



## CRS Report for Congress

# Taxation of Private Equity and Hedge Fund Partnerships: Characterization of Carried Interest

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### Summary

General partners in most private equity and hedge funds are compensated in two ways. First, to the extent that they contribute their capital in the funds, they share in the appreciation of the assets. Second, they charge the limited partners two kinds of annual fees: a percentage of total fund assets (usually in the 1% to 2% range), and a percentage of the fund's earnings (usually 15% to 25%, once specified benchmarks are met). The latter performance fee is called "carried interest" and is treated, or characterized, as capital gains under current tax rules. H.R. 2834, introduced by Representative Levin on June 22, 2007, would characterize carried interest as ordinary income. This report provides background on the issues related to the debate concerning the characterization of carried interest. It will be updated as legislative developments warrant.

**Background.** Most private equity and hedge funds are organized as partnerships.<sup>1</sup> For tax purposes, a partnership is broadly defined to include two or more individuals who jointly engage in a for-profit business activity. They typically consist of general partners (who actively manage the partnership), and limited partners (who contribute capital). General partners may also contribute capital.

Tax considerations likely motivate the organization of private equity and hedge funds as partnerships.<sup>2</sup> In general, partnerships do not pay the corporate income tax and, instead, pass all of their gains and losses on to the partners. The returns of these partnerships are generally taxed as capital gains. In addition, the tax rules for partnerships

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<sup>1</sup> For a more complete description of the tax issues surrounding hedge funds and private equity managers, see CRS Report RS22689, *Taxation of Hedge Fund and Private Equity Managers*, by Mark Jickling and Donald J. Marples.

<sup>2</sup> Testimony of Treasury Assistant Secretary for Tax Policy Eric Solomon, Senate Committee on Finance, *Carried Interest I*, July 11, 2007.

allow sufficient flexibility to accommodate many economic arrangements, such as special allocations of income or loss among the partners.

General and limited partners are compensated when the investment yields a positive return. This income, as mentioned above, is not taxed at the partnership level; only the individual partners pay taxes, usually at the capital gains rate.

In addition, the general partners generally receive additional compensation from the limited partners. Compensation structures may vary from fund to fund, but the standard pay formula is called “2 and 20.” The “2” represents a fixed management fee that does not depend upon the performance of the fund. It is characterized as ordinary income for the general partner and is taxed at ordinary income tax rates. The “20” is a share of the profits from the assets under management.<sup>3</sup> This portion of the general partners’ compensation is commonly referred to as the carried interest. Selecting this form of compensation aligns the interests of both the limited and general partners toward achieving a positive return on investment. Carried interest is currently characterized as a capital gain and taxed at the capital gains rate. Issues surrounding the characterization of carried interest are the focus of the remainder of this report.

**Character of Carried Interest.** Central to the current debate concerning the tax treatment of carried interest is whether it is compensation for services, or an interest in the partnership’s capital.<sup>4</sup> Current law treats carried interest the same as all other profits derived from the partnership and thus characterizes carried interest as being derived from an interest in the partnership’s capital. As a result, carried interest is taxed at capital gains rates, which have historically been lower than the rates on ordinary income. This rate differential is generally thought to motivate the current structure of compensation received by fund managers. If carried interests were treated as compensation for services provided by the general partners, then the realized gains would be characterized as ordinary income, taxed at generally higher rates, and subject to payroll taxes.

In the United States, debate on the appropriate characterization of carried interest has been brought to the forefront by both proposed legislation and a series of congressional hearings on carried interest. H.R. 2834, introduced on June 22, 2007, by Representative Sander M. Levin and others, would change the characterization of carried interest. The bill states that carried interest “shall be treated as ordinary income for the performance of services” and thus taxed as ordinary income at rates up to 35%. In addition, the Senate Finance Committee and the House Ways and Means Committee have held a series of hearings on carried interest.<sup>5</sup>

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<sup>3</sup> In some cases general partners are only entitled to a share of the profits if the fund surpasses a minimum rate of return, or hurdle rate.

<sup>4</sup> A second issue related to carried interest, deferral, is discussed more fully in CRS Report RS22689, *Taxation of Hedge Fund and Private Equity Managers*, by Mark Jickling and Donald J. Marples and in the testimony of Congressional Budget Office Director Peter R. Orszag, Senate Committee on Finance, *Carried Interest I*, July 11, 2007.

<sup>5</sup> U.S. Congress, Senate Committee on Finance, *Carried Interest, Part I*, July 11, 2007; U.S. Congress, Senate Committee on Finance, *Carried Interest, Part II*, July 31, 2007; U.S. Congress, Senate Committee on Finance, *Carried Interest Part III: Pension Issues*, September 6, 2007; U.S.

Debate concerning the characterization of carried interest is not unique to the United States. In fact, the United Kingdom's Treasury Select Committee has asked HM Revenue and Customs to explain a 2003 memorandum of understanding that allows general partners in private equity funds to characterize carried interest as investment income.<sup>6</sup> In addition, **Figure 1** illustrates that European countries have not achieved a consensus view on the appropriate characterization of carried interest.

**Table 1. Characterization of Carried Interest in the United States and Europe**

Characterization	Country
as capital gain:	Austria, Czech Republic, Denmark, Estonia, France, Greece, Ireland, Italy, Luxembourg, Norway, Spain, Sweden, United Kingdom, <b>United States</b>
as ordinary income:	Hungary, Latvia, Netherlands, Poland, Portugal, Romania, Slovenia, Switzerland
as dividend or other form of income:	Belgium, Finland, Germany

**Sources:** United States Internal Revenue Code and European Private Equity and Venture Capital Association, *Benchmarking European Tax and Legal Environments*, December 2006.

Most analysts view carried interest as representing, at least partly, compensation for services provided by the general partner. In some instances this distinction is clear, but in others it is more opaque. Analysts generally base their characterization of carried interest upon the degree to which the general partners' own assets are at risk and differences in the profit interest of the general and limited partners.

Some view carried interest as a type of performance-based compensation that should be characterized as ordinary income. That is, the general partner is being compensated for providing the service of generating a positive return on the investment. This argument would seem to have greater merit in cases where a "hurdle rate" must be reached prior to the award of a carried interest.

Some also argue for a change in the characterization of carried interest based upon the economic principles of efficiency and equity. Tax systems are generally deemed more efficient when they tax similar activities similarly. Critics note that under the current characterization of carried interest, these performance fees are taxed less heavily than other forms of compensation, leading to distortions in employment, organizational form,

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<sup>5</sup> (...continued)

Congress, House Committee on Ways and Means, *Hearing on Fair and Equitable Tax Policy for America's Working Families*, September 6, 2007.

<sup>6</sup> International Tax Review, *Private Equity Scrutiny Targets Tax*, August 2, 2007, and House of Commons, Treasury Committee, *Private Equity Volume 1 and 2*, July 24, 2007.

and compensation decisions.<sup>7</sup> As a result of these distortions they maintain that the economy misallocates its scarce resources. They also argue that the current treatment of carried interest violates the principles of both horizontal and vertical equity. That is, individuals with the same income should owe the same in taxes regardless of the form of the income, and that those that earn more should pay more in taxes than those that earn less.

Others view the current characterization of carried interest as appropriate, because of the general partners' contribution of "sweat equity" to the fund. That is, the general partners contribute their management skills to the partnership, in lieu of contributing capital. Once granted a carried interest, the general partner has an immediate ownership interest in the partnership, and thus is taxed on the proceeds of the partnership, based upon the character of the proceeds. Under this view, the limited partners agree to finance the carried interest through a reduction (relative to their capital investment) in their rights to the profits of the partnership.

This view, however, highlights a general inconsistency in the tax code, from an economic perspective — the blurring of the returns from labor and capital. For example, imagine the case of a sole proprietor who turns an idea into a business. If the sole proprietor is later able to sell the business for a profit, the tax system will characterize the profit as a capital gain, though the provision of labor unquestionably contributed to the increased value of the business. In other cases, such as when nonqualified stock options are exercised, the issue is more transparent, and the gain is characterized as compensation and taxed as ordinary income. Any subsequent gain or loss is characterized and taxed as a capital gain.

Some have interpreted this "sweat equity" argument to represent an implicit loan to the general partners that should be taxed somewhere between that of pure capital and pure ordinary income.<sup>8</sup> Under this option, the general partner would be viewed as receiving an interest-free loan from the limited partners equal to share of the partnership represented by the carried interest. The general partner would count the implicit interest from the loan as ordinary income.<sup>9</sup> Subsequent profits from the carried interest would then be taxed as capital gains.

Some view potential modifications to the treatment of carried interest as unadministrable. In testimony before the Senate Committee on Finance, Treasury Assistant Secretary for Tax Policy Eric Solomon stated that the current taxation of carried interest provides certainty for taxpayers and is administrable for the Internal Revenue

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<sup>7</sup> Aviva Aron-Dine, *An Analysis of the "Carried Interest" Controversy*, Center on Budget and Policy Priorities, August 1, 2007.

<sup>8</sup> Victor Fleischer, "Two and Twenty: Taxing Partnership Profits in Private Equity Funds," University of Colorado Legal Studies Research Paper Series, Working Paper No. 06 — 27 (June 12, 2007).

<sup>9</sup> The implicit interest is the interest that the general partner would have paid on the loan had it been made at market rates.

Service.<sup>10</sup> He cautioned against making significant changes in these rules, given the widespread reliance of partnerships on these rules.

Others argue that the current characterization of carried interest contributes to innovation and adds economic value to the economy. They assert that venture capitalists engage in risking time, money, and effort to assist the most compelling business models to improve the way that Americans live and work.<sup>11</sup> Further, they argue that private equity allows companies to invest in long-term strategies that might otherwise be ignored by the managers of publicly traded companies forced to keep a close eye on quarterly earnings.<sup>12</sup>

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<sup>10</sup> Testimony of Treasury Assistant Secretary for Tax Policy Eric Solomon, Senate Committee on Finance, *Carried Interest I*, July 11, 2007.

<sup>11</sup> Testimony of Kate D. Mitchell, Senate Committee on Finance, *Carried Interest I*, July 11, 2007.

<sup>12</sup> Testimony of Bruce Rosenblum, Senate Committee on Finance, *Carried Interest II*, July 31, 2007.