Taxation of Carried Interests: The Reform That Did Not Happen*

Howard E. Abrams**

Congress soon may revise the taxation of partnerships and their partners to treat as compensation income the returns to partners who contribute services to their venture. Under current law, the taxation of partnership income is determined not by reference to what the partners contribute to the venture but rather to the manner in which the partnership earns its profit.1 So, for example, if a partnership purchases capital assets and holds them for more than one year, any gain or loss then realized from the sale or exchange of those assets is includible by the partners as long-term capital gain.2 Similarly, inventory of the partnership is defined by reference to the business of the partnership (rather than to the businesses of its partners), and expenditures will be classified as “start-up costs” if the partnership enters a new trade or business even if one, two, or even all of its partners have actively conducted that trade or business for many years.3

The congressional interest in this technical nuance of partnership tax law flows directly from an article recently published by Professor Victor Fleischer.4 Professor Fleischer’s contribution to the literature does not rest on his recognition of this issue nor on his proposed revisions to the Internal Revenue Code; many have come before, with essentially the same arguments leading to the same proposed solutions.5 Rather, what

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** Professor, Emory Law School; Maurice R. Greenberg Visiting Professor, Yale Law School.
1. Treas. Reg. § 1.702-1(b) (as amended in 2005).
put Professor Fleischer on the map was a new contextualization of the carried interest issue: hedge funds and private equity investors operate as partnerships having billions of dollars under management, and the returns to the managing partners of these extraordinarily wealthy organizations have bordered on the astronomical. Thus, the scale of the carried interest issue has ratcheted up significantly, and that has shifted arguments from the technical to the fundamental: hedge fund and private equity managers make too much money, and it pours salt in the wounds when their tax rate is lower than everyone else’s.6 Or so the argument goes.7

I attempt in the pages that follow to address both the political and technical arguments raised in support of changing the taxation of carried interests. I conclude that (1) the current manner of taxing carried interests is more consistent with general principles of taxation than is admitted by its critics, and (2) changing the taxation of carried interests as suggested by its critics is far more difficult than claimed. As a result, I conclude that the statutory treatment of carried interests ought not be changed—which should not be understood as supporting the current system of taxation of the very wealthy. Those who annually are paid

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7 One often heard quip was: “it offends our values as a nation when an investment manager making $50 million can pay a lower tax rate on her earned income than a teacher making $50,000 pays on her income.” Kevin Drawbaugh, Hillary Clinton Slams Private Equity Tax Rate, BOSTON.COM, Jul. 13, 2007, http://www.boston.com/news/nation/articles/2007/07/14/hillary_clinton_slams_private_equity_tax_rate/.

$10 million or $100 million to do interesting work in an air conditioned office should pay more than we currently demand, even if that income arises from the sale or exchange of a capital asset. There are many ways to increase the taxation of our wealthiest citizens; my point is that changing the statutory taxation of carried interests is not the way to do it.

I. A BRIEF OVERVIEW OF THE TAXATION OF PARTNERSHIPS AND THEIR PARTNERS

A partnership is not a taxable entity. However, it computes its federal income taxes as if it were a taxable entity, and then the entity-level items of income, deduction, and credit are passed through to and reported by the partners. Each partner’s share of the entity’s taxable items is called the partner’s “distributive share.” Each partner must report her distributive share even if there are no distributions made by the partnership in the current taxable year. The characterization of each tax item (such as capital gain versus ordinary income or foreign versus domestic source income) is determined at the entity-level by reference to the partnership’s activities.

Because the partnership’s activities are taxable to the partners as the activities occur, they are not taxable again when distributions are made; that is, as a general rule, distributions from a partnership to a partner are treated as a tax-free return of basis. The partner’s entire adjusted basis in her partnership interest (usually called her “outside basis”) is available to offset the distribution; there is no basis allocation similar to

8. For example, the capital gain preference could be abolished as it was under the Tax Reform Act of 1986, it could be limited or phased out based on a taxpayer’s net capital gain includible in each taxable year (similar to the operation of Section 179 applicable to expensing in lieu of depreciation, see I.R.C. § 179(b)(2) (2000 & West 2008), amended by Pub. L. No. 110-185 § 102(a)), it could be limited based on the amount of a taxpayer’s gross income, net income or adjusted gross income (similar to the child care credit, see I.R.C. § 24(b)(1) (2000 & West 2008)), or it could be capped at a fixed amount without regard to a taxpayer’s other income or deductions (such as the exclusion for gain from the sale of a principal residence, see I.R.C. § 121(b) (2000 & West 2008)).
that applied in the corporate context. Further, if the distribution consists of property rather than of cash, there is no income recognition even if the value of the distributed property exceeds the distributee partner’s outside basis.\textsuperscript{17} The paradigm on which partnership taxation is based is entity transparency: the partnership is not a taxable entity and, generally, transactions between the entity and its owners are tax-free.\textsuperscript{18} Instead, taxation is imposed when the entity or its partners deal with third parties.\textsuperscript{19}

A partner’s outside basis starts at the amount of cash and the adjusted basis of property contributed to the venture by the partner.\textsuperscript{20} It is increased for distributive share of income and reduced for distributive share of loss.\textsuperscript{21} Additional contributions increase outside basis and distributions decrease outside basis,\textsuperscript{22} generally by the amount of cash and the adjusted basis of property distributed. Further, each partner increases outside basis for any increase (and decreases outside basis for any reduction) in share of the partnership’s borrowings. Thus, a partner’s outside basis generally reflects the partner’s after-tax investment (both debt and equity) in the venture.\textsuperscript{23}

The determination of each partner’s distributive share is determined by reference to the partnership agreement so long as each allocation as specified in the partnership agreement has “substantial economic effect.”\textsuperscript{24} In general, this requires that allocations must be consistent with the underlying economic arrangements of the partners\textsuperscript{25} and must affect the dollar amounts to be received by the partners from the partnership independent of tax consequences.\textsuperscript{26} With limited exceptions, the requirement of economic effect is satisfied by maintaining capital accounts for each partner and then using final capital account balances to determine liquidating distributions.\textsuperscript{27}

\textsuperscript{17} Id.
\textsuperscript{18} See generally Howard E. Abrams, \textit{The Section 734(b) Basis Adjustment Needs Repair}, 57 TAX LAW. 343, 343–44 (2004).
\textsuperscript{19} In its dealings with third-parties, a partnership is treated like any other taxpayer. United States v. Bayse, 410 U.S. 441 (1973).
\textsuperscript{22} See I.R.C. § 733 (2000) (discussing basis of distributee partner’s interest).
\textsuperscript{24} I.R.C. § 704(b)(2) (2000).
\textsuperscript{26} Treas. Reg. § 1.704-1(b)(2)(iii)(a) (requirement that economic effect be substantial).
Capital account maintenance is specified in detailed treasury regulations intended to ensure that each partner’s capital account reflects the partner’s economic share in the partnership.

The requirement of economic effect imposes a significant limitation on a partnership’s ability to allocate losses of the venture among the partners. In general, no allocation of loss can drive a partner’s capital account more negative than the maximum amount that the partner can be required to restore to the partnership upon liquidation of the partner’s interest in the venture. As a result, partnership losses cannot be allocated to a partner in excess of a partner’s net after-tax equity investment in the venture, unless the partner is willing to incur a potential obligation to contribute additional funds to the partnership; such an obligation, if it exists, is called a “deficit restoration obligation” (or a “DRO”).

II. A BRIEF DESCRIPTION OF CARRIED INTERESTS

The term “carried interest” is not defined in the Internal Revenue Code or in the Income Tax Regulations. Rather, it is a jargon term that has come to stand for a distributive share of partnership profits in excess of the partner’s relative capital contribution. Often, but not always, distributions on a carried interest are deferred until contributed capital has been repaid, sometimes with an interest-like return as well (usually called a “hurdle”). To understand the issues that surround the taxation of carried interests, it is important to appreciate the precise ways in which a carried interest can be specified.

As described above, a partner’s share of the economics of the partnership is defined by the partner’s capital account: the greater a partner’s capital account balance, the more value that eventually must be distributed to the partner. When we speak of the manner in which a partner’s interest is funded, we are describing the transactions that increase the partner’s capital account. A carried interest can be funded in at least three different ways.

First, a carried interest can be funded out of the partnership’s gross income, usually called a gross income allocation. For example, a partnership agreement might provide that S will be allocated 10% of the gross income of the venture. Such a funding mechanism divorces S’s

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31. For what constitutes an obligation to contribute funds to the venture, see Treas. Reg. § 1.704-1(b)(2)(c).
interest from that of the other partners because S becomes indifferent to the partnership costs and other expenditures. To be sure, if the partnership has no gross income, then S will be allocated nothing, and so a gross income allocation is dependent on the activities of the venture in a way that usual forms of compensation are not. Nonetheless, a gross income allocation is not in any sense an entrepreneurial return from the venture and so ought to be treated as compensation to the partner. Despite an initial misstep in this area, that is how such carried interests now are taxed.

Second, a carried interest might be funded out of annual net profit but without regard to profit or loss in other years. This funding mechanism, like the gross income allocation, really does not reflect an entrepreneurial return because one’s yearly profit is at most a fair substitute for long-term gain or loss.

Third, a carried interest could be funded out of overall income, taking into account all aspects of the partnership’s venture. So, for example, if the partnership has an aggregate net profit of $30,000, then S will be allocated 10% of that amount, or $3,000. It turns out to be surprisingly hard to craft such a funding mechanism.

Consider the following example. R contributes cash of $100,000 to the RS partnership while S contributes nothing but services. The partnership agreement provides that S will receive a carried interest of 10% of net profits. Assume that formation of the partnership is a tax-free event and that the partnership invests half of its cash in each of two investments: investment #1 and investment #2. Also assume that S manages the investments in exchange for the carried interest. Finally, assume that the partnership is formed in year 0, that investment #1 is sold in year 1 for $80,000, that investment #2 is sold in year 2 for $50,000, and that the partnership then liquidates. We get (where “CA” is the capital account and “OB” is the outside basis):

32. See Pratt v. Commissioner, 64 T.C. 203 (1975), aff’d in part, rev’d in part, 550 F.2d 1023 (5th Cir. 1977).

33. Rev. Rul. 81-300, 1982-2 C.B. 143 (payment based on gross rentals can be treated as a “guaranteed payment” under Section 707(c)). Congress has indicated that such gross income allocation received in exchange for services should be taxed under Section 707(a)(1) as compensation paid to a partner other than in his capacity as a partner. See S. PRT. NO. 169, 98th Cong., 2d Sess., at 226 (Comm. Print 1984).

As these final capital balances in Figure 1 show, the partnership’s cash of $130,000 will be distributed $127,000 to R and $3,000 to S, reflecting their 90/10 sharing ratio. In year 1, there was a partnership-level gain of $30,000, allocated $27,000 to R and $3,000 to S. None of the available cash of $80,000 was distributed in year 1, but that does not preclude immediate taxation in the year of sale. As described above, partners are taxed on the partnership’s income without regard to whether that income is distributed in the current year. Thus, R and S have a tax burden from their distributive shares even though neither received any funds with which to pay their tax obligations. While there is nothing intrinsically wrong with such a result, few taxpayers relish the prospect of paying tax now but receiving cash later. So suppose that the partnership agreement also requires that available cash be distributed each year and that R’s contributed capital be distributed before any distributions are made to S. In that case, the books would have been:

As these final capital balances in Figure 2 show, the partnership’s cash of $130,000 is distributed $47,000 to R and $3,000 to S, reflecting the 90/10 sharing ratio of the partners; the only change is that a portion of R’s return ($80,000) is received in year 1 and a portion ($47,000) in year 2. R now has plenty of cash with which to pay the tax liability incurred in year 1, but S continues to face the problem described above: no immediate cash despite the immediate tax obligation. Suppose, then, that the
partnership had distributed its available cash first as income was allocated and then as a return of capital. In that case, the books would have been:

As shown in Figure 3, each partner is distributed in year 1 cash equal to distributive share of gain, and this ensures that no partner faces the problem of a tax liability without equivalent cash. The overall sharing ratio remains unchanged at 90/10; the only difference now is that each partner has received cash in year 1. In fact, partner S receives all of her share of cash in year 1 rather than in year 2.

Suppose, though, that investment #2 had been sold in year 2 not for the $50,000 that it had cost the partnership, but instead for only $30,000; that is, suppose it were sold at a $20,000 loss. Now, over the life of the partnership there is gain of only $10,000: the profit in year 1 was partially offset by the loss in year 2. If S’s carried interest is to reflect a true entrepreneurial return, then S’s net share should be 10% of $10,000, or $1,000. Since S was allocated $3,000 of income in year 1, S must be allocated $2,000 of loss in year 2. Thus, the books would be:

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The totals in Figure 4 show that S must now repay $2,000 to the venture for distribution to R, a repayment that partially offsets the year 1 distribution to S. But if S has not agreed to a deficit restoration obligation, this repayment cannot be demanded. Indeed, if S has no deficit restoration obligation, the loss allocation to S is improper and so the books of the partnership actually will be:

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27,000 & 27,000 & 3,000 & 3,000 \\
(27,000) & (27,000) & (3,000) & (3,000) \\
50,000 & 50,000 & 0 & 0 \\
(20,000) & (20,000) & 0 & 0 \\
$30,000 & $30,000 & $0 & $0 \\
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As shown in Figure 5, though, the economics of the venture have been distorted: the partnership has turned a profit of $10,000, and of that amount S has been allocated $3,000, or fully 30%. As these examples make clear and is well known by tax advisors, there simply is no way to ensure that S receives exactly the agreed upon carried interest return without creating phantom income in the early years, risking a claw-back obligation in the later years, or some combination of both. In practice, we often see early distributions made to the owner of a carried interest in an amount sufficient to cover the anticipated tax liability but no more (usually called a “tax distribution”); this distribution creates the risk of either (a) a claw-back obligation to the holder of the carried interest or (b) excess loss allocated to the other partners. Whether the partnership agreement ultimately includes (a), (b), or some combination of the two is a business decision for the partners to resolve before the venture starts.

III. A BRIEF HISTORY OF THE TAXATION OF SERVICE PARTNERS\textsuperscript{35}

In the absence of a non-recognition provision, the transfer of property or services to a partnership in exchange for an interest in the venture would be a taxable event.\textsuperscript{36} However, since Subchapter K was first
added to the Code in 1954,\textsuperscript{37} Section 721 has provided that “[n]o gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.”\textsuperscript{38} It is far from clear whether this provision should apply to a transferor of services: courts have looked to Section 351 when interpreting Section 721,\textsuperscript{39} and the teaching of Section 351 plainly cuts in favor of non-recognition.

To be sure, the contribution of services to a corporation is not described in Section 351, but that is because Section 351(d)(1) specifically excludes services from the definition of “property.”\textsuperscript{40} There is, though, no partnership provision equivalent to Section 351(d)(1). Accordingly, unless Section 351(d)(1) is redundant, the correspondence of Sections 721(a) and 351(a) along with the lack of a Subchapter K provision corresponding to Section 351(d)(1) strongly suggests that Section 721(a) applies to the contribution of services.\textsuperscript{41} Further, Section 721(a) also protects the partnership from recognition on the transaction, and the corresponding provision in Subchapter C, Section 1032(a), applies to contributions of “property,” which in this context includes services.\textsuperscript{42}

Nevertheless, the regulation promulgated under Section 721 has long provided that the contribution of services in exchange for a partnership interest is a taxable transaction, at least in some circumstances. Cryptically, the regulation provides:

To the extent that any of the partners gives up any part of his right to be repaid his contributions (\textit{as distinguished from a share in partnership profits}) in favor of another partner as compensation for services . . . section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61.\textsuperscript{43}

\textsuperscript{38} I.R.C. § 721(a) (2000).
\textsuperscript{39} See, \textit{e.g.}, United States v. Stafford, 727 F.2d 1043, 1048–49 (11th Cir. 1984) (discussing non-recognition of limited partnership interest).
\textsuperscript{40} I.R.C. § 351 (2000 & West 2008).
\textsuperscript{41} That is, Section 351(a) does not apply to services because Section 351(d)(1) says so; in the absence of Section 351(d)(1), presumably Section 351(a) \textit{would} apply to services. So, since Section 721 uses the same language as Section 351(a) and because Subchapter K has no provision equivalent to Section 351(d)(1), Section 721 should apply to services.
\textsuperscript{42} Treas. Reg. § 1.1032-1(a) (as amended in 2008).
\textsuperscript{43} Treas. Reg. § 1.721-1(b)(1) (as amended in 2005) (emphasis added).
If a partner contributes services in exchange for a share of the capital and profits of the partnership, we say that the service partner has received a “capital” interest. The quoted regulation unquestionably provides that receipt of such a capital interest by a service partner is taxable to the partner, a result with which the courts have agreed. But by implication, this regulation seems to say that if the service partner receives only a share of future profits (a “profits interest”), then the event is tax-free.

Or so everyone thought until 1971. In *Diamond v. Commissioner*, the Tax Court held that the contribution of services to a partnership in exchange for a mere profits interest is taxable to the service partner, a result affirmed on appeal. Indeed, the appellate court recognized the “startling degree of unanimity” by the commentators in opposition to the Tax Court’s result in *Diamond* as well as a legislative history that was “equivocal.” But in the absence of regulations speaking directly to the issue, the Circuit Court thought “it sound policy to defer to the expertise of the Commissioner and the Judges of the Tax Court.”

So the fight shifted from the theoretical to the practical. Because the value of a profits interest depends on the future success of the partnership’s business venture, determining that value when the partnership interest is created often will be difficult. Taxpayers have argued for low, or even zero, initial values with surprising success. In response to the practical difficulties in valuing a profits interest, the Internal Revenue Service (IRS) promulgated an administrative rule that relinquished its victory in *Diamond* in most circumstances.

46. Diamond v. Commissioner, 56 T.C. 530 (1971), aff’d, 492 F.2d 286 (7th Cir. 1974); accord Campbell v. Commissioner, 943 F.2d 815 (8th Cir. 1991).
47. *Diamond*, 492 F.2d at 289.
48. *Id.*
receipt of such an interest as a taxable event for the partner or the partnership. 52

However, this rule does not apply:

(1) If 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) If within two years of receipt, the partner disposes of the profits interest; or
(3) If the profits interest is a limited partnership interest in a “publicly traded partnership” within the meaning of section 7704(b) of the Internal Revenue Code. 53

In Revenue Procedure 2001-43, 54 the IRS clarified that the rule of Revenue Procedure 93-27 applies whether or not the profits interest is vested when received and that, if the interest initially is unvested, the vesting of the interest is not itself a taxable event. Thus, Revenue Procedure 2001-43 made clear that the rules of Section 83 do not apply to the contribution of services to a partnership in exchange for a profits interest other than in the three narrow exceptional fact patterns identified in Revenue Procedure 93-27. However, neither Revenue Procedure actually mentions Section 83.

Section 83, enacted largely to rationalize the taxation of restricted stock provided to a corporation in exchange for services, 55 applies broadly whenever property is received “in connection with the performance of services.” 56 And while neither Revenue Procedure 93-27 nor Revenue Procedure 2001-43 mentions Section 83, proposed regulations have since been promulgated that apply the rules of Section 83 to a partnership interest received in connection with the performance of services. 57 In general, Section 83(a) provides that the excess of the fair market value of property over the price paid by the service provider is includible in the service provider’s gross income when the property first becomes vested, where vested means no longer subject to a

substantial risk of forfeiture.\textsuperscript{58} In this context, a “substantial risk of forfeiture” includes a requirement that services be provided in the future.\textsuperscript{59} Thus, a service partner who must perform future services can defer recognition of income that would otherwise be includible immediately under \textit{Diamond}.

There is, though, a cost for this deferral: when the partnership interest becomes transferable or is no longer conditioned on the performance of future services, the service partner must include the then-current fair market value of the interest as ordinary income.\textsuperscript{60} Thus, if the partnership interest appreciates, the entire appreciation eventually will be taxed as ordinary income.

Under the proposed regulation, property covered by Section 83(a) is not treated as transferred until the recipient is taxed.\textsuperscript{61} Thus, while the interest remains unvested, the service partner cannot be treated as a partner unless the service partner owns an additional partnership interest. That means, in particular, that no allocations of partnership-level items can be made to the service partner with respect to the unvested interest. Once the interest vests, the service partner will be taxed.\textsuperscript{62} Under the proposed regulation, the partnership is entitled to a deduction if payment to the service partner would have been deductible under Section 162 or Section 212,\textsuperscript{63} and the service partner is treated as contributing property to the partnership equal to the amount of income includible under Section 83(a).\textsuperscript{64}

But this result can be avoided if the service partner files an election under Section 83(b) within thirty days of receiving the interest.\textsuperscript{65} If such an election is filed, the service partner must immediately recognize as ordinary income the excess of the value of the partnership interest over the amount (if any) paid for the interest.\textsuperscript{66} For determining the
value of the interest, any risk of forfeiture is ignored. If a partner files an election under Section 83(b) with respect to an unvested partnership interest received in connection with the contribution of services and the interest is subsequently forfeited, the service partner is not entitled to a deduction despite the prior inclusion.

In sum: (1) in Diamond, the government won the legal argument that receipt of a profits interest is a taxable event; (2) having established in Diamond that receipt of a profits interest is taxable to the service partner, twenty years later the government reversed course and provided by administrative fiat that receipt of a profits interest generally will not be taxable; and (3) roughly fifteen years after that, the government proposed regulations that seemingly reject the prior administrative regime in favor of taxation under Section 83, a result consistent with Diamond but inconsistent with the Revenue Procedures. Unsatisfied with a mere 180 degree shift in policy, these newly-promulgated proposed regulations go 180 degrees more by allowing a service partner and the partnership to elect into a system of taxation much like that described in the Revenue Procedures. If a service partner receives a vested interest, receives an unvested interest and files an election under Section 83(b), or receives an unvested interest that eventually vests, the proposed regulations permit the income recognized by the service partner under Section 83 to be based on the liquidation value of the interest. Because the liquidation value of a profits interest always is $0, if the service partner receives only a profits interest and is taxed on its immediate liquidation value, there is no income to the service partner. Thus, while the mechanism for allowing a profits interest to go untaxed will change, the result will not. This election is only

68. I.R.C. § 83(b)(1) (final flush language).
69. See supra note 46 and accompanying text.
74. If an unvested interest is received by a service partner and an election is filed by the service partner under Section 83(b), a subsequent forfeiture of the interest will trigger a set of "forfeiture" allocations to back-out prior allocations to the service partner. See Prop. Treas. Reg. § 1.704-1(b)(4)(xii)(c), 70 Fed. Reg. 29675, 29681-82 (June 13, 2005); Prop. Treas. Reg. § 1.706-3(b), 70 Fed. Reg. 29682, 29682 (May 24, 2005). Note that the partnership must include in income any amount deducted upon the grant of the unvested interest if that interest ultimately is forfeited. Treas. Reg. § 1.83-6(c) (as amended in 2005).
disallowed when an interest (a) is an interest in a publicly-traded partnership, (b) is transferred to the service partner in anticipation of a subsequent disposition by the service partner, or (c) is related to a substantially certain and predictable stream of income.\footnote{See I.R.S. Notice 2005-43, 2005-1 C.B. 1221, available at http://www.irs.gov/irb/2005-24_IRB/ar10.html.}

IV. PROPOSALS TO CHANGE THE TAXATION OF CARRIED INTERESTS

Professor Fleischer did not propose that Section 83 be applied to the grant of a profits interest,\footnote{Fleischer, supra note 4.} nor did Professor Gergen before him.\footnote{Reforming Subchapter K, supra note 5.} Several bills have been introduced in Congress that would increase the tax burden on service partners who receive a carried interest, but none of those bills propose taxation under Section 83. As we know, the courts have held that Section 83 in fact applies to the grant of a profits interest,\footnote{See supra notes 46–49 (discussing Diamond v. Commissioner, 56 T.C. 530 (1971), aff’d, 492 F.2d 286 (7th Cir. 1974)).} but the Treasury and the IRS have determined that such a system is unworkable.\footnote{See supra notes 51–53, 70 (discussing Revenue Procedure 93-27).} As a result, reform efforts have headed in a different direction.

Professor Gergen argued more than two decades ago that receipt of a profits interest should continue to be tax free but that distributive share on the carried interest, to the extent it is allocable to (a) the partnership’s current earnings or (b) unrealized appreciation in partnership assets, be treated as compensation without regard to the partnership’s activities that generate the income.\footnote{See generally Reforming Subchapter K, supra note 5.} Professor Fleischer advocates a similar regime, albeit one in which partners could elect to report as ordinary income not their actual distributive share but instead an objective return based on an imputed invested amount of capital.\footnote{Fleischer, supra note 4.}

On October 25, 2007, Representative Charles B. Rangel (D-NY), Chairman of the House Committee on Ways and Means, introduced a comprehensive tax reform bill (H.R. 3970) that includes a proposed new
Section 710 of the Internal Revenue Code. This provision also has been included in the Temporary Tax Relief Act of 2007 (H.R. 3996), introduced by Chairman Rangel on October 30, 2007. Proposed Section 710 would change the taxation of any “investment services partnership interest” and represents the most recent legislative response to the carried interest debate.

The basic thrust of proposed Section 710 follows in broad outline the proposals of Professors Gergen and Fleischer that distributive share on carried interests be treated as compensation income to the service partner. Proposed Section 710 applies only to a partnership investing in securities, commodities, or real estate and then only to a partner who provides to the partnership a “substantial quantity” of service consisting of investment advice, management of assets, or help in arranging financing. Such a partnership interest is called an “investment services partnership interest.”

Under the general rule of proposed Section 710(a)(1), the net income with respect to an “investment services partnership interest” must be treated by the partner as ordinary income without regard to the character of the partnership’s activity. If, for example, the partnership owns an apartment complex, then this rule would have little impact on the partner’s distributive share of rental income (because it would be ordinary income even in the absence of proposed Section 710). But it

85. H.R. 3970 § 710.
86. Technically, an “investment service partnership interest” is defined as a partnership interest if the partner provides to the partnership any of the following services: (1) advice as to the advisability of investing in, purchasing, or selling any “specified asset”; (2) managing, acquiring, or disposing of any “specified asset”; or (3) arranging financing with respect to acquiring “specified assets.” H.R. 3970 § 710(c)(1). It also includes “any activity in support of any service described in” (1) through (3). H.R. 3970 § 710(c)(1)(D). In this context, a “specified asset” includes securities, commodities, and real estate. It also includes options and derivative contracts with respect to such assets. H.R. 3970 § 710(c)(1) (final flush language).
87. Distributive share of net loss allocated to an “investment services partnership interest” is limited to the extent of prior distributive shares of net income, with any excess loss carried forward. H.R. 3970 § 710(a)(2)(B). This limitation is relaxed for the purchaser of an “investment services partnership interest.” H.R. 3970 § 710(a)(2)(D). Suspended losses do not reduce the partner’s outside basis. H.R. 3970 § 710(a)(2)(C).
would convert distributive share from disposition of the real estate into ordinary income from capital gain. However, even as to the rental income, proposed Section 710 would have an impact because it specifically provides that the net income allocated to the owner of an “investment services partnership interest” is treated as compensation for purposes of the Social Security and Medicare taxes under Section 1402(a). 88

However, proposed Section 710 does not recharacterize as compensation that portion of a partner’s distributive share reasonably allocated by the partnership to the “invested capital” of the partner owning an “investment services partnership interest.” 89 For this purpose, an allocation will not be considered reasonable if it results in an allocation of income to the “invested capital” of a partner providing investment services in excess of the amount that is allocated to the same amount of “invested capital” of any other partner not providing investment services. 90 “Invested capital” includes the amount of cash contributed by a partner as well as the fair market value of other property contributed by the partner (measured as of the date of contribution of the property). 91

“Invested capital” of a partner owning an “investment services partnership interest” does not include any funds loaned by the partner to the partnership (because it includes only the value of cash and property “contributed” to the partnership). 92 In addition, it does not include any amount contributed by such a partner to the extent “attributable to the proceeds of any loan or other advance made or guaranteed, directly or indirectly, by any partner or [by] the partnership.” 93 Application of this rule does not turn on whether the loan is with or without recourse, whether the owner of the “investment services partnership interest” is credit-worthy, or to whom the creditor will look for repayment. 94 For example, in the most extreme case, funds could be borrowed by a credit-worthy service partner (“G”) on a fully recourse basis and then contributed to the partnership. But if the partnership’s assets are pledged to secure the loan, the loan will not count as “invested capital” of G even though G is fully liable to the lender and even if the partnership’s assets eventually are used to repay some or all of the debt.

88. See H.R. 3970 § 710(a)(1)(A).
89. H.R. 3970 § 710(c)(2)(A).
90. H.R. 3970 § 710(c)(2)(A).
91. H.R. 3970 § 710(c)(2)(C).
92. H.R. 3970 § 710(c)(2)(C).
93. H.R. 3970 § 710(c)(2)(D)(i).
94. H.R. 3970 § 710(c)(2)(D)(ii).
G is fully liable to the partnership and to the other partners. Further, in computing a “reasonable” allocation on the investment services partner’s “invested capital” as compared with the “invested capital” of partners who have not contributed services to the venture, the loan made or guaranteed by a non-service partner is treated as “invested capital” of that non-service partner.95

If appreciated property is distributed to a partner with respect to an “investment services partnership interest,” the property is treated as sold by the partnership.96 As a result, gain will be recognized to the partnership and allocated among the partners in accordance with the usual rules governing allocation of partnership income, with that portion of the gain allocated to the owner of an “investment services partnership interest” subject to recharacterization as compensation under proposed Section 710(a) to the extent not attributable to the partner’s “invested capital.”97

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The following section is divided into three parts. First, I explain why Professors Gergen and Fleischer are misguided when they propose that distributive share on carried interests should be treated as compensation income independent of the activities of the partnership. Second, I suggest how a more nuanced focus on the technical details of carried interests should lead to a recharacterization of some distributions to service partners. Third, I identify some of the many technical faults in proposed Section 710, a provision which is so flawed that it should not be enacted even if taxation of carried interests should be modified.

95. H.R. 3970 § 710(c)(2)(D)(ii).
96. H.R. 3970 § 710(b)(4).
97. The rules recharacterizing gain as compensation extend beyond “investment services partnership interests” to certain “disqualified interests.” H.R. 3970 § 710(d)(1). A “disqualified interest” is any interest (other than nonconvertible and noncontingent debt) in any entity other than stock in a domestic C corporation or a foreign corporation subject to a comprehensive foreign income tax. H.R. 3970 § 710(d)(2). While a “disqualified interest” does not include a partnership interest, H.R. 3970 § 710(d)(2)(A) (final flush language), it includes an option to acquire a disqualified interest in an entity as well as derivative instruments entered into (directly or indirectly) with an entity or with an investor in an entity. An interest in an entity will only be a “disqualified interest” if the person holding the interest performs investment management services for any entity and the value of the interest is “substantially related to the amount of income or gain (whether or not realized) from the assets with respect to which the investment management services are performed.” H.R. 3970 § 710(d)(1).
V. HOW SHOULD CARRIED INTERESTS BE TAXED?

A. Distributive Share on a Carried Interest Properly Can Be Capital Gain

The character of distributive share under current law is determined by reference to the partnership’s activities.98 Thus, if the partnership earns ordinary income, it passes through to the partners as ordinary income. Conversely, if the partnership earns capital gain, it passes through to the partners as capital gain. Professors Gergen and Fleischer have argued that distributive share on a carried interest generally should be treated as compensation income to the service partner.99 Their proposals follow from their assumption that all returns to labor should be treated as compensation income, including the value (when received or as received over time) of an interest in partnership profits received in connection with the performance of services.100

While it is commonplace that income from labor cannot qualify as capital gain, the statute does not actually say this. The closest it comes is in its definitional sections, which limit capital gain to the “sale or exchange of a capital asset” and provide that a “capital asset” is all “property” with certain exceptions.101 These definitions are read as excluding returns to labor either for want of a “sale or exchange” or because “property” does not include services. Neither reading, though, is as strong as its advocates claim.

A “sale or exchange” requires, as a technical matter, that something owned by one taxpayer be transferred to another.102 So, for example, the cancellation of a share of stock or of a debt security is not a “sale or exchange” because the underlying property is extinguished rather than transferred. A second requirement of a “sale or exchange” is that the transferor receive something in return for the transferred item.103 Thus, an abandonment of property is not a “sale or exchange” even though ownership of the property moves from the abandoning taxpayer to someone else.104

98. See supra note 14 and accompanying text.
99. See supra notes 4–5.
100. See supra notes 4–5.
103. See Treas. Reg. § 1.1002-1(d).
Neither of these limitations necessarily excludes services from the reach of capital gains. The transferee of services surely receives something valuable that it did not have before, whether that something is a haircut, improved plumbing, or a new heart valve. And since in all these cases the transferor may be paid for the services rendered, it surely seems as if a “sale or exchange” of services has occurred.

The “sale or exchange” limitation has been interpreted to exclude carve-outs from the reach of the capital gain provisions. So, for example, renting property yields ordinary income rather than capital gain because the owner of the property has not sold or exchanged the rented property but rather has sold only a limited, carved-out slice. Similarly, the landlord who accepts payment for terminating a favorable lease (unfavorable from the perspective of the tenant) recognizes ordinary income because the landlord has retained rather than disposed of the underlying property.

It is hard to characterize the sale of one’s labor as the mere carve-out from a larger property interest. To be sure, the laborer generally sells only a portion of her labor and retains the greater share, but that by itself does not resolve the matter: a taxpayer who sells only a part of a larger piece of property is still entitled to capital gain treatment on the transaction so long as what is sold can fairly be described as “property” rather than as “income from property.” It may be the case that labor should not be described as “property,” an argument discussed immediately below, but if labor fairly can be so described, then selling only a portion of one’s labor (the effort of an hour or a day or a week,


for example) cannot fairly be characterized as a temporary, carved-out portion.\footnote{110}

This brings us to the “property” limitation. It is too late in the day to argue that the naked sale of one’s labor generates capital gain.\footnote{111} But, of course, the issue is not whether a carried interest is property under current law but rather whether the statute should treat a partnership interest received in connection with the performance of services as a capital asset. And while it often is said that the term “property,” when used in the Internal Revenue Code, does not include services, that is simply not true. To be sure, the term “property” sometimes does not include unadorned services, but sometimes it does. Consider Section 1032, providing that a corporation does not recognize income upon the transfer of shares in exchange for “property.”\footnote{112} Since a corporation has not engaged in profitable activity when exchanging its stock for assets of any kind, it makes sense for this provision to include services within the reach of “property,” and the regulations properly reach that conclusion.\footnote{113}

As discussed above, there is a reasonable statutory argument that Section 721 should have been interpreted to cover the contribution of services to a partnership. But putting aside the technical requirements of the Code for a moment, we should ask whether it makes sense for returns to labor to be treated as capital gain under any circumstances. As a starting point, it is clear that the capital gain/ordinary income distinction is not equivalent to the difference between returns to capital and returns to labor. Many returns to capital are taxed as ordinary income, and many returns to labor are taxed as capital gain.

Interest and dividends are returns to capital that are taxed as ordinary income.\footnote{114} While that result follows from the “sale or exchange” language in the statute, we are at this point trying to determine what Congress sought to capture when it defined capital gain, and regardless of the mechanism of exclusion, it is clear the interest and dividends are excluded from the definition of “capital gain.”\footnote{115} Gains from the

\footnote{110. It long has been recognized that the “sale or exchange” limitation in the definition of capital gain does a poor job of excluding from capital gain those returns which ought not qualify. See, e.g., Stanley S. Surrey, \textit{Definitional Problems in Capital Gain Taxation}, 69 Harv. L. Rev. 985, 988 n.7 (1956).


\footnote{113. Treas. Reg. § 1.1032-1(a) (as amended in 2008).


\footnote{115. Hort, 313 U.S. at 31; \textit{Stranahan}, 472 F.2d at 869.
disposition of inventory also are excluded (though not for want of a sale or exchange), as are amounts received for a letter if received by the writer of the letter or by the intended recipient. Conversely, amounts received for the sale of letters patent are treated as capital gain even if received by the inventor. Surely capital assets cannot plausibly be described as returns to capital nor can exclusions be described as returns to labor.

If a taxpayer purchases and improves a capital asset (by painting, plumbing, or roofing, for example), sale or exchange of the improved property qualifies as capital gain even though some or all of the gain is allocable to the owner’s labor. A taxpayer who forms a corporation enjoys capital gains on the sale or exchange of the shares even if the increase in value of the shares is attributable to the taxpayer’s efforts or business savvy. Indeed, a taxpayer who actively, regularly, and continuously trades securities reports the gains and losses as capital even though those gains and losses derive from the taxpayer’s acumen (or lack thereof) in making the trades.

Those who say that returns to labor cannot qualify as capital gain recognize these exceptions but treat them as anomalies. That is one way to view the matter, but there are alternatives. There is an anecdote that mathematicians tell about physicists:

The physicist hypothesized that all odd numbers greater than one are prime. To test this hypothesis, the physicist started with three and counted upward by twos, finding that five and seven and eleven and thirteen all were prime numbers, as predicted. The number nine, of course, was not prime, which presented a theoretical difficulty. So the physicist decided that nine was an experimental error and declared the theory proven.

Those who say that the capital gain/ordinary income distinction draws a sharp line between returns to capital and returns to labor treat these exceptions as anomalies, but perhaps they are not so anomalous if the line is drawn differently. We know that capital gain does not include inventory gain, wages and other usual forms of compensation, interest on debt, dividends on equity, or rental income. But it does

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121. Surrey, supra note 110, at 1002–03; see also Fleischer, supra note 4, at 43–44; Pendergraft, supra note 5, at 711.
include gain from the sale of stock despite the level of energy put into running the corporation or selecting the stocks. Is there a unifying theme? What is the touchstone of capital gain? Over the years, many explanations have been offered for the capital gain preference (and for the limitation imposed on capital loss), such as a bunching problem, amelioration of the corporate double tax, a general disinclination to tax returns to capital, and a proxy for an inflation adjustment. But none of these justifications for the capital gain preference holds up; indeed, I think it fair to say that the consensus today is that the capital gain preference is best supported by a non-tax policy argument coupled with a second-best solution to the lock-in problem caused by the realization doctrine.

First, the non-tax policy argument: the capital gain preference reduces the tax rate on returns to entrepreneurial risk to encourage risk-taking. From this perspective, it should reward only residual returns on investment, thereby excluding both periodic returns such as interest, rents, and dividends, as well as most compensation and any other income not dependent on the long-term success of the underlying

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122. At least one commentator has asserted that the original justification for the capital gain preference was that recognition of accrued gain in a single year would unjustifiably push a taxpayer into a higher bracket. William A. Friedlander, “To Customer”: The Forgotten Element in the Characterization of Gains on Sales of Real Property, 39 TAX L. REV. 31, 31 (1983).


124. The solution to the bunching problem is income averaging; reducing the rate of tax on capital gain provides a benefit even to taxpayers who perennially are in the highest tax bracket and so face no bunching problem. See Del Cotto, supra note 105, at 4 (discussing the meaning of “Property” in the Capital Assets definition). Because the capital gain preference applies to more than corporate stock, it cannot be justified as an amelioration of the corporate double tax. Accounting for inflation requires a proportional basis adjustment rather than a reduction in the rate applicable to taxable gain, a basis adjustment which should also be incorporated into the taxation of debt obligations to adjust both principle and interest computations. See Mitchell L. Engler, Partial Basis Indexation: Tax Arbitrage and Related Issues, 55 TAX L. REV. 69 (2001) (arguing that partial indexation of assets, but not debt, is a better response to lock-in than the capital gains preference).

125. See Noel B. Cunningham & Deborah H. Schenk, The Case for a Capital Gains Preference, 48 TAX L. REV. 319 (1993) (examining the capital gains preference); Del Cotto, supra note 105, at 4–5; Posting of Daniel Shaviro to Start Making Sense, http://danshaviro.blogspot.com/2007/05/tax-break-for-managers-of-private.html (May 15, 2007, 12:09 EST); Blum, supra note 123, at 266 (“Of the arguments against taxing capital gains in full, only a few carry much weight . . . . Full taxation of gains would tend to retard investment by enterprises, discourage risk-taking, and interfere with the mobility of capital.”).

126. As long ago as 1941, the Supreme Court recognized that “[t]he taxation of capital gains after deduction of capital losses on a more favorable basis than other income, was provided for . . . as the means of encouraging profit-taking sales of capital investments.” Helvering v. Hammel, 311 U.S. 504, 509 (1941) (citing H.R. REP. NO. 67-350, at 8 (1921)).
venture. Conversely, the capital gain preference should benefit owners to the extent they profit after accounting for operating costs (including labor and capital) of their business.

Nonentrepreneurial return includes all business income not dependent on the success of the venture. So, for example, it includes interest payments received by creditors because they get paid even if the borrower loses money. And it includes my salary from Emory Law School because I get paid even if the school is unable to fill its class. Indeed, almost all compensation lacks entrepreneurial risk and so should be classified as ordinary income. Even most performance-based compensation generally lacks entrepreneurial risk because it generally is payable even if only short-term goals are reached, and the owners of the business must, out of necessity, care about the long-term success of the venture. This is an important distinction and one to which we will return.

The capital gain preference also responds to the economic disincentives created by the realization doctrine. Because the realization doctrine defers taxation on unrealized appreciation so long (but only so long) as an appreciated asset remains unsold, the realization doctrine discourages the free movement of capital. This lock-in effect is exacerbated by the step-up in basis given to property held by a taxpayer until death. Of course, if the realization doctrine were eliminated either directly or indirectly, this problem would disappear. But the administrative difficulties created by such a direct attack on the

127. See, e.g., Surrey, supra note 110, at 990 (noting that the capital gain definition seeks to exclude “everyday profits of the business and commercial world”); id. at 1001 (stating that “salaries, wages, commissions, and professional fees are on the ordinary income side, along with the everyday profits of the businessman”).

128. This point recently was made by one of the business columnists for the New York Times, albeit not in the context of carried interests. In her column of June 8, 2008, Gretchen Morgenson proposed that corporate executives who receive performance-based compensation be required to repay such compensation if the corporation is required to restate past earnings on which such compensation was based; this is especially true when the restatement is based on actions of the executives. She further advocates that executives be required to repay performance-based compensation when they “take outsized risks to generate fatter pay packages.” Her argument is based on the disconnect between the need for shareholders to be concerned with long-term growth as compared with executive compensation triggered by short-term results; in effect, Ms. Morgenson argues that the existing compensation structure is essentially nonentrepreunerial, and she calls for that to be changed. Gretchen Morgenson, Pay It Back If You Didn’t Earn It, N.Y. TIMES, June 8, 2008, Business Section at 1–2.

129. See, e.g., Cunningham & Schenk, supra note 125, at 344–45.

130. The realization doctrine would be eliminated directly by requiring taxpayers to mark all assets to market; it would be eliminated indirectly by allowing recognition of gain to wait until disposition (as under current law) but with an imposition of an interest charge to account for the deferral.
realization doctrine have dissuaded Congress from making the attempt; as a second best alternative, Congress has reduced the lock-in effect by reducing the tax burden on most recognized gains.

This suggests that income ought to be excluded from the capital gain preference if the taxpayer cannot easily control the timing of its recognition. Such a limitation supports the exclusion from the capital gain preference of day-to-day profits of a business as well as inventory gains\(^{131}\) and most compensation. But note that this reasoning is fully consistent with current law applicable to the taxation of partners, even partners who receive their interests in connection with the performance of services, because the timing of the income includible by such partners is determined by the activities of the partnership. Thus, if distributive share will be characterized as ordinary income on the sale by the partnership of capital assets, the partners will have an incentive to defer such sales. This is precisely the lock-in effect to which the capital gain preference was intended to speak.

It may seem as if Section 83 is inconsistent with this interpretation of the capital gain preference, but in fact it is not. Under Section 83(a), recognition of compensatory property transfers are deferred until ownership of the property vests in the transferee, where vesting generally means that the property is not subject to a substantial risk of forfeiture.\(^{132}\) At least in the context of restricted stock, such vesting usually occurs after a fixed period of time or when certain corporate earning goals are reached. In such cases, timing of the recognition is not within control of the service-providing shareholder, and therefore, recognition as ordinary income is appropriate.

What makes the application of Section 83 to partnership interests fundamentally different from its application to corporate stock is the pass-thru taxation of partnership earnings. A controlling shareholder has no reason to cause the corporation to defer sale of its capital assets to exploit deferral under Section 83 because recognition of corporate-level gains does not affect shareholder-level taxation. But a controlling partner facing recharacterization of partnership-level capital gain into compensation income has good reason to defer the entity-level sale, and it is for this reason that application of Section 83 to profits interests is fundamentally inconsistent with the capital gain preference viewed as an ameliorating influence on the lock-in problem.

\(^{131}\) See Friedlander, supra note 122, at 34–35 (discussing the meaning and function of term “to customers”).

\(^{132}\) See Treas. Reg. § 1.83-3(b) (as amended in 2005).
B. Entrepreneurial and Nonentrepreneurial Carried Interests

As described above, one rationale underlying the capital gain preference is that it should reward only entrepreneurial returns. Not all distributive share fairly can be described as entrepreneurial. For example, gross income allocations made to a service partner are best characterized as compensation, and the law now characterizes such allocations in that way. Under Section 707(a)(1), “[i]f a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall . . . be considered as occurring between the partnership and one who is not a partner.” Further, Section 707(a)(2)(A) provides that:

If (i) a partner performs services for a partnership . . . (ii) there is a related direct or indirect allocation and distribution to such partner, and the performance of such service . . . and (iii) the allocation and distribution, when viewed 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, such allocation and distribution shall be treated as a transaction described in [Section 707(a)(1)].

This rule should capture not only gross income allocations (as are captured under current law) but also annual net income allocations that will not be offset by subsequent allocations of loss even if the partnership suffers losses in the future. That is, allocation on a carried interest, followed by the distribution of the allocated amount, to the extent not subject to a potential claw-back allocation does not reflect an entrepreneurial return because it is independent of the overall success of the venture. Such allocations and distributions, therefore, should be “properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership.” Indeed, while no regulations have been promulgated with respect to the service transfer component of Section 707(a)(2)(A), regulations under the corresponding property transfer component in Section 707(a)(2)(B) provide that the touchstone of

133. Technically it is not the gross income allocation itself but rather the associated distribution that is recharacterized under Section 707(a) as compensation.
136. Lee Sheppard also has suggested that carried interest taxation can be handled adequately under Section 707(a)(2)(A). See Sheppard, supra note 5, at 19–21.
recharacterization under Section 707(a)(2) is the extent to which a
distribution is subject to the entrepreneurial risks of the venture.\textsuperscript{138}

When an allocation and distribution are recharacterized as
compensation under Section 707(a)(2), the partnership-level capital gain
is not eliminated. Rather, it is allocated among the partners, who are
then treated as paying compensation to the service partner. To the
extent such payments constitute ordinary and necessary business
expenses, an offsetting deduction will arise.\textsuperscript{139} In many cases, all
partners will be in the same marginal tax bracket, and so the effect of
recharacterization will be to shift income among the partners but will
not change the net income they report in the aggregate. If, however,
some of the partners are exempt organizations or foreign taxpayers not
generally subject to U.S. taxation, recharacterization will have
significant fiscal impact.

The virtues of this approach are many. First, it does not create any
new complexity in the Internal Revenue Code: Section 707(a)(2)(A) is
already there. Second, it does not eliminate capital gain: when a
partnership sells a capital asset, the gain is includible without
recharacterization. Third, it is consistent with the premise underlying
the capital gain preference: entrepreneurial returns alone will qualify for
reduced taxation and income arising in connection with the performance
of services but not dependent on success of the venture will be taxed as
ordinary income. Fourth, when all of the relevant parties are high-
bracket U.S. taxpayers, it does not have the result of turning the
payment of compensation for ordinary and necessary business expenses
into a net income producing event, a result that is inconsistent with the
tax base as consisting of accessions to wealth: payment of compensation
for ordinary and necessary business expenses moves funds around but
produces nothing of value (that is, in fact, precisely what separates
payment of an ordinary and necessary business expense from a capital
expenditure).

C. Technical Flaws in the Legislative Reform Proposals

There are many technical flaws in the proposed legislation adding
Section 710 to the Internal Revenue Code, and there is no need to
recount all of them here.\textsuperscript{140} But it is worthwhile, I think, to identify the

\textsuperscript{139} I.R.C. § 162 (2000 & West. 2008).
\textsuperscript{140} See Close Look, supra note 5, at 962–71 (discussing the ambiguities and the
implementation difficulties of Section 710); see also AMERICAN BAR ASSOCIATION SECTION OF
TAXATION, supra note 84 (providing commentary on H.R. 2834); Schler, supra note 5, at 832–53
(discussing the specific and technical issues of Section 710).
most important conceptual failure in the proposed statute because it makes clear just how difficult it is to recharacterize distributive share on a carried interest as ordinary income without regard to the partnership’s activities.  

While proposed Section 710 excludes from its reach reasonable allocations made with respect to a partner’s “invested capital,” a ceiling is placed on this allowable reasonable allocation:  

An allocation will not be treated as reasonable for purposes of this subparagraph if such allocation would result in the partnership allocating 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 term “invested capital” means the fair market value at the time of contribution of any money or other property contributed to the partnership.  

These rules can be easily understood in the context of a simple example. Suppose X contributes cash of $96 to a partnership while Y contributes cash of $4 as well as services in exchange for an interest that falls within the definition of an “investment services partnership interest.” An allocation to Y will not be subject to the rules of proposed Section 710 to the extent that the partnership expressly makes an allocation attributable to Y’s contributed capital and that allocation does not exceed 4% of the partnership’s net income.  

If, in the next taxable year, Y contributes additional cash of $20 to the venture, then the maximum reasonable allocation of net partnership income that can be allocated to Y without recharacterization under proposed Section 710 increases to 20% (24 of 120 equals 20%). Such a result makes sense because, had Y contributed $24 initially, Y could have been allocated as much as 20% of the venture’s net income as a return to Y’s contributed capital. There is no reason why the same result should not be reached if the capital is contributed in a subsequent year, and the language of proposed Section 710 plainly reaches this proper result.  

141. This discussion is excerpted from Close Look, supra note 5, at 962, 970–71. 


143. H.R. 3970 § 710(c)(2)(C).  

144. This example assumes that all capital shares equally in distributions. If there are multiple classes of capital, the analysis becomes more complicated.  

145. The general rule recharacterizing distributive share as compensation explicitly is applied on a year-by-year basis, see H.R. 3970 § 710(a)(1)(A)-(B), while the definition of “invested capital” includes the value of all contributions (valued at the time of contribution), H.R. 3970 § 710(c)(2)(C).
But what if, rather than Y contributing additional cash in a subsequent year, the partnership instead returns some of X’s capital to X? Suppose, for example, that the partnership ultimately determines that it requires less capital than originally anticipated and so in year 2 distributes cash of $20 to X. Once that distribution is made, Y’s proportionate share of the contributed capital increases from 4% to 5%. But proposed Section 710 makes no allowance for adjusting the definition of a “reasonable” allocation on capital for distributions even if this distribution increases Y’s claim on all future distributions.

This omission in the context of carried interests is particularly important because many carried interests receive distributions only after capital is returned to the investing partners. As a result, the relative capital contributed by the general partner may increase year by year. But by ignoring such distributions, proposed Section 710 blinds itself to the changing economic relationship of the parties.

A similar significant omission in the definition of a “reasonable” allowance for distributive share attributable to contributed capital is the failure of Section 710 to account for undistributed distributive (i.e., allocated) share. For example, again assume that X contributes cash of $96 while Y contributes cash of $4, and assume that Y’s interest in the venture falls within the definition of an “investment services partnership interest.” Assume further that under the partnership agreement, net profit from the venture will be allocated 80% to X and 20% to Y. On these facts, and assuming the partnership has a single class of capital, the maximum reasonable allocation on Y’s capital equals 4%, and if the partnership makes such a specification, the remainder (16%) of the allocation to Y will be captured by proposed Section 710.

Assume the partnership earns a taxable profit of $50 in year 1, and that this income is allocated 80% (that is, $40) to X and 20% (that is, $10) to Y. Under the analysis presented above, of the $10 allocated to Y, $2 will be treated as attributable to Y’s capital and $8 will treated as compensation to Y. If the partnership retains its $50 profit, it now has aggregate capital of $150, of which $100 was contributed and $50 was earned.

What is the maximum reasonable allocation that can be made to Y, attributable to Y’s capital in the next taxable year? While Y’s contributed capital remains at $4, Y’s share of the venture’s aggregate capital now equals $14, and that is almost 10% of the venture’s aggregate capital ($14 of $150). That is, as the partnership allocates

146. Following the distribution, X’s contributed capital equals $76 while Y’s remains at $4, and $4 out of $80 equals 5%.
profit to Y in excess of Y’s relative share of contributed capital, Y’s share of the aggregate capital increases. To be sure, if the earned profit is distributed in the same proportion that it is allocated (that is $40 to X and $10 to Y), there will be no change in shares of aggregate capital. But to the extent such amounts remain undistributed, the maximum allowable allocation on Y’s capital should increase to reflect the prior taxable inclusion by Y. Indeed, by distributing the venture’s profits to the partners, followed by a re contribution of those profits, the partners can arrive at precisely this result. But surely there is no reason to force such a circular transfer of cash simply to arrive at what should be the correct statutory result.

Most holders of carried interests not only do not receive distributions equal to allocations, but in fact the investing partners generally receive distributions in excess of allocations; that is, carried interests share in allocations from the start but receive distributions only after capital has been returned to the limited partners.147 As a result, the relative share of partnership capital properly allocable to the carried interest simultaneously increases because (1) the owner of the carried interest sees his distributive share accumulated rather than distributed and (2) the other partners receive distributions not only of distributive share but also as a return of capital. Thus, in many partnerships, the relative share of invested capital (including both contributed capital and retained profits) dramatically shifts toward the holder of the carried interest.

Finally, in many partnerships, the return to the general partner is subordinated to a specified return (usually called a “hurdle”) on the capital of the limited partners. As a result, in many taxable years, the distributive share of the general partner may be far less than the allowable “reasonable” maximum if that amount is determined based on a pro rata comparison of “invested capital.” Such partnerships often authorize so-called “catch up” allocations in years of significant profit, which ensure that the general partner’s aggregate return is not prejudiced by an uneven earning stream of the venture.

For example, suppose a general partner holding an “investment services partnership interest” contributes 2% of the capital to a partnership. Suppose further that in the first three years of the venture, the partner’s net income is allocated exclusively to the limited partners. Finally, assume that in the fourth year of the venture, the partnership’s income is substantial and the partnership allocates 2% of the venture’s aggregate net income to the general partner, an amount that equals, say, 5% of the partnership’s income for the current taxable year. Under

147. See generally Abrams, supra note 34.
proposed Section 710 as written, the catch-up 5% allocation may be recharacterized as compensation to the extent of 3% out of the 5% of that allocation.148 But, of course, the entire 5% is nothing but a return on capital, albeit delayed. That is, if an amount could be allocated to the owner of “an investment services partnership interest” over multiple years without recharacterization under proposed Section 710, then the same amount should be permitted without recharacterization if allocated in one or more subsequent years. As this and the examples above show, in a complex partnership, it can be frighteningly difficult to define what is a carried interest and what is not.

VI. WHY NOTHING WAS DONE (AND WHY NOTHING WAS THE RIGHT THING TO DO)

There are, it seems, three possible explanations for the failure of carried interest reform to have succeeded. First, it could be that private equity outfoxed reform-minded academics. Professor Fleischer framed the carried interest issue largely in class-warfare terms, with private equity and hedge managers as the bad guys. Somehow, by the time legislative reform was proposed, the change captured real estate partnerships as well. But the arguments in favor of reform fit less comfortably on such a broad class of partners, many of whom are not wealthy and almost all of whom vote. Had the legislation targeted only private equity and hedge funds, it is hard to see how it could have failed.

A second explanation is that Congress did not want it to succeed in the first place. As Professor Fred McChesney first recognized more than twenty years ago,149 legislators who seek to maximize the value of their legislative activity for themselves can threaten insular groups with disadvantageous reform and then collect economic rents in exchange for not passing the legislation. While cynical in its view of the legislative process, it does no more than treat politicians as individual actors who have their own goals and work to accomplish their desired ends.

A third explanation is that the proposed reform of carried interest taxation was a bad idea badly executed, and sometimes bad laws fail simply because they should. It is a naïve view, to be sure, but I like to think that is has explanatory power. Of course, there is revenue to be raised, and private equity is a deep and politically expedient pocket. For

149. See generally Fred S. McChesney, Rent Extraction and Rent Creation in the Economic Theory of Regulation, 16 J. LEGAL STUD. 101 (1987) (examining politicians’ role in rent extraction and rent creation); see also Fred S. McChesney, Rent Extraction and Interest-Group Organization in a Coasean Model of Regulation, 20 J. LEGAL STUD. 73 (1991) (discussing the different models of redistribution within the economic theory of regulation).
carried interest reform to fail, it must be defeated every time it is proposed; for it to succeed, it must succeed only once. Carried interest reform was proposed in June as a way to pay for the extenders bill, and while it was defeated in that context, it surely will be introduced again after the November elections. Carried interest reform seems inevitable. Unwise, but inevitable.