst., *Federal Income Tax Project Subchapter K*, at 7 (1984) (“The pure pass-through model can only be achieved in practice at an intolerable cost in complexity.”).

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ity in the abuse of entity treatment rule found in Treasury Regulation 1.701-2(e). This rule holds that the Commissioner can treat a partnership as an aggregate in whole or in part where appropriate.⁸¹ It is also the basis of the general subchapter K anti-abuse rule found in sections (a) through (c) of Regulation 1.701-2. For example, the first factor listed for measuring abuse is whether “[t]he present value of the partners’ aggregate federal tax liability is substantially less than had the partners owned the partnership’s assets and conducted the partnership’s activities directly.”⁸²

The anti-abuse regulation recognizes that there will often be results that differ from aggregate treatment, but, reflecting the logic of Bittker and Lokken, these differences arise only for administrative convenience rather than because they clearly reflect income. Thus, Example 9 considers a case where failure to make an election under Section 754 creates a disparity between inside and outside basis, resulting in a tax advantage because of the entity-type treatment given to partners’ bases in their partnership interests.⁸³ The regulation notes that the “electivity of section 754 is intended to provide administrative convenience for bona fide partnerships.”⁸⁴ Under the facts of the example, the failure to make a Section 754 election was respected. The baseline for clear reflection, however, was aggregate treatment, treating the partners as if they engaged directly in the partnership activity.

The same policy is seen in the so-called “Brown Group” regulations. In *Brown Group, Inc. v. Commissioner*, the Eighth Circuit held that income that would have been subpart F income were it earned directly by the taxpayer was not when earned through a partnership.⁸⁵ The government viewed this deviation from the aggregate approach as intolerable and issued regulations that overruled the case.⁸⁶ The underlying notion is the same as that underlying the partnership anti-abuse rule: when the tax treatment of an

⁸¹ Treas. Reg. § 1.701-2(e) (as amended in 1995).

⁸² Id. § 1.701-2(c)(1).

⁸³ Id. § 1.701-2(c) ex. 9.

⁸⁴ Id.

⁸⁵ 77 F.3d 217 (8th Cir. 1996).

⁸⁶ See Treas. Reg. § 1.702-1(a)(8)(ii) (as amended by T.D. 9008, 67 Fed. Reg. 48,023).

individual in a partnership varies too much from the treatment when engaged directly in the activity, abuses will arise.

Not only does current law reflect the “direct engagement” notion, policy discussions on reform of the partnership tax rules start with the same premise: treating partners as if they engaged in partnership activity directly is the best baseline. The proposal that best exemplifies this thinking is the 1984 ALI proposal on partnership taxation. As the ALI summarized, “the ideal mode for taxing partnership earnings is to tax each partner as though he were directly conducting his proportionate share of the partnership business.”⁸⁷ The ALI recognized that in many cases, treating the partnership as a separate entity is desirable nonetheless, but the basic reason in each of these cases is administrative.

If this policy baseline of direct engagement is applied in the carried interest context, holders of carried interests would receive whatever treatment the partnership receives. Pass-through of capital gain, therefore, is mandated by this basic premise of partnership taxation. If the holders of carried interests were directly engaged in the activity of the private equity fund, they would be treated as investors exactly as the private equity fund is treated. We do not make investors segregate the portion of their return attributable to labor effort, and neither, therefore, would we make holders of carried interests if we treated them as directly engaged in the partnership activity.

B. Entity Notions and Nonpartners Nominally Acting as Partners

There are many places where the partnership rules deviate from this aggregate approach. For example, partners have a basis in their partnership interests separate from the partnership’s basis in its assets. Many elections are made at the partnership level, and partnerships can have taxable years different than minority partners. Also, within an aggregate notion of partnership taxation, many more recent tax rules are focused on the shifting of tax attributes among the partners—getting the correct allocation of items to each partner. Most of these are not relevant to the treatment of carried interests.

⁸⁷ Am. Law Inst., Federal Income Tax Project, Subchapter K, at 5 (1984).

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The rule relevant to the present discussion is Section 707(a)(2)(A), which treats some service providers as nonpartners even though they nominally hold a partnership interest. The underlying idea of this section is that if the partner had engaged in the activity directly, his payments would depend on the partnership business. If the payments instead are fixed, it is not appropriate to treat him as if he engaged in the partnership business directly. Instead, he looks more like a service provider. Therefore, we carve out these cases and treat them similar to transactions between the partnership and third parties.

Historically, the aggregate approach predominated. Prior to 1954, payments to individual partners were not treated as salary. Instead, all payments to partners were treated as distributions.⁸⁸ This approach was unworkable in many contexts because of the complexity of the capital account adjustments that were needed; as a result, in 1954, Congress added a rule that allowed a partnership to pay its partners so-called guaranteed payments for services. This rule treats payments made without regard to partnership income as payments to a nonpartner for purposes of Sections 61, 162(a), and 263.⁸⁹

This approach, however, was insufficient. In particular, partnerships could pay service providers by calling them partners and allocating gross income to them. By doing so, they could avoid rules that would apply to payments to third parties for services, such as the rule that certain payments be capitalized under Section 263. For example, payment for an architect's services must generally be capitalized. If the architect is given a partnership interest and is allocated the same income, the capitalization requirement is avoided. While the guaranteed payments rule, if it applied, would prevent this avoidance, taxpayers could base the payment on gross income and not run afoul of those rules.⁹⁰

To prevent this avoidance, Congress added Section 707(a)(2)(A). This section treats a payment to a partner as one made to a nonpartner if (1) a partner performs services for a partnership, (2) there is a related allocation or distribution of income,

⁸⁸ See *Lloyd v. Comm'r*, 15 B.T.A. 82, 86–87 (1929); Bittker & Lokken, *supra* note 50, ¶ 89.1.1.

⁸⁹ I.R.C. § 707(c) (2000).

⁹⁰ *Pratt v. Comm'r*, 64 T.C. 203 (1975).

and (3) when viewed together the services and allocation are properly characterized as between the partnership and a nonpartner. As noted, Congress listed six factors for making this determination, and a typical carried interest in private equity partnerships has none of these factors. It is not even a close question, at least under current law, that the private equity sponsor is acting in its capacity as a partner with respect to a carried interest.

It is possible that the lines drawn in Section 707(a)(2)(A) should be changed. In the twenty-three years since that section was enacted, compensation arrangements have changed significantly. Modern compensation is much more likely to depend on the success of the business than it was in 1984. This makes the problem posed by Section 707(a)(2)(A) much more challenging. Nevertheless, absent a complete rethinking of Section 707(a)(2)(A), which would have broad and unclear ramifications about who can and who cannot be treated as a partner, it is hard to see an argument that private equity sponsors are not properly taxed as partners. Not only are all six of the current law tests easily met but the economics indicate that the private equity sponsor is the primary partner. It is the general partner who has all of the decisionmaking authority and residual risk. Given how far private equity sponsored interests are from where the line is currently drawn, moving the line to change their treatment would require wholesale examination of the underlying premise. The long partnership tax history indicates, however, that it is unlikely that doing so would be desirable.

C. Summary

The long history of the development of the partnership tax rules and the many policy proposals for their reform indicate the strong preference for taxing partners as if they engaged in partnership activity directly. This principle is also supported by the partnership anti-abuse rule, which treats deviations from this baseline as potentially abusive. The major scenario in which this treatment does not apply is if the partner is sufficiently remote from partnership activities that he is best not treated as a partner at all. There is no argument that this exception should apply in the private equity context.

Taken together, this history provides impressive evidence that the right place to draw the line between service provider and investor is to treat the private equity sponsor the same way that the

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partnership is treated. That is, this history strongly supports the notion that carried interests in private equity partnerships should get pass-through treatment and, consequently, capital gains and losses on the sale of investments by the partnership.

V. COMPLEXITY AND AVOIDANCE

The second piece of evidence for the line drawing exercise is the likely complexity of any rule that attempts to tax carried interest as ordinary income and the ease of avoiding any such rule. Attempting to tax all or a portion of carried interests as service income will likely have the effect of simply making partnership tax more complex without actually changing the tax results for anyone who cares sufficiently to plan around the new rules.

The key problem with a rule that taxes carried interests as ordinary income is the need to distinguish labor income from capital income. There is simply no general method of making this distinction, and attempts to do so are complex. Moreover, even if we could devise a rule, because the proposed changes would apply only in the partnership context, the new rule would be easily avoidable. This Section considers these points, first discussing the problem of identifying labor income and second analyzing likely avoidance possibilities.

A. Complexity and the Problem of Identifying Labor Income

Suppose that the laws were changed to tax carried interest as ordinary income on the theory that they represent labor income. The question is how carried interests are to be identified.

The problem is that cash flows do not often come neatly labeled as capital or labor.⁹¹ Current private equity structures use simple carried interests which are easy to identify because there is no reason to disguise them. As illustrated below, however, in many cases the flows will be complicated and difficult to identify. Moreover, to the extent this is not the case now, it would become the case were

⁹¹ Even in this case, we know that some portion—perhaps a substantial portion—is capital income in the sense that it represents returns that are left in the business rather than taken out each year as salary. Nevertheless, we might sensibly say that the best compromise is to treat it all as labor income exactly as we do in the case of restricted stock or nonqualified options.

there to be unfavorable rules for pure carried interests. If cash flows are complicated and represent combined returns from labor and capital, we have no method—nor even a theory—for identifying the labor component and, therefore, no method for determining when a partner has a carried interest.

To illustrate the problems, suppose that there is a two-person partnership with partners *A* and *B*, each of whom works for the partnership and contributes capital. They get paid equal salaries but their services may not be worth the same. They contribute equal capital, but their risk preferences may not be the same. To properly identify a profits interest, we have to be able to identify what portion of their returns should properly be recast as additional salary.

Time variation. Suppose that *A* strongly prefers to get his money out soon, perhaps because he needs it soon or because risk increases with the length of an investment and he is more risk averse than *B*. Therefore, they agree that *A* gets 60% of the profits for the first five years and 40% of the profits thereafter. *B* gets the reverse. In addition, the partnership pays *A* and *B* equal salaries.

This may or may not be a fair division of the returns to the capital they have invested, and their service contributions may or may not be equal. Perhaps the present value of *A*'s 60/40 split is greater than the present value of *B*'s 40/60 split with the difference representing *A*'s relatively greater contribution of labor income, or vice versa. Taking present values is difficult in this case because the returns are risky and the risk profile may change with time. There is no way to draft laws or regulations that identify any potential service component to the capital allocation. The government could attempt to challenge this on audit, but any such challenge would be expensive and come down to a battle of experts, with the IRS having little chance of winning except in egregious cases.

Risk variation. Alternatively, *A* may prefer to get the first returns from the venture in exchange for giving *B* all of the upside should it do very well. For example, *A* may be much more risk averse than *B*. Therefore, they may allocate the first 6% of profits to *A* and give everything above that amount to *B*. Or, alternatively, *A* could get the first 8%, *B* get the next 2%, and they share everything beyond that with 80% going to *B* and the rest to *A*. Any degree of complexity is possible.

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Just like in the time variation case, to determine whether *A* or *B* is hiding labor income in these capital returns, we would have to compare the present discounted values of each partner's share of the capital returns. In this case, doing so would be particularly difficult because the returns explicitly have different risk profiles. Indeed, *B*'s return may look very much like an option, and option valuation methodologies may be necessary instead of merely taking present values. Option valuation would, however, be very difficult because the underlying assets may not be traded, so volatility cannot be observed. Again, there would be no way to write legislation or regulations to capture cases like this, and the government would have no easy way of challenging this on audit.

Location variation. Finally, *A* and *B* may have different views about the returns from the venture in different locations. For example, if the partnership operates in both California and Illinois, *A* may prefer a relatively greater portion of the California returns and a correspondingly lower portion of the Illinois returns. Thus, suppose *A* gets 70% of the profits from the California operations and 30% of the profits from the Illinois operations, and *B* gets the reverse. Like in the above cases, there would be no easy way to determine whether these allocations have equal value, and, therefore, no way to determine whether there is hidden labor income being taxed as capital income. Challenging this case on audit would require valuation of reasonable expectations of business returns in different locations, a task that would be far more difficult and subjective than present value or even option valuations.

Combinations. Any of the above cases can be combined with any of the other cases. For example, *A* may get the first 6% of returns from California and 30% of all returns from Illinois for some fixed period, after which allocations could flip to a 50/50 allocation. Real economic arrangements could have almost any degree of complexity, as could arrangements designed solely or primarily as tax avoidance.

In each of these cases, it is entirely possible that the allocations have equal present values and therefore do not contain hidden service income.⁹² It is also equally plausible that they do not have

⁹² The salaries could be below market, and some portion of the returns could be service income equally to *A* and *B*. In the text, I am trying to see whether we can identify

equal values, and compensation for service income—a profits interest—is hidden within these allocations. There is no easy formula for making this determination. Without a method of making this determination, Congress cannot readily enact a rule.

The basic approach of the partnership rules is to accept the economic allocations as real and require the tax allocations to follow. The limited exception to this rule is in the substantiality requirement under Section 704(b), which attempts to find obvious cases of tax avoidance but nothing beyond that.⁹³ That is, the 704(b) rules take the approach that there is, in general, no way of determining whether these various allocations are fair. Instead, they trust that if arm's length parties agree to the returns, they are likely to be close enough. If we want to separate labor and capital returns, however, this approach cannot work. Instead, we must be able to examine the economic arrangements and find hidden returns to labor, a task that would likely prove impossible. In a sense, the task of those who would change the law is to revise the basic capital accounts rules of Section 704(b) to reflect time value concepts, including making the proper adjustments for risk.

As noted, Section 707(a)(2)(A) is the one place under current law where we come close to making this separation. It attempts to draw a line between where it is appropriate to treat the partner as in business for himself—and, therefore, we do not recharacterize capital gain as compensation even if it is due to labor income—and when the partner should be viewed as a third-party service provider. Even this allocation, which seems likely to be easier than distinguishing between labor and capital, is too hard to implement. Twenty-three years after the provision was enacted, there are no regulations or other guidance on the issue.

None of the proposals for changing the treatment of carried interests grapple with these problems. They simply assume that we can identify labor income when we see it. For example, the proposal introduced by Congressman Levin requires taxpayers to make a reasonable allocation between capital and labor with, effectively, a presumption that straight-up allocations are the only ap-

a profits interest—an allocation to one of the partners as a payment for services. The problem of undercompensation arises even with straight-up allocations.

⁹³ I.R.C. § 704(b) (2000).

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propriate allocations. Given that there is no way the government can determine whether the variously allocated returns to capital have equal risk-adjusted present values, there would be no way for it to determine whether an allocation is reasonable.

Similarly, Gergen would treat any payment that is not a straight-up, pro rata allocation of returns (to a partner that provides at least some services) as entirely for services. Essentially, he would require strict, pro rata sharing of all returns to capital regardless of the economic arrangement. Under this approach, none of the risk-sharing arrangements considered above would work because none are pro rata, even if they were entirely driven by the underlying economic arrangement and even if there was no service element or tax motivation in the allocations. Gergen might defend his approach by arguing that there is no better rule, but, given its inaccuracy, it is not clear that his rule is better than nothing, even if one were convinced that analogizing carried interests to service income is correct. This is particularly true because, as will be discussed below, it is easily avoidable.

The imputed loan approach suffers from the same problem. To implement the approach, we would have to identify when one partner has implicitly loaned funds to another partner and then impute an appropriate cost of capital. If allocations are not straight-up, it would be impossible to identify implicit loans.

It is doubtful that there are any solutions to the problem that are not complex, and regardless, any solution is likely to be inaccurate. The underlying problem is that outside of the employer/employee context, we do not have a method of distinguishing labor income from capital income, and without such a method, we cannot draft partnership tax rules to do so.

B. Avoidance

The exact avoidance strategies will depend on the precise legislation, if any, that is enacted, so it is difficult to make definite predictions. Nevertheless, it is clear that avoidance will be relatively easy because of the underlying theoretical problem: the difficulty of distinguishing labor and capital income.

The analogy to a debt-financed investor suggests that using debt could largely be successful in avoiding any change in the law; the proposed changes only apply to partnerships, so avoiding the use of

partnerships avoids the changes. For example, the limited partners could lend money to the sponsors with payments contingent on performance. Although tax planners would have to ensure that the resulting instrument qualifies as a debt instrument, our long experience with the debt/equity distinction shows that the government has a very hard time policing this boundary. Under the proposals being considered, dramatic tax consequences would depend on this distinction, giving taxpayers incentives to structure around it to their advantage.

Even within the partnership structure, there are a number of ways the proposals could be avoided. The most obvious, suggested by the discussion of complexity above, is to make the returns complex and argue that what had been the 20% carry, and is now a flow that is intertwined with other flows from the partnership, is a return to capital. Without a theory for measuring the return to capital, the government would have little ability to challenge this claim.

A second method of avoiding the various proposals while continuing to use a partnership structure is to document the transaction as a loan between the limited and general partners consistent with the Schmolka imputed loan approach. The sponsor would borrow funds from the limited partners at a low interest rate, perhaps the AFR, and then invest those funds. Partnership allocations would be made so that after the allocation of income to the various partners and payment of the interest on the loan, the net amounts were roughly the same as under current law.

The actual numbers would depend on the specifics of the transaction, but suppose that the structure is the one described above: the limited partners get the first 8% of the return, the general partners get the next 2%, and everything beyond that is shared 80/20. Suppose also that the AFR is 5%. Finally, suppose that total partnership capital is \$100, all contributed by the limited partners.

Although it is commonly assumed that the imputed loan amount is \$20, this is not correct. If the partnership does well, the general partners can end up with 20% of the partnership returns, but their returns are riskier than the returns to the limited partners—the

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limited partners get the first 8%.⁹⁴ This means that someone contributing capital for that set of returns would contribute *less* than 20% of partnership capital, so that the risk-adjusted return is appropriate.

Suppose, however, that we use the \$20 number as a simple starting point. The general partner would have to borrow \$20 from the limited partners, and suppose it does so at the AFR (5%). This means that the general partners owe the limited partner \$1 each year. There are many possibilities, but partnership allocations could provide that the limited partners receive the first 7% of profits, the general partners receive the next 3%, and everything after that is split pro rata (80/20). Although the general partners would be getting more than a 20% return for their contribution of 20% of partnership capital, this return is riskier than the return to the limited partners, so that they could easily justify this difference. At a minimum, the government would be hard-pressed to challenge this valuation on audit. The net payments would be substantially identical to those under the current structure with no additional payment of tax.⁹⁵

There are many different versions that would also work. The loan amount from the limited partners to the general partners could be different from the \$20 used in the illustration, the interest on the loan could differ from a fixed AFR, or the partnership allocations could be different from those described. Professor Howard Abrams suggests that the partnership could simply pay the general partners a fee sufficient to cover the interest payment due to the

⁹⁴ As the Joint Committee noted, the carried interest got nothing in 30% of private equity transactions during the period they studied. Partnership Carried Interests, Part I, Sept. 4, *supra* note 2, at 23.

⁹⁵ One potential tax difference is that the interest on the loan from the limited partners would be investment interest subject to the limitations under § 163(d). Either the general partners would have to have that much investment income otherwise in their portfolios or the private equity fund could ensure that the portfolio companies pay dividends sufficient to cover this amount. An economic difference is that if the fund does not earn at least 8%, the general partners would owe the limited partners the interest on the loan without receiving an offsetting distribution from the partnership. This risk could be mitigated by using a different allocation scheme, where the general partners receive their first 1% earlier.

limited partners.⁹⁶ What is clear is that something very close to the current economics and current tax treatment could be achieved through a loan from the limited partners to the general partner.⁹⁷

A third method, suggested by Professor Michael Knoll, is to have the portfolio companies pay fees to the sponsors equivalent to the carried interest.⁹⁸ A deduction for these fees by the portfolio companies would offset the income inclusion by the general partners. This is simply an application of the idea that the treatment of carried interests does not matter unless the limited partners are tax-exempt or otherwise cannot deduct the fees. By shifting the payment of the carried interest to the portfolio company, this method ensures that it is deductible (or, at a minimum, capitalized and recovered over time).

Yet another method of avoidance is to capitalize the partnership with debt. For example, if the limited partners contribute a substantial fraction of their investment as debt, the allocations for the equity contributions made by the limited and general partners could be closer to straight-up allocations, making it difficult to separate the returns to labor and to capital.

C. Summary

This analysis of avoidance strategies barely scratches the surface. Once rules are in place and a lot of money is at stake, many additional methods are likely to come to light. Moreover, even if any one of these methods might be challenged, complex structures will combine elements of each, making it very difficult, if not impossible, for the government to sort it out.

⁹⁶ Howard E. Abrams, *Taxation of Carried Interests*, 116 *Tax Notes* 183, 186 (2007). An advantage of this structure over the one described above is that it avoids problems created by § 163(d).

⁹⁷ Professor Michael Knoll argues that this structure would not be respected because it implicitly relies on a below-market interest rate on the loan from the limited partners. Knoll, *supra* note 75, at 14–15. It will, however, be difficult for the government to challenge the interest rate on audit. The government would have to rely on § 482, which is rarely successful. Moreover, if this simple structure with a direct loan between partners can be challenged, the loan can be made through third-party financial intermediaries, similar to the transactions described in Rev. Rul. 87–89, 1987-2 C.B. 195.

⁹⁸ Knoll, *supra* note 75, at 16–18.

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These facts about complexity and avoidance show that the cost of funds from changing the tax treatment of private equity is likely to be high. The reason is that very little actual revenue is likely to be raised— MR is low. This will be because there is substantial shifting and avoidance, so the ratio of the static revenue estimate to actual expected revenue, $X:MR$, is likely to be high. Further, the administrative and compliance costs will be high, increasing the cost of funds.

VI. DISTRIBUTIONAL CONSIDERATIONS AND CONCLUSION

Distributional concerns are probably the underlying factor that is driving the discussion, not technical concerns about identifying labor income.⁹⁹ Many private equity sponsors are extraordinarily wealthy at a time when inequality has been increasing and the government faces severe fiscal pressure, both immediate and future. In addition, private equity sponsors are seen as financiers rather than inventors, which makes the value they add to the economy harder for many to see. Bill Gates is many times richer than any private equity sponsor, earned all his money through labor effort, will be taxed on virtually all of his returns at the long-term capital gains rate, and, to the extent he dies with built-in gains, will have his income tax entirely forgiven on the gains.¹⁰⁰ Because he is seen as inventing a product, however, these facts have not caused a clamor for change.

The distributional problem with the taxation of wealthy private equity sponsors, however, should not be solved by changing the technical rules for the taxation of carried interests. The issue arises because of the capital gains preference more generally. A special rule for private equity sponsors would not significantly change the distributional implications of the capital gains preference. To the extent it collected any tax at all, it would merely pick off one class of beneficiaries of the preference. A change to the capital gains rate, by contrast, would have broader distributional effects. It would be far less avoidable than technical changes to the partnership tax rules: a technical change to the partnership tax rules leaves

⁹⁹ For example, Victor Fleischer entices the reader with terms like “airplane rich” (meaning you can afford your own airplane). Fleischer, *supra* note 2, at 20 n.73.

¹⁰⁰ Gates and private equity sponsors will equally be subject to the estate tax.

the capital gains preference generally available and relies on the ability of the government to distinguish labor income from capital income. This is not a promising approach, even if one is primarily concerned about the distributive consequences of current law.

The considerations discussed above indicate that the treatment of carried interests should not be changed. Under current law, private equity sponsors are treated the same way they would be treated if they engaged in the activity directly rather than through a partnership. There are sound reasons, many deeply embedded in partnership tax law, for retaining this approach. Moreover, changes would likely be very complex and easily avoidable, imposing costs on the economy while raising little revenue. Distributional concerns are important, but they are not centrally related to the taxation of carried interests. Instead, they arise because of the capital gains preference and, if they are going to be addressed, should be dealt with directly.