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The Current Debate About the Federal Income Tax Treatment of "Carried" Interests – Status and Possible Approaches

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Ever since word leaked that the Senate Finance Committee was studying the federal income tax treatment of "carried" partnership interests, there has been much speculation but little information about what legislation addressing this controversial area might do. Our understanding is that this study is in the early stages, as has been reported in the media, and there is no "proposal", despite rumors to the contrary. Instead, the study has been going on at the staff level - Congressional tax staffs are currently gathering information to determine whether, and if so how to act. We suspect that this process will take months and may even see Congressional hearings on the topic.

Anticipating a continued interest in this issue, we thought it might be helpful to inform clients about the parameters of the current debate and what we think are realistic possibilities for legislative action. What follows are guesses and only guesses. Congress, as usual, will have the last legislative word.

Background

On a technical level, the current controversy stems from the fact that a service partner (such as a general partner managing an investment partnership) can take his or her carried interest (i.e., the right to share in appreciation of fund investments) at capital gains rates. Thus, for example, in the typical domestic venture capital or private equity fund, the GP is entitled to a management fee equal to a specified percentage (e.g., 2%) of capital commitments per annum and a carried interest equal to a specified percentage (e.g., 20%) of realized gains. A 2 percent annual management fee may be taxed to individual members of the GP at today's 35 percent ordinary income rates. The 20 percent, if earned as long-term capital gains by the fund, is taxed to individual members of the GP at today's 15 percent preferential capital gain rate. Such a carried interest is just one variation of a broader category of partnership interests, "profits interests", where a partner's share of profits is greater than its share of capital.

There has been a longstanding debate in the tax community whether the receipt of a profits interest, such as a typical carried interest, results in gross income to the service partner when received. Through a series of cases (including *Sol Diamond*[1] and *Campbell v. Commissioner*[2]) and administrative guidance,[3] however, the law is relatively well settled that, except in very unusual circumstances, receipt of a profits interest does not result in current taxation. Our perception, however, is that this issue is not the subject of today's legislative focus. Instead, the debate revolves around whether it is good policy to permit a service partner to earn pure capital gains from a partnership profits interest and, if so, under what circumstances.

The Federal income tax treatment of corporate stock options and restricted stock generally results in ordinary compensation income for a portion of the gain. With non-qualified stock options, the compensatory element is deferred but taxed at ordinary income rates when the option is exercised. Restricted stock grants give the recipient a choice of including ordinary income upon receipt of the stock, based on the stock's fair market value at that time or deferring recognition until vesting at the cost of ordinary income treatment based on value at that time. These typical corporate compensation tools thus yield different tax results than the treatment of carried interests in the partnership context that allow both for deferral (no tax upon receipt of the carried interest) and long term capital gain only when a realization event occurs at the partnership level.

Current Status

We understand that no decision has been made by the staff or members of Congress to propose legislation to change the treatment of a carried interest and that the treatment of a carried interest has not been included on any agenda prepared for the tax-writing committees of Congress. Staff members have informally confirmed that they have had difficulty in developing a rule based on any rational policy that would not affect all taxpayers receiving profits interests. Having said this, it would seem that the focus of any legislation would be on the treatment of income attributable to certain carried interests as capital gain income eligible for the reduced 15% rate. As mentioned earlier it is unlikely that Congress would seek to make any change as to the treatment of the receipt of a carried interest, structured as a profits interest, as a non-taxable event because that treatment is viewed as settled law. Moreover, the Democratic leadership of the Congressional tax-writing committees has expressed their intent to strictly follow procedural rules so that any proposed tax changes would be carefully scrutinized with an opportunity for public comment.

In reaching their conclusion on whether and how the tax treatment of the carried interest might be altered, the staff is reaching out to knowledgeable tax practitioners and others familiar with partnership taxation and transactions, including private equity and hedge funds, to ensure that they have a good understanding of how these funds operate and to ensure that no proposal has unintended consequences for partnership taxation generally. The staff is well aware that in this case there is no abuse of the tax system and no artificial tax benefit. In the typical situation, the carried interest only has value if there are realized capital gains at the partnership level over the life of the fund, an outcome that is in no way assured when the fund is formed and the carried interest is received. Gains from the sale or exchange of securities by investors or traders have always been treated as capital gains. Further, under fundamental partnership taxation principles, that tax treatment "flows through" to the partners in the partnership. There is no suggestion by the staff that the partnership form is being abused or that the current characterization of those gains as capital gains is inappropriate under current law.

Possible Approaches

Having noted that no decision has been made to change the treatment of the taxation of carried interests, it is nevertheless interesting that commentators have suggested several possible approaches to recharacterize a portion of the capital gain attributable to a carried interest.[4] One approach is to treat the GP as having received a loan from the limited partners in an amount equal to the carried interest with the GP then investing that amount in the partnership. Under Section 7872 of the Internal Revenue Code ("Code"), the deemed below market (interest free) loan would be deemed to be forgiven over time. This would create cancellation of indebtedness income to the GP, taxable as ordinary income over the life of the deemed loan. This treatment also finds support under Section 467 of the Code, which applies to prepaid or deferred rent under certain rental agreements. Other proposals recharacterizing a portion of the gain would be based on an asset composition and size test applied to the partnership. Thus, funds whose income consists of substantially all capital gains and which meet an assets or income threshold would have a portion of the income attributable to a carried interest recharacterized as ordinary income. Still other proposals would provide for a longer term holding period for the gains from the sale of the securities to qualify as capital gain in the hands of the GP. Finally, rules similar to those which apply to futures contracts under Section 1256 of the Code could be developed in which 40 percent of the gain is short-term capital gain and 60 percent is long-term gain. Since these rules would be arbitrary and inconsistent with basic partnership tax principles in a situation where no abuse of those principles is present, this would not be a preferred approach.

Many partnerships, such as real estate partnerships and traditional hedge funds, derive most of their income from transactions producing short-term capital gains or ordinary income. However, there has been a blending or convergence of private equity strategies with hedge fund strategies. Accordingly, it is unclear how any proposal would operate in the case of a hybrid fund that produces a combination of long-term and short-term capital gain.

Footnotes:

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

[2] *Campbell v. Commissioner*, 868 F.2d 833 (6th Cir. 1989)

[3] See Rev. Proc. 93-27, 1993-2 CB 343 and Rev. Proc. 2001-43, 2001-2 CB 191

[4] See, e.g., Victor Fleischer, "Two and Twenty: Taxing Partnership Profits in Private Equity Funds" (March 2007). University of Colorado Law Legal Studies Research Paper No. 06-27