PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS AND RELATED ISSUES, PART I

Scheduled for a Public Hearing
Before the
HOUSE COMMITTEE ON WAYS AND MEANS
on September 6, 2007

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

September 4, 2007
JCX-62-07

CONTENTS

INTRODUCTION AND SUMMARY

The Committee on Ways and Means of the House of Representatives has scheduled a public hearing on September 6, 2007, on the Federal tax issues surrounding the use of partnership carried interests. This document,[1] prepared by the staff of the Joint Committee on Taxation, includes a description of present law and analysis of Federal tax issues relating to partnership carried interests in general.

Part One provides background information about carried interests and going-public transactions of partnerships involved in private equity, hedge fund, venture capital fund, and similar alternative asset management and financial advisory business activities. Part Two provides economic data relating to partnerships, and to private equity, venture capital, and hedge funds, and certain carried interests. Part Three describes present law relating to Federal tax rates for individuals, tax treatment of partnership profits interests for services, and tax rules relating to compensation and employment tax. Part Four describes present law relating to taxation of partners and partnerships, including publicly traded partnerships, and compares the tax treatment of taxable corporations and of passthrough and untaxed entities. Part Five describes recent legislative proposals. Part Six provides a description and analysis of Federal tax issues relating to carried interests.

A companion document[2] relating to the Ways and Means Committee hearing on September 6, 2007, prepared by the staff of the Joint Committee on Taxation, provides a description of present law and analysis of Federal tax issues relating to partnership carried interests and related issues particularly involving the use of offshore entities.

Part One of the companion document provides background information about offshore structures for private equity, hedge fund, venture capital fund, and similar alternative asset management and financial advisory business activities. Part One also provides background information about tax-exempt investors and unrelated business income tax, foreign individual investors and income effectively connected to a trade or business, and deferral of income of managers. Part Two describes geographic distribution of hedge funds and private equity funds. Part Three describes present law and history of the law relating to unrelated business income tax and debt-financed income, an overview of U.S. international tax rules, and an overview of ways to defer services income under present law. Part Four provides a discussion of issues and analysis of Federal tax issues relating to these areas.

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[1] This document may be cited as follows: Joint Committee on Taxation, "*Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I,"* (JCX-62-07), September 4, 2007. This document is available on the internet at www.house.gov/jct.

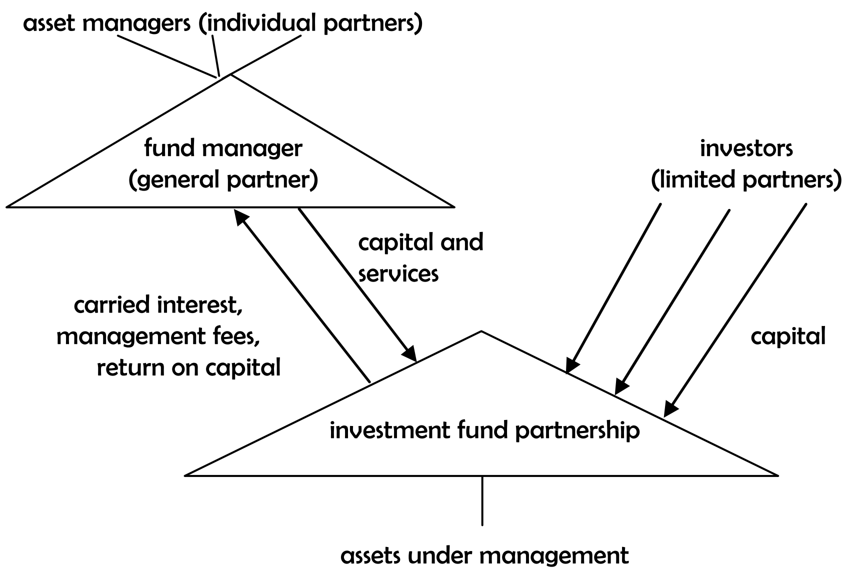
[2] That document may be cited as follows: Joint Committee on Taxation, "*Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part II"*, (JCX-63-07), September 4, 2007. The document is available on the internet at www.house.gov/jct.

I. BACKGROUND

Factual background

Over the past several decades, private equity funds, venture capital funds, hedge funds, and similar alternative investment vehicles[3] have attracted large amounts of capital investment from institutional investors such as pension funds and educational and charitable institution endowments, as well as from wealthy individual investors. These investors become limited partners in the funds, which are generally structured as partnerships. Some of the funds are established in offshore jurisdictions as well as in the U.S.[4] The assets invested in these funds generally are managed by groups of individuals who contribute a relatively small amount of capital to the fund (in relation to amounts of capital contributed by the investors) and who provide investment expertise in selecting, managing, and disposing of fund assets.

Private Investment Fund Structure



It is a common practice for managers of the funds to receive "carried interests." A carried interest generally is a right to receive a percentage of fund profits without an obligation to contribute to the capital to the fund. In the case of a fund that is a partnership, the carried interest may be structured as a partnership profits interest, under which the partner has a right to receive a percentage of partnership profits, but has no obligation to contribute capital to the partnership, and has no right to partnership assets on liquidation of the partnership.[5] Under a partnership

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[3] These types of funds have differing investment strategies. These are briefly described in the Economic Data section of this document.

[4] Lynnley Browning, "A Hamptons for Hedge Funds: Offshore Tax Breaks Lure Money Managers," *New York Times*, July 1, 2007.

[5] As income is earned by the partnership but is not yet distributed to the partner with the profits interest, the partner's share of these earnings is credited to his capital account. However, the capital

profits interest, a partner generally does not have an obligation to contribute to the partnership's capital if the partnership experiences losses.

In addition to a carried interest, a fund manager typically may receive a management fee, often calculated as a percentage of fund assets. The combination of a management fee and a carried interest has been referred to as "two and twenty," referring to the practice of providing the fund managers a fee at two percent of capital and a carried interest at 20 percent of overall partnership profits.

In a typical structure for this arrangement (though other structures are possible), the investment fund is a partnership (a triangle shape in the above diagram). The fund manager is a separate partnership whose partners are the individuals with investment management expertise. The fund manager partnership is itself a partner in the investment fund partnership. The investors are limited partners in the investment fund partnership.

In this typical structure, the carried interest held by the fund manager is a profits interest in the investment fund partnership. The Internal Revenue Service takes the position that the receipt of a partnership profits interest for services generally is not a taxable event.[6] Because the character of a partnership's income passes through to partners, the fund manager's share of income has the same character as the income has when it is realized by the underlying investment fund. Accordingly, income from a carried interest may be reported as long-term capital gain to the extent that the income is attributable to gains realized by the investment fund from capital assets held for more than one year.

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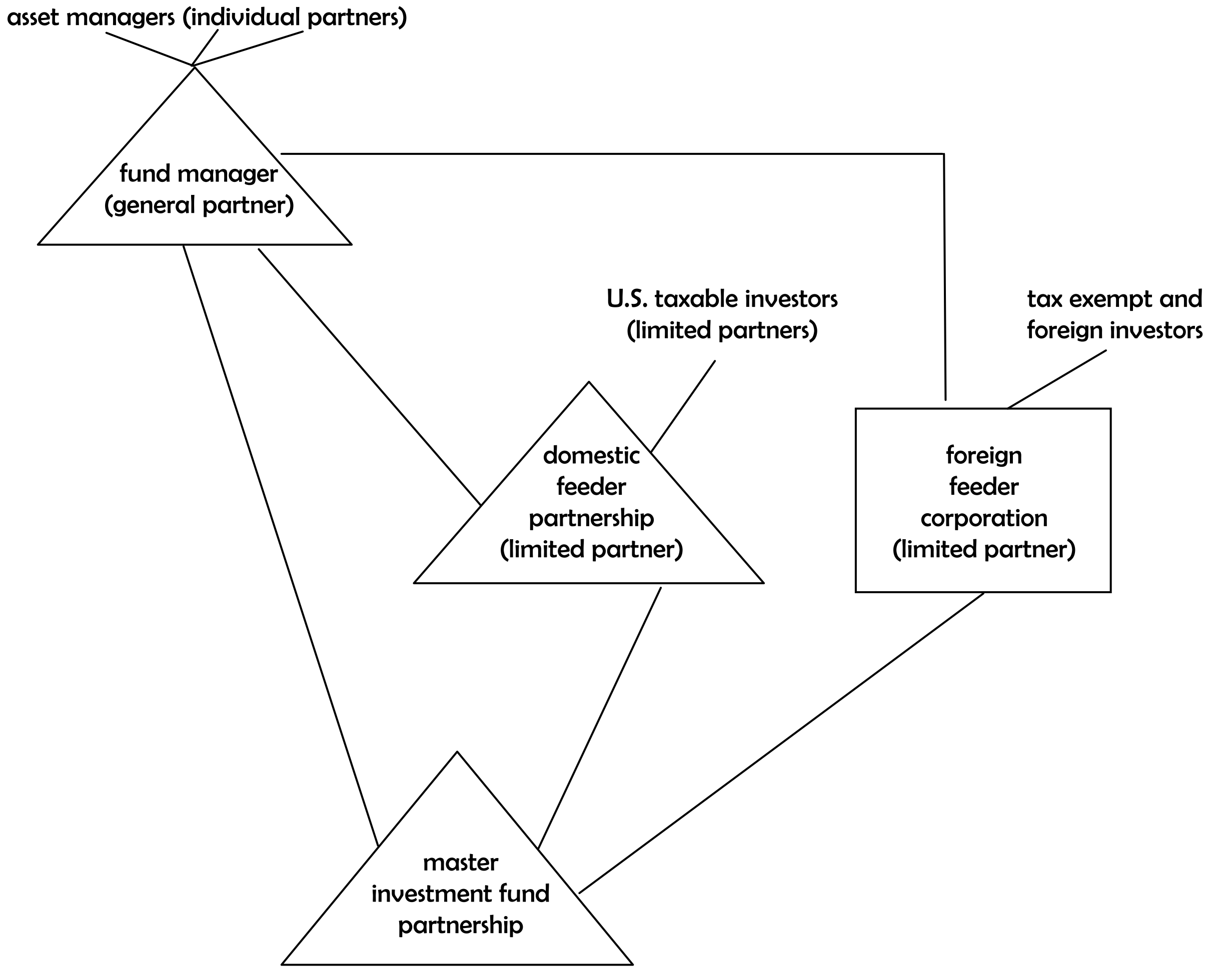
account is debited when the earnings are distributed to the partner. Thus, the partner does not have rights in liquidation of the partnership once his profit share is distributed to him.

[6] The Federal income tax treatment of partnership profits interests for services (of which carried interests can be an example) has evolved through litigation and Internal Revenue Service positions. This is discussed in the section of this document entitled Tax Treatment of the Receipt of a Partnership Profits Interest for Services.

Master-Feeder Investment Fund Structure



When intermediate entities (partnerships or corporations) are inserted into the structure, serving to feed capital to the investment fund, the arrangement is sometimes referred to as a “master-feeder” structure. A master-feeder structure generally involves a corporate “feeder” through which tax-exempt and foreign investors invest, and a partnership “feeder” through which U.S. taxable investors invest. The corporate feeder also serves as a “blocker,” in that it blocks the character of the income and operations of the underlying investment fund from flowing through to investors holding interest in the investment fund indirectly through that corporation.

Under any of these structures, the fund manager's carried interest may be subject to a “hurdle rate,” so that the profits percentage is payable only after the fund has returned their capital, or returned a specified rate, to the investors. The carried interest may also be subject to a “clawback” provision, under which the recipient partner must repay amounts previously received if, in a later year, agreed profit targets in the fund being managed are not met. For example, if the fund sells a portfolio investment at a profit so that the hurdle rate for investors is met and the fund manager receives a distribution pursuant to the carried interest, the fund manager could be required to pay back the amount of the distribution in a later year under the clawback provision if a cumulative fund return below the hurdle rate results after sales of other portfolio investments. By contrast, without a clawback provision, if the carried interest percentage is payable on a deal-by-deal or investment-by-investment basis, the fund manager receives its profits payment for those investments that are individually profitable, regardless of whether the partnership has an overall or cumulative profit, or a cumulative loss, on all its investments in the end (when the investment partnership wraps up or liquidates). The clawback provision has the effect that the carried interest pays out net or cumulative profits of the fund to the fund manager, but does not pay out if the fund is not cumulatively profitable. The clawback provision is therefore said to aid in aligning the economic interests of the fund manager with those of the investors in the fund.

A roughly similar result is achieved in hedge funds with the use of "high water mark" provisions. Under such a provision, distributions to the fund manager pursuant to the carried interest are suspended if the cumulative profitability of the fund at any point in time dips below a hurdle rate.

Management of the investment fund partnership and its assets is carried out by the general partner, the separate partnership of individuals with fund management expertise. The fund manager's carried interest may be subject to time and effort commitments and key person requirements with respect to the individual managers, designed to ensure that the individuals personally devote the necessary effort to fund management activities.[7]

There are variations on the structure of the income of fund managers. For example, with respect to management fees, some fund managers do not receive a management fee and instead receive only a carried interest. In such cases, the fund manager receives a larger carried interest than the manager would have otherwise received. In other cases, the fund manager is entitled to an annual management fee, but elects to defer receipt of the management fee until a later year, or to convert the fee to another arrangement, such as an interest in partnership gross (as opposed to net) income.[8]

Techniques for deferring the management fee are also used with respect to the fund manager's carried interest. Sometimes, in lieu of a carried interest, the fund manager's right to income is structured as a contractual right on the part of the fund manager to receive additional fees as opposed to an equity interest in the fund. Income received by the fund manager under this alternative, non-equity method of structuring the carried interest is ordinary income from the performance of services. When the non-equity method of structuring the carried interest is used, it is common for the fund manager to enter into a deferred compensation agreement with the

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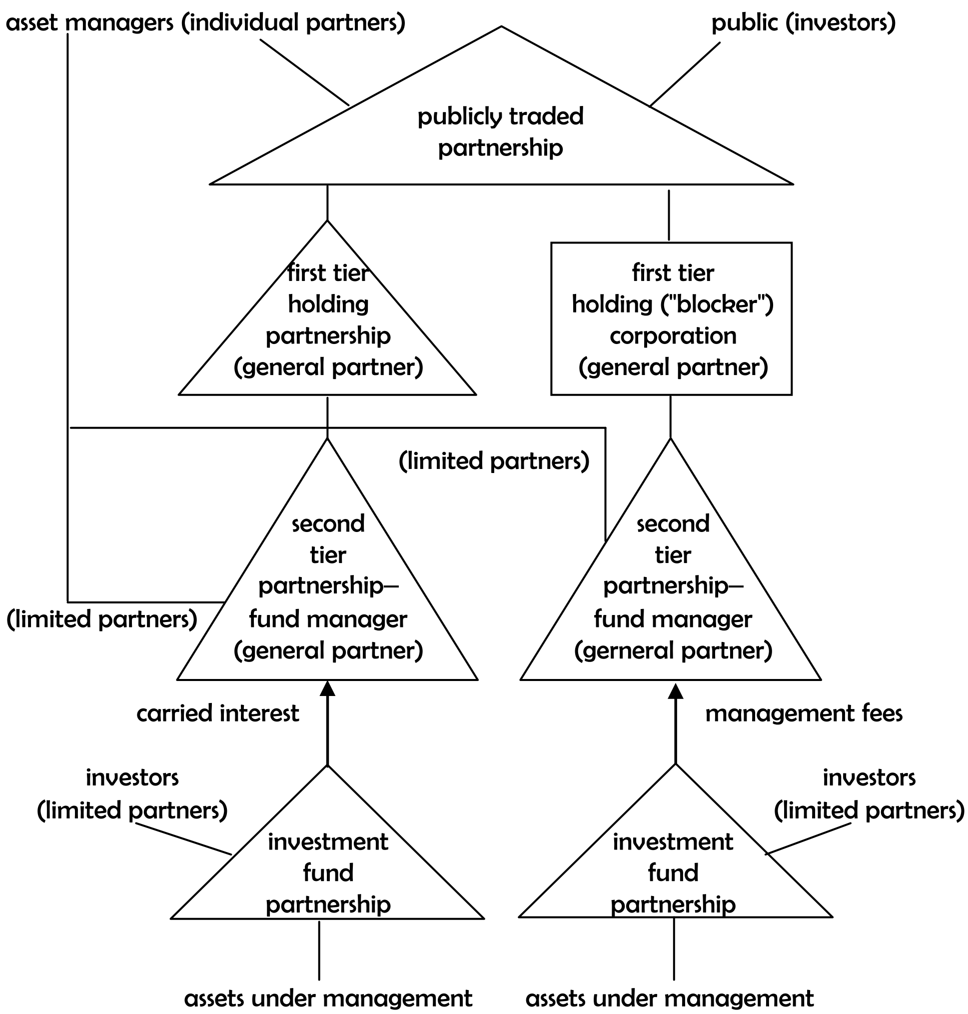
[7] For example, if a fund manager receives both an annual fee and a carried interest, an annual fee based on a percentage of the assets of a very large fund can provide substantial income regardless of profitabilility of the fund, potentially mitigating the incentive effect of the carried interest. Investors seeking to align the fund manager's economic interest with their own by means of a manager's carried interest might therefore negotiate time and effort and key person commitments on the part of the fund manager.

[8] Lee Sheppard, "Carried Away: Management Fee Conversion," 116 *Tax Notes* 532, August 13, 2007.

fund with respect to the additional fee income. For example, if the carried interest is structured as a fee that is based on a percentage of the profits realized by the fund each year, the arrangement might further allow the fund manager to elect to defer the fees that are earned by the fund manager entity in a particular year to a later year.

Publicly Traded Partnership Investment Fund Structure



Recent news reports have publicized transactions in which partnerships involved in private equity, hedge fund, venture capital fund, and similar alternative asset management and financial advisory business activities have made their interests available on an exchange or market.[9] The publicity surrounding these transactions, and their large dollar value, have drawn

[9] Reuters, "Blackstone I.P.O. in June," *New York Times*, June 13, 2007; Jenny Anderson, "Scrutiny on Tax Rates that Fund Managers Pay," *New York Times*, June 13, 2007; Jenny Anderson, "Blackstone Founders Prepare to Count their Billions," *New York Times*, June 12, 2007; Michael J. de la Merced, "Fortress Goes Public, a First for Hedge Funds Inside U.S.," *New York Times*, Feb. 9, 2007; Bloomberg, "Hedge Fund is Planning Public Offering," *New York Times*, Nov. 9, 2006; Randall Smith, "Goldman Takes 'Private' Equity to a New Level," *Wall Street Journal*, May 24, 2007; "Oaktree to List

attention to issues relating to the tax rules governing the transactions and the manner in which amounts are paid out of these businesses. One example of a possible structure for a public offering of an investment management firm is illustrated in the above diagram.

The business that effectively goes public in these transactions is the fund manager (the general partner), rather than the investment fund itself. The public does not invest in the underlying fund, or directly in the fund manager entity, but rather, in a partnership that is established for the purpose of offering publicly traded partnership units and which owns, directly or indirectly, interests in one or more fund manager entities (possibly including other financial services operations). Thus, this structure permits public investors to acquire an interest in the fund manager, while permitting the private investors who are limited partners directly in the fund to retain those investments even while the fund manager goes public.[10]

While the details of the transactions differ, they generally involve a public offering of (or making a market for) units in a partnership. Following the public offering, partnership units are traded on an exchange, such as the New York Stock Exchange. The publicly traded partnership is a holding partnership which, through lower-tier partnerships and corporations, has an interest in operating entities that are the fund managers.[11] Thus, the fund manager, but not the investment fund itself, goes public. The lower-tier partnerships and corporations serve to allocate income and, in the case of lower-tier corporations, to block a variety of types of income received and convert this income to dividends (or interest) when distributed.[12] The operating

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on New Goldman Market, Reports Say," *New York Times*, May 11, 2007; Tom Petruno, "A Market for Private Stock Sales," *Los Angeles Times*, May 11, 2007.

[10] In contrast to the transaction in which the fund manager goes public, some investment funds have sought a source of permanent capital (distinct from the capital provided by limited partners) by offering interests on exchanges in Europe. See Ben White and James McIntosh, "Lehman plans Euronext Listing," *Financial Times*, May 31, 2007; James McKinnon, "Companies UK: Fund Managers Hedge Bets on Ability to Raise 'Permanent Capital' for Listing," *Financial Times*, November 29, 2006; Peter Smith, "Companies UK: Private Equity Seeds Public Vehicles," *Financial Times*, June 12, 2006; Peter Smith, "KKR Beats Target with $5bn Raised for Investment Vehicle," *Financial Times*, May 2, 2006.

[11] The individual managers may retain a substantial interest (e.g., 75 percent) in the second tier fund management partnerships through limited partnership interests, while the publicly traded partnership holds the remaining portion (e.g., 25 percent) through intermediate holding entities. The individual managers' limited partnership interests may be exchanged at a later time for interests in the publicly traded partnership. The individual managers may hold operational control of the publicly traded partnership, while the public investors' interests give the public the right to substantially all of its income. Through this means, the public investors share indirectly in the carried interests held by the second tier partnerships.

[12] The going-public transaction may also involve the establishment of a tax receivables agreement. Under this agreement, goodwill or other intangible assets of the asset management business that are amortizable for tax purposes are transferred to a lower-tier partnership, or sold to a lower-tier corporation possibly using proceeds of the public offering of partnership units. As the goodwill or other intangibles are amortized, generating tax deductions, typically 85 percent of the tax savings attributable to the deductions is paid to the contributors of the management business.

entities conduct businesses involved in asset management and investment advisory activities with respect to funds such as private equity funds and hedge funds. The public investors have an indirect interest in the fund manager entity, and thus have an indirect interest in the fund manager's carried interests paid by the investment funds.

Federal tax issues

The Federal tax aspects of these arrangements raise several issues.[13] A core question is whether a carried interest received by an asset management business should be viewed as a form of compensation for services, or whether it is more similar to a right to income or gain from capital. Carried interests and similar arrangements may also raise issues relating to the application of tax rules governing compensation, such as the rules governing the receipt of property for services and deferred compensation (which affect both the timing and the character of income). Valuing carried interests may be difficult in many situations. Some approaches to taxing carried interests may necessitate some mechanism for preventing double taxation of partnership income. These arrangements also raise issues relating to the application of employment or self-employment tax to amounts received under a carried interest if such amounts are considered compensation.

Federal tax issues are also raised with respect to the tax treatment of publicly traded partnerships and the implications of carried interests in that context. While partnerships are pass-through entities for tax purposes, corporations are subject to tax at the entity level. Publicly traded partnerships are generally subject to tax as corporations (with certain exceptions), because of concern over erosion of the corporate tax base. This issue is raised when businesses not previously conducted by publicly traded partnerships go public in partnership form. A related issue of stripping earnings from the corporate tax base arises to the extent income received by a publicly traded partnership is passed through a corporation that might substantially reduce or eliminate its corporate tax through the use of deductions or credits.

[13] These issues are addressed in the Federal Tax Issues and Analysis section of this document. Additional issues are addressed in the Issues and Analysis section of the related document, Joint Committee on Taxation, "*Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part II*", (JCX-63-07), September 4, 2007.

II. ECONOMIC DATA

In general

Many types of investment partnerships exist, including hedge funds and private equity funds (of which venture capital funds can be considered a subset). Hedge funds and private equity funds typically differ in their investment strategies. Hedge funds generally invest in very liquid assets and seek to profit from correcting inefficiencies (pricing mistakes) in capital markets. This is often referred to as "financial arbitrage." Private equity funds generally invest in highly illiquid assets, buying stakes in companies and seeking to restructure them. However, they are similar in many respects. Both typically collect large commitments of private capital from investors (often at least $1 million). Both typically compensate managers with a fixed fee component and some percentage of the fund's return. It is this percentage component that is referred to as a carried interest. However, there is a broader universe of contexts in which carried interests for managers may be used. This includes not only hedge funds and private equity funds but also real estate partnerships or any partnership engaged in any business activity, in which managers' interests are aligned with those of investors by sharing of returns from the activity.

Table 1 below provides data regarding partnerships generally. The remainder of the data in this section relate to the narrower group of hedge, private equity, and similar funds.

Partnership assets

In 2005 as part of tax return filing requirements, partnerships reported assets with book value of more than $13.7 trillion. Table 1 shows the tabulation by self-reported North American Industrial Classification System (NAICS) industry code, and provides further detail for the finance and insurance and real estate industries. Together these two industries account for 57.3 percent of all partnership returns and 78.4 percent of all reported partnership assets, with securities, commodity contracts, and other financial investments partnerships representing the largest concentration.

Table 1.-Partnerships Assets by NAICS Code of Principal Business Activity, 2005
Assets in Millions of Dollars

Industry	Number of Returns	Total Assets Reported[1]	Percent of Returns	Percent of Total Assets Reported
Ag, Forestry, Fishing, and Hunting	127,605	$110,982	4.6	0.8
Mining	28,205	$172,751	1.0	1.3
Utilities	2,897	$218,555	0.1	1.6
Construction	182,153	$270,316	6.6	2.0
Manufacturing	44,828	$421,831	1.6	3.1
Wholesale Trade	48,178	$122,503	1.7	0.9
Retail Trade	141,798	$108,370	5.1	0.8
Transportation & Warehousing	42,162	$132,050	1.5	1.0
Information	37,438	$543,831	1.4	4.0
Finance & Insurance	287,958	$7,658,566	10.4	55.8
Depository Credit Intermediation	210	$10,739	*	0.1
Nondepository Credit Intermediation	11,656	$211,267	0.4	1.5
Activities Related to Credit Intermediation	3,068	$26,570	0.1	0.2
Securities, Commodity Contracts, & Other Fin. Investments	219,171	$6,493,379	7.9	47.3
Insurance Carriers & Related Activities	11,354	$19,756	0.4	0.1
Funds, Trusts, & Other Financial Vehicles	42,499	$896,855	1.5	6.5
Real Estate, Rental, and Leasing	1,295,948	$3,100,978	46.9	22.6
Real Estate	1,264,422	$2,992,558	45.8	21.8
Rental and Leasing Services	31,148	$98,227	1.1	0.7
Lessors of Nonfinacial Intangible Assets (Except Copyrights)	379	$10,192	*	0.1
Professional, Scientific, & Technical Svcs.	170,245	$131,302	6.2	1.0
Management of Companies (Holding Cos.)	24,966	$372,757	0.9	2.7
Admin and Support & Waste Management & Remediation	48,069	$36,029	1.7	0.3
Educational Services	10,563	$3,352	0.4	*
Health Care and Social Assistance	59,981	$79,166	2.2	0.6
Arts, Entertainment, and Recreation	49,267	$65,870	1.8	0.5
Accommodation and Food Services	96,004	$169,545	3.5	1.2
Other Services	61,631	$14,535	2.2	0.1
Not Allocable	3,729	$967	0.1	*
All	2,763,625	$13,734,256	100.0	100.0

* Indicates less than 0.1 percent.
[1] A partnership is generally required to report balance sheet information if it has total receipts of $250,000 or more and total assets of $600,000 or more.
Source: IRS Statistics of Income tabulations by JCT Staff

Hedge funds

Historical background

Hedge funds are private pooled investment limited partnerships generally limited to high net worth individual investors or large institutional investors. Alfred W. Jones is credited with launching the first hedge fund in 1949.[14] Jones earned a Ph.D. in sociology from Columbia

[14] A. W. Jones, History of the Firm, http://www.awjones.com/historyofthefirm.html

University and joined the editorial staff of Fortune magazine. While conducting research for an article on market technical analysis, he started thinking about ways in which a fund could invest its capital in the markets while lowering its exposure to market fluctuations.[15] He is credited with launching the first hedged fund, as he called it, when in 1949 with $100,000 he started using short sales and leverage to "hedge" the risk of long positions in the stock market.[16] In 1952, Jones reorganized his fund as a limited partnership and established what has become the industry standard rule that the general partner would keep 20 percent of fund profits. By the mid-1950s, other funds started using short-selling strategies, although most did not focus on hedging market risk.[17] By 1990, hedge funds assets under management amounted to less than $50 billion.[18] In recent years, the industry has experienced rapid growth due to both the influx of new capital and market appreciation. As of the end of 2006, the industry had grown to an estimated $1.46 trillion in assets under management worldwide.[19]

Hedge fund investment strategies

In addition to the growth in size, hedge funds have expanded the scope of investment strategies to a wide array of strategies which vary in returns, volatility, and use of leverage. Because of the restriction to accredited investors, hedge funds are not subject to the same regulation as other entities and typically have more flexibility in the investment options available to them. Strategies may have a broad degree of exposure to market movements (directional), low correlation to overall market movements (market-neutral), attempt to profit from perceived pricing inefficiencies related to specific events (event-driven), or represent some combination of the above. This combination strategy is most common in the "fund of funds" segment of the industry, which includes closed-end registered investment companies that invest in other existing hedge funds. The fund of funds segment represents more than 36 percent of global hedge fund

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[15] Peter Landau, "The Hedge Funds: Wall Street's New Way to Make Money," *New York Magazine*, 1:29, October 21, 1968, pp. 19-24.

[16] Short sales involve the sale of a borrowed security that the seller does not own, usually with the expectation that the security will drop in price. If so, the short seller makes money by buying the security at the lower price to pay off the borrowed shares. A long position is one in which the investor owns the security outright.

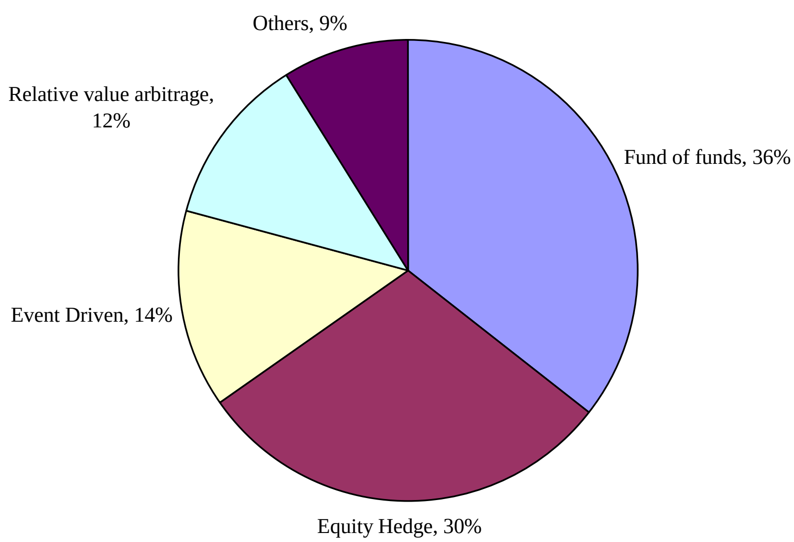
[17] Isaac Ruiz-Carus, Varun Bhat, and Emily Marriott, "What is a Hedge Fund?", The University of Iowa Center for International Finance and Development, available at http://www.uiowa.edu/ifdebook/faq/Hedge.shtml

[18] Rene M. Stulz, "Hedge Funds: Past, Present, and Future." *Journal of Economic Perspectives*, 21, Spring 2007, pp. 175-194.

[19] Hedge Fund Research in Britt Erica Tunick "Hedge Fund 100" AlphaMagazine.com, June 12, 2007, available at http://www.alphamagazine.com/article.aspx?articleID=1372539.

investments overall at the end of 2005, and about half of all institutional hedge fund investment.[20]

Figure 1.-Global Hedge Fund Strategies



Source: International Financial Services, London, Hedge Fund Research

<u>Industry size</u>

While estimates vary, one commonly cited source estimates that hedge funds controlled an estimated $1.46 trillion in assets worldwide as of the end of 2006, up from an estimated $1.1 trillion at the end of 2005 and $973 billion at the end of 2004.[21] The largest 100 funds alone

[20] International Financial Services, London, Hedge Fund: City Business Series, April 2007, available at http://www.ifsl.org.uk/uploads/CBS_Hedge_Funds_2007.pdf.

[21] Hedge Fund Research in Britt Erica Tunick "Hedge Fund 100" AlphaMagazine.com, June 12, 2007, available at http://www.alphamagazine.com/article.aspx?articleID=1372539. Treasury Assistant Secretary for Financial Markets, Anthony Ryan, placed the amount at $1.4 trillion in remarks before the Managed Funds Association Conference, June 11, 2007, available at http://www.treas.gov/press/releases/hp450.htm. Jickling and Marples, "Taxation of Hedge Fund and Private Equity Managers," July 5, 2007 put the number at $1.2 trillion. Rene M. Stulz, "Hedge Funds: Past, Present, and Future." *Journal of Economic Perspectives*, 21, Spring 2007, pp. 175-194, notes that larger estimates exist of up to $2.17 trillion as of 2005 from a survey by Hedgefundmanager and Advent. Hedgefund.net estimates the assets at $2.401 trillion as of the end of the first quarter of 2007, up from $2.154 trillion at the end of 2006. Hedgefund.net, "HFN Hedge Fund Industry Asset Flow/Performance

managed $1 trillion, or 69 percent of the fund industry's assets compared with 65 percent in 2005 and 58 percent the previous year. The industry has experienced substantial growth; in 1990, hedge funds investments amounted to less than $50 billion.

Hedge fund capital by type of investor

Hedge funds raise capital from various sources: individuals, pension funds, endowments and foundations, corporations and other institutions, and other hedge funds (commonly referred to as "fund of funds"). Table 2 shows the share of global hedge funds' capital by source over the previous decade. High net worth individuals historically have contributed the greatest share of capital to hedge funds, though institutional investors have increased their contributions to achieve near parity with individuals. Pension funds have more than doubled their share of hedge fund capital, while endowments and foundations have nearly doubled their share, reflecting a large increase in 2006. Corporations and other institutions have remained nearly constant in their relative participation in hedge funds. After individuals and institutions, fund of funds provide the balance of capital and have become an increasingly important source of funding, representing approximately one-quarter of all investments in hedge funds in 2006.

Table 2.-Percentage Share of Global Hedge Funds by Source of Capital

Year	Individuals	Fund of funds	Pension funds	Corporations and institutions	Endowments and foundations
1997	61	14	5	9	11
1998	54	18	10	8	10
1999	53	20	12	7	8
2000	54	17	14	7	8
2001	48	20	15	8	9
2002	42	27	15	7	9
2003	44	24	15	8	9
2004	44	24	15	8	9
2005	44	30	12	7	7
2006	40	23	11	8	18

Source: Hennessee Group LLC

The rise of the institutional hedge fund investor in the U.S. mirrors that seen in the global hedge fund market. As recently as 2000, U.S. institutions accounted for only 2 percent of net capital flows into hedge funds.[22] By 2005, they accounted for 38 percent, and this figure is expected to increase to more than 50 percent by 2008 and more than 60 percent by 2010.

Report, First Quarter Ending March 31, 2007," sample pages available at http://www.hedgefund.net/reports/Q1_2007_Asset_Flow_Report_sample.pdf

[22] The Bank of New York and Casey, Quirk & Acito, "Institutional Demand for Hedge Funds: New Opportunities and New Standards," September 2004, available at http://www.fundadmin.com/Publications/WP1.pdf

Pension funds are expected to drive demand to meet future pension obligations. The average long-term return assumptions of the 100 largest corporate defined benefit plans exceeds the forecasted return on a portfolio composed of 60 percent U.S. equities and 40 percent U.S. fixed income instruments by more than 275 basis points.[23] Not only are pension funds expecting higher returns, but also they typically demand less volatility. These components have been features of the hedge fund industry. A widely used index of the hedge fund industry, the Credit Suisse/Tremont Hedge Fund index had an average annual return of 11.20 percent from January 1994 through June 2007, with a standard deviation of 7.53 percent.[24] This compares to a return of 11.05 percent and volatility of 14.15 percent for the S&P 500.[25]

Estimates suggest that, worldwide, 15 percent of institutions globally invest in hedge funds, with holdings representing 2 percent of total global institutional assets at the end of 2005. In the U.S., half of all non-profit endowments, foundations, and hospitals invested in hedge funds. Approximately 10 percent of U.S. corporate defined benefit plans held hedge fund investments.[26]

Hedge funds use of leverage

Hedge funds have the ability to use leverage to make investments and to take short positions. Approximately two-thirds of hedge funds utilize at least some form of leverage.[27] One measure of leverage is the gross market exposure (long positions plus short positions) as a percentage of hedge fund assets under management. According to one survey of hedge fund managers, gross market exposure has averaged 142 percent since 1997. After bottoming out in 2001, this measure of leverage has been rising steadily.

Another measure of leverage is the use of margin, that is, borrowing money to take long positions. A recent survey of hedge fund managers placed the average long exposure at 102 percent in 2004, suggesting the average fund was using margin for the first time since 1999 when average long exposure was 104 percent.[28] This increased to 106 percent in 2005[29] and 109

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[23] The Bank of New York and Casey, Quirk & Associates, "Institutional Demand for Hedge Funds 2: A Global Perspective," *Thought Leadership Series White Paper*, October 2006, available at http://www.fundadmin.com/Publications/hedge_funds_2.pdf

[24] Credit Suisse/Tremont Hedge Fund Index Monthly Performance Overview as of June 30, 20007, available at http://www.hedgeindex.com/hedgeindex/en/hedgperformance.aspx?cy=U.S.D

[25] Calculations based on Standard & Poor's S&P 500 historical returns, available at http://www2.standardandpoors.com/spf/xls/index/MONTHLY.xls

[26] Bank of New York and Casey, Quirk & Associates, supra.

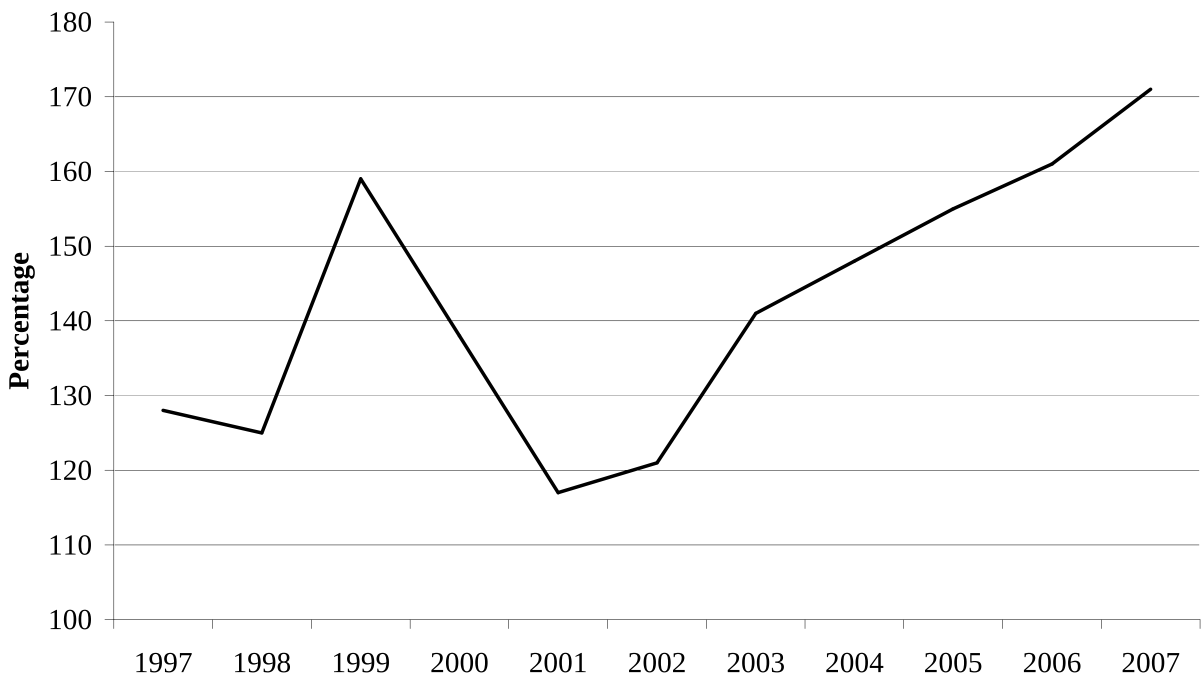
[27] International Financial Services, London supra.

[28] Hennessee Group, LLC, 11th Annual Hedge Fund Manager Survey Press Release, May 31, 2005, available at http://www.hennesseegroup.com/releases/release20050531.html

[29] Hennessee Group, LLC, 12th Annual Hedge Fund Manager Survey Press Release, December 5, 2006, available at http://www.hennesseegroup.com/releases/release20061205.html

percent in 2006[30], indicating growing use of margin. By either measure, leverage in the hedge fund industry has increased to new highs in recent years.

Figure 2.-Gross Market Exposure as a Percentage of Assets Under Management



Source: International Financial Service, London and Hennessee Group, LLC

<u>Hedge fund performance</u>

The literature on hedge funds' performance is relatively limited. Four main reasons have been suggested for this.[31] First, hedge funds are not required to disclose their performance. Any available information is based on the sample of firms that voluntarily release information, and therefore, may not be representative of the industry as a whole. Second, performance should be adjusted for market exposure, which can vary tremendously over a short period of time. Monthly return data may not adequately reflect the true market risks of the fund. Third, hedge funds are often exposed to risks that have high incidence with low probability. While volatility in any given time frame may appear low, there might be a higher probability over time of the fund losing all its assets. Finally, hedge funds exhibit serial correlation, that is, the return of a fund during one month provides information about the return over the next month. This can

[30] Hennessee Group, LLC 13th Annual Hedge Fund Manager Survey Press Release, May 1, 2007, available at http://www.hennesseegroup.com/releases/release20070501.html

[31] Stulz, "Hedge Funds: Past, Present, and Future."

arise if managers use their discretion to present a picture of low risk and consistent performance.[32] The average monthly return for hedge funds in December is more than twice what it is for the rest of the year.[33]

A common way to deal with these concerns is to evaluate hedge fund investments based on their relative risk-adjusted performance. A widely used index of the hedge fund industry, the Credit Suisse/Tremont Hedge Fund index, had an average annual return of 10.8 percent from January 1994 through the middle of 2006. The Standard & Poor's 500 would have earned 10.3 percent. However, the hedge fund index is much less volatile (7.8 percent versus 14.5 percent) because of the hedging strategies of hedge funds. Consequently, an investor who could have invested in the hedge fund index would have done almost twice as well as the S&P 500 index investor, per unit of volatility. Research generally concludes that hedge fund managers deliver returns net of their fees that are at least as good on average as alternative investments with similar market risk exposure. The question is how much better they do and whether these returns persist.[34]

Private equity funds, including venture capital, buyout, and other types of funds

Private equity investment strategies

Private equity funds manage approximately $1 trillion of capital globally.[35] The thirteen largest of these funds manage an estimated $374 billion in assets under management.[36] These funds typically buy stakes in companies to restructure those companies' capital, management, and organization. Restructuring may be accomplished through a variety of financing alternatives including buyout, mezzanine capital, venture capital, growth capital, turnaround and/or recapitalization funds. A buyout fund typically contributes the equity portion of a heavily leveraged, or debt-financed, acquisition. Mezzanine capital is a broad term that refers to unsecured, high-yield, subordinated debt often coupled with an equity component. Venture capital funds generally provide cash in exchange for equity stakes in new companies whose

[32] Mila Getmansky, Andrew W. Lo, and Igor Makarov, "An Econometric Model of Serial Correlation and Illiquidity in Hedge Fund Returns," *Journal of Financial Economics*, 74, 2004, pp. 529-609.

[33] Vikas Agarwal, Nicole M. Boyson, and Narayan Y. Naik, "Why is Santa so Kind to Hedge Funds? The December Return Puzzle!" available at Social Science Resource Network: http://ssrn.com/abstract=891621.

[34] A more detailed discussion is available in Stulz, "Hedge Funds: Past, Present and Future."

[35] Andrew Metrick and Ayako Yasuda, "The Economics of Private Equity Funds," (July 1, 2007). Available at Social Science Research Network: http://ssrn.com/abstract=996334. The Congressional Research Service places the figure at over $1 trillion raised in the last 10 years. Mark Jickling and Donald J. Marples, "Taxation of Hedge Fund and Private Equity Managers," July 5, 2007.

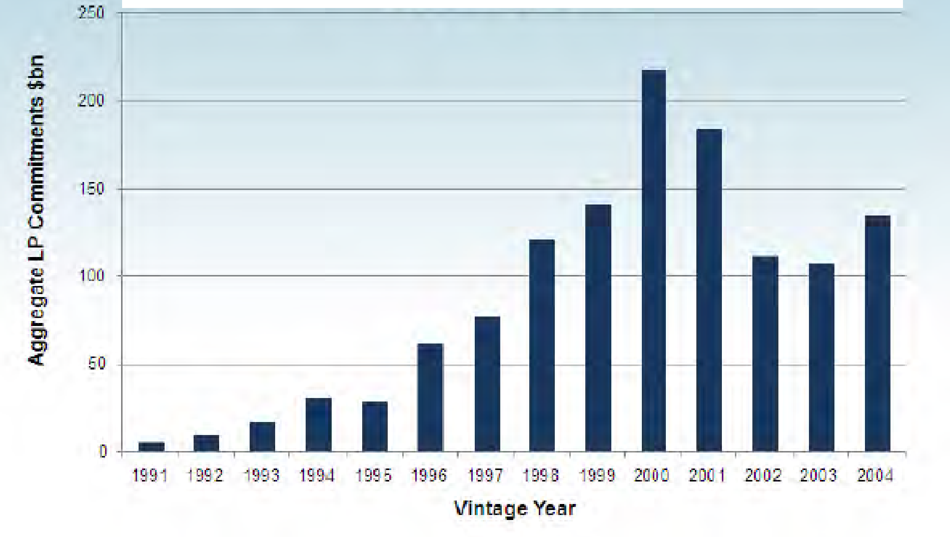
[36] "Who's Who in Private Equity," *The Wall Street Journal Online*, http://online.wsj.com/public/resources/documents/info-pequity0607-12.html?printVersion=true

limited operating history may restrict their access to other capital markets. However, venture capital funds may also make investments in companies at various stages of the business life cycle. Growth capital describes funds that provide financing for expansion beyond a certain critical mass. Funds that specialize in later stage investing may be known as turnaround or recapitalization funds.

Private equity fund raising and investments

Private equity funds typically operate by collecting capital commitments from investors. These are promises to make funds available for investment. These commitments may then be called upon to make investments when opportunities arise. The investments generally include leverage, which can increase the size of the investment beyond the amount of equity capital. Figure 3 below shows the aggregate commitments by investors to a sample of private equity funds by year the fund was established (vintage year).

Figure 3.–Aggregate Private Equity Fund Commitments



Source: Private Equity Intelligence, Ltd.

Buyout funds constitute the largest segment of private equity funds, with nearly half of all investment commitments between 1991 and 2004. Buyout transactions can exceed partners' commitments of capital because buyout funds often assume substantial debt financing as well. This accompanying debt can leverage the investment of buyout equity funds to permit total investments several times this base. Venture capital funds are the other main type of private equity. Together buyout and venture capital funds represent about 70 percent of all private equity funds raised globally between 1991 and 2004.[37] Table 3 contains estimates of the amount of private equity fundraising raised by each type of fund since 1998.

Table 3.-Trends in Private Equity Investing

	Venture Capital Funds		Buyout Funds*	
Year	No. Funds	Millions of Dollars Raised	No. Funds	Millions of Dollars Raised
1998	297	31,350.9	185	74,064.7
1999	459	61,910.7	172	70,500.3
2000	653	106,933.2	180	86,826.2
2001	331	40,713.0	147	59,821.0
2002	172	3,820.4	86	24,831.4
2003	146	10,707.8	91	28,952.8
2004	203	18,557.1	139	51,236.4
2005	214	28,001.8	178	96,087.4
2006	200	28,596.5	138	102,940.7

Source: Thomson Financial/National Venture Capital Association

* This category also includes mezzanine, turnaround, and recapitalization funds.

Not all funds raised by private equity funds find suitable investment opportunities. To use the industry's terminology, not all capital commitments (funds raised) are called (invested). Thus, amounts raised will not equal actual investments made. Table 4 shows estimates on funds raised and amounts invested for global private equity funds. In any given year, funds committed in prior years may be called in subsequent years resulting in larger sums invested than raised (as in 2003), or funds committed that year may not find investments that year resulting in smaller sums invested than raised (as in 2005).

Private equity fund raising has continued to expand in recent years. Private equity fund raising in 2006 totaled $335 billion, while investments reached a record $365 billion globally. Buyout funds have garnered an increasing share of private equity investments in recent years, representing more than 80 percent of investments in 2006. These funds have grown faster than venture capital funds, which have seen their share of private equity investments decline.[38]

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[37] Private Equity Intelligence, Ltd. 2006 “Value Creation and Carry Review”, available at http://www.preqin.com/carry.aspx

[38] International Financial Services, London, Hedge Fund: City Business Series, August 2007, available at http://www.ifsl.org.uk/uploads/CBS_Private_Equity_2007.pdf.

Table 4.-Global Private Equity

Year	Funds Raised Billions of Dollars	Investments Billions of Dollars
1997	108	59
1998	133	70
1999	154	124
2000	262	192
2001	177	103
2002	93	86
2003	88	115
2004	133	110
2005	272	136
2006	335	364

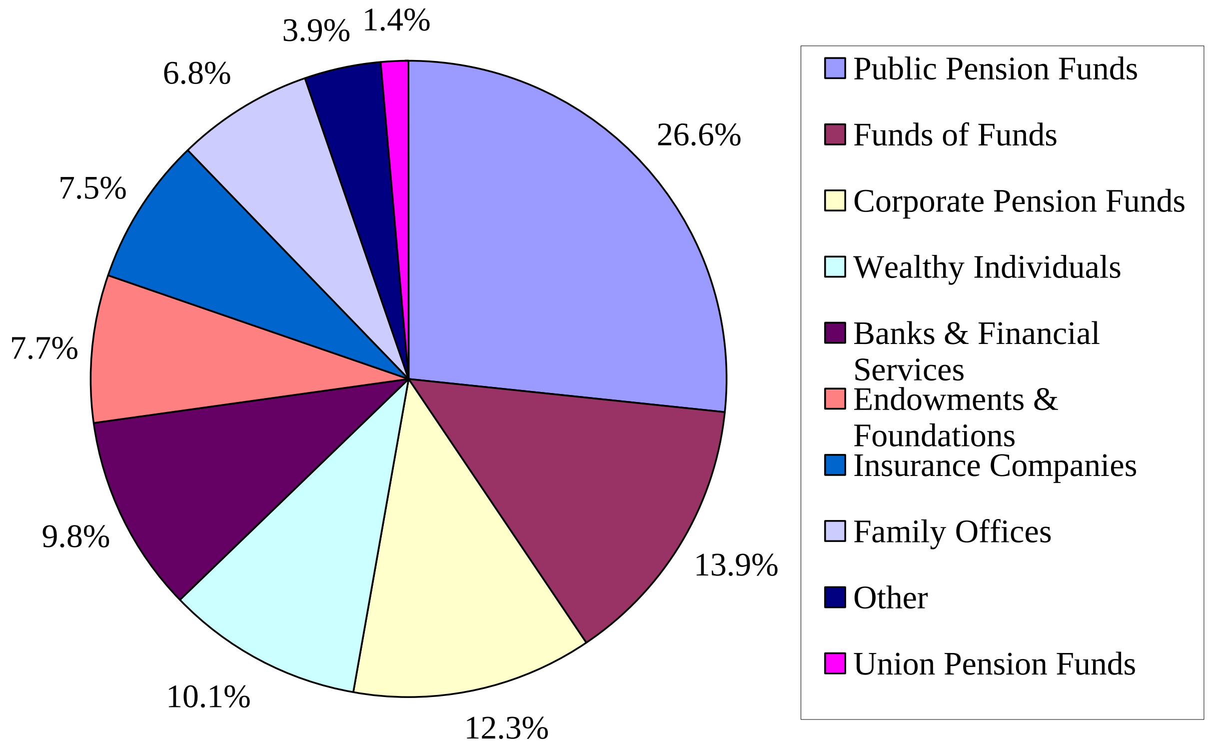
Source: IFSL estimates based on EVCA/Thomson Financial/PwC, APER, NVCA, Private Equity Intelligence and Dealogic data

Private equity capital by type of investor

Investors in private equity funds are varied. Data for 2006, shown in Figure 4, indicate that public pension funds are the largest source of private equity capital.[39] Funds of funds are the second largest source with 13.9 percent of all capital. Total pension fund investment in private equity, including public, corporate, and union pension funds, represent over 40 percent of all capital committed to private equity in 2006. Other tax exempt investors include endowments and foundations at 7.7 percent. Taxable investors include wealthy individuals (10.1%), banks and financial services companies (9.8 percent), insurance companies (7.5 percent), and wealthy families investing through family offices (6.8 percent), which together supply more than one-third of all private equity capital. Other sources account for less than 4 percent of all private equity capital.

[39] Private Equity Council, Public Value: A Primer on Private Equity, 2007, available at http://www.privateequitycouncil.org/wordpress/wp-content/uploads/pec_primer_layout_final.pdf.

Figure 4.-Private Equity Capital Commitments by Type of Investor

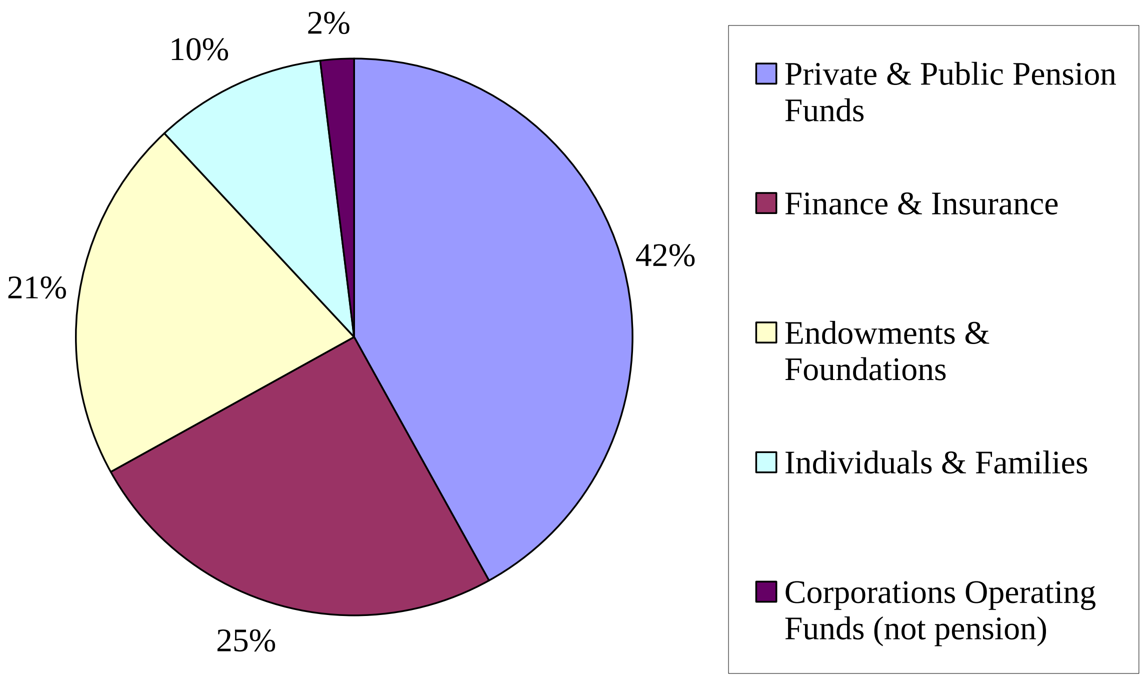


Source: Private Equity Council

<u>Venture capital by type of investor</u>

For venture capital funds, a subset of private equity funds, data are also available on the sources of funds by type of investor. Data for 2003, shown in Figure 5, suggest that the largest sources of funding for venture capital funds are private and public pension funds, which are responsible for more than two-fifths of all commitments globally. Finance and insurance companies represent one-quarter of investment in all funds, followed closely by endowments and foundations. Individuals, including managers' own contributions are responsible for 10 percent of commitments. Non-pension corporate funds provide the balance of venture capital funding.

Figure 5.-Investors in Venture Capital Funds



Source: 2004 National Venture Capital Association Yearbook

<u>Carried interests in private equity</u>

A recent study on a sample of 94 venture capital funds and 144 buyout funds estimates the present value of expected revenue to fund managers, both in the form of fixed management fees and the variable component including carried interests. [40] In this sample, over 60 percent of expected revenue is derived from fixed management fees, while income from carried interests represents approximately one-third of the total revenue to the private equity funds' general partners.

These numbers represent the present value of what the general partners can expect to receive as a percentage of invested funds. For the venture capital firms, each $100 of invested funds will generate an estimated $8.98 in present value of carried interest and estimated total revenue of $23.78 in present value. The data above are expressed in present value terms. One reason for the greater percentage of revenue attributable to management fees is the timing of

[40] Metrick and Yasuda, "The Economics of Private Equity Funds." Because funds make investments and partners earn revenue spread out over the typical ten-year lifetime of the fund, Metrick and Yasuda express all outlays in present value terms, as of the inception date of the fund using a discount rate of five percent.

revenue. While various fees are earned over the lifetime of the fund, the payments under the carried interests are made generally towards the end of the life of the fund, as investment gains are realized.

Table 5 reports summary information for the estimates of carried interest from this sample. While buyout funds earn less per dollar invested relative to venture capital funds, they raise nearly four times the amount of capital on average to garner more carried interest and total revenue per partner.

Table 5.-Present Value of Partner Revenue

Present Value of:	Mean of 94 Venture Capital Funds	Mean of 144 Buyout Funds
Carry per $100 invested ($)	8.98	5.41
Fees per $100 ($)	14.80	11.91
Total revenue per $100 ($)	23.78	17.37
Fund Size ($ Millions)	322.00	1,238.00

Source: Calculations based on Metrick and Yasuda "The Economics of Private Equity Funds." Detail may not add to total due to rounding.

Another study estimates the value created by private equity firms and the corresponding carried interests for a much larger sample of 1,016 funds over the period 1991 through 2006 for private equity funds with vintages from 1991 to 2004.[41] These funds delivered total distributed and unrealized gains of $440 billion after fees and carry, and general partners earned a net carry of $78 billion, $24 billion in the prior 12 months alone.[42]

Carry is only paid to fund managers upon distributed gains; therefore, it is weighted towards older funds. Of the $78 billion of aggregate carried interests paid to date, only $18 billion has been received by managers of funds with vintages from 1999 onwards. Figure 5 below shows aggregate carry to date expressed as a percentage of this total by vintage year. For the older vintages, carry is nearly 25 percent of the total distributed and unrealized net gains to limited partners, as expected given the standard 20 percent carry share (20 percent being one-quarter of the remaining 80 percent). For newer funds, carry represents a smaller percentage of the total distributed and unrealized gains.

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[41] Private Equity Intelligence, Ltd. (2006), *supra*.

[42] Estimates of total distributed and unrealized gains for limited partners and carry earned by general partners to date are based on the most recent data available for these funds. Most funds in this study report data as of March 31, 2006.

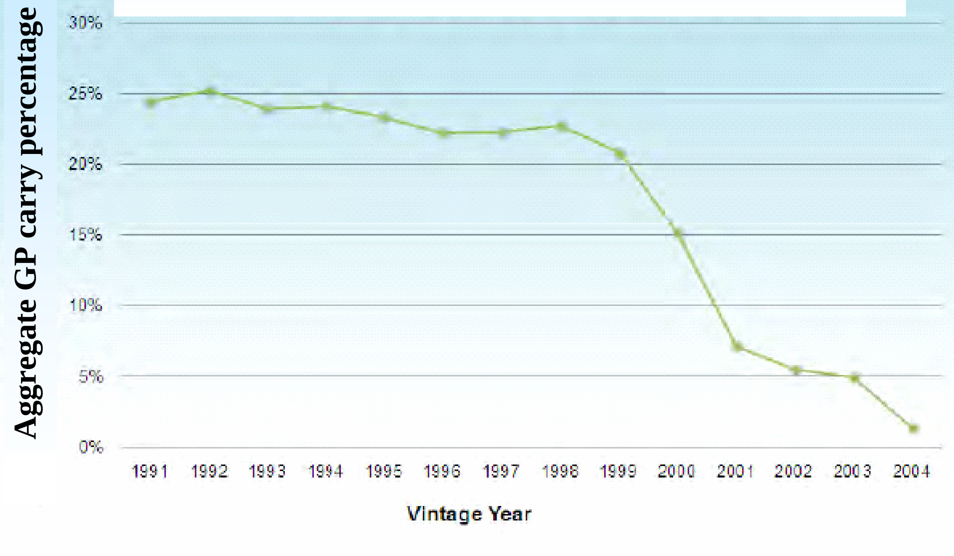

Figure 5.–Carry as a Percentage of Total Distributed and Unrealized Gains to Limited Partners by Vintage Year

Only about 40 percent of funds generated carried interest for partners, as can be seen in Table 6. However, one might expect this number to grow as more funds mature. Nevertheless, looking at only mature funds with vintages from 1991 to 1997 (for whose partners the gains should largely be realized), 70 percent of the funds generated net gains for limited partners and carried interests for general partners, 10 percent generated net gains for limited partners but failed to meet the hurdle rate required to generate carried interests for general partners, and 20 percent failed to deliver net gains.

Among those funds that generated carried interests, amounts are concentrated in a small group of larger funds. Fewer than 10 percent of the funds (151 out of 1,673 in this study) have earned more than $100 million in total carry.

Table 6.-General Partner Carry Earned to Date

Number of Funds, Vintages 1991-2004							
Carry Earned ($)	**US Venture**	**Europe Venture**	**US Buyout**	**Europe Buyout**	**Real Estate**	**Other Funds**	**Total**
0	385	97	185	85	92	167	1011
1-49 million	144	28	114	18	28	73	405
50 million to 99 million	27	3	38	6	11	21	106
100 million to 199 million	23	1	18	11	8	9	70
200 million to 499 million	10	1	35	12	5	6	69
500 million to 999 million	5	0	1	1	0	1	8
1 billion or more	3	0	0	0	0	1	4
Total	597	130	391	133	144	278	1673

Source: Private Equity Intelligence, Ltd. Value Creation & Carry in Private Equity, 1991-2006

III. PRESENT LAW – CARRIED INTERESTS AND COMPENSATION OF INDIVIDUALS

A. Tax Rates Applicable to Ordinary Income, Capital Gains, and Dividends of Individuals

Ordinary income tax rates

An individual subject to Federal income tax generally pays tax at graduated rates on taxable income. The tax rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer's income increases. For 2007, the tax rates range from 10 percent to 35 percent.

In addition, under present law, individuals are liable for an alternative minimum tax to the extent the tentative minimum tax exceeds the regular tax liability. The tentative minimum tax is computed at rates of 26 and 28 percent on an expanded tax base.

Capital gains and dividends rates

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. Any net capital gain of an individual is taxed at maximum rates lower than the rates applicable to ordinary income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, (5) certain U.S. publications, (6) certain commodity derivative financial instruments, (7) hedging transactions, and (8) business supplies. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain.

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

A separate rate structure applies to capital gains and dividends. Under present law, for 2007, the maximum rate of tax on the adjusted net capital gain of an individual is 15 percent. In addition, any adjusted net capital gain otherwise taxed at a 10- or 15-percent rate is taxed at a five-percent rate. These rates apply for purposes of both the regular tax and the alternative minimum tax.

For 2007, dividends received by an individual from domestic corporations and qualified foreign corporations generally are taxed at the same rates that apply to adjusted net capital gain.

B. Tax Treatment of the Receipt of a Partnership Profits Interest for Services

A profits interest in a partnership is the right to receive future profits in the partnership but does not generally include any right to receive money or other property upon the immediate liquidation of the partnership. Although the Internal Revenue Code does not specifically address the treatment of the receipt of a profits interest in a partnership in exchange for the performance of services, a taxpayer receiving a profits interest for performing services generally has not been taxable upon the receipt of the partnership interest.[43]

In 1993, the Internal Revenue Service, referring to the results of cases it had litigated, specifically ruled that the receipt of a partnership profits interests for services generally is not a taxable event for the partnership or the partner.[44] Under the ruling, this treatment does not apply, however, if: (1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease; (2) within two years of receipt, the partner disposes of the profits interest; or (3) the profits interest is a limited partnership interest in a publicly traded partnership. A more recent ruling[45] clarifies that this result applies provided the service partner takes into income his distributive share of partnership income, and the partnership does not deduct any amount either on grant or on vesting of the profits interest.[46]

By contrast, a partnership capital interest received for services is includable in the partner's income under generally applicable rules relating the receipt of property for the performance of services.[47] A partnership capital interest for this purpose is an interest that would

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[43] Only a handful of cases have ruled on this issue. Though one case required the value to be included currently, where value was easily determined by a sale of the profits interest soon after receipt (*Diamond v. Commissioner,* 56 T. C. (1971), *aff'd* 492 F. 2.2d 286 (7th Cir, 1974)), a more recent case concluded that partnership profits interests were not includable on receipt, because the profits interests were speculative and without fair market value (*Campbell v. Commissioner* (943 F. 2d. 815 (8th Cir. 1991)).

[44] Rev. Proc. 93-27, 1993-2 C.B. 343, citing the *Diamond* and *Campbell* cases, *supra*.

[45] Rev. Proc. 2001-43 (2001-2 C.B. 191).

[46] A similar result would occur under the 'safe harbor" election of proposed regulations regarding the application of section 83 to the compensatory transfer of a partnership interest. REG-105346-03, 70 Fed. Reg. 29675 (May 24, 2005). These proposed regulations are described in the section of this document entitled Tax Treatment of Property Transferred in Connection with the Performance of Services.

[47] Secs. 61 and 83; Treas. Reg. sec. 1.721-1(b)(1)); see *U.S. v. Frazell*, 335 F.2d 487 (5th Cir. 1964), *cert denied*, 380 U.S. 961 (1965).

entitle the receiving partner to a share of the proceeds if the partnership's assets were sold at fair market value and the proceeds were distributed in liquidation.[48]

The character of partnership items passes through to the partners, as if the items were realized directly by the partners.[49] Thus, for example, long-term capital gain of the partnership is treated as long-term capital gain in the hands of the partners.

A partner holding a partnership interest includes in income its distributive share (whether or not actually distributed) of partnership items of income and gain, including capital gain eligible for the lower income tax rates. A partner's basis in the partnership interest is increased by any amount of gain thus included and is decreased by losses. These basis adjustments prevent double taxation of partnership income to the partner, preserving the partnership's tax status as a passthrough entity. Amounts distributed to the partner by the partnership are taxed to the extent the amount exceeds the partner's basis in the partnership interest.

[48] Rev. Proc. 93-27, 1993-2 C.B. 343.

[49] Section 702.

C. Tax Treatment of Property Transferred in Connection with the Performance of Services

In general

Section 83 governs the amount and timing of income and deductions attributable to transfers of property in connection with the performance of services. If property is transferred in connection with the performance of services, the person performing the services (the "service provider") generally must recognize income for the taxable year in which the property is first substantially vested (i.e., transferable or not subject to a substantial risk of forfeiture). The amount includible in the service provider's income is the excess of the fair market value of the property over the amount (if any) paid for the property.

Under section 83(b), even if the property is not vested at the time of transfer, the service provider may nevertheless elect within 30 days of the transfer to recognize income for the taxable year of the transfer. Such an election is referred to as a "section 83(b) election." The service provider makes an election by filing with the IRS a written statement that includes the fair market value of the property at the time of transfer and the amount (if any) paid for the property. The service provider must also provide a copy of the statement to the service recipient.

Under section 83, a deduction is allowed to the person for whom such services are performed (the "service recipient") equal to the amount included in gross income by the service provider.[50] The deduction is allowed for the taxable year of the service recipient in which or with which ends the taxable year for which the amount is included in the service provider's income.

A transfer of property occurs when a person acquires a beneficial ownership interest in such property. The term "property" is defined very broadly for purposes of section 83.[51] Property includes real and personal property, but does not include money or an unfunded and unsecured promise to pay money in the future.

Property is subject to a substantial risk of forfeiture if the individual's right to the property is conditioned on the future performance of substantial services (such as full-time services for two years or more) or on the nonperformance of services (such as a noncompete requirement). In addition, a substantial risk of forfeiture exists if the right to the property is subject to a condition other than the performance of services, provided that the condition relates to a purpose of the transfer and there is a substantial possibility that the property will be forfeited if the condition does not occur. Risks that do not fall within this legal definition, such as the risk that the property will decline in value, do not result in a substantial risk of forfeiture. Whether a substantial risk of forfeiture exists depends on the facts and circumstances, including whether the service requirement or other condition will in fact be enforced. Property that is subject to a

[50] Sec. 83(h).

[51] Treas. Reg. sec. 1.83-3(e). This definition in part reflects previous IRS rulings on nonqualified deferred compensation.

substantial risk of forfeiture is referred to as nonvested property; property that is not (or is no longer) subject to a substantial risk of forfeiture is referred to as vested property.

Property is considered transferable if a person can transfer his or her interest in the property to anyone other than the transferor from whom the property was received. However, property is not considered transferable if the transferee's rights in the property are subject to a substantial risk of forfeiture. A temporary restriction on the transferability of property (called a "lapse" restriction) is disregarded in determining the value of the property for purposes of section 83. A permanent restriction on the transferability of property (a "nonlapse" restriction) is taken into account in determining the value of the property.

<u>Compensatory stock</u>

Stock may be granted to an employee (or other service provider) without restrictions in the sense that the stock is fully vested and transferable. In some cases, the employee is granted "restricted" stock in the sense that the stock must be forfeited or sold back to the company in certain circumstances. For example, an employee may receive stock that is subject to a substantial risk of forfeiture because of a requirement that the stock be forfeited if the employee terminates employment within five years. Stock that is subject to a substantial risk of forfeiture is referred to as nonvested stock; stock that is not (or is no longer) subject to a substantial risk of forfeiture is referred to as vested stock.

Stock that is granted to an employee (or other service provider) is subject to the rules that apply under section 83 to transfers of property in connection with the performance of services. Accordingly, if vested stock is transferred to an employee, the excess of the fair market value of the stock, over the amount, if any, the employee pays for the stock is includible in the employee's income for the year in which the transfer occurs. The amount includible in the income of the employee is generally deductible by the employer for the taxable year of the employer in which the employee's taxable year of inclusion ends.

If nonvested stock is transferred to an employee (or other service provider), no amount is includible in income as a result of the transfer unless the employee makes a section 83(b) election. Otherwise, the excess of the fair market value of the stock at the time of vesting, over the amount, if any, the employee pays for the stock is includible in the employee's income for the year in which vesting occurs.

In the case of an employee, the amount includible in income under section 83 is also subject to income tax withholding and to social security tax (subject to the social security wage base) and Medicare tax and must be reported on a Form W-2. In the case of an individual who is not an employee, the amount includible in income under section 83 must be reported on a Form 1099.

<u>Compensatory stock options</u>

A stock option is the right to purchase stock at a specified price (or at a price determined under a specified formula) at a specified time or during a specified period. Stock options granted to employees or other service providers are considered to be compensation for services. There are two general types of compensation-related stock options under the Code: nonqualified options (which are subject to section 83) and statutory options (which are subject to special tax rules under section 421). Statutory options include incentive stock options (described in section 422) and options provided under an employee stock purchase plan (described in section 423). Nonqualified options are any other options (other than statutory options) granted in connection with the performance of services.

The income taxation of a nonqualified option is determined under section 83 and depends on whether the option has a readily ascertainable fair market value when granted. A nonqualified option has a readily ascertainable fair market value if (1) the option is actively traded on an established market, or (2) the option is transferable, it is immediately exercisable in full, the option and the stock subject to the option are not subject to any restriction or condition that has a significant effect on the value of the option, and the fair market value of the option privilege is readily ascertainable. The option privilege is the opportunity to benefit from increases in the value of the stock during the option period without risking capital.

If an individual receives a nonqualified option that has a readily ascertainable fair market value at the time the option is granted (which is generally not the case), the excess of the fair market value of the option over the amount, if any, paid for the option is includible in the recipient's gross income as ordinary income in the first taxable year in which the option is either transferable or is not subject to a substantial risk of forfeiture (or, if the taxpayer makes a section 83(b) election, in the taxable year in which the option is granted). When such an option is later exercised, no amount is includible in the gross income of the option recipient due to the exercise of the option.

If the nonqualified option does not have a readily ascertainable fair market value at the time of grant (which is generally the case), no amount is includible in the gross income of the recipient with respect to the option until the recipient exercises the option. The transfer of stock on exercise of the option is subject to the general rules of section 83. That is, if vested stock is received on exercise of the option, the excess of the fair market value of the stock over the option price is includible in the recipient's gross income as ordinary income in the taxable year in which the option is exercised. If the stock received on exercise of the option is not vested, the excess of the fair market value of the stock at the time of vesting over the option price is includible in the recipient's income for the year in which vesting occurs (unless the recipient elects to make a section 83(b) election).

In the case of an employee, the amount includible in income under section 83 with respect to nonqualified stock options is also subject to income tax withholding and to social security tax (subject to the social security wage base) and Medicare tax and must be reported on a Form W-2. In the case of an individual who is not an employee, the amount includible in income under section 83 must be reported on a Form 1099.

A compensation expense deduction equal to the amount of ordinary income included in the gross income of the option recipient is generally allowable to the employer for the taxable year of the employer in which the recipient's taxable year of inclusion ends.

Proposed regulations on compensatory transfer of a partnership interest

The Department of Treasury has issued proposed regulations regarding the application of section 83 to the compensatory transfer of a partnership interest.[52] The proposed regulations provide that a partnership interest is "property" for purposes of section 83. Thus, a compensatory transfer of a partnership interest is includible in the service provider's gross income at the time that it first becomes substantially vested (or, in the case of a nonvested partnership interest, at the time of grant if a section 83(b) election is made).

However, the proposed regulations also contain a rule that permits a partnership and a partner to elect a safe harbor under which the fair market value of a compensatory partnership interest is treated as being equal to the liquidation value of that interest. Therefore, under the proposed regulations, the grant of a vested profits interest in a partnership (or, if a section 83(b) election is made, the grant of a nonvested profits interest) results in no income inclusion under section 83 because the fair market value of the property received by the service provider is zero. The proposed safe harbor is subject to a number of conditions. For example, the election cannot be made retroactively and must apply to all compensatory partnership transfers that occur during the period that the election is in effect.

[52] 70 Fed. Reg. 29675 (May 24, 2005).

D. Tax Treatment of Nonqualified Deferred Compensation[53]

Deferred compensation occurs when the payment of compensation to a service provider is deferred for more than a short period after the compensation is earned (i.e., the time when the services giving rise to the compensation are performed). Payment is generally deferred until some specified event, such as the service provider's death, disability, or other termination of services, or until a specified time in the future, such as five or ten years.

The Code provides tax-favored treatment for certain types of employer-sponsored deferred compensation arrangements that are designed primarily to provide employees with retirement income. These arrangements include qualified defined contribution and defined benefit pension plans (sec. 401(a)), qualified annuities (sec. 403(a)), tax-sheltered annuities (sec. 403(b)), savings incentive match plans for employees or "SIMPLE" plans (sec. 408(p)), simplified employee pensions or "SEPs" (sec. 408(k)), and eligible deferred compensation plans of State or local government employers (sec. 457(b)). For simplicity, these plans are referred to collectively here as "qualified employer plans." A nonqualified deferred compensation arrangement is generally any deferred compensation arrangement that is not one of these qualified employer plans.

Nonqualified deferred compensation arrangements are contractual arrangements between a service recipient (e.g., an employer or a hedge fund) and a service provider (e.g., an employee or a hedge fund manager) covered by the arrangement. Such arrangements are structured in whatever form achieves the goals of the parties; as a result, they vary greatly in design. Considerations that may affect the structure of the arrangement are the current and future income needs of the service provider, the desired tax treatment of deferred amounts, and the desire for assurance that deferred amounts will in fact be paid.

Section 409A of the Code provides specific rules governing the tax treatment of nonqualified deferred compensation.[54] Prior to the enactment of section 409A, there were no rules that specifically governed the tax treatment of nonqualified deferred compensation. In determining the tax treatment of nonqualified deferred compensation prior to enactment of section 409A, a variety of tax principles and Code provisions were relevant, including the doctrine of constructive receipt, the economic benefit doctrine, the provisions of section 83 relating generally to transfers of property in connection with the performance of services, and provisions relating specifically to nonexempt employee trusts (sec. 402(b)) and nonqualified

[53] This section summarizes applicable Federal tax rules. A more detailed explanation of present-law rules applicable to nonqualified deferred compensation is set forth in *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part II* (JCX-63-07), September 4, 2007. This document is available on the internet at www.house.gov/jct.

[54] Section 409A was added by The American Jobs Creation Act of 2004 (Pub. L. No. 108-357) and generally applies to amounts deferred after December 31, 2004.

employee annuities (sec. 403(c)).[55] Section 409A does not override these tax principles and Code provisions. Thus, they are relevant in determining the tax treatment of nonqualified deferred compensation. Section 409A does not prevent the inclusion of amounts in gross income under any provision or rule of law earlier than the time provided under its rules.

Under section 409A, all amounts deferred by a service provider under a nonqualified deferred compensation plan[56] for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture[57] and not previously included in gross income, unless certain requirements are satisfied. Under section 409A, a nonqualified deferred compensation plan may not allow distributions other than upon the permissible distribution events and may not permit acceleration of a distribution. Section 409A also includes rules governing the timing of deferral elections. If the requirements of section 409A are not satisfied, in addition to current income inclusion, interest at the rate applicable to underpayments of tax plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to a 20-percent additional tax.

Special statutory provisions govern the timing of the deduction for nonqualified deferred compensation.[58] Under these provisions, the amount of nonqualified deferred compensation that is includible in the income of the service provider is deductible by the service recipient for the taxable year in which the amount is includible in the service provider's income.

With respect to employment taxes, in the case of an employee, nonqualified deferred compensation is generally considered wages both for purposes of income tax withholding and for purposes of taxes under the Federal Insurance Contributions Act ("FICA"), consisting of social security tax and Medicare tax. However, the income tax withholding rules and social security and Medicare tax rules that apply to nonqualified deferred compensation are not the same.

In the case of an employee, nonqualified deferred compensation is generally subject to income tax withholding at the time it is includible in the employee's income as discussed above.

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[55] Under general tax principles, if the nonqualified deferred compensation arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received under section 451 (unless earlier income inclusion applies under section 409A). If an arrangement is funded, then income is includible under section 83 for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture.

[56] A plan includes an agreement or arrangement, including an agreement or arrangement that includes one person. Amounts deferred also include actual or notional earnings.

[57] As under section 83, the rights of a person to compensation are subject to a substantial risk of forfeiture if the person's rights to such compensation are conditioned upon the performance of substantial services by any individual.

[58] Secs. 404(a)(5), (b) and (d) and sec. 83(h).

In general, nonqualified deferred compensation is subject to social security and Medicare tax when it is earned (i.e., when services are performed), unless the nonqualified deferred compensation is subject to a substantial risk of forfeiture. If nonqualified deferred compensation is subject to a substantial risk of forfeiture, it is subject to social security and Medicare tax when the risk of forfeiture is removed (i.e., when the right to the nonqualified deferred compensation vests). In the case of a self-employed individual, nonqualified deferred compensation amounts that are includible in income are also taken into account in determining net earnings from self-employment for social security and Medicare tax purposes unless an exception applies.

E. Self-Employment Tax Treatment of Partners

As part of the financing for Social Security and Medicare benefits, a tax is imposed on the wages of an individual received with respect to his or her employment under the Federal Insurance Contributions Act ("FICA").[59] A similar tax is imposed on the net earnings from self-employment of an individual under the Self-Employment Contributions Act "SECA") .[60]

The FICA tax has two components. Under the old-age, survivors, and disability insurance component ("OASDI"), the rate of tax is 12.40 percent, half of which is imposed on the employer, and the other half of which is imposed on the employee.[61] The amount of wages subject to this component is capped at $97,500 for 2007. Under the hospital insurance component ("HI"), the rate is 2.90 percent, also split equally between the employer and the employee. The amount of wages subject to the HI component of the tax is not capped. The wages of individuals employed by a business in any form (for example, a C corporation) generally are subject to the FICA tax.[62]

The SECA tax mirrors the FICA tax, and the SECA rate is the combined employer and employee rate for FICA taxes. Thus, the SECA tax has two components. Under the OASDI component, the rate of tax is 12.40 percent and the amount of earnings subject to this component is capped at $97,500 (for 2007). Under the HI component, the rate is 2.90 percent, and the amount of self-employment income subject to the HI component is not capped.

For SECA tax purposes, net earnings from self-employment means the gross income derived by an individual from any trade or business carried on by the individual, less the deductions attributable to the trade or business that are allowed under the self-employment tax rules[63]. Specified types of income or loss are excluded, such as rentals from real estate in certain

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[59] See Chapter 21 of the Code.

[60] Sec. 1401.

[61] Secs. 3101 and 3111.

[62] S corporation shareholders who are employees of the S corporation are subject to FICA taxes. A considerable body of case law has addressed the issue of whether amounts paid to S corporation shareholder-employees are reasonable compensation for services and therefore are wages subject to FICA tax or are properly characterized as another type of income (typically, dividends) and therefore not subject to FICA tax.

[63] For purposes of determining net earnings from self-employment, taxpayers are permitted a deduction from net earnings from self-employment equal to the product of the taxpayer's net earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent), i.e., 7.65 percent of net earnings. This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas a self-employed individual's net earnings are economically the equivalent of an employee's wages plus the employer share of FICA taxes. The deduction is intended to provide parity between FICA and SECA taxes. In addition, self-employed individuals may deduct one-half of self-employment taxes for income tax purposes (sec. 164(f)).

circumstances, dividends and interest, and gains or loss from the sale or exchange of a capital asset or from timber, certain minerals, or other property that is neither inventory nor held primarily for sale to customers.

For an individual who is a partner in a partnership, the net earnings from self-employment generally include the partner's distributive share (whether or not distributed) of income or loss from any trade or business carried on by the partnership (excluding specified types of income, such as rents and dividends, as described above). This rule applies to individuals who are general partners. A special rule applies for limited partners of a partnership.[64] In determining a limited partner's net earnings from self-employment, an exclusion is provided for his or her distributive share of partnership income or loss. The exclusion does not apply with respect to guaranteed payments to the limited partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.

[64] Sec. 1402(a)(13). For this purpose, limited partner status is determined under State law. Issues have arisen under present law as to the proper SECA tax treatment of individuals who may be limited partners under State law but who participate in the management and operation of the partnership.

IV. PRESENT LAW - TAXATION OF BUSINESS ENTITIES

A. Tax Treatment of Partnerships and Partners

Passthrough treatment

A partnership generally is not treated as a taxable entity (except for certain publicly traded partnerships), but rather, is treated as a pass-through entity. Income earned by a partnership, whether distributed or not, is taxed to the partners.[65] The character of partnership items passes through to the partners, as if the items were realized directly by the partners.[66] The items of income, gain, loss, deduction or credit of a partnership generally are taken into account by a partner as allocated under the terms of the partnership agreement (or in accordance with the partners' interests in the partnership if the agreement does not provide for an allocation), so long as the allocation has substantial economic effect.[67]

Basis in a partnership interest

A partner's basis in its partnership interest is separate from the partnership's basis in partnership property. The basis of a partnership interest acquired by a contribution of property (including money) to the partnership is equal to the sum of the amount of money and the contributing partner's adjusted basis for the property at the time of contribution, reduced by gain (if any) recognized by the contributing partner.[68] The basis of a partnership interest acquired by transfer is generally its cost.[69]

Adjustments to the basis of a partnership interest are made to take account of the partner's distributive share of income and loss of the partnership, and to take account of distributions by the partnership to the partner, during the taxable year. The basis of the partnership interest is increased by the partner's distributive share of taxable and tax-exempt income of the partnership.[70] The basis of the partnership interest is decreased by (1) the amount of money distributed to the partner and the partner's basis in property distributed, and (2) the

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[65] Section 701.

[66] Section 702.

[67] Section 704(a) and (b).

[68] Sections 705(a) and 722.

[69] Sections 742 and 1012.

[70] Section 705(a)(1). The basis is also increased by the excess of deductions for depletion over the basis of the property subject to depletion, if the partnership has an interest in such property.

partner's distributive share of partnership losses and of nondeductible expenditures that are not properly chargeable to capital account.[71]

Partnership's basis in its property; section 754 election

A partnership that acquires property by contribution from a partner has an adjusted basis in the property equal to the contributing partner's adjusted basis in the property.[72] A partnership that acquires property by purchase generally has a cost basis in the property.

In the event of a transfer of a partnership interest by sale or exchange (or on the death of a partner), the basis of partnership property is adjusted if the partnership has a section 754 election in effect, or if the partnership has a substantial built-in loss[73] immediately after the transfer.[74] The partnership increases the adjusted basis of partnership property by the amount by which the transferee's basis in its partnership interest exceeds its proportionate share of the adjusted basis of partnership property. The partnership decreases the adjusted basis of partnership property by the amount by which the transferee's proportionate share of the adjusted basis of partnership property exceeds the transferee's basis in its partnership interest. These adjustments are made with respect to the transferee partner. They are intended to adjust the basis of partnership property to approximate the result of a direct purchase of the property by the transferee partner. Thus, the adjusted basis of partnership property generally is stepped up when a partner acquires a partnership interest by transfer at a price that exceeds the amount of its proportionate share of the adjusted basis of partnership property.

Partnership distributions generally tax-free

In the case of a distribution by a partnership, no gain or loss is recognized by the partnership on a distribution to a partner of property, including money.[75] A partner generally is permitted to receive distributions of partnership property without recognition of gain or loss.[76]

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[71] Sections 705(a)(2) and 733. The basis is also decreased (but not below zero) by certain depletion deductions (sec. 705). Special rules may apply under regulations in the case of a partnership termination (sec. 705(b)).

[72] Section 723.

[73] For this purpose, a substantial built-in loss exists if the partnership's adjusted basis in partnership property exceeds by more than $250,000 the fair market value of the property (sec. 734(d)). An alternative rule providing for loss deferral for the transferee partner applies in the case of an electing investment partnership that would otherwise be treated as having a substantial built-in loss (sec. 734(e)).

[74] Sections 743 and 754. Similar rules apply with respect to adjustments to the basis of partnership property in the case of a distribution of partnership property to a partner (sec. 734).

[75] Section 731(b). Adjustments to the basis of the partnership's property in the event of a distribution may be required if the partnership has made a section 754 election or if there is a substantial basis reduction with respect to the distribution (sec. 734).

[76] Section 731(a)(1) and (c).

Several exceptions to this partner nonrecognition rule apply. Gain is recognized by the distributee partner to the extent that any money (and the fair market value of marketable securities) distributed exceeds the partner's adjusted basis in its partnership interest immediately before the distribution. Loss is recognized by the distributee partner when only money and unrealized receivables and inventory are received in a liquidating distribution in which the amount of money and the adjusted basis of the receivables and inventory does not exceed the partner's adjusted basis in its partnership interest.[77] Gain or loss may be recognized by the distributee partner in the case of certain disproportionate distributions involving inventory and unrealized receivables,[78] or in the case of certain distributions relating to contributed property.[79] In addition, if a partner engages in a transaction with a partnership other than in its capacity as a member of the partnership, the transaction generally is considered as occurring between the partnership and one who is not a partner.[80]

Contributions to a partnership generally tax-free

No gain or loss is recognized by a partnership, or by any of its partners, on the contribution of property to the partnership in exchange for an interest in the partnership.[81] This rule of nonrecognition does not apply in the case of a partnership interest received in exchange for services (which are not considered property).

Transactions between partner and partnership

If a partner engages in a transaction with a partnership other than in his capacity as a member of the partnership, the transaction may be considered as occurring between the partnership and a person that is not a partner.[82] In general, this rule applies if a partner performs services for a partnership, and there is a related direct or indirect allocation and distribution to the partner, and the performance of the services and the allocation and distribution (when viewed

[77] Section 731(a)(2).

[78] Section 751(b).

[79] Sections 704(c) and 737.

[80] Section 707.

[81] Section 721. This nonrecognition rule does not apply to the transfer of property to a partnership that would be an investment company if it were a corporation (sec. 721(b)). If, in connection with the contribution to the partnership, there is a related direct or indirect transfer of money or other property by the partnership to a partner, the transfers may be treated as a taxable sale or exchange between partners or between the partnership and one who is not a partner (sec. 707).

[82] Section 707(a).

together) are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership.[83]

A separate rule governs the tax treatment of guaranteed payments to partners. Under the rule for guaranteed payments, to the extent they are determined without regard to the income of the partnership, payments to a partner for services are considered as made to one who is not a member of the partnership, but only for purposes of inclusion of gross income and deduction of compensation expense (subject to capitalization rules).[84]

<u>Dispositions of partnership interests taxable</u>

In the case of a sale or exchange of an interest in a partnership, gain or loss is recognized. This is treated as gain or loss from the sale of a capital asset.[85] However, the gain or loss is not treated as capital in nature to the extent it is attributable to unrealized receivables and inventory items.[86] Unrealized receivables include rights (contractual or otherwise) to payment for (1) goods delivered, or to be delivered that do not give rise to capital gain or loss, and (2) services rendered, or to be rendered.[87]

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[83] Section 707(a)(2)(A). A similar rule applies in the case in which a partner transfers property to the partnership.

84 Section 707(c). A similar rule applies in the case of guaranteed payments for the use of capital.

[85] Section 741.

[86] Section 751.

[87] Section 751(c). Unrealized receivables also include certain items generating ordinary income or gain under specified tax rules.

B. Treatment of Publicly Traded Partnerships

Present Law

Under present law, a publicly traded partnership generally is treated as a corporation for Federal tax purposes (sec. 7704(a)). For this purpose, a publicly traded partnership means any partnership if interests in the partnership are traded on an established securities market, or interests in the partnership are readily tradable on a secondary market (or the substantial equivalent thereof).

An exception from corporate treatment is provided for certain publicly traded partnerships, 90 percent or more of whose gross income is qualifying income (sec. 7704(c)(2)). However, this exception does not apply to any partnership that would be described in section 851(a) if it were a domestic corporation, which includes a corporation registered under the Investment Company Act of 1940 as a management company or unit investment trust.

Qualifying income includes interest, dividends, and gains from the disposition of a capital asset (or of property described in section 1231(b)) that is held for the production of income that is qualifying income. Qualifying income also includes rents from real property, gains from the sale or other disposition of real property, and income and gains from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber). It also includes income and gains from commodities (not described in section 1221(a)(1)) or futures, options, or forward contracts with respect to such commodities (including foreign currency transactions of a commodity pool) in the case of partnership, a principal activity of which is the buying and selling of such commodities, futures, options or forward contracts.

The rules generally treating publicly traded partnerships as corporations were enacted in 1987 to address concern about long-term erosion of the corporate tax base. At that time, Congress stated, “[t]o the extent that activities would otherwise be conducted in corporate form, and earnings would be subject to two levels of tax (at the corporate and shareholder levels), the growth of publicly traded partnerships engaged in such activities tends to jeopardize the corporate tax base.” (H.R. Rep. No. 100-391, 100th Cong., 1st Sess. 1065.) Referring to recent tax law changes affecting corporations, the Congress stated, “[t]hese changes reflect an intent to preserve the corporate level tax. The committee is concerned that the intent of these changes is being circumvented by the growth of publicly traded partnerships that are taking advantage of an unintended opportunity for disincorporation and elective integration of the corporate and shareholder levels of tax.” (H.R. Rep. No. 100-391, 100th Cong., 1st Sess. 1066.)

C. Comparison to Corporations and to Other Business Entities

1. Tax treatment of corporations

Corporation is a taxable entity

Income of a corporation is subject to Federal income tax at the corporate level. The top statutory marginal rate of tax on income of a corporation is 35 percent. The rate of tax on corporate capital gains is the same as that for ordinary income.

A corporation is generally recognized as an entity separate from its investors, that may receive income from business or other activities and that may make distributions to investors in the form of dividends to its shareholders, or interest to holders of its indebtedness.

Distributions by a corporation to shareholders generally taxable

Amounts distributed by a corporation to its shareholders as a dividend out of the corporation's earnings and profits generally are taxable to shareholders and not deductible by the corporation. Currently, the individual income tax rate on dividends is the same as the rate of tax on capital gains, generally 15 percent for 2007, in the case of qualified dividends.

If the shareholder is itself a corporation, however, the dividend is eligible for a dividends-received deduction of 70 percent to 100 percent, depending on the percentage of the recipient corporation's ownership of the payor corporation.[88] Distributions paid with respect to stock that exceed the amount of the paying corporation's current or accumulated earnings and profits are treated as nontaxable return of capital to the shareholders. To the extent such distributions exceed a shareholder's stock basis, the distribution is treated as capital gain.[89] A distribution may also be treated as capital gain to a shareholder, such that the shareholder can recover its basis in the stock before realizing taxable income, if it is treated as a sale of the shareholder's stock, due to a termination, substantially disproportionate redemption (as defined), or other reduction in the shareholder's interest in the corporation that causes the transaction to be not essentially equivalent to a dividend.[90]

A distribution of appreciated property by a corporation to its shareholders is generally taxable to the corporation as if it had sold the property at fair market value and recognized

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[88] In general, the dividends-received deduction is 70 percent if the corporate shareholder owns less than 20 percent of the stock of the distributing corporation; 80 percent if the corporate shareholder owns at least 20 percent and less than 80 percent of the stock of the distributing corporation; and 100 percent if the corporate shareholder owns 80-percent or more of the stock of the distributing corporation and the dividend is paid out of earnings and profits of a year or years when such ownership requirement was met. Section 243.

[89] Section 301(c).

[90] Section 302.

taxable income from the sale.[91] The shareholders are taxed on the amount realized based on the fair market value of the property distributed.

<u>Contributions to a corporation generally tax-free</u>

No gain or loss is recognized if property is transferred to a corporation solely in exchange for stock of the corporation, and immediately after the exchange, the contributing persons are in control of the corporation.[92] For this purpose, control means the ownership of stock with at least 80 percent of the total combined voting power of all classes of voting stock, and at least 80 percent of the total number of shares of all other classes of the corporation's stock.[93]

<u>Deductions against corporate income such as interest and amortization of intangibles</u>

A corporation, like other business entities, may generally deduct amounts paid or accrued as interest on debt.[94] A deduction is permitted for other ordinary and necessary business expenses, including compensation paid for services, rents or royalties for the use of tangible or intangible property. Like other business entities, a corporation is also entitled to deduct depreciation or amortization with respect to purchased property.[95] Present law provides a deduction for 15-year straight-line amortization of goodwill and certain other intangible assets that are purchased by the taxpayer.[96]

2. Tax treatment of other business entities

<u>In general</u>

In addition to partnerships, the Code provides for several other types of entities that generally are not taxed at the entity level.[97] However, those that allow public shareholders to

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[91] Section 311.

[92] Sections 351.

[93] Section 368(c).

[94] Section 163.

[95] Section 167. Section 1239 requires that the sale of depreciable assets that would otherwise produce capital gain to the seller will result in ordinary income if the sale is directly or indirectly between related parties (as defined).

[96] Section 197. Under anti-churning rules, no amortization deduction is allowed for assets that are acquired from a related party that held or used them within a specified time period prior to enactment of this deduction in 1993, and that were previously nonamortizable. Sec. 197(f)(9). Sales of these intangibles are also subject to the related party sale rules of section 1239.

[97] The mechanisms for eliminating tax at the entity level differ among the types of entities. The entities are referred to here generally as "non-taxed" entities. They do not all pass through the character of the income received; and some are subject to corporate level tax to the extent they do not either distribute their income or designate undistributed income as currently taxable to their beneficial interest holders.

invest in a vehicle that is not subject to entity-level tax generally are subject to restrictions regarding their structure, nature of income, nature of assets, and ownership of other entities. These limits reduce the potential for indirectly deriving non-permitted types of income through a related or controlled entity. Some of the restrictions limit the potential for extracting earnings of a taxable corporation as deductible amounts that reduce corporate-level tax when paid to the non-taxed entity.

S corporations

In general, an S corporation is not subject to corporate-level income tax on its items of income and loss. Instead, an S corporation passes through its items of income and loss to its shareholders. Each shareholder takes into account separately his or her pro rata share of these items on his or her individual income tax return. To prevent double taxation of these items, each shareholder's basis in the stock of the S corporation is increased by the amount included in income (including tax-exempt income) and is decreased by the amount of any losses (including nondeductible losses) taken into account.

Eligibility to elect S corporation status is limited. To elect, a corporation must be a domestic corporation which does not have (1) more than 100 shareholders; (2) as a shareholder, a person who is not an individual (other than certain trusts or estates and certain exempt organizations that, except for ESOPs, generally are taxable on their share of S corporation income); (3) a nonresident alien as a shareholder; or (4) more than one class of stock.

Trusts

Regulations governing the classification of entities as trusts or corporations provide that trusts generally do not have associates (for example, shareholders) or an objective to carry on business for profit. Thus, a trust cannot generally conduct an active business of any kind, nor can it engage in the purchase and sale of assets for profit.

A grantor trust is a trust whose grantor has retained the right to exercise certain powers over the trust. A grantor trust is not treated as a separate taxable entity. Instead, the grantor is treated as the owner of the trust's property and is subject to tax on trust income.

Regulated investment companies

A regulated investment company ("RIC") is an entity that receives most of its income from passive investments in stock and securities, currencies and similar instruments; in common parlance, a mutual fund. A RIC must be an electing domestic corporation that, at all times during the taxable year, is registered under the Investment Company Act of 1940 as a management company or as a unit investment trust, or that has elected to be treated as a business development company under that Act. A RIC also is subject to specific requirements with respect to the source of its income and the nature of its assets.

A RIC is an untaxed entity because it deducts dividends paid to shareholders in computing its taxable income. The dividends generally are included in the RIC shareholders' income. Thus, distributed income of a RIC is taxed only at the shareholder level, not at the regulated investment company level. A RIC generally is required to distribute at least 90 percent of its income during the taxable year as dividends to shareholders. A RIC is subject to detailed restrictions on permitted assets and investments.[98]

If RIC stock is "stapled" to the stock of another entity (such that an interest in one changes hands together with the interest in the other) and if such "stapled" stock represents more than 50 percent in value of the beneficial ownership of each of the entities, then the two entities are treated as one.[99] These rules limit the degree to which the shareholders of the RIC may derive income that would not be qualifying income for the RIC indirectly through a related entity, while retaining RIC status for the amounts of income that do qualify. These rules also provide a limit on the extent to which a RIC that is commonly owned with a taxable corporation might extract business income from the corporation in the form of interest or other deductible payments, or by causing the corporation to bear expenses of the RIC's operations.

<u>Real estate investment trusts</u>

A real estate investment trust ("REIT") is an entity that derives most of its income from passive real-estate-related investments. A REIT must satisfy a number of tests on an annual basis that relate to the entity's organizational structure, the source of its income, and the nature of its assets. If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to its investors each year generally is treated as a dividend deductible by the REIT and includible in income by its investors. In this manner, the distributed income of the REIT is not taxed at the entity level. The distributed income is taxed only at the investor level. A REIT generally is required to distribute 90 percent of its income (other than net capital gain) to its investors before the end of its taxable year.

In order for an entity to qualify as a REIT, at least 95 percent of its gross income generally must be derived from certain passive sources (the "95-percent income test"). In addition, at least 75 percent of its income generally must be from certain real estate sources (the "75-percent income test"), including rents from real property (as defined) and gain from the sale or other disposition of real property. Amounts received as impermissible "tenant services income" are not treated as rents from real property.[100] In general, such amounts are for services

[98] At least 50 percent of the assets of a RIC must consist of (i) cash and cash items, Government securities, securities of other RICs, and (ii) any other securities, provided that for purposes of this 50-percent calculation, they must be securities as to which the RIC owns not more than 10 percent of the outstanding voting securities of any one issuer and that are not greater in value than 5 percent of the assets of the RIC. Not more than 25 percent of RIC assets may be invested in (i) the securities of any one issuer (other than certain government securities or securities of other RICs), (ii) securities (other than of other RICs) of two or more issuers which the taxpayer controls (defined as 20 percent of the voting power or value of the issuer) and that are engaged in the same or similar lines of business, or (iii) securities of one or more qualified publicly traded partnerships.

[99] Section 269B. These stapled stock restrictions also generally apply to real estate investment trusts (REITs).

[100] A REIT is not treated as providing services that produce impermissible tenant services income if such services are provided by an independent contractor from whom the REIT does not derive or receive any income. An independent contractor is defined as a person who does not own, directly or

rendered to tenants that are not "customarily furnished" in connection with the rental of real property.

Rents from real property, for purposes of the 95-percent and 75-percent income tests, generally do not include any amount received or accrued from any person in which the REIT owns, directly or indirectly, 10 percent or more of the vote or value.[101] An exception applies to rents received from a taxable REIT subsidiary ("TRS") if at least 90 percent of the leased space of the property is rented to persons other than a TRS or certain related persons, and if the rents from the TRS are substantially comparable to unrelated party rents.[102] A TRS may conduct business or receive income from activities that would generate non-qualifying income if conducted by the REIT that owns the TRS securities. However, a REIT may hold no more than 20 percent of the value of its total assets in securities of a TRS.[103] Transactions between a TRS and a REIT are subject to a number of specified rules that are intended to prevent the TRS (taxable as a separate corporate entity) from shifting taxable income from its activities to the non-taxed REIT, or from absorbing more than its share of expenses. Under one such rule, a 100-percent excise tax is imposed on rents, deductions, or interest paid by a TRS to a REIT, to the extent such items would exceed an arm's length amount as determined under section 482.[104]

Real estate mortgage investment conduits

A real estate mortgage investment conduit is an entity used for securitizing mortgages on real estate.[105] A real estate mortgage investment conduit is not subject to tax at the entity level (except for a 100-percent excise tax on prohibited transactions, which include the receipt of compensation for services or other non-permitted income). Income or loss of the real estate mortgage investment conduit is taken into account by the holders of interests in the real estate mortgage investment conduit. Real estate mortgage investment conduits are subject to restrictions on organizational structure, income, assets, and permitted transactions.

Cooperatives

There are several types of cooperatives, including tax-exempt farmers' cooperatives and other corporations operating on a cooperative basis. In determining its taxable income, a

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indirectly, more than 35 percent of the shares of the REIT. Also, no more than 35 percent of the total shares of stock of an independent contractor (or of the interests in net assets or net profits, if not a corporation) can be owned directly or indirectly by persons owning 35 percent or more of the interests in the REIT.

[101] Sec. 856(d)(2)(B).

[102] Sec. 856(d)(8).

[103] Section 856(c)(4)(B)(ii).

[104] If the excise tax applies, then the item is not reallocated back to the TRS under section 482.

[105] Section 860A.

cooperative does not take into account the amount of patronage dividends to patrons of the cooperative. The cooperative deducts other distributions, including dividends paid on capital stock, and amounts distributed on a patronage basis to patrons during the taxable year. Patrons of the cooperative include in their income the amount of patronage dividends and other distributions made on a patronage basis. Thus, these amounts are subject to tax in the hands of the patrons, but not in the hands of the cooperative. To this extent, a cooperative is treated as a passthrough entity.

A cooperative can be a publicly traded entity; however, only patrons are entitled to the benefits of the pass-through treatment through the dividends paid deduction. To the extent the earnings of the cooperative are allocated or distributed to public shareholders that are not dealing with the cooperative patrons, the cooperative is subject to corporate level tax.

V. LEGISLATIVE PROPOSALS IN THE 110TH CONGRESS

H.R. 2834 (introduced by Messrs. Levin, Rangel, Stark, McDermott, Lewis of Georgia, Neal, Pomeroy, Larson of Connecticut, Blumenauer, Kind, Pascrell, Frank of Massachussets, and Mrs. Jones of Ohio)

The bill generally treats net income from an investment services partnership interest as ordinary income for the performance of services. Thus, the bill recharacterizes the partner's distributive share of income from the partnership, regardless of whether such income would otherwise be treated as capital gain, dividend income, or any other type of income. Such income is taxed at ordinary income rates and is subject to self-employment tax.

Net income means, with respect to an investment services partnership interest, the excess (if any) of (1) all items of income and taken into account by the partner with respect to the partnership interest for the partnership taxable year, over (2) all items of deduction and loss taken into account by the partner with respect to the partnership interest for the partnership taxable year.

The bill provides that an investment services partnership interest is a partnership interest held by any person who provides (directly or indirectly), in the course of the active conduct of a trade or business, a substantial quantity of certain services to the partnership. The services are: (1) advising the partnership as to the value of a specified asset; (2) advising the partnership as to the advisability of investing in, purchasing, or selling any specified asset; (3) managing, acquiring, or disposing of any specified asset; (4) arranging financing with respect to acquiring specified assets; (5) any activity in support of any of the foregoing services.

For this purpose, specified assets means securities (as defined), real estate, commodities (as defined), or options or derivative contracts with respect to such securities, real estate, or commodities. A security for this purpose means a (1) share of corporate stock, (2) partnership interest or beneficial ownership interest in a widely held or publicly traded partnership or trust, (3) note, bond, debenture, or other evidence of indebtedness, (4) interest rate, currency, or equity notional principal contract, (5) interest in, or derivative financial instrument in, any such security or any currency (regardless of whether section 1256 applies to the contract), and (6) position that is not such a security and is a hedge with respect to such a security and is clearly identified. A commodity for this purpose means a (1) commodity that is actively traded, (2) notional principal contract with respect to such a commodity, (3) interest in, or derivative financial instrument in, such a commodity, and (4) position that is not such a commodity and is a hedge with respect to such a commodity and is clearly identified.

The bill provides an exception to recharacterization as ordinary income for performance of services in the case of the portion of the partner's distributive share of partnership items with respect to the partner's invested capital. Invested capital means the fair market value at the time of contribution of any money or other property contributed to the partnership. The exception applies provided that the partnership makes reasonable allocation of partnership items between the portion of the partner's distributive share attributable to invested capital and the remaining portion. An allocation is not treated as reasonable if it would result in the allocation of a greater portion of income to invested capital than any other partner not providing services would have been allocated with respect to the same amount of invested capital.

The bill provides rules for the treatment of losses with respect to an investment services partnership interest, as well as for disposition of all or a portion of such a partnership interest and distributions of partnership property with respect to such a partnership interest. Consistently with the general rule providing that net income with respect to such a partnership interest is ordinary income for the performance of services, the bill provides that net loss with respect to such a partnership interest (to the extent not disallowed) is treated as ordinary loss. For this purpose, net loss means, with respect to an investment services partnership interest, the excess (if any) of (1) all items of deduction and loss taken into account by the partner with respect to the partnership interest for the partnership taxable year, over (2) all items of income and taken into account by the partner with respect to the partnership interest for the partnership taxable year. The net loss is allowed for a partnership taxable year, however, only to the extent that the loss does not exceed the excess (if any) of (1) aggregate net income with respect to the partnership interest for prior partnership taxable years, over (2) the aggregate net loss with respect to the partnership interest not disallowed for prior partnership years. Any net loss that is not allowed for the partnership taxable year is carried forward to the next partnership taxable year. Notwithstanding the present-law rule that the basis of a partnership interest generally is reduced by the partner's distributive share of partnership losses and deductions (sec. 705(a)(2)), the bill provides that no adjustment is made to the basis of a partnership interest on account of a net loss that is not allowed for the partnership taxable year. When any such net loss that is carried forward is allowed in a subsequent year, the adjustment is made to the basis of the partnership interest.

On the disposition of an investment service partnership interest, gain is treated as ordinary income for the performance of services, notwithstanding the present-law rule that gain or loss from the disposition of a partnership interest generally is considered as capital gain or loss (sec. 741; except ordinary treatment applies to the extent attributable to inventory and unrealized receivables, sec. 751). Loss on the disposition of an investment service partnership interest is treated as ordinary loss, but only to the extent of the amount by which aggregate net income previously treated as ordinary exceeds aggregate net loss previously allowed as ordinary under the bill.

On the distribution of appreciated property by a partnership to a partner with respect to an investment services partnership interest, the present-law rule providing that no gain or loss generally is recognized to a partnership on a distribution to a partner of property or money does not apply. Rather, the partnership recognizes gain as if the partnership had sold the property at its fair market value at the time of the distribution. For this purpose, appreciated property means property with respect to which gain would be realized if sold by the partnership at the time of distribution.

Under the bill, net income from an investment services partnership interest is subject to self-employment tax. Net income from an investment services partnership interest is derived from the performance by a person of a substantial quantity of services to the partnership in the course of the active conduct of a trade or business. This income falls within the definition of net earnings from self-employment, which generally includes a partner's distributive share (whether or not distributed) of income or loss from any trade or business carried on by the partnership (sec. 1402(a)), with certain exclusions. Because net income from an investment services partnership is treated as ordinary income for the performance of services, the present-law exception for gain or loss from the sale or exchange of a capital asset does not apply, even though the net income from the investment service partnership interest might otherwise be characterized as capital gain. The bill also provides that, in the case of a limited partner, the present-law exclusion for limited partners does not apply to any income treated as ordinary income from an investment services partnership interest that is received by an individual who provides a substantial quantity of the specified services.

Under the bill, a publicly traded partnership, more than 10 percent of whose gross income consists of net income from an investment services partnership interest, is treated as a corporation for Federal tax purposes under section 7704. The present-law exception to corporate treatment for a publicly traded partnership, 90 percent or more of whose gross income is qualifying income within the meaning of section 7704(c)(2), does not apply, because net income from an investment services partnership interest is not qualifying income within the meaning of section 7704(c)(2).

S. 1624 (introduced by Senator Baucus and Senator Grassley)

The bill provides generally that the exception from corporate treatment for a publicly traded partnership, 90 percent or more of whose gross income is qualifying income, does not apply in the case of a partnership that directly or indirectly derives income from investment adviser services or related asset management services. Thus, such a partnership is treated as a corporation for Federal tax purposes and is subject to the corporate income tax.

Under the bill, the exception from corporate treatment for a publicly traded partnership does not apply to any partnership that, directly or indirectly, has any item of income or gain (including capital gains or dividends), the rights to which are derived from services provided by any person as an investment adviser, as defined in the Investment Advisers Act of 1940, or as a person associated with an investment adviser, as defined in that Act. Further, the exception from corporate treatment does not apply to a partnership that, directly or indirectly, has any item of income or gain (including capital gains or dividends), the rights to which are derived from asset management services provided by an investment adviser, a person associated with an investment adviser, or any person related to either, in connection with the management of assets with respect to which investment adviser services were provided. For purposes of the bill, these determinations are made without regard to whether the person is required to register as an investment adviser under the Investment Advisers Act of 1940. In the absence of regulatory guidance as to the definition of a related person, it is intended that the definition of a related person in section 197(f)(9)(C)(i) apply.

For example, a publicly traded partnership that has income (including capital gains or dividend income) from a profits interest in a partnership, the rights to which income are derived from the performance of services by any person as an investment adviser, is treated as a corporation for Federal tax purposes under the bill. As a further example, a publicly traded partnership that receives a dividend from a corporation that receives or accrues income, the rights to which are derived from services provided by any person as an investment adviser, is treated as a corporation for Federal tax purposes under the bill.

Under the Investment Advisers Act of 1940 definition, an investment adviser means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities. Under this definition, exceptions are provided in the case of certain banks, certain brokers or dealers, as well as certain others, provided criteria specified in that Act are met. These exceptions apply for purposes of the bill. No inference is intended that income from activities described in the exceptions is qualifying income for purposes of section 7704.

The bill generally is effective for taxable years of a partnership beginning on or after June 14, 2007.

Under a transition rule for certain partnerships, the bill applies for taxable years beginning on or after June 14, 2012. The transition rule applies in the case of a partnership the interests in which on June 14, 2007, were traded on an established securities market, or were readily tradable on a secondary market (or the substantial equivalent thereof). In addition, the transition rule generally applies in the case of a partnership which, on or before June 14, 2007, filed a registration statement with the Securities and Exchange Commission under section 6 of the Securities Act of 1933 (15 U.S.C. 77f) that was required solely by reason of an initial public offering of interests in the partnership. However, the transition rule does not apply if the registration statement is filed with respect to securities that are to be issued on a delayed or continuous basis (pursuant to Rule 415 under the Securities Act of 1933). Thus, a shelf registration on or before June 14, 2007, of interests in a partnership does not cause the partnership to be eligible for the transition rule. Rather, in the case of such a partnership, the bill is effective for taxable years of the partnership beginning on or after June 14, 2007.

H.R. 2785 (introduced by Mr. Welch)

The bill is the same as S. 1624, except that it is effective for taxable years of a partnership beginning after June 20, 2007 (the date of introduction).

VI. FEDERAL TAX ISSUES AND ANALYSIS

Tax issues relating to carried interests

In general

The use of carried interests in asset management businesses raises conceptual questions under the income tax rules. In these arrangements, the investment fund typically is a partnership. The investors are limited partners that contribute capital to acquire fund assets, and the fund manager is the general partner of the investment fund partnership. The general partner is itself a partnership of individuals with investment management expertise. The fund manager receives management fees along with a carried interest. The carried interest is generally a profits interest in the investment fund partnership.[106] Because the character of a partnership's income passes through to partners, income from a carried interest may take the form of long-term or short-term capital gain realized by the underlying investment fund as the fund sells off investment assets.

Historically, labor income of individuals has generally been taxed at ordinary rates, while some forms of capital income[107] have generally been taxed at lower rates.[108] In addition, labor income generally is subject to employment tax (generally 2.9 percent for amounts over $97,500, in 2007). In 2007, for individuals generally, the top rate of tax on capital gain is 15 percent, while the top rate on ordinary income is 35 percent. When the employment tax is added, the top rate on ordinary compensation income is 37.9 percent. This rate differential is thought to be a motivating factor in taxpayers' choice to structure income as a carried interest that can give rise to capital gain rather than as fees or other ordinary compensation income. Carried interests may also be structured to achieve deferral of income compared to alternative structures.

[106] As described in the Background section of this document, generally a partnership profits interest generally gives the partner a right to receive a percentage of a partnership's profits without an obligation to contribute to partnership capital and without a right to partnership assets on liquidation.

[107] In general, capital income taxed at lower rates has historically included capital gain. Qualifying dividend income of individuals has been taxed at the same maximum rate as capital gain since 2003. This treatment is scheduled to expire at the end of 2010, as are the current maximum rates for both ordinary income and capital gain. However, during the 1970's, income from services was taxed at a maximum rate of 50 percent while investment income, including dividends, but not including capital gain, was taxed at a higher maximum rate of 70 percent. As an exception to the generalization that capital gains have historically been taxed at a rate lower than labor income, for taxable years beginning in 1988, 1989, and 1990, the maximum tax rates of individuals on all income, ordinary as well as capital gain, was 28 percent.

[108] When labor income and capital income are taxed at the same rates, then issues of the character of income (i.e., whether capital or ordinary) are much less significant. Some distinctions between capital and ordinary income would remain, however, even if the tax rate differential were eliminated. Unlike ordinary income treatment, capital gain treatment entitles investors to tax-free return of basis to the extent of basis in the asset. Another difference between ordinary and capital gain treatment is that capital losses are subject to a limitation on deductibility against ordinary income. Issues of timing (i.e., when income is taxed) are not affected by setting capital and ordinary income rates at the same level.

The use of carried interests is not limited to asset management businesses, but can extend to any business in which investors desire to align the interests of managers with those of investors by using positive investment yield as the measure of managers' income (though the loss of fund capital does not usually require the manager to contribute capital to the fund). However, this discussion is focused on carried interests used in asset management businesses, a feature of which is that the business income may include income taxed at lower rates.

Capital income or compensation

The primary question is whether the carried interest is a form of compensation for services, or whether it is more similar to a right to income or gain from capital. Related questions involve the interaction of the tax situations of the fund manager and fund investors.[109]

In many cases, it is fairly clear whether money is paid for services rendered, on the one hand, or for the use of capital as equity or debt, on the other hand. This distinction can become more difficult in a business activity involving capital assets and individuals' investment expertise with respect to the capital assets. Issues relating to the distinction between gains and earnings from investment in property, on the one hand, and income from the performance of services or from other types of businesses, on the other hand, can be found in many areas other than the asset management and investment advisory business. The distinction has been a general source of complexity.[110] Distinctions have been established legislatively for tax purposes in some instances, for example, a self-created copyright, which is treated as property that is not a capital asset.[111]

In the case of a fund manager's carried interest, it is argued that, regardless of the capital structure of an investment fund and its manager, the carried interest arrangement primarily involves the performance of services by individuals whose professional skill generates capital income for investors in the fund. While these individuals' economic interests are aligned with

[109] For example, the structure of a particular investment vehicle can depend in part on tax issues for investors such as unrelated business income tax on tax-exempt investors, imposition of U.S. income tax, return filing obligations, and withholding on foreign investors, and deduction limitations for U.S. taxable investors. The potential for deferral of manager compensation raises additional issues. These issues are discussed in *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part II* (JCX-63-07), September 4, 2007. This document is available on the internet at www.house.gov/jct.

[110] *See, e.g., Comm'r v. Jose Ferrer,* 304 F.2d 125 (2d Cir, 1962), *rev'g* 35 T.C. 617 (1961), involving a disputed distinction between compensation for acting services, on the one hand, and capital gain from the disposition of property rights in the resulting productions, on the other. *See also* Bittker and Lokken, *Federal Income Taxation of Income, Estates, and Gifts,* (Third Edition, 1999) p. 3-73.

[111] *See, e.g.,* section 1221(a)(3)(A), providing that certain copyrights and other property in the hands of a taxpayer whose personal efforts created the property are not a capital asset and thus are not eligible for capital gain treatment; section 751 (gain on sale of a partnership interest is not capital gain to extent it reflects certain unrealized receivables, including certain rights to payment for services); section 7701(e)(1) (providing for recharacterization of a services contract as a lease in certain situations).

those of the fund investors to the extent their compensation is based on the positive investment yield of the fund, the individuals are nevertheless performing services. Therefore, the income should be taxed as ordinary compensation income.

In this connection, it is argued that common aspects of carried interest arrangements support compensation treatment. Time and effort clauses relating to the manager or to specific key persons arguably suggest that the fund manager is required to perform services under the carried interest arrangement. In the case of hedge funds, the income of which is often subject to ordinary rates as short-term gain or ordinary income, some point to the fact that the fund manager often receives a carried interest from the U.S. portion of the fund and receives a similar income stream denominated as compensation from the offshore portion of the fund, suggesting that both income streams are compensation for services. Similarly, some argue that clawback and hurdle rate restrictions on payment of carried interests give rise to an analogy to performance-based compensation; that is, the carried interest provides that amounts become payable only when the investment performance of the fund being managed surpasses a hurdle rate.[112]

This type of argument would suggest that income from a carried interest, in respect of which the investment manager contributes no capital to the fund, resembles compensation for services. This is the case even though income generated through the carried interest is otherwise capital gain and dividend income, for instance.[113] Income from a carried interest can be distinguished from the service provider's separate return on any capital that the manager contributes to the business, under this view, and from the capital contributed by the limited partner investors, who are owners rather than mere financers of the mangers' capital.

Carried interest as implementing partners' shared tax reduction

A carried interest arrangement can alternatively be viewed as a sharing by the fund manager and the investors of favorable tax treatment in such a way as to minimize their aggregate tax.[114] Under this analysis, if the investors and the manager were subject to tax at the same rates, and if the investors could fully deduct any compensation included in the manager's income, there would be no tax advantage to choosing to structure the arrangement as a partnership carried interest rather than as ordinary compensation. This result would follow

[112] It has also been pointed out that in registration statements filed with the Securities Exchange Commission when fund management firms go public, it is asserted that the fund manager's business is the performance of investment advisory services, for purposes of whether or not the entity going public is subject to the Investment Company Act of 1940. See Victor Fleisher, "Blackstone IPO: Analysis of the Tax Risk," March 25, 2007, http://www.theconglomerate.org/2007/03/blackstone_ipo_.html

[113] Capital gain and dividend income of a partnership retains its character as such for tax purposes in the hands of the partners, i.e., the individual managers. This passthrough treatment is described in the section of this pamphlet entitled Tax Treatment of Partnerships and Partners.

[114] See Chris William Sanchirico, "The Tax Advantage to Paying Private Equity Fund Managers with Profit Shares: What is it? Why is it bad?," *Institute for Law and Economics, University of Pennsylvania Law School Research Paper No. 07-14*, August 19, 2007, http://ssrn.com/abstract_996665.

because any Federal income tax benefit shifted to the fund manager would yield a precisely offsetting tax detriment to the investors. For example, to the extent the manager's income is treated as a share of overall partnership profits taxable at capital gains rates, rather than as compensation taxable to him at ordinary rates but deductible to the investors, the investors lose the compensation deduction.[115]

The carried interest arrangement is more tax-efficient than a deductible compensation arrangement, however, if the investors do not lose the tax benefit of the deduction when the manager's income is converted from ordinary income taxed at higher rates to capital gain (derived through a carried interest) that is taxed at lower rates.[116] This arrangement could be viewed as a sharing of the tax benefit of the lower capital gain tax rate as between the manager and the investors. Alternatively, it could be viewed as a sharing of the tax benefit of the tax-favored status of a tax-exempt or foreign investor as between the manager and the investors. In either case, a question that is presented is whether it is appropriate to permit the general partner to have favorable tax treatment premised on an offsetting tax disadvantage to limited partners, when by virtue of the limited partners' tax status, no such disadvantage occurs.[117]

In addressing this question, it could be said that a rule designed to treat income from a partnership profits interest as ordinary only if other partners have a tax-favored status raises administrability concerns. It could also be argued that such a distinction is unnecessary, as taxpayers are motivated by economic self-interest to utilize the carried interest arrangement only when shared tax reduction of all the partners is maximized. Thus, market forces effectively narrow the use of fund managers' carried interests to this type of situation, so the tax law need not define and single out such situations.

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[115] The manager's carried interest, unlike deductible compensation, reduces the investors' shares of overall partnership income by shifting a share of overall partnership income from them to the manager. The carried interest is economically equivalent to deductible compensation, but the tax impact of the two arrangements may be different if the partners' tax rates or tax situations differ.

[116] This situation can arise if the investors were never entitled to the deduction, such as investors that are tax-exempt or foreign persons not subject to U.S. tax, or are not entitled to a full compensation deduction on a current basis. For example, such an investor might be a taxable corporation with NOLs (reducing the current value of the deduction to it), or an individual subject to a deduction limitation (such as the alternative minimum tax, the 2-percent floor on miscellaneous itemized deductions, or the overall limitation on itemized deductions). Other limitations, such as the $1 million cap on deductible employee compensation fur public corporations, or the rules matching the timing of the deduction for compensation that is deferred, could also tend to have this effect.

[117] A corollary question stemming from the same factual analysis of the partners' mutual tax situations is whether the tax treatment of carried interests should be changed because they are facilitating avoidance of deduction limitations such as the alternative minimum tax, the 2-percent floor on miscellaneous itemized deductions, or the overall limitation on itemized deductions. On the other hand, it could be said that the tax policy issue of whether these deduction limitations are avoidable is distinct from the tax policy issue of whether carried interests of fund managers resemble compensatory interests or not, and that these distinct tax policy issues should be addressed separately rather than being conflated.

Further, this approach fails to take into account the 2.9 percent employment tax for amounts over $97,000, which would still be a net tax detriment in the situation in which investors and fund managers subject to tax at the same rates include, and deduct, ordinary compensation to the manager. Another perspective is that the tax law already includes a number of rules that serve to limit the shifting of tax benefits, and arguably, the complexity added by another such limitation targeted to a narrow situation involving partners with specific tax attributes would outweigh any improved accuracy of income measurement. To the extent such a rule depends on the tax status of partners other than the fund managers, it could be said that such a rule does not address the basic question of whether the fund manager's income is compensatory in nature and should be treated as ordinary, nor does it address the horizontal equity concern that some fund managers' compensation for services can be structured to be taxed at lower rates, while other taxpayers' compensation for services is taxed at ordinary rates.

Non-taxation of imputed income

It may be argued that a carried interest of a fund manager represents a bundling of capital income and labor income, but in this situation these types of income are too closely intertwined for them to be practicably separated.[118] Under this view, an analogy can be drawn to an individual investor who works to manage his own assets. Conceptually, the investor has imputed labor income from this work that the present-law rules do not separately tax. This is the case even though if the investor hired another person as his investment manager, the other person's income from the investment management activity would be separately taxed. Based on the analogy to non-taxation of imputed income from managing one's own assets, it is argued that the fund manager's income should not be taxed as labor income either.

A variant of this argument is that the general partner effectively is itself the investment fund, and the limited partners are simply providers of temporary or rented capital to the general partner. Alternatively, the carried interest arrangement is merely a financing by the other investors of the manager's large capital investment in the fund. The fund manager is conceptually the fund owner, and the investors can be viewed conceptually as lenders. Again, by analogy to the non-taxation of imputed income from managing one's own assets, the fund manager arguably should not be taxed on labor income.

Nevertheless, the fund manager does not have imputed income, but rather, has actual income from the carried interest, so that the analogy to imputed income may not be relevant. Moreover, for this analogy to work, it must be assumed that the capital in the investment fund is

[118] Some transactions that bundle together labor income and capital income are not unbundled for Federal tax purposes. Trying to impute separate income streams in the absence of any cash flows between taxpayers would be needlessly complex, difficult to understand, and time-consuming for taxpayers and the tax administrator, and probably would not materially change the taxpayers' net tax consequences if their tax rates are similar or the same. An example of this might be a "free" checking account held by a business at a commercial bank. This could be analyzed as if the checking account owner deposits money that earns overnight rates of interest, and the bank provides financial services (honoring and clearing checks) in return for compensation equal to the interest. As a practical matter, this transaction is not unbundled into these components.

owned entirely by the fund manager, an unsustainable assumption. Such an assumption would be inconsistent with the idea that the fund manager has only a partnership profits interest, not a partnership capital interest.[119] It would also be inconsistent with the passthrough to investors, as partners, of a share of long-term capital gain earned by the fund (rather than treating investors as lenders whose return consists of interest on capital loaned to the manager). Further, it is questionable whether the Internal Revenue Service and the courts would respect as debt (rather than limited partners' equity) an arrangement in which the limited partners loaned the entirety of their contributed capital to the fund manager on a nonrecourse basis, particularly if the taxpayers structure the transaction as limited partnership interests rather than as debt.

Furthermore, the bundling concept as applied to a carried interest could be questioned. Generally, a carried interest does not require a capital contribution to the partnership, nor does it provide rights to receive partnership assets on liquidation of the partnership;[120] any capital that the fund manager general partner contributes can be separated from the carried interest. While the investors may demand that the fund manager contribute nominal or significant capital to the investment partnership and maintain a capital interest in the investment partnership, it is not part of the carried interest, which is a pure profits interest and not intrinsically bundled with any capital.

Risk taking

Another argument relates to risk-taking. It is argued that the fund manager takes risk by investing substantial time and effort in managing the fund, and receives economic returns on the carried interest only if the underlying investments are successful (not taking into account management fees). Particularly in the venture capital context, it is argued that the fund manager assumes socially desirable risk by financing and providing management services to fledgling businesses that, when successful, increase the size and productivity of the economy. Capital gain treatment is accorded when risk is taken, and therefore is appropriate in this situation.

The risk argument can be criticized, however, in that the capital gains rates apply to the disposition of capital assets, not to risk-taking in general that does not involve capital assets. Further, the capital gains tax rates apply to the disposition of capital assets that are not risky, or have little risk, such as the sale of U.S. Treasury debt with a yield close to the risk-free rate of return. Moreover, the capital gains tax rates do not apply to many types of income related to risk-taking. For example, capital gains rates do not apply to employee compensation that is performance-based, contingent on meeting sales targets or other performance measures. To the extent that the fund manager is risking his time and effort, but not his money, it is argued that the risk rationale for capital gains treatment does not apply.

[119] Receipt of a partnership capital interest for services is a taxable event under present law (see the section of this document on Tax Treatment of the Receipt of a Partnership Profits Interest for Services). This is a less favorable tax result than if the partner held only a partnership profits interest.

[120] As described in the Background section of this document, the partner does not have rights in liquidation of the partnership once his profit share is distributed to him.

Analogy to “sweat equity”

A related argument involves the analogy to other types of businesses in which the business owner contributes “sweat equity” by providing his labor in the business. The business owner is said to have a tax advantage, in that his ownership interest in the business gives rise to capital gain on sale.[121] For example, the owner of a widget business, whose labor causes the business to increase in value, generally is entitled to capital gain treatment when he sells the widget business. Similarly, if a person in a service business, for example, a barber, sells the barbershop, he has capital gain on the sale. It is argued that the sweat equity of investment fund managers does not differ from other types of businesses, and that denying capital gain treatment in the case of the fund management business unfairly singles out one type of business activity for less favorable tax treatment.

A variant of this argument relates to “founder's equity.” An individual entrepreneur -- founder of a business -- who starts up a new enterprise that is successful is generally entitled to capital gain treatment on the sale of the business. It is argued that the activity of a venture capital fund manager in financing and helping to manage startup businesses is the same type of activity, and should also be entitled to capital gain treatment. However, later-arriving owners of the business who did not participate in startup activities also are entitled to capital gain treatment, potentially weakening the analogy to founders or entrepreneurs. It may be observed that for purposes of capital gain treatment on sale of a business, present law does not distinguish among an individual who starts a business, an owner who resuscitates a failing business, an owner who labors in a successful business, and an owner who merely contributes capital passively to a business. Generally, capital gain treatment applies in all of these cases.

In response to the assertion that fund manager's carried interest resembles sweat equity or founder's equity and should be accorded capital gain treatment, some point out that this argument proves too much with respect to the operating income of the business. Generally, operating income of a business is taxed at ordinary rates as it is earned. For example, in a widget business, as widgets are manufactured and sold, the operating income of the business from inventory sales is subject to tax as ordinary income. Similarly, a barber has income as he takes payment for haircuts. In these situations, inventory income and services income are taxed currently. This current taxation of operating income at ordinary rates differs from treatment of fund managers' carried interests: deferral until the fund's portfolio assets are sold, and conversion of operating income from investment advisory services to capital gain.[122]

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[121] See Victor Fleisher, “Two and Twenty: Taxing Partnership Profits in Private Equity Funds,” Legal Studies Research Paper Series, Working Paper no. 06-27, March 11, 2007, revised June 12, 2007.

[122] It could be argued that a rule treating gain or loss from sale or disposition of a fund manager's partnership profits interest as ordinary compensation is inconsistent with the present-law treatment of sweat equity on sale of a business as capital gain. On the other hand, if current income under a carried interest is taxed as ordinary compensation, but gain on sale of the interest is capital gain, and income deferral is an acceptable or desirable outcome, then ordinary income treatment on the sale of the profits interest is arguably a necessary anti-avoidance rule, even though it might appear inconsistent with taxing "sweat equity" on sale of a business as capital gain.

A related point is that the more appropriate analogy to sweat equity, in the case of a fund manager, is not to the ongoing income received through a carried interest, but rather, to the tax treatment on sale of a fund manager's interest in his fund management firm. This situation would arise if an individual who is a partner in a fund manager partnership sells his partnership interest to someone else. Any analogy to capital gain treatment should, it is argued, apply to that sale transaction, rather than to the income of the investment fund managed by that partner. Proponents of this view point out that present law provides that the sale or exchange of a partnership interest generally gives rise to capital gain, except to the extent that the amount realized is attributable to inventory or to accounts receivable, including rights to payment for services rendered or to be rendered. Thus, it may be argued that present law properly treats sweat equity of a fund manager – or any partner who is a service provider – as capital gain to the extent of his capital interest, but as ordinary compensation income to the extent of his right to payment for services.

Reduction in returns to pension funds and other institutional investors

Some have argued that taxing income from carried interests as ordinary would reduce the investment returns of pension funds and other investors in alternative investment funds. Under this argument, a change in the taxation of carried interests could lead management firms to increase the management fees and the carried interest percentages they charge their limited partner investors, with the ultimate effect that returns to workers and other individuals who are beneficiaries of the institutional investors in alternative investment funds would be reduced. Others respond that the commercial arrangements between management firms and the investors in the funds they manage are determined by market forces, and that if fund managers could demand a larger share of the yield of the investment fund, they would already have done so without regard to their tax liability.

A related argument is that, if tax rates on management firms rise, fewer individuals would pursue that career, and investment management charges would have to rise for that reason. Nevertheless, the opportunity for individuals with skills in asset management but little capital of their own to achieve high income would arguably ensure a sufficient supply of individuals to engage in this activity.

Income previously taxed

It is also argued that capital gain treatment is appropriate for carried interests of fund managers because the operating income of the underlying portfolio companies held by the fund has already been taxed as ordinary income at the portfolio company level. Thus, it is argued, all the income earned by a private equity fund has already borne corporate-level tax, so there is no reason to impose ordinary income tax again on the fund manager when it receives its profit share of the operating income of the fund (i.e., the profits the funds realizes on the sale of portfolio company stock).

On the other hand, this point conflates two different business activities: (1) the underlying business of the portfolio company in which the investment fund invests, and (2) the investment advisory service business of the management firm that is the general partner of the investment fund. The fact that the business profits of a portfolio company have been taxed to the portfolio company does not mean that the business profits of the investment advisory business should not also be taxed as ordinary income, according to this view.[123] It could also be said that if taxing the portfolio company's business profits were equivalent to taxing the investment advisory firm's business profits, then the investment advisory firm should pay no tax, an argument that proves too much.

Additional complexity

It is said that characterizing income from carried interests as ordinary compensation income introduces significant additional complexity to the already complex tax law relating to partnerships. Such a rule may cause taxpayers to engage in tax-motivated restructuring of current and future business arrangements between fund managers and investors in the funds in order to avoid the tax cost of ordinary income treatment to the manager. It is also said that fund managers may be motivated to increase the carry percentage beyond the traditional 20 percent to a greater percentage to compensate for the cost of the tax change. The additional complexity and the tax-motivated behavioral responses to such a change in the tax rules create inefficiencies and distortions in the economy that reduce overall productivity.

Nevertheless, the preference for simplicity in the tax law must be balanced with fairness and accuracy of income measurement. It is said that the perception that taxpayers with income from different categories of personal services are taxed at disparate rates may increase noncompliance among taxpayers who believe that they are over-taxed or who believe that the tax system is inherently unfair. Such a result violates the principle of horizontal equity (the principle that similarly situated taxpayers should be subject to similar tax burdens). It is argued, for example, that low-income workers do not have the opportunity to structure their personal services income as capital gain, and must pay tax on compensation at a higher marginal rate than highly-paid fund managers. Thus, the detriment of additional complexity must be weighed against the benefit of increased accuracy of income measurement and an increased perception of fairness, necessary aspects of a self-assessing income tax system. The impact of the tax change relating to carried interests would arguably affect a relatively small number of high-income individuals, so that the detriment of any added complexity in the tax law would be more than offset by the benefits of increased accuracy of income measurement and an improved perception of fairness in the tax system.

Tax incentive for specific activities

Another way of viewing the issue is to ask whether or not the activities engaged in by fund managers should be given an incentive through the tax law in the form of preferential tax rates on their income. On the one hand, it can be argued that (depending on the investment strategy of the fund, and other factors), fund managers may be increasing the efficiency of the economy by restructuring businesses in which they invest so as to maximize their value, or for

[123] It is possible, particularly in some types of funds with particular investment strategies, such as buyout, turnaround or distressed business investment funds, that some portfolio companies may themselves pay little or no tax on a current basis due to poor previous economic performance or high leverage.

some types of funds, may be making financial markets more efficient. On the other hand, some might say that the funds' investment strategy as determined by the fund managers may serve to strip out value from the businesses in which the fund invests for the benefit of fund investors but without added value or increased productivity in the economy. A related point is that a tax incentive for carried interests in investment funds (which have historically been privately rather than publicly owned) tends to favor private over public ownership of businesses, whereas the tax law should be neutral and not prefer one over the other. It could also be said that, regardless of whether the activities of investment funds and their managers are desirable, no tax incentive is needed for the activity, and that any tax subsidy would be a windfall to persons who would conduct the activity regardless of whether a preferential tax rate applies.

Timing and valuation considerations

If the income from a carried interest is treated as compensation subject to tax as ordinary income, an important question is the timing and amount of the income. The Internal Revenue Service currently takes the position that the receipt of a partnership profits interest is not generally a taxable event to the partner or to the partnership unless unusual circumstances indicate the interest is easy to value and it is held for a relatively short time. As acknowledged by the Internal Revenue Service in taking this position, however, courts have reasoned that the value of the profits interest for services should be included in income on receipt.[124] The Internal Revenue Service has proposed regulations attempting to mesh conceptually inconsistent present-law statutory rules that provide, on the one hand, that contributions of property to a partnership in exchange for a partnership interest are not taxable, and on the other hand, that property received for services is generally included in income at its fair market value.[125]

An obstacle to the practical application of the approach of taxation of profits interests on receipt has been that valuation of partnership profits interests has proved factually difficult. The valuation difficulty arises because the profits interest depends on the future profitability of a business which may be extremely speculative, where, as is often the case, there is no current public market for interests in the partnership that would aid valuation at the time the profits interest is granted.[126] Difficulty of valuation would be an issue at the time a nonpublicly traded partnership profits interest is received by the partner, even if the partnership later goes public, establishing a market value for partnership interests at that later time.[127] A further difficult

[124] This is described in the section of this document entitled Tax Treatment of the Receipt of a Partnership Profits Interest for Services.

[125] This is described in the section of this document entitled Tax Treatment of Property Transferred in Connection with the Performance of Services.

[126] Courts and the Internal Revenue Service have acknowledged the difficulty of valuing partnership profits interests; see the section of this document entitled Tax Treatment of a Partnership Interest Received for Services.

[127] The recent going public transactions have generally involved formation of new entities to hold carried interests that were established in earlier years. While some have argued that valuation techniques have been created that help to determine value in the absence of market value, it is also argued that these

aspect of this approach is that if a profits interest were taxed to a partner on receipt of the interest, the partnership rules would require addition of a potentially complex mechanism to prevent double taxation when profits are later realized.[128]

If, alternatively, the timing of the compensation is not considered to be at the time of receipt of the profits interest, but rather, as the partner's share of partnership profits is realized, other issues arise. The idea that a partner's distributive share of capital gain and dividend income can be recharacterized as compensation could be viewed as inconsistent with the notion of a partnership as an aggregate of its partners. A partner should not be considered as an employee of the partnership, but rather, as a participant in a joint venture with the other partners, under this view. In response, it is argued that the partner is performing services measured by capital income, whether he is providing those services to a third party through a partnership in which he is a partner, or as an individual performing these services for a third party. The interposition of a partnership does not change the nature of the income as services income, under this view. It could also be argued that this approach avoids the practical obstacles to imposing tax on partnership profits interests on receipt.

Employment tax

A corollary issue relates to the employment tax treatment of payments of income received under a carried interest. Because capital gain income is not subject to employment taxes, the desire to avoid the application of the 2.9 percent hospital insurance tax (which is not subject to an income cap) may be one reason that taxpayers wish to structure payments as carried interests. However, to the extent such interests are viewed as payments for compensation, failing to subject them to employment taxes, while other compensation is subject to such taxes, can lead to distortion and economic inefficiency. Thus, if carried interests are viewed as properly characterized as compensation for services, it would be consistent with the general tax treatment of such compensation to apply employment taxes.

Loan approach to taxing carried interests

An alternative approach to the tax treatment of carried interests is to view the managers' carried interest as a loan of a percentage of the invested capital, made by the investors to the

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valuation techniques are subject to volatility and other assumptions and may not be particularly accurate. See Lee A. Sheppard, "Blackstone Proves Carried Interests Can Be Valued," *Tax Notes*, June 25, 2007, 1236.

[128] Presumably, the value of a partnership profits interest depends on the size and timing of the expected future income stream from the profits interest. Under an approach taxing the value of a profits interest on receipt, this value would be the amount realized by the partner upon grant. The partner would be taxed again on his distributive share of subsequent partnership income as it is earned by the partnership, whether or not the income is distributed to him. Partnership distributions generally are not taxed, except, for example, if money distributed to a partner exceeds the partner's adjusted basis in its interest. Thus, adding to the partner's basis the amount realized on a taxable receipt of a profits interest would not fully prevent double taxation of the partner's share of later-realized partnership income. Rather, a more complex concept of previously taxed income would probably be necessary.

managers, and to consider the possibility that the parties might directly structure such a loan. One possible legislative approach has been suggested that would recharacterize the carried interest as such a loan and, to the extent that any interest charged by the investors for this loan, in the form of their preferred return rate, is below an "adequate" interest rate, would tax the non-charged interest as compensation to the managing partner. It is argued that that this approach would anticipate the possibility that if all the income from a manager's carried interest were taxed as ordinary income, the parties could restructure the carried interest to the form of a loan, claiming that the "borrowed" capital should be viewed as capital invested by the managing partner, and the return on it entitled to capital gain.[129]

One significant issue under such an approach is identifying an appropriate market interest rate against which to measure the "bargain" compensation element. It has been suggested that the applicable Federal rate ("AFR"), a U.S. Treasury debt-based rate, be used as a measure of "adequate" interest.[130] Because the fund investments are frequently risky enough that very high rates of return are contemplated, the use of a Treasury debt rate, generally considered to be a "risk-free" rate, may not be appropriate. A managing partner that provided such a rate would avoid any ordinary income treatment. It could also be argued that the yield may be so much higher than the AFR that this return cannot be interest, but rather is some other form of earnings.

An additional conceptual issue relating to this approach is whether it is appropriate to treat an interest in a venture that is acquired with non-recourse debt from the venture or its investors, as an interest that was "purchased" at the time the debt was incurred.[131]

<u>Alternatives to carried interests; application of deferred compensation rules</u>

Alternatives to carried interests that provide economic benefits similar to partnership profits interests may also be used to provide compensation for fund managers. In considering the tax treatment of carried interests, it may be appropriate to consider the alternative arrangements and whether they are sufficiently comparable that similar tax treatment should apply to them.

One alternative in the corporate context is to seek to limit currently taxable compensation income by using two classes of stock with differing rights and, consequently, differing values

[129] Victor Fleischer, "Two and Twenty: Taxing Partnership Profits in Private Equity Funds," Legal Research Paper Series, Working Paper Number 06-27 (March, 2006, revised June 12, 2007). The paper refers to this approach as the "Cost of Capital" approach. The paper does not conclude that this approach should be adopted legislatively. However, the paper considers the possibility of self-help adoption of such an approach, which it considers "perfectly acceptable from a tax policy viewpoint."

[130] *Id.* Section 7872 uses the AFR as the rate against which to measure when stated interest is inadequate in certain situations, with the result that additional interest will be imputed if it has not been stated. However, section 7872 only imputes interest at the AFR.

[131] *Compare* Treas. Reg. Sec. 1.83-3(a)(2), which states: "[I]f the amount paid for the transfer of property is an indebtedness secured by the transferred property, on which there is no personal liability to pay all or a substantial part of such indebtedness, such transaction may be in substance the same as the grant of an option."

(for example, common stock and convertible preferred stock). For example, in the context of specific buyout or venture capital transactions involving corporations, managers may make a small equity investment in exchange for stock said to have little immediate value but with a potential for participation in future appreciation, while investors take a different type of stock interest for their investment. The managers may then make an election to include the low or zero asserted value of its stock interest in income when received, leaving the upside to be taxed as capital gain. This may produce returns comparable to those of managers of and investors in private equity or venture capital partnerships, including the manager's right to participate in the upside of the investment.[132]

In some cases, as an alternative to the use of a partnership profits interest, fund managers' interests may be structured as a contractual arrangement to pay compensation based on the profits of the fund. In such cases, the issue of proper characterization of the income as capital or ordinary does not arise, as the income is compensation for services. In such cases, however, the compensation may be deferred (as may be the typical two percent up-front management fee where there is also a carried interest). Questions have been raised as to whether deferral of the compensation for management services is appropriate.[133]

Deferral and conversion of fees

In some circumstances, taxpayers may seek to convert management fees, which are generally subject to tax as ordinary income, to an arrangement that achieves deferral of income recognition, or conversion to capital gain treatment, or both. Under these arrangements, tax issues may be raised. Exchanging or relinquishing a right to a fee may raise issues under the rules requiring current inclusion of the value of property transferred in connection with the performance of services, if the person entitled to the fee receives a right constituting property in the exchange. In the partnership context, the transaction, and the arrangement in lieu of the fee, may implicate the guaranteed payment rules, or the rules treating services performed by a partner when there is a related direct or indirect allocation and distribution to the partner as a transaction between the partnership and a person who is not a partner.

Tax issues relating to publicly traded partnerships

Another question involves whether, as a matter of tax policy, a business that derives income from asset management and investment advisory services and that takes the form of a

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[132] *See* Ronald J. Gilson and David M. Schizer, "Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock," Practicing Law Institute, Tax and Estate Planning Course Handbook Series, Tax Law and Practice, No. 9062 (2006). There may be disadvantages to applying this structure to replicate an investment partnership that would make multiple investments through a single entity.

[133] See *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part II* (JCX-63-07), September 4, 2007. This document is available on the internet at www.house.gov/jct.

publicly traded partnership should be subject to tax as a corporation.[134] In an income tax system with a corporate income tax, Congress has enacted rules limiting passthrough (and untaxed) entity treatment. Passthrough and untaxed entities (such as partnerships, S corporations, mutual funds, and real estate investment trusts) are subject to significant restrictions under the tax rules that either prohibit public tradeability of interests (or make it impracticable), or limit the permitted income, assets, structure, and activities of the entity while permitting its interests to be publicly traded. Publicly traded partnerships generally are subject to tax as corporations (with certain exceptions), because they are considered to resemble corporations in that both have access to capital markets through issuance of traded interests in the entity.

It can be said that an asset management business tends to generate income such as capital gains and dividend income that is treated as qualifying income of a publicly traded partnership, and thus falls within the bounds of the present-law exception to corporate treatment of publicly traded partnerships. Arguably, nothing in the rules or their legislative history specifically excludes this type of business, but rather, the types of qualifying income listed in the statute explicitly include these, without any requirement to look through lower-tier entities or to investigate the fundamental nature of the income.

On the other hand, it can be argued that, when the limitations on eligibility for passthrough treatment of publicly traded partnerships were enacted in 1987, only a few types of businesses had taken the form of publicly traded partnerships. The types of income that those businesses generated served to make up the listed qualifying income, without any intent to extend the publicly traded partnership form to other types of business. Rather, the concern was to limit the use of publicly traded partnerships so as to prevent disincorporation and erosion of the corporate tax base. Consequently, it may be inconsistent with the tax policy, and the purpose, of the publicly traded partnership tax rules to permit passthrough treatment to a publicly traded partnership with such income.

Tax issues relating to corporate earnings stripping

A related issue involves the inclusion in a partnership structure of corporations that receive income that is not qualifying income under the publicly traded partnership rules, and that distribute it in the form of qualifying income such as dividends or interest. For example, a publicly traded partnership may own a corporation that receives income in the form of management fees, and distributes income to the publicly traded partnership as dividends.[135] Such a structure is not explicitly prohibited under the statutory rules, and may not be inconsistent

[134] This analysis applies whether the business derives any income from these activities, or alternatively, derives more than a certain portion of its income from these activities. Under present law, an exception to corporate treatment of publicly traded partnerships applies if at least 90 percent of the partnership's income is qualifying income, including such income as dividends, interest, and capital gain, but does not include compensation for services.

[135] Such a corporation is known as a "blocker" corporation, for blocking non-qualifying income from the upper-tier entity (in this case, the publicly traded partnership). This document does not address the use of blockers in contexts other than by publicly traded partnerships.

with the purpose of the tax rules to prevent erosion of the corporate tax base if such income is subject to tax in the hands of the recipient corporation.

On the other hand, the arrangement may be inconsistent with the purpose of the publicly traded partnership rules if the income is subject to little or no tax at the corporate level, and is paid to a publicly traded partnership that is a passthrough entity. In this circumstance, the income is not subject to corporate income tax, even if its original character (management fees, in the above example) was not that of qualifying income for the publicly traded partnership. A corporation may be subject to little or no tax if it has substantial deductions to offset its income. There may be a potential for related party transactions such as interest paid to the partnership, or costs borne by the corporation that benefit the partnership, to reduce the corporate level tax.[136] By comparison, other publicly-traded non-taxed entities such as RICs and REITs are subject to restrictions limiting the potential for such transactions.[137] If untaxed (or lightly taxed) corporate income is distributed to a publicly traded partnership that is treated as a passthrough entity for tax purposes, concerns about stripping the corporate income are raised.

It can be said that a rule requiring identification of corporations which are lightly taxed, or even defining what it means to be lightly taxed, would be inadministrable or excessively complex. On the other hand, the concern could arguably be addressed by rules designed to prevent corporate earnings stripping applied only through corporations in which a publicly traded partnership has a substantial ownership interest, or from which the partnership receives a non-de minimis amount of such income.

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[136] In the case of an asset management business with substantial goodwill or other intangibles, such intangibles can be transferred to the corporation so that the deductions for amortization of goodwill can offset management fee income received by the corporation. In this situation, the corporation's tax on the management fee income may be reduced by deductions for amortizable intangibles.

[137] See discussion in the section of this document entitled Comparison to Corporations and Other Business Entities.