The Taxation of Carried Interest: Understanding the Issues

Abstract - Congress has recently considered taxing the carried interest of private equity fund managers at ordinary rates rather than at the 15 percent rate that currently applies to a portion of this income. The proposed change is intended to promote neutrality between the labor compensation of fund managers and other types of labor income. The case for reform, though, is less compelling than initial appearances suggest. The proper treatment of carried interest raises difficult second-best questions.

INTRODUCTION

In the spring of 2007, a then-unpublished law review article by Victor Fleischer helped turn an obscure aspect of partnership taxation into a contentious tax policy issue. Intense media and political debate took place on the appropriate tax treatment of the “carried interest” received by managers of private equity funds. Although no changes have yet been made to current law, the issue is likely to resurface in 2009.

Carried interest is a share, allocated to the fund managers, of the income generated by the fund’s holdings in its portfolio companies. When that income consists of qualified dividends or long-term capital gains, the managers are taxed at the 15 percent rate applicable to those forms of income. The case for reform is simply stated: Since the managers are being compensated for their labor, the payments should be taxed at the same rates as other labor income rather than at the lower rate for dividends and capital gains. Put more strongly, managers’ labor income should not be taxed at a lower marginal rate than their secretaries’ labor income.

Despite its initial appeal, the case for reform becomes more uncertain upon closer examination. The appropriate treatment of carried interest raises difficult second-best questions.

The use of carried interest rather than salary does not convert ordinary income into capital gains and dividends at the aggregate level, but instead changes the allocation of the two types of income. The use of carried interest causes the fund managers to receive capital gains and dividends rather than ordinary income, thereby lowering their tax liability. But, it has the opposite implications for the fund investors. Rather than deducting a salary payment to the managers,
which would have reduced their ordinary income, the investors instead face a reduction in their dividend and capital gains income, reflecting the distribution of a portion of that income to the managers. If the investors are taxable individuals, they experience a tax increase that offsets the tax savings for the managers. In practice, though, many of the investors are tax-exempt organizations that face no tax on either type of income. In that case, the use of carried interest yields aggregate tax savings by allocating dividend and capital gains to managers who benefit from the lower tax rate on such income and away from tax-exempt investors who would receive no tax benefit.

The key normative question is whether this type of tax-reducing allocation should be allowed. As discussed in the paper, that determination turns upon several difficult issues, including the extent to which managers and investors can reallocate income through means other than carried interest, the non-tax purposes served by the use of carried interest, and the extent to which the tax savings from carried interest offset over-taxation elsewhere in the tax system. The uncertainty surrounding these issues precludes a definitive resolution.

Contrary to some suggestions, the initial award of carried interest to the managers when the private equity fund is established should remain untaxed. Prepayments for future labor services are economically equivalent to borrowing against future labor income and, therefore, should not be taxed.

The remainder of the paper is structured as follows. In the second section, I describe carried interest and its tax treatment. In the third section, I describe the economic issues posed by reallocation of dividends and capital gains. In the fourth section, I discuss the role of these tax savings in offsetting an implicit payroll tax on fund managers in some circumstances. In the fifth section, I discuss the tax treatment of the initial award of carried interest. I briefly discuss some additional issues in the sixth section and conclude in the seventh section.

CARRIED INTEREST AND ITS TAX TREATMENT

Private Equity

This description is largely drawn from U.S. Congress, Joint Committee on Taxation (2007a, pp. 2–4), Fleischer (2005; 2008, pp. 8–9), and conversations with former American Enterprise Institute fellow John Chapman. A private equity fund is a partnership, in which the sponsoring private equity firm is the general partner. The firm is itself a partnership, in which the managers are general partners. The limited partners in the fund are investors, often a mix of wealthy individuals, corporations, and tax-exempt organizations.

The fund, which may last for ten to 14 years, owns a number of portfolio companies, perhaps ten or more, at a time. There may be significant turnover in the fund’s holdings, as the fund may liquidate its stake in a given portfolio company after a holding period of several years. The fund’s stake in the portfolio company may be as small as five percent or as large as 100 percent. Private equity funds include both buyout funds that purchase established companies and venture capital funds that finance start-up companies.

The private equity fund, through its managers, provides a variety of services that are intended to increase the value of the portfolio company. They may decide on and carry out mergers, take a seat on the board of directors, change the company’s financial structure and the compensation structure of its managers, and decide on lines of business to enter or exit. As Crook (2007) notes, a common change in financial structure is an increase in debt.

The private equity fund receives the income from its holding of the portfolio
company and from its eventual sale. Because the fund is a partnership, the income is allocated among the fund’s partners. A common arrangement calls for the managers, as general partners, to receive an annual fixed fee equal to two percent of the invested capital and a “carried interest” potentially equal to 20 percent of the income.

As Fleischer (2005) details, the design of carried interest varies among firms. For venture–capital firms, the carried interest is usually a straight one–fifth of the fund’s income. For buyout firms, a common arrangement requires that the rate of return on the fund’s investment clear a hurdle rate of eight percent before the managers receive any carried interest, with the managers then receiving all of the next two percentage points of return (so that they receive two percentage points of the first ten) and also receiving one–fifth of the return beyond ten percent.

**Current Tax Treatment**

The current tax rules are discussed by U.S. Congress, Joint Committee on Taxation (2007a, pp. 5–30) and Fleischer (2008, pp. 9–15, 55–56).

Section 1(h) of the Internal Revenue Code provides a preferential maximum individual income tax rate of 15 percent for qualified dividends and gains on capital assets held for longer than one year. I refer to these two types of income as “dividend–and–gain income.” In comparison, section 1(a) provides a top rate of 35 percent for other, “ordinary,” income such as wages, interest, and short–term capital gains. Section 55(b)(3) provides that the preferential rate for dividend–and–gain income also applies under the individual alternative minimum tax (AMT).

If an individual owned a portfolio company and held it for longer than one year, income from its sale would generally be long–term capital gain. Also, distributions from a portfolio company that is a C corporation would generally be qualified dividends. Therefore, much of the income generated by the company would receive the 15 percent rate if the managers, or other individuals, directly owned the company.

The portfolio company is actually owned by a partnership, the private equity fund, rather than by individuals. Because partnerships are flow–through entities, however, the character of its income passes through to the partners; section 702(b) states that partners are taxed on partnership income in the same manner “as if such item were realized directly from the source from which realized by the partnership.” Accordingly, individual partners in the fund, both the managers and any individual investors, enjoy the 15–percent rate on any dividend–and–gain income generated by the portfolio company.

The key to the tax treatment of carried interest is the flexibility partnerships enjoy in allocating different categories of income and expense among the partners. Under section 704(a), the allocation is generally determined by the partnership agreement. While one might think, for example, that the partnership’s dividend–and–gain income should be allocated to the partners who supplied the capital investment, current law does not require such an allocation. The partnership may allocate the income in some other manner, whether to satisfy risk preferences or moral hazard concerns or to minimize combined tax liability.1 However, the substantial–economic–effect rule of section 704(b) requires that the allocation of

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1 In this respect, partnerships are quite different from S corporations. Since section 1361(b)(1) requires each S corporation to have a single class of stock, each stockholder must receive a pro–rata fraction of each item of income and expense.
items for tax purposes be consistent with how the items are actually divided among the partners.

Sections 702 and 704 apply to partnerships throughout the economy. For example, if two partners operate a restaurant, with one supplying labor and the other supplying capital, they may allocate the resulting income as they please, potentially assigning any dividend–and–gain income to the partner who provides labor. The ability of private equity funds to allocate dividend–and–gain income to their managers is not a special privilege for that sector, but is instead an application of economy–wide tax rules.

It is also important to recognize that the 15–percent rate does not apply to all carried interest, but only to the portion that represents dividend–and–gain income. For example, any carried interest that represents gains from assets held by the fund for one year or less is taxable at ordinary rates.

Legislative Proposals

Several factors combined in 2007 to direct congressional attention to the tax treatment of carried interest in private equity firms. A lavish 60th birthday party held on February 13, 2007 for Blackstone chairman Stephen A. Schwarzman drew extensive unfavorable publicity. Announcements that leading private equity firms would institute initial public offerings also focused attention on the sector. The then–unpublished paper that became Fleischer (2008) drew interest on Capitol Hill in the spring of 2007. Following an earlier suggestion by Gergen (1992), Fleischer suggested consideration of a policy that would tax all carried interest as ordinary income. Fleischer presented his paper at a closed–door briefing for Senate Finance Committee aides on May 7, 2007.

On June 22, 2007, Rep. Sander Levin (D–Michigan) and Rep. Charles Rangel (D–New York), the chairman of the Ways and Means Committee, introduced H.R. 2834. The bill would apply ordinary tax rates to income received by partners who perform a “substantial quantity” of “investment management services,” except to the extent that the income was attributable to those partners’ own capital investments. The bill did not specify an effective date or transition provisions. The bill, which has 27 sponsors, has not been acted upon.

The Senate Finance Committee held hearings on this issue on July 11, 2007 and July 31, 2007 and the House Ways and Means Committee held a hearing on September 6, 2007. On October 25, 2007, Rep. Rangel introduced H.R. 3970, a broad tax reform bill that included a provision similar to H.R. 2834. That bill has also not been acted upon.

On November 9, 2007, the House of Representatives approved H.R. 3996, which included a similar provision to offset part of the revenue loss from a 2007 AMT “patch” and other temporary tax relief. The provision, which would have applied to income received after November 1, 2007 with no transition relief for existing partnerships, would have raised an estimated $25.6 billion of revenue in fiscal years 2008 through 2017 (U.S. Congress, Joint Committee on Taxation, 2007b). The provision was not included, however, in the Senate version of the bill or in the conference agreement passed by Congress and signed into law on December 26, 2007.

On June 25, 2008, the House passed H.R. 6275, which includes a carried–interest provision to offset part of the revenue loss from a 2008 AMT patch. The provision, which would apply to income received on or after June 18, 2008 with no transition relief, would raise an estimated $31.0 billion of revenue in fiscal years 2008 through 2018 (U.S. Congress, Joint Committee on Taxation, 2008). The bill did not become law.
In March 2008, a Senate Finance Committee tax counsel quoted by Shreve (2008) stated that the issue could be “front and center” in future tax reform discussions. Democratic presidential nominee Barack Obama has pledged to “close the carried–interest loophole,” as stated in Obama (2007), but Republican nominee John McCain has not endorsed any change to current law. Soon after the debate began in 2007, Treasury Secretary Henry Paulson and a White House spokesman expressed the Bush Administration’s opposition to a change in current law, as reported by Mullins (2007).

I now turn to an economic analysis of the tax treatment of carried interest. As shown in the next section, the underlying normative issue is the extent to which managers and investors should be allowed to allocate dividend–and–gain income in a manner that minimizes aggregate tax liability.

ALLOCATION OF DIVIDEND–AND–GAIN INCOME

One might initially think that the use of carried interest increases the aggregate amount of dividend–and–gain income in the national economy while reducing the aggregate amount of ordinary income. As emphasized by Sanchirico (2008), however, the arrangement instead reallocates the two types of income among different parties without changing the aggregate amounts. In this section, I review the impact of such reallocations on aggregate tax liability and discuss policy implications.

Reallocation Through Carried Interest

The reallocation can be illustrated with a simple example. I assume that the competitive before–tax rate of return is eight percent. Without loss of generality, I consider a private equity fund with one manager and one investor. For simplicity, I ignore the two–percent fee and also assume that the carried interest exhibits the design common among venture–capital funds, a straight one–fifth of the fund’s income.

The portfolio company has a $10,000 capital stock, which would generate $800 of before–tax income in the absence of the services provided by the fund manager. Assume that the private equity fund purchases a 100 percent stake in the portfolio company. The manager provides services that boost the portfolio company’s before–tax income to $1,000, which the private equity fund receives as the company’s owner. Under the stated assumptions, the manager’s $200 carried interest matches his marginal product and the investor receives an eight percent market return on his investment.

To highlight the impact of carried interest, assume that all of the fund’s income is dividend–and–gain income. Then, the manager is taxed on $200 of dividend–and–gain income while the investor is taxed on $800 of dividend–and–gain income. If the manager was instead paid a straight salary, he would be taxed on $200 of ordinary income. The investor would be taxed on the entire $1,000 of dividend–and–gain income while claiming a $200 deduction against ordinary income for the salary payment to the managers.

Table 1 compares the two compensation arrangements, using DGI to denote dividend–and–gain income and OI to denote ordinary income. Under either arrangement, aggregate dividend–and–gain income equals $1,000 and aggregate ordinary income equals zero. The two arrangements differ, however, with regard to the allocation of each type of income between the manager and the investor.

The use of carried interest in place of salary reallocates $200 of dividend–and–gain income from the investor to the manager and reallocates the same amount of ordinary income from the manager to the investor.
What are the tax implications of this reallocation? If the investor, as well as the manager, is a taxable individual subject to the maximum tax rate, there is no change in aggregate tax liability, as shown in the “Individual Investor” columns of Table 2. The dividend–and–gain income is taxed at 15 percent regardless of which party receives it and the ordinary income is taxed at 35 percent regardless of which party receives it. Aggregate tax liability is equal to $150 under both compensation arrangements. Of course, the reallocation changes the value of each party’s tax payments; with carried interest, the manager pays $40 less and the investor pays $40 more. But, the two parties can and should alter their payments to each other to keep their disposable incomes unchanged.

If the investor is not an individual, however, the reallocation may change aggregate tax liability. For example, if the investor is a tax–exempt organization, it bears no offsetting tax increase when ordinary income rather than dividend–and–gain income is allocated to it. In that case, aggregate tax liability is lower with carried interest than with salary, as shown in the “Tax–Exempt Investor” columns of Table 2. With a tax–exempt investor, the manager’s $40 tax saving constitutes a $40 aggregate tax reduction.

As Sanchirico (2008) explains, the relevant tax attribute is not the level of tax rates faced by the investor, but rather the gap between the investor’s tax rate on ordinary income and tax rate on dividend–and–gain income. The gap is relevant because the reallocation of dividend–and–gain income is accompanied by an equal and opposite reallocation of ordinary income. Since the manager has a 20–percentage–point gap between the two rates, the use of carried interest reduces (increases) aggregate tax liability if the investor faces a gap smaller (larger) than 20 percentage points.

The gap is generally zero for tax–exempt organizations, which face no tax on either type of income, and for C corporations, which are taxed at 35 percent on both ordinary income and capital gains.2 U.S. Congress, Joint Committee on Taxation (2007a, p. 37) reports that 42 percent of investors in venture capital funds are pension funds and 21 percent are endowments and foundations. Sanchirico (2008) states that roughly half of investors are pension funds and endowments. Knoll (2007, p. 8) reports that less than 20 percent of investors are wealthy individuals, more than 50 percent are tax–exempt or foreign, and less than 20 percent are C corporations. In view of these investment patterns, the use of carried interest typically reduces aggregate tax liability.

The normative question is whether the reduction in aggregate tax liability arises...

<p>| TABLE 1 |
| TAXABLE INCOME |</p>
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<thead>
<tr>
<th>Carried Interest</th>
<th>Salary</th>
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<tbody>
<tr>
<td>Manager</td>
<td>200 DGI</td>
</tr>
<tr>
<td>Investor</td>
<td>800 DGI</td>
</tr>
<tr>
<td>Total</td>
<td>1000 DGI</td>
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</tbody>
</table>

| TABLE 2 |
| TAX LIABILITY |
|------------------|-------|
| Individual Investor | Carried Interest | Salary |
| Manager          | 30 | 70 |
| Investor         | 120 | 80 |
| Total            | 150 | 150 |

<table>
<thead>
<tr>
<th>Tax–Exempt Investor</th>
<th>Carried Interest</th>
<th>Salary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manager</td>
<td>30</td>
<td>70</td>
</tr>
<tr>
<td>Investor</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>30</td>
<td>70</td>
</tr>
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2 Corporations pay a lower tax rate on dividends due to the dividends–received deduction provided by section 243.
ing from this reallocation is appropriate. Before addressing that question, it is useful to consider the other ways in which such reallocation can be achieved.

**Other Means of Reallocation**

In some cases, the parties may be able to achieve or undo this reallocation through other means. The tax savings from the use of carried interest are illusory if such reallocation can be costlessly achieved through other means because the use of carried interest then does not change the equilibrium and its tax treatment.

To see a case in which this occurs, assume that the manager holds at least $2,000 or more of bonds producing ordinary interest income in his personal portfolio. Then, if the manager was paid a salary rather than carried interest, the manager could sell $2,000 of bonds to the tax-exempt investor and purchase a $2,000 stake in the portfolio company from the investor. When combined with the salary payment, that transaction would leave the manager with $200 of dividend-and-gain income and the tax-exempt investor with $800 of dividend-and-gain income, the same outcome as in the carried-interest case.3

In such a case, the income reallocation and resulting tax savings achieved by the carried interest arrangement could alternatively be achieved through simple purchases and sales of financial assets. Taking as given the tax treatment of the financial transactions, the tax savings from carried interest would be unobjectionable.

Consider an analogous system that subsidizes market transactions in which individuals sell apples to tax-exempts. Then, a tax-exempt organization’s payment of apples to an individual worker as in-kind compensation for his labor should be subsidized, even though the organization’s payment of cash wages is not subsidized. Despite the superficial disparity of treatment, the compensation decision is undistorted, since workers paid in cash can receive the same subsidy by buying apples in the open market. Neutrality prevails because workplace transactions involving apples are treated the same as other transactions involving apples.

In reality, though, the typical manager is unlikely to have sufficient bond holdings to implement the above strategy. For a manager with no bond holdings, the corresponding strategy involves borrowing $2,000 from the investor and using the proceeds to buy a $2,000 stake in the portfolio company. If the manager can deduct all of his interest expense against ordinary income while receiving the 15 percent rate on the dividend-and-gain income, this strategy again replicates the tax savings from the use of carried interest.

Such favorable tax treatment is unlikely to be available. Although section 163(h)(2)(B) allows itemizers to deduct investment interest expense under both the regular tax and the AMT, section 163(d) limits the deduction to the amount of “net investment income.” That term does not include dividend-and-gain income unless the taxpayer elects to pay tax on such income at ordinary rates rather than the 15 percent rate. Any disallowed investment interest expense can be carried forward to future years without limit, but cannot be carried back to earlier years.

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3 Recall that bonds pay eight percent ordinary income while the portfolio company pays ten percent dividend-and-gain income and negative two percent ordinary income. The manager has $200 ordinary income from his salary, foregoes $160 of ordinary interest income on the sold bonds, and receives $200 of dividend-and-gain income and negative $40 ordinary income from his $2,000 stake in the portfolio company. The investor has $800 of dividend-and-gain income and negative $160 of ordinary income from his remaining $8,000 stake in the portfolio company, plus $160 of ordinary income from the purchased bonds. In a stochastic model, the replicating transaction would be somewhat more complex.
In most cases, then, the carried interest arrangement provides a reduction in aggregate tax liability that the manager and investor cannot replicate through portfolio transactions and thereby allows the manager to avoid the 163(d) limit. That provision normally limits the amount on which a taxpayer can receive dividend–and–gain treatment to the amount of his financial income, forbidding him to go into debt to acquire additional income taxed at the 15 percent rate. With carried interest, however, the manager effectively avoids this limit by turning labor income directly into dividend–and–gain income. The relevant policy question is whether such avoidance should be allowed.

**Normative Assessment**

To frame the issue properly, it is necessary to recognize a key feature of the 15 percent rate. Although the rate rewards the creation of dividend–and–gain income, it does not do so uniformly. The preferential rate offers a 20–percentage–point reward when the dividend–and–gain income is received by a high–bracket individual, but no similar reward when such income is received by a tax–exempt organization. It, therefore, provides an incentive for reallocation of dividend–and–gain income away from tax–exempt organizations and toward high–bracket individuals. Regardless of the precise purpose of the preferential rate, such tax–motivated reallocation is likely to be inefficient. It is, therefore, desirable to limit tax–motivated reallocation of dividend–and–gain income.

One way to limit tax–motivated reallocation is to deny the preferential rate to individuals who hold dividend–and–gain assets for only a short time around the date at which the income is realized, because such holdings are likely to reflect tax–motivated reallocation. Or, it might be denied to individuals who nominally receive dividend–and–gain income while hedging the associated risks, because such arrangements remove the portfolio considerations that normally deter tax–motivated reallocation. Congress has indeed imposed restrictions of this kind. Carried interest does not run afoul of these restrictions.

Another way to limit tax–motivated reallocation is to place an upper bound on the amount of dividend–and–gain income that ends up in individual rather than tax–exempt hands. Such upper bounds are a crude instrument for this purpose, because they can easily limit allocations that serve non–tax purposes as well as those that are tax–motivated. Section 163(d) follows this approach by effectively preventing taxpayers from going into debt to acquire dividend–and–gain income greater than their financial income; section 265 imposes a similar denial of interest deductibility to deter tax–motivated reallocations of tax–exempt municipal bonds to high–bracket individuals who benefit most from the tax exemption. Auerbach (1988) studies the general tradeoffs arising when interest deductions are restricted to limit reallocation of assets.

Given the second–best nature of section 163(d) as a way to limit tax–motivated reallocations, is it desirable to allow it to be avoided through carried interest (or similar partnership agreements between individuals and tax–exempt organizations elsewhere in the economy)? The answer presumably depends upon the

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4 Under sections 1(h)(1) and 1222, the 15 percent rate applies to capital gains only if the capital asset has been held for longer than one year. Also, under section 1(h)(1)(B)(iii), the 15 percent rate applies to dividends only if the stock was held (without hedging) for a minimum interval around the dividend date. Section 901(k) imposes similar restrictions on the availability of the foreign tax credit.
extent to which these arrangements are tax–motivated.

Carried interest serves important non–tax purposes by alleviating the effects of asymmetric information. Managers have the strongest incentive to choose the best investments and manage them properly when they share in the resulting gains. That type of compensation arrangement is also most attractive to, and, therefore, helps select, more able managers. Victor Fleischer, the most prominent advocate of changing the tax treatment of carried interest, makes this point forcefully. He notes that, because the managers’ abilities and the quality of their choices are difficult to observe, legal requirements can play only a limited role in influencing manager behavior and an arrangement like carried interest is, therefore, necessary: “The common law provides incentives not to lie, cheat, or steal, but not much of an incentive to work especially hard or to be especially talented in the first place . . . . The carried interest thus provides the most powerful incentive to work hard . . . and is considered essential to attracting talented managers” Fleischer (2005, pp. 96–97). Carried interest would, therefore, likely be used even if it offered no tax savings. Indeed, Weisbach (2008, p. 726) cites evidence that carried interest was used even in years when there was no rate differential between ordinary income and dividend–and–gain income.

That, however, is only the beginning of the inquiry. Even if the existence of the arrangement serves non–tax purposes, various aspects of it may still be driven by tax motivations. For example, the availability of tax savings may have prompted an increase in the size of the carry. Also, the availability of tax savings may have increased the fraction of private equity investment that comes from tax–exempt organizations. (Since partnerships between tax–exempt investors and individual managers generate aggregate tax savings that would otherwise not be available, the two groups have a tax incentive to form such partnerships and share the resulting tax savings.) Since empirical evidence sheds little or no light on the magnitudes of these responses, the underlying normative question is difficult to resolve.

Even if it is desirable to prevent carried interest from being used to avoid 163(d), one aspect of H.R. 3996 and H.R. 6275 seems hard to justify. Unlike the earlier House bills, these bills would deny managers the 15 percent rate on dividend–and–gain income from their own investments in the private equity fund, to the extent that those investments were financed by borrowing from the fund’s investors. Since managers who borrow from the investors would face the same 163(d) limit as other leveraged investors, it is hard to see why such borrowing should be targeted for an additional restriction. As Fleischer (2008, p. 57) notes, there is “nothing offensive” about such borrowing.

The tax savings from the use of carried interest can play a useful role not consid-

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Fleischer (2005; 2008, pp. 21–22) argues that, in the absence of tax considerations, venture capital firms would follow the practice of buyout firms and provide a carried interest only above a hurdle rate of return. He conjectures that the omission of a hurdle rate is a tax–motivated way to increase the size of carried interest. (Although buyout firms have a similar tax incentive, he conjectures that they have a stronger non–tax need to include the hurdle rate of return.) He also suggests that the 100 percent allocation to buyout–fund managers immediately above the hurdle rate is inefficient on a non–tax basis and, therefore, likely reflects tax considerations. These inferences, which are not grounded in a formal economic model, are interesting but not completely persuasive. It is not clear why a tax–motivated increase in the size of the carry would take these forms rather than a simple increase in the manager’s share of income.

Indeed, Fleischer (2008, pp. 39–43, 52–54) follows some earlier authors by suggesting consideration of a “cost–of–capital” method under which managers and investors would be taxed as if such borrowing had occurred, without requiring that actual borrowing transactions be implemented.
eral in the above analysis. In some cases, the corporate income tax imposes an implicit employer payroll tax on the fund managers and the tax savings from carried interest partly offset that tax.

OFFSETTING THE IMPLICIT PAYROLL TAX

The implicit employer payroll tax arises only under certain assumptions. To begin, the portfolio company must be a taxable C corporation. Also, the manager’s labor must cause an increase in the current or future operating income of the portfolio company. In that case, the output produced by the manager’s labor is subject to corporate income tax. Moreover, there is no corporate-tax deduction for the compensation paid to the manager, because the manager is employed by the company’s stockholder (the private equity fund) rather than by the company. As noted by Gravelle (1992, pp. 32–33) and U.S. Council of Economic Advisers (2004, p. 108), the corporate income tax imposes an implicit payroll tax on labor when labor compensation cannot be deducted by the corporation.

Since there is no dispute about the correctness of the tax treatment that would apply if the manager were employed by and received a salary from the portfolio company, that case can be taken as a benchmark. Since the manager provides $200 of services, he is paid $200 in wages, which are taxed at ordinary rates. The portfolio company deducts the $200 wage expense from its $1,000 output, leaving $800 subject to corporate income tax. At a 35 percent corporate tax rate, the corporation pays $280 of tax. The investor then receives $520 of dividend–and–gain income from the corporation. These results are shown in the “Benchmark” column of Table 3, below.

If the manager is employed by the private equity fund and receives carried interest, the following results are obtained. The portfolio company has $1,000 of income subject to corporate income tax, because it cannot deduct the payment to the manager. The company pays $350 of corporate income tax, leaving $650 to be distributed to the private equity fund. The manager has $130 of dividend–and–gain income while the investor has $520 of dividend–and–gain income. The results are tabulated in the “Carried Interest” column of Table 3. For a final comparison, the “PE w/ Salary” column shows the tax treatment when the manager is paid a salary of $130 (the manager’s net–of–corporate tax marginal product) by the private equity fund.

Relative to the situation in which the private equity fund pays a salary to the manager, the use of carried interest continues to leave unchanged the aggregate amounts of ordinary income and dividend–and–gain income. The last two columns of the table show that the only impact of using carried interest rather than salary is the now–familiar reallocation of the two types of income between the manager and the investor.

Relative to the benchmark, however, the use of carried interest has more dramatic effects. It increases aggregate dividend–and–gain income by $130 and reduces aggregate ordinary income by the same amount. Since an identical effect

<p>| TABLE 3 |</p>
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<tr>
<th>TAXABLE INCOME</th>
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<tr>
<td><strong>Manager</strong></td>
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<td><strong>Benchmark</strong></td>
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<tr>
<td>Manager</td>
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<tr>
<td>Investor</td>
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<td>Sum</td>
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<td>Company</td>
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occurs when the private equity fund pays
the manager a salary, the compensation
system is not the determinative factor.
Instead, this effect arises whenever the
manager is employed by the fund rather
than by the portfolio company.

This aggregate conversion of ordinary
income into dividend–and–gain income
is accompanied, however, by the creation
of an additional $200 of taxable corporate
income. The effects on tax liability are
shown in Table 4, where the investor is
assumed to be tax–exempt.

Under the stated assumptions, the
use of the carried–interest arrangement
pushes aggregate tax liability closer to
that in the benchmark case. The use of
carried interest rather than salary reallo-
crates $130 of dividend–and–gain income
from managers to investors and $130 of
ordinary income in the opposite direction.
This reallocation yields a $26 tax saving,
which offsets part of the implicit payroll
tax.

If there were no non–tax costs to com-
pensating the manager through salaries
from the various portfolio companies,
the implicit payroll tax could and would
be costlessly avoided without the use of
carried interest. Contrary to actual obser-
vation, carried interest would not be used
when the portfolio company is a taxable
C corporation. Salary payments from the
portfolio companies would not, however,
address the asymmetric–information
concerns that motivate carried interest;
even performance–based salaries would
provide no incentives to properly choose
which portfolio companies to acquire.

Also, direct contractual arrangements
with each of the portfolio companies
would limit the manager’s flexibility
in the allocation of his time across the
various companies, including companies
newly acquired by the fund during its
lifetime. The acquisition of each new
company would require not only a salary
negotiation with that company, but also a
renegotiation of existing agreements with
the other companies to account for the
new demand on the manager’s time.

While deductible payments from port-
folio companies are far from a perfect
substitute for carried interest, limited
substitution may be possible on the
oberves that private equity firms already
receive some governance and transaction
fees from their portfolio companies for
certain types of services, such as sitting
on the board or providing management
consulting services. As Knoll (2007,
pp. 16–17) and Weisbach (2008, p. 762)
note, the taxation of carried interest as
ordinary income might prompt private
equity firms to increase the size of these
fees.

Of course, there are many circum-
stances in which the managers’ activities
do not result in the payment of additional
corporate income tax and the implicit
payroll tax does not arise. The portfolio
company may be a pass–through entity
or a C corporation in net–operating–loss
status. Also, the managers’ labor may
consist of buying and selling companies
to exploit price discrepancies in securi-
ties markets rather than boosting the
companies’ operating profits, although
that description would apply to hedge
funds more than to private equity funds.

Or, the managers’ labor may consist of
devising better ways for the portfolio
company to avoid corporate income tax;
as noted above, private equity funds
often increase portfolio companies’ debt
levels, which generally reduces corporate
tax payments.

<table>
<thead>
<tr>
<th>TABLE 4</th>
<th>TAX LIABILITY</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Manager</td>
</tr>
<tr>
<td></td>
<td>Investor</td>
</tr>
<tr>
<td>Sum</td>
<td>70</td>
</tr>
<tr>
<td>Company</td>
<td>280</td>
</tr>
<tr>
<td>Total</td>
<td>350</td>
</tr>
</tbody>
</table>
INITIAL AWARD OF CARRIED INTEREST SHOULD NOT BE TAXED

The above discussion assumes that there is no tax on the initial award of the right to carried interest when the private equity fund is established. Some observers, such as Sheppard (2007), advocate that the manager be taxed on this award at its fair market value, with the manager then receiving a cost basis equal to that value. This suggestion is unsound, since the award is made for future services. Before turning to the economic issues, I examine the current muddled state of the law in this area.

Taxation of Property Received for Services

Section 83 governs the receipt of “property” in exchange for services performed by the taxpayer. It requires the taxpayer to recognize gross income equal to the fair market value of the property at the first time that the taxpayer’s interest in the property is either transferable or vested; property is not vested if its receipt is conditioned on the performance of future services. The taxpayer then receives basis in the property equal to the taxed value and any subsequent gain is eligible for the 15 percent capital gains rate if the other requirements of section 1(h) are satisfied. The taxpayer may make a section 83(b) election and recognize income equal to the fair market value of the property at the time of receipt, even if it is still nontransferable and unvested. The firm that provides the property is entitled to a compensation expense deduction in the year that the taxpayer recognizes the income.

As described by Cunningham (1991), Gergen (1992), and Fleischer (2008, pp. 11–12), it has become settled law that the award of a right to share in future partnership profits is not taxable under section 83. To be sure, a 1974 decision by the Fifth Circuit and a 1991 decision by the Eighth Circuit suggested a contrary view. In 1993, however, the IRS issued a ruling, which it slightly modified in 2001, in which it conceded that a partnership profits interest is not taxable when awarded, unless it relates to a relatively certain stream of income, is disposed of in two years, or is a limited partnership investment in a publicly traded partnership. In May 2005, the IRS issued proposed regulations on the taxation of partnership equity interests. The proposed regulations would essentially maintain current law by generally allowing a share in future partnership profits to be treated as having zero value upon receipt. The regulations have not yet been finalized; Coder (2008) quotes an IRS attorney’s recent statement that the regulations will not be finished in 2008 and will be rolled over into 2009.

Under current law, then, a manager need not pay tax on the initial award of carried interest. I now turn to proposals that would require managers to pay tax on that award.

Economic Analysis of Prepayments for Future Labor

If one begins with the premise that cash received for future labor should be taxed upon receipt, only a few steps in logic are required to conclude that the initial award of a carried interest should also be taxed. If cash receipts for future labor are to be taxed, then the receipt of stocks, bonds, and other marketable securities for future labor must also be taxed. If those securities are to be taxed, then any future stream of labor income that can be valued with even rough accuracy should be taxed. As Sheppard (2007, pp. 1238–1240) observes, carried interests can be valued using option–pricing formulas and publicly traded private equity firms report such valuations in disclosure statements. Although such valuations are imperfect, they are far more accurate than a valuation
of zero. Similarly, since the future income stream of a lawyer who becomes a partner in a law firm can be reliably valued to be worth far more than zero, the above logic suggests that the new partner should pay tax on the present discounted value of that stream.

Prepayments for future labor should actually not be taxed, however, regardless of the form in which they are received or how easily they can be valued. The correct tax treatment of prepayments is to ignore the initial receipt and to tax the value of the labor when it is performed. Since there should be no tax on cash prepayments that can be valued with perfect accuracy at no cost, it is irrelevant that carried interests can be valued with rough accuracy at modest cost.

As Halperin (1986, pp. 515–519) observes, receiving a prepayment today for future services is identical to receiving a future payment when the services are performed and borrowing today against that future payment. Borrowing proceeds are not subject to income tax, although they can readily be valued; the absence of arbitrage then requires that prepayments also not be subject to income tax.7

Any distinction between these economically indistinguishable transactions leads to incoherence of the type confronted by the U.S. Supreme Court in Commissioner of Internal Revenue v. Indianapolis Power & Light Co., 493 U.S. 203 (1990). Struggling to determine whether deposits made by electricity consumers were a prepayment or a loan of funds subsequently used to provide electrical services, the Court stated, “In economic terms, to be sure, the distinction between a loan and an advance payment is one of degree rather than kind,” 493 U.S. at 208. In fact, there is no economic distinction of degree or kind because advance payments and loans are different labels for the same transaction.

One red herring should be addressed. Johnson (1995, p. 385) and others argue that, since taxpayers do not have basis in their own labor, the obligation to perform future labor is a zero–basis obligation that cannot offset the accession to wealth from the advance payment. According to this argument, borrowing is different from a prepayment, because borrowing requires a cash repayment in which the taxpayer has basis. This distinction is invalid. As noted above, the correct tax treatment of prepayments includes taxation of the value of the labor when performed, although no payment is received at that time. While basis would not arise from the performance of labor alone, it arises from the taxation of the deemed income when the labor is performed.

If the investors in the private equity fund are taxable at the same rate as the managers, taxation of the initial award of carried interest would have no net tax effect because the fund would receive an offsetting deduction, just as the reallocation of ordinary income and dividend–and–gain income has no net tax effect in that case.8 As noted above, however, many fund investors are actually tax–exempt, so taxation of the initial award of carried interest would result in net over–taxation.

It should be noted that managers in private equity funds do enjoy one form of tax deferral, as do taxable investors in such funds. They receive deferral with respect

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7 The recipient of the prepayment should also get a deduction for the implicit interest expense on the implicit loan. For a recipient of a non–cash prepayment such as a carried interest, the necessary deduction is allowed by simply not taxing the rise in its present value over time, in addition to not taxing the initial present value when awarded.

8 Halperin (1986, pp. 517–518) provides a general discussion of the taxation of one party to a prepayment transaction as a substitute for the taxation of the other party when both parties face the same tax rates.
to the accrued capital gains as the portfolio company appreciates in value; the gain is not taxed until the company is sold. That deferral is similar to the deferral of tax on unrealized capital gains throughout the economy.

I now consider a few other issues raised by the tax treatment of carried interest.

OTHER ISSUES

Although the Medicare component of the self–employment tax usually applies to income received by a general partner of a partnership, sections 1402(a)(2) and (3) exclude interest, dividends, and capital gains from the tax. Carried interest, therefore, normally escapes Medicare tax, a result that the House bill would change. Medicare tax is significantly less important than income tax. The stated rate of Medicare self–employment tax is a mere 2.9 percent and the effective rate is about 2.21 percent.

The scope of the House bill raises some interesting issues. Under the bill, ordinary tax rates would apply to the income of partners who perform “a substantial quantity” of any of the following “investment services”: advising about the value of securities, real estate, commodities, and related derivatives; advising about the desirability of holding such assets; managing, acquiring (or arranging financing with respect to acquiring), or disposing of such assets. So long as the partner provided a substantial quantity of the above services, ordinary tax rates would apply to even those parts of his or her income attributable to the provision of other services.

Some aspects of the definition are problematic, as detailed by American Bar Association Section on Taxation (2007) and Schler (2008). A key ambiguity is how to determine whether the quantity of services is “substantial,” particularly if the quantity of services varies across different years of the fund’s life. To some extent, these problems can be addressed through improved drafting.

At a more fundamental level, it is not clear why partners providing investment services, however defined, should be treated differently from partners providing other forms of labor to partnerships, such as those working in restaurants. To be sure, there are at least three reasons why the tax savings from carried interest in private equity funds are likely to be greater than the tax savings from income allocations in other partnerships. First, the dollar amounts are larger. Second, capital gains play a much larger role for private equity funds than other partnerships; in a restaurant partnership, most of the income may be ordinary operating income. Third, tax–exempt organizations provide more of the investment in private equity funds. Still, the singling out of investment services seems an imperfect fit for these factors.

The recent debate about the taxation of private equity has focused on more than the taxation of carried interest. Changes have also been considered in the rules for determining whether publicly traded private equity firms are subject to corporate income tax. Another issue concerns the use of offshore deferred compensation. Those topics lie outside the scope of this paper.

9 Although the same treatment applies under the Social Security component of the self–employment tax, that component applies to only the first $102,000 of earnings in 2008 and, therefore, does not affect the typical fund manager on the margin.

10 Under section 1402(a)(12), the 2.9–percent tax applies to only 92.35 percent of self–employment earnings, reducing the effective tax rate to 2.68 percent. Moreover, half of the tax is deductible against income tax under section 164(f), yielding an income–tax saving of 0.47 percent for a taxpayer in the 35–percent income tax bracket.
CONCLUSION

While the case for changing the taxation of carried interest is initially appealing, it becomes more uncertain upon careful examination. The tax savings from carried interest reflect a reallocation of dividend–and–gain income from tax–exempt organizations to taxable individuals. The reallocation is an application of economy–wide partnership tax rules. Although the reallocation allows managers to avoid restrictions that would apply if similar results were sought through borrowing, it is not entirely clear that the reallocation is inappropriate since the use of carried interest serves significant non–tax purposes by addressing the effects of asymmetric information. In some cases, moreover, the tax savings from carried interest partly offset an implicit payroll tax imposed on fund managers by the corporate income tax. The taxation of carried interest poses difficult second–best issues, precluding a definitive resolution.

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