

# CBO TESTIMONY

Statement of  
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## The Taxation of Carried Interest

before the  
**Committee on Ways and Means**  
**U.S. House of Representatives**

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Chairman Rangel, Congressman McCrery, and Members of the Committee, thank you for inviting me to testify on the taxation of carried interest.

My testimony makes the following main points:

- A growing amount of financial intermediation is occurring through private equity and hedge funds. Typically organized as partnerships or limited liability companies, those funds now have at least \$2 trillion under management. Many private equity funds attempt to identify underperforming and inefficient publicly traded firms, buy a controlling share of those companies, restructure their operations and management, and then resell them at a higher price. Others seek out attractive investment opportunities in undervalued small start-up companies. By contrast, hedge funds traditionally have attempted to identify opportunities for arbitrage, in which combinations of financial instruments with the same expected cash flows have different market prices.
- A general partner of a private equity or hedge fund typically receives two types of compensation: a management fee tied to some percentage of assets under management and “carried interest” tied to some percentage of the profits generated by those assets. The management fee is taxed as ordinary income to the general partner. Taxation of the carried interest is deferred until profits are realized on the fund’s underlying assets, and any resulting profits to the general partner are taxed at the capital gains tax rate to the extent that the fund’s profits reflect capital gains.
- However, most economists would view at least part, and perhaps all, of the carried interest as performance-based compensation for management services provided by the general partner rather than as a return on financial capital invested by that partner. That perspective would suggest taxing at least some component of the carried interest as ordinary income, as most other performance-based compensation is currently treated, regardless of the nature of the underlying investments generating the profits of the fund.
- A variety of proposals have been put forward to alter the tax treatment of carried interest. Policymakers considering those changes need to evaluate many factors, including the potential distortions created by the current tax treatment of partnerships and carried interest relative to that of other organizational forms and types of income; the consequences for a broad range of industries (including real estate development) if a general solution is adopted—or the advisability of industry-specific rules if a solution targeted to financial investment funds is pursued; the potential unintended effects, complexity, and perceived fairness of tax changes; and any impact on net tax revenues.

- Much of the complexity associated with the taxation of carried interest arises because of the differential between the capital gains tax rate and the ordinary income tax rate, which creates an incentive to shift income into a form classified as capital gains. Further widening of that differential between the taxation of capital gains and of ordinary income would create even stronger incentives to shift income into the tax-preferred form of capital.

I would also emphasize that any revenue estimates associated with changing the tax treatment of carried interest would be undertaken by the Joint Committee on Taxation. My testimony therefore does not discuss specific revenue effects from proposed changes to that tax treatment.

## Recent Innovations in Financial Services

Financial markets have experienced substantial innovation over the past several decades. Those innovations have affected the assessment and pricing of risk (including the development of credit derivatives and interest rate swaps) and the use of financial markets in supplying credit. The resultant changes in the allocation of capital and the pricing and dispersion of risk have probably contributed to continued economic growth. By increasing businesses' and households' access to capital, financial innovations probably also help explain the dampening of business cycles and the significant decrease in macroeconomic volatility over the past two decades.<sup>1</sup> The innovations also, however, have facilitated individual market participants' ability to assume substantially greater degrees of risk and thus have raised concerns about potential systemic risks to the financial system. Recent problems in the subprime mortgage market have underscored those types of concerns.

Private equity and hedge funds in particular have played an increasingly important role as financial intermediaries:

- **Private equity** funds raise capital to purchase or invest in new and existing businesses. They are private in the sense that their ownership interests are not publicly traded. Instead, they raise investment capital outside public financial markets from sources such as pension funds, endowments and foundations, and wealthy individuals. With those funds, they make various investments, including in publicly traded companies. Private equity firms may acquire mature public companies with the intent of converting them to private companies, restructuring or reorganizing their activities, and then reselling them to the public or another firm. The initial purchase of a public firm by a private equity fund

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1. See Karen E. Dynan, Douglas W. Elmendorf, and Daniel E. Sichel, *Can Financial Innovation Help to Explain the Reduced Volatility of Economic Activity?* Finance and Economics Discussion Series, Working Paper No. 2005-54 (Washington, D.C.: Federal Reserve Board, November 2005). The decline in macroeconomic volatility, however, does not appear to have been associated with a reduction in the volatility of household earnings or income. See the statement of Peter R. Orszag, Director, Congressional Budget Office, *Economic Volatility*, before the Joint Economic Committee (February 28, 2007).

can be done through a leveraged buyout (LBO), in which the private equity firm relies heavily on debt raised from third-party investors to finance the necessary purchases of the public company's shares. Venture capital is a type of private equity particularly used in investing in small start-up businesses.

- **Hedge funds** trade in a variety of financial markets and typically adopt complicated investment strategies, often involving financial derivatives. Some funds buy and sell stocks of publicly traded companies or derivative instruments based on stocks, such as options. Some specialize in debt instruments based on corporate loans, mortgages, and credit card debt. Many derivatives of subprime mortgages are held in hedge funds. Other hedge funds specialize in trading currencies, commodities, and derivatives based on them. Despite their name, hedge funds are not necessarily “hedged” in the traditional sense of being insulated from risk; many hedge funds take significant risks either knowingly or unknowingly. As with private equity funds, hedge funds do not raise their own capital through public issuance of securities; instead, they typically raise capital from institutions and wealthy individuals. Hedge funds' investments are often intended to be shorter term and typically do not involve management control, in contrast to the investments made by private equity funds, although the distinction between hedge funds and private equity funds can become blurred in practice.

The effects of those types of intermediaries on financial markets and overall economic efficiency are complicated to assess. In purchasing target firms, private equity funds have historically paid a premium of about 20 percent over the current market value, which is somewhat less than the amount offered by publicly traded takeover companies.<sup>2</sup> The acquired companies are held for an average of about seven years before the funds bring them back to market for resale. Private equity funds usually retain a significant ownership and management interest in the retooled firms. Such firms that have been resold to the public appear to outperform the market after the sale.<sup>3</sup> Firms resold to the public, however, are a small fraction of all acquired companies, and the returns to those firms may not be representative. Further, it is not clear why resold firms should continue to outperform if equity markets are operating efficiently.

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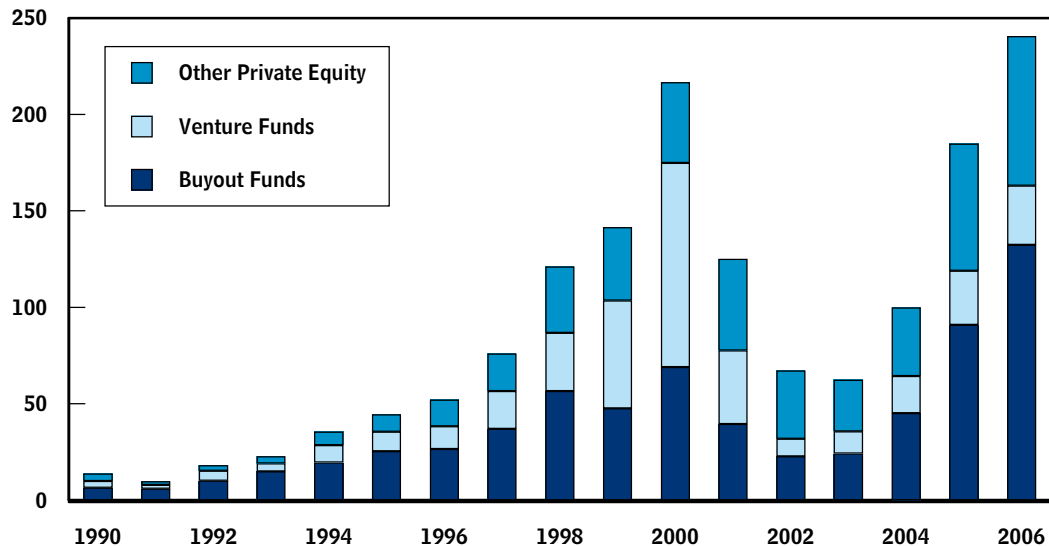
2. Leonce Barger and others, *Why Do Private Acquirers Pay So Little Compared to Public Acquirers?* Working Paper No. 13061 (Cambridge, Mass.: National Bureau of Economic Research, April 2007).

3. Jerry X. Cao and Josh Lerner, *The Performance of Reverse Leveraged Buyouts*, Working Paper No. 12626 (Cambridge, Mass.: National Bureau of Economic Research, October 2006).

**Figure 1.**

## Capital Raised by U.S. Private Equity Funds

(Billions of dollars)



Source: Congressional Budget Office based on data from Thomson Financial, Morgan Stanley Research.

The role of private equity and hedge funds has expanded substantially in the past 20 years. From 1980 to 1995, the amount of capital under management in the private equity market increased from roughly \$5 billion to over \$175 billion.<sup>4</sup> In the past decade, the market has continued to experience rapid growth, and by some estimates, private equity funds now have more than \$1 trillion under management. Estimates also suggest that roughly 8,000 to 9,000 hedge funds now exist, with more than \$1 trillion in funds under management. In other words, private equity funds and hedge funds together have more than \$2 trillion under management.

In 2006, private equity firms raised more than \$240 billion in capital, up from less than \$25 billion a year in the early 1990s (see Figure 1). The private equity market is dominated by a small number of major players. Over the past five years, the top five private equity firms have raised an average of \$30 billion in capital. The average amount raised among the next five largest firms was \$18 billion, and among the next 40 largest firms, about \$8 billion.

The volume of private equity deals more than doubled in 2006, with LBOs accounting for almost 20 percent of the \$3.5 trillion in global mergers and acquisi-

4. See Stephen D. Prowse, "The Economics of the Private Equity Market," *Economic Review*, Federal Reserve Bank of Dallas (Third Quarter 1998), pp. 21–34.

tions. This year, LBOs accounted for more than 17 percent of the \$2.26 trillion in deals through June 2007 and are on pace to break last year's record volume.<sup>5</sup>

Tax data provide another indication of the significant income that flows through entities such as private equity and hedge funds, along with other partnerships and S corporations. In 2005, capital gains from partnerships and S corporations were 22 percent of the total current-year long-term capital gains reported on individual income tax returns and 27 percent of the gains received by the 1 percent of taxpayers with the highest income (those figures do not include losses carried over from previous years).

## **Structure and Tax Treatment of Private Equity and Hedge Funds**

Most private equity and hedge funds are organized as partnerships or limited liability companies. In most of this testimony, they are referred to simply as partnerships, because the tax characteristics of partnerships and most limited liability companies are essentially identical.

A partnership typically consists of one or more general partners, who manage the entity and determine the investment strategy, and limited partners, who contribute capital to the partnership but do not participate in management. General partners may also invest their own financial capital in the partnership, but such investments usually represent a small share of the total funds invested. (The general partner is itself typically a partnership, with the individual managers of the fund as partners.)

Several factors may motivate private equity and hedge funds to be organized as partnerships. A partnership structure is often attractive because its flexibility can accommodate complex financial arrangements among those managing the fund and those contributing capital to it. However, it is likely that tax law plays an important role in explaining why so much financial management activity is now occurring through partnerships. In particular, private partnerships (and limited liability companies electing to be treated as a partnership for tax purposes) do not pay a separate corporate income tax. Instead, they pass all income and losses through to the partners, who are liable for any income tax. As described below, the partnership structure is also attractive to investment fund managers because of the manner in which part of their compensation (the so-called carried interest) is taxed.

In contrast to private partnerships, publicly traded partnerships are generally treated as corporations for tax purposes and are subject to the corporate income tax. (The primary exception to that rule is that certain partnerships that derive at least 90 percent of their income from passive investments such as dividends, interest, rents, and capital gains or from mining and natural resources and that are

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5. Thomson Financial, as cited in "Who's Who in Private Equity," *The Wall Street Journal Online*, available at [www.wsj.com](http://www.wsj.com).

therefore not required to register as investment companies under the Investment Company Act of 1940 do not pay the corporate tax.)

The taxation of the partnership entity itself is not the primary focus of my testimony, although it is worth noting that corporate income tax revenues have declined over the past several decades relative to the size of the economy, partly because of the effects of financial innovation and global integration and possibly because of the increased use of noncorporate forms of conducting business (which were created in part to avoid the potential distortions associated with corporate taxation).<sup>6</sup> Developments such as the growth of private equity and hedge funds may affect corporate income tax revenues in the future; a number of private equity firms, for example, are taking steps to go public without relinquishing their exemption from the corporate tax. Legislation introduced by Senators Baucus and Grassley would tax as corporations publicly traded partnerships that derive income from managing assets or advising investors.

## Carried Interest

A general partner in a private equity or hedge fund is typically compensated in two ways: through a fixed management fee and a share of profits.

The fixed management fee, usually 1 percent to 2 percent of the assets under management, does not depend on the performance of the fund. For example, if the fund had \$1 billion in assets under management and a 2 percent management fee, the management fee would amount to \$20 million a year, regardless of the return on the \$1 billion in assets. The \$20 million would be taxed as ordinary income to the general partner and would generate a deduction as an investment expense for the limited partners.

The second component of the general partner's compensation is a share of the profits on the assets under management. That component, which is often 20 percent of such profits, is usually referred to as carried interest (or, simply, carry).<sup>7</sup> For example, assume the fund with \$1 billion in assets generated a 15 percent realized profit in a year. Of the \$150 million in profits, the general partner earning 20 percent carried interest would receive \$30 million. The other \$120 million in

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6. Corporate tax revenues declined from 3.6 percent of gross domestic product (GDP) in 1962 to 1.2 percent in 2003. A recent surge in corporate tax collections has temporarily reversed that longer-term trend—corporate tax revenues rose from 1.2 percent of GDP in 2003 to 2.7 percent in 2006, explaining the bulk of the overall increase in federal revenues over that time—but CBO projects a gradual decline in that share from current levels. See Congressional Budget Office, *Federal Tax Revenues from 2003 to 2006* (May 18, 2007), and *The Budget and Economic Outlook: Fiscal Years 2008 to 2017* (January 2007).

7. Managers of public mutual funds are not permitted to be paid in that fashion. Because private equity and hedge funds are exempt from the Investment Company Act of 1940, however, that form of compensation is permitted for their managers.



profits would be split among the investors in the fund (including the general partner if he or she owned some of the capital in the fund in addition to managing it). In many cases, the general partner earns carried interest only when profits exceed some threshold.<sup>8</sup> For example, in many private equity funds, the general partner will receive carried interest only when profits exceed a “hurdle rate,” often an 8 percent return.<sup>9</sup>

## **Tax Issues Surrounding Carried Interest**

Carried interest arrangements for partnerships raise two significant tax issues: the timing and the character of the income earned by the general partner. Both of those issues involve the same underlying question, which is whether, which is whether a general partner’s carried interest should be treated as a quasi-investment in the partnership by the general partner, with the result that the carried interest would be subject to the same tax rules that apply to the limited partners’ partnership interests, or whether the general partner’s carried interest is more properly viewed as some form of contractual undertaking by the limited partners (or the partnership) to compensate the general partner for management services.

### **Deferral of Taxation**

The first tax issue involves the timing of a general partner’s tax liability for the carried interest that he or she receives for managing the fund. Under current law and regulations, carried interest is not taxed when the right to the future profits is granted (for example, when the partnership is created) but rather when the partnership realizes profits that are allocated to the general partner.

At one level, deferral is a specific example of a more pervasive phenomenon, which is the tax code’s reliance on realization events—the sale of an investment, for example—to determine the timing of income from investments. Indeed, limited partners in a private equity fund also enjoy the benefits of deferral: They do not pay tax on unrealized gains but only on gains that have been recognized through a sale or similar event.

At another level, however, deferral as applied to a general partner’s carried interest effectively assumes the conclusion of the underlying technical and policy issue: whether that carried interest should be treated as a simple investment by the general partner (albeit one that has no claim to the current capital of the fund but only to the future appreciation thereof) or whether, at least to some degree, the carried

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8. Such a preferred return for the limited partners is more common in private equity buyout firms than in venture capital firms. See Victor Fleischer, *The Missing Preferred Return*, Research Paper No. 05-8 (Los Angeles: UCLA School of Law, February 2005).

9. If that 8 percent hurdle rate applied to the example, the general partner would receive the 20 percent carried interest on \$70 million (which is the \$150 million in profits minus the threshold of \$80 million that must be exceeded before carried interest applied), or \$14 million.

interest is in substance a form of compensation paid by the limited partners to the general partner for services in managing the fund. Most analysts believe that alternative characterization is more accurate.

More specifically, carried interest can be viewed as a call option on a limited partnership interest, with a value equal to 20 percent of the future capital in the fund and a strike price equal to 20 percent of the initial value of the fund.<sup>10</sup> Options-pricing formulas, such as the Black-Scholes formula, can then be applied to valuing the carried interest. Although various complications arise in applying such options-pricing techniques (including the requirement to estimate both the duration of the fund and the volatility of the underlying investments), it is clear that whatever the imperfections in the valuation process, an interest in future profits has some value greater than zero.

It is worth noting that deferral of taxation on carried interest generates a tax benefit to the general partner (who does not recognize income initially) but a tax cost to the limited partners (who do not enjoy a deduction or other reduction in taxable income at that point). However, many limited partners are either tax-exempt entities in the United States or foreign institutions (see Table 1), so they may be largely unaffected by the lack of an immediate U.S. tax benefit. The net result is, therefore, the overall deferral of a net tax liability.

### **Treatment as Capital Gains or Ordinary Income**

The second issue is the character of the income received as carried interest. Under current law and regulations, carried interest is treated in the same way as all other profits from a partnership for tax purposes. In particular, carried interest flows through to the general partner on the basis of the nature of the income from the underlying investments. Thus, if the carried interest arises from realizations of long-term capital gains on the investments held by the fund, the general partner is taxed on the carried interest at the long-term capital gains rate. In the paradigmatic private equity case, most profits arise from long-term capital gains, so the profit allocated to the general partner's carried interest will be taxed as long-term capital gains.<sup>11</sup> For simplicity, the remainder of this testimony assumes that case and also assumes that no hurdle rate is applied to the carried interest. Such a hurdle rate

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10. A call option gives the holder the right to purchase an asset at the strike price. Consider a fund with \$1 billion under management and 20 percent carried interest. If the fund then grows to \$1.5 billion, the general partner will be entitled to 20 percent of the \$500 million increase, or \$100 million. That outcome is equivalent to a right to receive 20 percent of the future value of the fund ( $\$1.5 \text{ billion} \times 20 \text{ percent} = \$300 \text{ million}$ ) in exchange for paying 20 percent of the initial value of the fund ( $\$1 \text{ billion} \times 20 \text{ percent} = \$200 \text{ million}$ ). The example assumes that no hurdle rate is applied to the carried interest; the presence of such a hurdle rate would be reflected in the valuation of the option.

11. A hedge fund's income from securities trading, by comparison, usually constitutes a short-term capital gain or ordinary income—particularly if, as often is the case, the fund has elected to be taxed as a securities trader under section 475(f) of the Internal Revenue Code.

**Table 1.**


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## Percentage of Capital Investment in Private Equity by Type of Limited Partner

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	2005 <sup>a</sup>	2006 <sup>b</sup>
Public Pension Funds	22	26.6
Corporate Pension Funds	10	12.3
Union Pension Funds	1	1.4
Banks and Financial Services	6	9.8
Insurance Companies	12	7.5
Endowments/Foundations	10	7.7
Family Offices	11	6.8
Wealthy Individuals	10	10.1
Funds of Funds	13	13.9
Other	5	3.9
<b>Total</b>	<b>100</b>	<b>100</b>

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Source: Private Equity Council, *Public Value: A Primer on Private Equity* (Washington, D.C., 2007), p. 11.

- a. Based on a sample of more than 75 global funds with total capital of over \$32 billion.
  - b. Based on a sample of more than 110 global funds with total capital of over \$44 billion.
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would affect the precise examples and calculations but not the underlying substance of the issue.

To see how that system of taxation works, assume that a fund realized a profit of \$150 million in long-term capital gains and that the carried interest was equal to 20 percent of that profit, or \$30 million. The general partner would then pay capital gains tax on that \$30 million; at a capital gains tax rate of 15 percent, the tax owed would be \$4.5 million.

As an economic matter, the character of carried interest income should not depend on whether the compensation is performance-based. A wide range of performance-based compensation—including arrangements in which service providers accept the entire risk of the success or failure of an enterprise—is effectively labor income and taxed as ordinary income for services. Contingent fees based on movie revenue for actors, for example, are taxed as ordinary income, as are performance bonuses, most stock options, and restricted stock grants.<sup>12</sup> So too are incentive fees paid to managers of other people's investment assets, when those fees are doc-

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12. The tax treatment of nonqualified stock options, which are the most common type of options, is an example. Nonqualified stock options are generally taxed when they are exercised (although the tax can be delayed if the purchased shares are subject to a substantial risk of forfeiture), and the difference between the market price at the time of exercise and the strike price (multiplied by the number of shares) is taxed as ordinary income. The tax treatment of incentive stock options is more advantageous, but current law significantly limits the value of such options that can receive favorable tax treatment.

umented as such rather than as carried interest in a formal partnership. Instead, the key issue is whether the carried interest represents a fee for services provided or a return on the partnership's long-term capital gains allocated to one partner (the general partner) under conditions that are not qualitatively different from the returns allocated to the other partners (the limited partners).

Most legal and economic analysis suggests that carried interest represents, at least in part, a form of performance-based compensation for services undertaken by the general partner. Although individual analyses differ slightly, there are two important themes with which most analysts concur. First, a general partner in a private equity or hedge fund undertakes a fundamentally different economic role from that of the limited partners, because the general partner is responsible (by virtue of his or her expertise, contacts and experience, and talent) for managing the fund's assets on a day-to-day basis. Second, the carried interest is not principally based on a return on the general partner's own financial assets at risk. If the purpose of the preferential rate on long-term capital gains is to encourage investors to put financial capital at risk, there is little reason for that preference to be made available to a general partner, whose risk involves his or her time and effort rather than financial capital.

Some observers view carried interest as a mixture of compensation for management services and capital returns. For example, one can think of carried interest as an interest-free nonrecourse loan from the limited partners to the general partner equal to 20 percent of the partnership's assets, with the requirement that the loan proceeds be reinvested in the fund. (A borrower is not personally liable for a nonrecourse loan, beyond the pledged collateral, which in this case is the general partner's claim on future profits.) To see how this example works, imagine a fund worth \$100 million. With no direct capital investment, the carried interest entitles the general partner to the profits on \$20 million (20 percent of the profits on \$100 million is equivalent to the full profits on \$20 million). It is therefore as if the limited partners have contributed \$80 million to the fund and then lent the general partner \$20 million to invest in the fund too, but without charging the general partner interest on that loan.

This perspective of characterizing carried interest as an implicit loan would result in treatment somewhere between those of purely capital income and purely ordinary income. In particular, under current tax rules, the implicit interest on an interest-free loan would be taxed as ordinary income, with the interest rate set at the current rate on federal securities with the same duration as the loan. At the time the partnership sold its assets, any gain or loss to the general partner, after paying back the loan, would be treated as capital. In effect, then, this perspective would suggest that the component of carried interest attributable to implicit interest on the

implied loan would be ordinary income and that the returns in excess of that implicit interest would be capital income.<sup>13</sup>

The differential tax treatment of carried interest relative to the management fees earned by general partners has apparently led to efforts to transform management fees into carried interest. Consider the example of the \$1 billion investment fund with a 2 percent management fee, 20 percent carried interest, and a 15 percent realized profit on long-term capital gains. The general partner would then receive \$50 million in income: \$20 million in management fees and \$30 million in carried interest. With a 35 percent ordinary income tax rate and a 15 percent long-term capital gains tax rate, the general partner would pay \$11.5 million in income taxes. If the general partner was able to reduce the management fee to 1 percent and increase the carried interest to 26.7 percent, the income flowing to the general partner would remain \$50 million (\$10 million in management fees and \$40 million in carried interest). However, the taxes owed would decline by \$2 million, to \$9.5 million. Such transformations of management fees into carried interest have apparently occurred, in some cases even after realized profits are known. Those types of transformations further highlight some of the similarities between—and, therefore, the interchangeability of—management fees and carried interest. That those components of compensation are substituted for each other suggests, at least in part, that both types of income represent compensation to the general partner for management of the fund.

Finally, the issue of characterizing a flow of income as a return on capital or compensation for services provided is not unique to private equity or hedge fund partners and is not a new development. Many real estate development deals, for example, are structured as partnerships with essentially similar characteristics, in which

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13. A hurdle rate or preferred return would affect the calculation of the forgone interest. If the preferred return was set at the same rate as the interest rate on the implicit loan, it would not be appropriate to impute an additional interest charge on the implicit loan, although there would need to be some provision to account for the implicit below-market rate if the private equity fund failed to achieve a return at least equal to the preferred rate. For example, consider a private equity fund that starts with \$100 million in assets and grows at a 15 percent rate each year. If profits are realized after seven years, the general partner earning 20 percent carried interest will receive \$33.2 million of the \$166 million in total profits. With a preferred rate of 6 percent, the limited partners will receive the first \$50.4 million in profits, and the general partner will receive \$23.1 million—20 percent of the remaining \$115.6 million in profits above the preferred return. Compare that instead with treating the 20 percent carried interest as a nonrecourse loan with an interest rate equal to the 6 percent preferred rate. In that case, the general partner would be treated as if he or she had received a \$20 million loan from the limited partners that he or she then invested in the fund, obtaining 20 percent capital interest. After seven years, the general partner would receive \$53.2 million—20 percent of the fund's \$266 million in assets. After paying back the \$20 million loan with interest compounded at 6 percent per year (\$30.1 million), the general partner would be left with \$23.1 million, as above.

an active manager or developer obtains a disproportionate share of partnership income or profits in return for his or her contributions of intangibles (contacts, know-how, and so forth) and management of the project. Nonetheless, the typical private equity firm presents the paradigmatic case for considering the appropriate tax treatment of carried interest (see Box 1 for a related discussion— of “sweat equity” and carried interest).

## **Options for Modifying the Tax Treatment of Carried Interest**

The tax issues described in the previous section have given rise to proposals to change the current tax treatment of carried interest. Policymakers considering such proposals may want to weigh the underlying substance of the tax issue at hand with various other considerations. For example, in general, changes in tax policy that have significant and potentially unexpected effects on particular industries should be approached with caution, because a broader policy objective may be served by stability and an associated perception of fairness. Furthermore, as noted above, carried interest arises not just within private equity and hedge funds; it is also a common feature of partnerships in other sectors. Many of the underlying tax issues that relate to the taxation of carried interest in the financial services sector apply to those other sectors as well. Policymakers interested in changing the tax treatment of carried interest therefore need to evaluate the costs and benefits of changing that treatment for all carried interest relative to restricting the change to the financial services industry.

One concern that has been raised about altering the tax treatment of carried interest is that it may drive private equity and hedge fund activities abroad. However, a significant number of such funds are already registered offshore. Despite foreign registration, most private equity and hedge fund activities still take place in financial centers such as New York; Greenwich, Connecticut; and London. Changes in the tax treatment of carried interest would be unlikely to drive those activities away to any significant degree: The changes would not generally affect the taxation of the limited partner investors in such funds, and with regard to the general partner, the United States taxes the worldwide income of its citizens, wherever they may perform services. U.S. citizens who are managing partners in private equity funds or hedge funds will therefore generally be taxed by the United States wherever they may choose to live and operate their businesses.

Several proposals have been put forward to modify the tax treatment of carried interest. Under those proposals, some, if not all, carried interest would be treated

as ordinary income regardless of the type of asset generating the fund's profits.<sup>14</sup>

**Tax Carried Interest as Property When Granted.** One alternative would be to tax the general partner on carried interest when granted. Under section 83 of the Internal Revenue Code, property (other than an option) transferred to a person in connection with the performance of services is generally taxed when that property is transferred. Under relatively unusual facts, the tax court held in *Diamond v. Commissioner* that the grant of a carried-interest right “with determinable market value” constituted current ordinary income to the general partner.<sup>15</sup> Because carried interest may be difficult to value, though, most practitioners continued to view the granting of carried interest as a nontaxable event. The Internal Revenue Service later embodied that view in Revenue Procedure 93-27. One possibility would be to alter that revenue procedure and apply section 83 to the grant of carried interest. The valuation could then be done by Black-Scholes or some other method.<sup>16</sup> The grant would be currently taxable as ordinary income to the general partner and could generate a deduction for the limited partners.<sup>17</sup>

This approach would affect both the deferral component of carried interest and its character. For the reasons described above regarding the limited impact from a deduction granted to the limited partners, the result would be a net acceleration of revenues received by the federal government. Another result would be that the carried interest (its value determined at the time it was granted) would be treated as ordinary income. To the extent that the carried interest then appreciated or depreciated in value relative to the initial estimate, the changes would be taxed as capital gains or losses.

This approach would require some acceptable valuation methodology, which might be difficult to apply in the wide variety of circumstances in which carried interest arises. Furthermore, even with an accepted valuation methodology, modest changes in the assumptions applied might generate significant changes in valuation—creating opportunities to understate the value of the carried interest when granted. Finally, as noted above, deferral arises in a variety of settings across the

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14. To implement any of the options, policymakers would also need to decide whether to treat the resultant ordinary income as labor income; if so, the income would also generally be subject to payroll taxation. The arguments in favor of viewing carried interest as ordinary income would tend to suggest that tax treatment.

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

16. See, for example, Lee A. Sheppard, “Blackstone Proves Carried Interests Can Be Valued,” *Tax Notes*, vol. 115, no. 13 (June 25, 2007), pp. 1236–1243.

17. Although the valuation of the grant may be undertaken using options-pricing methodologies, this tax treatment would differ from that applied to nonqualified stock options, which are typically taxed not when they are granted but when they are exercised.

**Box 1.**

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**Sweat Equity and Carried Interest**

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To some observers, carried interest simply reflects the “sweat equity” of the partner providing the know-how—that is, his or her investment of time and energy rather than financial capital. Those observers typically argue that carried interest should not be treated as ordinary income because other sweat equity is taxed as capital income.

Consider two individuals who open a shop. One of them provides all of the cash, the other provides the know-how, and each takes a 50–50 interest in the partnership. The issue is how the partner providing the know-how is taxed—and how that tax treatment corresponds to that for carried interest.

In analyzing those questions, it is important to distinguish two different levels of taxation: the taxation of annual operations over the firm’s life and the taxation of gains realized by the partners if they sell the firm. When observers argue that people who are providing labor to a partnership should be taxed on the compensation for that labor at rates for ordinary income, they are referring to the taxation of the current year’s operations, not to the gains realized on the ultimate sale of the firm. In particular, assume that the 50–50 split is of partnership profits only and that the partner providing the know-how does not obtain any current interest in the capital contributed. (If that partner was given a capital interest in the partnership, which entitled him or her to a share of the proceeds if the partnership was immediately liquidated, that share would be treated as immediate taxable income to the partner.)

Then consider what happens as the operation sells its products to customers. The business will earn ordinary business income from its operations; that ordinary business income will be shared by, and taxed to, the two partners according to their partnership agreement. As a result, the partner providing the know-how will pay tax every year at ordinary income rates on his or her 50 percent share of the partnership’s profits.



**Box 1.****Continued**

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After some time, the two partners sell the partnership for a price that reflects not only machinery, leasehold improvements, and products in inventory but also the operation's good will, trade name, and similar intangibles. Tax law provides that the profit from the sale of the business for the partner providing the know-how (to the extent that the profit is not attributable to certain ordinary income assets of the partnership) will constitute long-term capital gains. In effect, then, tax law distinguishes between the current returns from the sweat equity provided by that partner—annual operating profits, which are taxed as ordinary income—and that partner's share of the value that his or her work has helped to create when the partner sells those self-created intangible assets through the sale of his or her interest in the partnership—which will be treated as long-term capital gains.

A similar outcome on the final sale of an operation has occurred with some recent initial public offerings of private equity management companies that were organized as partnerships. The owners of a management company sold their interests for prices significantly above their tax basis in their partnership interests.

At least in part, their sales price represented the good will, trade name, and value of the management business as a going concern, which the partners had built up through years of hard work. Those partners appear to have treated the gain attributable to those sorts of intangible assets as long-term capital gains; analysts who believe that carried interest represents performance-based compensation for

services provided would nonetheless probably agree that such treatment of proceeds from the sale of the management company itself as long-term capital gains is indeed appropriate. Thus, the issue of the treatment of carried interest relates to the taxation of the private equity management company's operating profits, not to the taxation of the sale of the company.

tax code, and some observers believe that eliminating deferral in this context but not others would not be justified.<sup>18</sup>

**Tax Carried Interest as Ordinary Income When Realized.** A second option would be to continue to allow deferral but to view carried interest as a fee for services provided and therefore tax the income distributed to the general partner as ordinary income. Carried interest would thus be taxable to the general partner as ordinary income and deductible as an expense incurred to earn investment income to the limited partners.<sup>19</sup> As an example of this broad approach, consider the fund with \$1 billion in assets and 20 percent carried interest. If the fund earned a realized profit of 50 percent, the carried interest of \$100 million would be taxed to the general partner as ordinary income (rather than capital gains). At a 35 percent tax rate, the income tax owed would be \$35 million, rather than the \$15 million that would be due if the income was taxed at the 15 percent capital gains tax rate.<sup>20</sup>

H.R. 2834, introduced by Congressman Levin and others, would implement a version of this approach. Another approach that is similar in spirit involves modifying section 707(a)(2)(A) of the Internal Revenue Code to require that carried interest be treated as a transaction between the partnership and a nonpartner; the result would be to treat the carried interest as ordinary income.<sup>21</sup>

This type of approach would most closely mirror the tax treatment of nonqualified corporate stock options, which share many characteristics with carried interest. As with the tax treatment of nonqualified options, this approach would not eliminate the deferral of taxation (because it would not impose the tax when the carried interest was granted), but it would impose ordinary income taxation.<sup>22</sup> This

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18. For example, carried interest in the partnership context has much in common with employee stock options that a corporation might grant to valued employees. The tax code typically taxes those options as ordinary income only on exercise, in an amount equal to an employee's economic gain at that time (that is, the difference between the corporate stock's fair market value on the exercise date and the price paid by the employee under the terms of the option). Policy-makers may want to consider whether it is appropriate to create a timing rule for carried interest that would vary significantly from the general rule adopted for somewhat analogous nonqualified employee stock options.

19. Various provisions of the tax code could reduce the value of the deduction to the limited partners.

20. Again, the limited partners would receive an ordinary income tax deduction, but the net effect would probably be a revenue gain for the reasons described earlier in the text.

21. See Lee A. Sheppard, "The Unbearable Lightness of the Carried Interest Bill," *Tax Notes*, vol. 116, no. 2 (July 12, 2007), pp. 15–21.

22. As described, nonqualified stock options are generally taxed not when they are granted, but rather when they are exercised—apparently because of concerns about valuation. Such concerns are similar to those surrounding the value of carried interest when granted, and the typical deferral of taxation on nonqualified stock options until they are exercised may suggest that the taxation of carried interest should also be deferred, as this option would entail.

approach would also most directly reflect the view that carried interest fully represents performance-based compensation for services provided.

The approach might, however, create various tax-planning opportunities—including the use of nonrecourse loans from the limited partners to the general partner—to attenuate its impact. Finally, although there is widespread agreement among analysts that at least some component of carried interest represents compensation for services provided, there is somewhat less agreement that the full amount of carried interest represents such compensation. To the extent that at least some component of carried interest is viewed as a return on capital invested, this approach could be seen as overtaxing carried interest.

**Tax Imputed Interest on the Implied Loan.** A third option would be to explicitly treat the general partner's carried interest as a nonrecourse loan from the limited partners and tax the value of the implicit interest to the general partner as it accrued.<sup>23</sup> As a result, that part of the carried interest would be treated as ordinary income, and the rest would be treated as a return on capital.

Consider again a private equity or hedge fund partnership that starts with \$1 billion in assets. The underlying assets are sold after three years for \$1.5 billion, generating a realized profit of \$500 million. With 20 percent carried interest, the general partner would receive \$100 million when the fund liquidated or sold the assets (20 percent of the \$500 million profit). Under current law, the general partner would pay a tax of \$15 million on his or her share of the profits (15 percent of \$100 million), under an assumption that the distributions qualified as long-term capital gains. If the carried interest was treated as ordinary income, as in the option above, the general partner would pay a tax of \$35 million (35 percent of \$100 million).

If, instead, the 20 percent carried interest was treated as a nonrecourse interest-free loan with the loan proceeds invested in the fund, the general partner would generally pay more tax than under current law but less than under the option treating carried interest as ordinary income. In particular, in the example, the general partner would be treated as if he or she had received a \$200 million loan from the limited partners, which he or she then invested in the fund, obtaining a 20 percent interest in the fund. After three years, the general partner would be treated as if he or she received a 20 percent share of the \$1.5 billion in assets held by the fund, or \$300 million, and paid back the \$200 million loan. The general partner would thus have a realized gain of \$100 million (the underlying carried interest). The tax on that \$100 million would be \$15 million, again under the assumption that the fund's profits qualified as long-term capital gains. However, because the loan from the limited partners was interest-free, the general partner would be required by current

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23. One analyst describes this option as a cost-of-capital approach. See Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, Legal Studies Research Paper No. 06-27 (Boulder, Col.: University of Colorado Law School, June 12, 2007).

law to count the forgone interest payments as ordinary income and pay tax on them each year.<sup>24</sup> With a 5 percent interest rate, the implied ordinary income would be \$10 million per year, and the tax would be \$3.5 million per year.<sup>25</sup> The time value of money aside, the total tax bill would be \$25.5 million (\$15 million plus \$10.5 million). That tax liability, as expected, falls between the tax liability of \$15 million under full capital gains tax treatment and the \$35 million under full ordinary income tax treatment.

One advantage of this approach is that it may be more resistant to financial planning that does not change the underlying economics of the partnership arrangement. It also reflects the view of some analysts that carried interest is neither entirely a return on capital nor entirely labor compensation. However, the approach is clearly complex, and the extent of the complications involved may make it particularly difficult to implement in practice.

## **A Broader Issue: Differential Tax Rates on Capital and Labor Income**

Much of the complexity associated with the taxation of carried interest arises because of the differential between the capital gains tax rate and the ordinary income tax rate. In particular, ordinary income for high-income taxpayers is typically subject to a 35 percent marginal income tax rate and, in the case of labor income, an additional 2.9 percent payroll tax rate for Medicare. Long-term capital gains for such taxpayers are typically subject to a 15 percent tax rate. The difference creates a strong incentive to shift income into forms classified as capital gains. Whether carried interest represented compensation for services provided or a return on capital invested would be largely irrelevant if the tax rates on labor and capital income were the same (although the issue of deferral would still remain).

The Tax Reform Act of 1986 set the tax rate on capital gains at the same rate as the tax on ordinary income, but legislation since then has reintroduced differential tax treatment. A lower tax rate on capital gains and dividends than on other forms of income creates opportunities for tax avoidance and complicates the tax system. Income from sole proprietorships, S corporations, and other noncorporate entities

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24. This option assumes that the general partner would not receive a deduction for the imputed interest payments on the implicit loan. Under current law, imputed interest on actual loans may generate a deduction for the borrower. Advocates of this option, however, would not extend such a deduction to the general partner (the borrower of the implicit loan); they justify such a deduction in different ways. In addition, the example assumes no hurdle rate or preferred return. As noted, such a provision would affect the calculation.

25. The example follows the convention of using the federal interest rate on short-term securities. The choice of the proper interest rate is a significant issue in this approach, though. A 5 percent interest rate is arguably too low for a nonrecourse loan on a risky asset. Again, the presence of a hurdle rate would affect the calculation of implicit interest.

is a mix of returns on capital and returns on labor, and a significant portion of the tax code is devoted to attempting to distinguish one type of income from another.

As the tax rate differential increases, the distinctions among different types of income assume greater importance. Proposals to reduce the tax on capital income (for example, by moving to a consumption tax) or to raise the tax on labor income (for example, by increasing the payroll tax) would increase the differential further and thereby create an even stronger incentive to shift income into a form classified as capital.

One motivation for differential tax treatment has been a desire to promote capital formation and economic activity. The empirical evidence suggests, however, that a low capital gains tax rate has only modest effects on such outcomes. Furthermore, the application of that broader motivation to carried interest in investment funds is unclear, because the financial capital that is gathered and invested in such funds is provided almost entirely by the limited partners, not the general partner.

Many considerations need to be taken into account in evaluating the appropriate tax rate on capital income. The income-shifting incentives and potential associated distortions created by differential rates on capital and income, which are highlighted by the debate over carried interest, represent one consideration.