TESTIMONY ON TAXING PARTNERSHIP PROFITS IN PRIVATE EQUITY FUNDS

HOUSE OF REPRESENTATIVES COMMITTEE ON WAYS AND MEANS

Victor Fleischer

Associate Professor
University of Illinois College of Law

September 6, 2007

COMMITTEE ON WAYS AND MEANS

TESTIMONY ON TAXING CARRIED INTEREST

Victor Fleischer*

Thank you for inviting me here today to present my views.

Summary. Current law creates a tax planning opportunity for private equity fund managers who receive the industry-standard "two and twenty" compensation for running a fund (i.e., a two percent management fee and twenty percent profits interest). By taking a portion of their pay in the form of partnership profits, fund managers defer income derived from their labor efforts and convert it from ordinary income into long-term capital gain. This quirk in the tax law is what allows some of the richest workers in the country to pay tax on their labor income at a low rate.

Changes in the investment world have transformed this tax issue from a byzantine academic issue into a pressing matter of social policy. Congress never intended to allow investment fund managers to enjoy this tax subsidy. The fact is that when Congress enacted the partnership tax rules in 1954, it could not have foreseen the changes that have created the situation we see today. The partnership tax rules were designed with small business in mind, not billion-dollar investment funds. The changes in the capital markets include massive inflows of capital into the private equity sector, an increase in the number of tax-exempt investors like pension funds and endowments, the adoption of portable alpha strategies by these institutional inves-

---

* Associate Professor, University of Illinois College of Law. I thank David Kamin for his assistance in editing these remarks. I discuss these issues in more detail in *Two and Twenty: Taxing Partnership Profits in Private Equity*, N.Y.U. L. REV. (forthcoming 2008). The article is available in draft form at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=892440.
I welcome comments and suggestions at victor.fleischer@gmail.com.

tors, the adoption of the carried interest structure by other financial intermediaries, and the aggressive conversion of management fees into carried interest. Congress should respond to these changes in the investment world by bringing the law up-to-date.

While there is ample room for disagreement about the scope and mechanics of different reform alternatives, there is widespread agreement among tax professors and economists that the status quo is an untenable position as a matter of tax policy. Among the various reform alternatives, H.R. 2834 makes a lot of sense, providing a baseline rule that would treat carried interest distributions as ordinary income. By taxing carried interest distributions to fund managers in a manner that more closely matches how our tax system treats other forms of compensation, H.R. 2834 will improve economic efficiency and discourage wasteful regulatory gamesmanship. These changes would also reconcile private equity compensation with our progressive tax rate system and widely-held principles of distributive justice.

Labor income vs. Investment income. The first point that I will make concerns the difference between labor income and investment income.

So long as we have a difference in the rates at which we tax capital gains and ordinary income, we have no choice but to pay attention to the lines that distinguish between the two. When capital gains are taxed at lower rates, as they are now, taxpayers have an incentive to restructure their activities to make their labor income look like investment income. While carried interest has elements that make it sound like an investment – it's risky, it's tied to the appreciation of a capital asset – it is better characterized as compensation.

The carried interest that fund managers receive is an incentive fee received in exchange for managing assets on behalf of investors. The carried interest aligns the interests of the fund managers and their investors: If the fund does well, the managers share in the treasure. But the fact that the fund managers do well financially if the assets appreciate does not somehow magically transform what they receive into a return on investment capital. The fund managers share in the appreciation in the fund, but bear little of the downside risk. The carried interest is received in exchange for services, not investment capital.

This conversion of labor income into capital gain is contrary to the general approach of the tax code, and it diverges from the treatment of other compensatory instruments. Partnership profits interests are treated more favorably than other economically similar methods of compensation, such as partnership capital interests, restricted stock, or at-the-money nonqualified stock options (the corporate equivalent of a partnership profits interest).[1] A partnership profits interest is, under current law, the single most tax-efficient form of compensation available without limitation to highly-paid executives.

Congress has dealt with this labor vs. investment issue before, in section 83 of the tax code. From an academic perspective, the two code sections that cannot be reconciled conceptually are section 702, which defines the character of income received by partners, and section 83, which determines the timing and character of income received by employees. In the context of corporate stock, section 83 puts executives to a choice: they may make a section 83(b) election and recognize income immediately on the current value of the property, or they can wait-and-see. If they make the election, any further gain or loss is capital gain or loss. If they wait-and-see, however, the character of the income is ordinary.

In the partnership context, on the other hand, we do not require partners to make a choice. The usual import of section 83 is, as a practical matter, disregarded. Partners can wait-and-see, and yet the character of the income when it is realized later is capital gain, not ordinary income. Because a profits interest in a partnership is difficult to value, I do not believe it is practical to try to force a valuation at the moment a carried interest is granted. Instead, the logical solution is to change the character on the back end when profits are received, which is what the House Bill does.

---

[1] The tax treatment of carry is roughly equivalent to that of Incentive Stock Options, or ISOs. Congress has limited ISO treatment to relatively modest amounts; the tax subsidy for partnership profits interests is not similarly limited. In both cases, the executive receives the benefit of deferral and conversion into capital gain, while the employer loses the benefit of a current ordinary deduction for compensation. Because, in the case of private equity funds, the "employers" are mostly tax-exempt investors, the loss of the benefit of a current ordinary deduction in less important than in the context of a corporation issuing ISOs. Congress has limited ISO treatment to options on $100,000 worth of underlying stock, measured on the grant date, per employee per year. See § 422(d).

Why now? The second point that I want to make has to do with why Congress should address this issue now.

For some members, the most compelling point is simply one of distributive justice. This quirk in the partnership tax rules allows some of the richest workers in the country to pay tax on their labor income at a low effective rate. While the high pay of fund managers is well known, the tax gamesmanship is not. This simple fact will suffice to persuade many of you that changing the tax law is the only just response.

For other members, however, it may be more helpful to expand on how we got to where we are. The relevant code sections and regulations have actually been stable over time. The key development has been the growth and professionalization of the private equity industry. The private equity revolution has shaped the source of investment capital and spurred an increase in demand for the services of intermediaries. These institutional changes have put increasing pressure on the partnership tax rules, which were designed with small businesses in mind.

In the 1980s, following a change in pension law, institutional investors such as pension funds, foundations, and endowments began to include alternative assets like venture capital funds, private equity funds, and hedge funds in their portfolios. The most powerful investors, such as large public pension funds and university endowments, may invest as much as half of their portfolio in alternative assets. This shift in the source of investment capital creates some tax planning opportunities. Many of these institutional investors are tax-exempt; substitute taxation is not available as a backstop to prevent exploitation of gaps in the tax base created by the realization doctrine and conversion of ordinary income into capital gain.

More recently, as the industry has professionalized, the demand for private equity has increased. Smaller institutions, family offices, and high net worth individuals now seek access to the industry. Funds-of-funds and consultants have stepped in to provide these services. In addition to providing increased access to funds, these intermediaries screen funds to find the best opportunities and monitor the behavior of managers in the underlying funds. In exchange, they often receive a share of the profits – a carried interest of their own.

Each year, more and more financial intermediaries take advantage of the tax treatment of two and twenty.

Additionally, fund managers have become more aggressive in their regulatory gamesmanship. Fund managers receive management fees, usually a fixed percentage of committed capital, in addition to the carried interest. (This fee, often 2%, is the "two" in "two and twenty.") These fees are normally taxed as ordinary income. Fund managers, however, have become aggressive in strategically converting these fees into additional shares of carried interest.[2] This tax planning strategy defers income and may ultimately convert labor income into capital gain. Some fund managers opt to reduce the management fee in exchange for an enhanced allocation of fund profits. The choice may be made up front, triggered upon certain conditions, during formation of the fund; in other cases the managers may reserve the right to periodically waive the management fee in exchange for an enhanced "priority" allocation of fund profits during the next fiscal year of the fund.

Lastly, the problem warrants renewed attention because the treatment of a profits interest in a partnership represents a striking departure from the broader design of executive compensation tax policy. Economically similar transactions are being taxed differently. Investors structure deals to take advantage of the different tax treatment. Generally speaking, this sort of tax planning is thought to decrease social welfare by creating deadweight loss, that is, the loss created by inefficient allocation of resources. Specifically, the tax-advantaged nature of partnership profits interests may encourage more investments to take place through private investment funds, which are taxed as partnerships, rather than through publicly-traded entities, which are generally taxed as corporations. Choices about how to structure transactions should be made based on which form would allow for the greatest economic productivity—and not based on which form is more tax-advantaged.

Together these institutional factors have contributed to an important but largely overlooked shift in executive compensation strategy in the financial services industry. The most talented financial minds

---

[2] See Joint Committee on Taxation, *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests*, July 10, 2007, at 50.

among us are increasingly leaving investment banks and other corporate employers to start or join private investment funds organized as partnerships.

The scholarly viewpoint. The third and final point is to underscore the widespread agreement among academics and economists that the status quo is untenable as a matter of tax policy.

As academics, we are privileged to have the opportunity to reflect on broader policy issues, to research and track the evolution of the law over time, and to make reasoned judgments with some distance from the politics of the day. The Senate Finance Committee has already heard from Professors Mark Gergen (University of Texas), Joseph Bankman (Stanford), Charles Kingson (University of Pennsylvania), and Darryl Jones (Stetson). Numerous other academics that I have spoken with agree that there is a powerful case for reform, including Lily Batchelder (NYU), Dan Shaviro (NYU), Noel Cunningham (NYU), Alan Auerbach (Berkeley), John Colombo (Illinois), and Richard Kaplan (Illinois).

To be clear, not everyone agrees on exactly what we ought to do about the problem. Some academics believe the only way to solve this problem would be to eliminate the capital gains preference altogether.[3] I disagree with that view. Professor Michael Knoll (University of Pennsylvania) and others are justifiably concerned that the revenue generated by the bill might be limited by creative workarounds.[4] A few professors have been retained by the private equity industry to argue for the status quo; there may be a handful of others who independently support the status quo, but they are few and far between. Our treatment of carried interest is simply inconsistent with other broad principles of tax policy, like having a progressive rate structure and taxing compensation as ordinary income.

The fact that there may be additional opportunities for gamesmanship in response to the proposed bill is not, to my mind, a reason

---

[3] Cf. Chris Sanchirico, *The Tax Advantage to Paying Private Equity Fund Managers with Profit Shares: What is it? Why is it Bad?*, 2007 working paper available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=996665.

[4] See Michael Knoll, *The Taxation of Private Equity Carried Interest: Estimating the Revenue Effects of Taxing Profits Interests as Ordinary Income*, 2007 working paper available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1007774.

for inaction now. Some of the workarounds, like paying carried interest on a deal-by-deal basis, change the fundamental economic contract between the fund managers and the investors in a way that investors may not put up with. Other workarounds may not actually "work" under current law. The point is that these details can be ironed out, and we should not let the private equity industry's threat of further gamesmanship justify inequities and inefficiencies in the current law.

Contact Information

Victor Fleischer
Associate Professor
University of Illinois College of Law
504 E. Pennsylvania Ave.
Champaign, IL 61820
(217) 333-1286

victor.fleischer@gmail.com