The Carried Interest Controversy: Let's Not Get Carried Away

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The Carried Interest Controversy: Let’s Not Get Carried Away

Noël B. Cunningham* & Mitchell L. Engler**

Abstract

Fueled by significant press scrutiny, the tax treatment of “carried interests” has generated intense controversy in the tax academy and on Capitol Hill. Carried interests are profit shares granted to investment fund managers in exchange for services. Under current law, wealthy fund managers often report the income from the compensatory carried interest at the low 15% capital gains rate. This has provoked the recent outrage since ordinary workers pay tax on their compensation at regular rates as high as 35%. In response, Representative Levin recently proposed a bill which would tax fund managers at the higher 35% rate on all their fund earnings. While this response initially appeals as a matter of basic fairness, we believe that deeper analysis exposes several fatal defects in the Levin Proposal. In contrast to others who critique the Levin proposal, however, we similarly reject the do-nothing status quo. We advocate instead a more moderate legislative fix. Under our approach, the increased tax rate would apply to only a portion of the carried interest return, equal to a fixed rate of interest on the investors’ capital subject to the carried interest. As discussed below, this narrowed application has strong theoretic appeal. It also provides a practical middle-ground compromise between the two extremes of the Levin Proposal and the status quo.

The carried interest is best analyzed as an implicit loan to the manager since the manager receives the full profits from the invested capital subject to the carried interest. From this perspective, the taxable compensation is limited to the lack of interest on the “loaned” capital. Despite some recognition of its theoretic appeal, no commentator has yet to advocate adoption of the interest charge approach. We believe that several missing pieces to the analysis, including our key modification to the approach, explain its failure to gain traction. In contrast to other commentators, we would grant the manager an interest expense allowance for any foregone interest on the loaned capital. Our adjustment provides desirable consistency with the treatment of an actual interest-free loan. It also avoids an undesirable double taxation of the foregone interest (once as compensation, and a second time upon the fund’s actual realization of the carried interest profit). We grant this interest expense allowance in reliance upon an existing, but under appreciated, provision that permits

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“investment interest” expense to be deducted only against “investment income.” This significant limitation insures that the compensation from the carried interest will be taxed at the desired higher rates since it blocks use of the interest expense against the reportable compensation.

In sum, our approach makes sound economic sense and favorably treats the implicit carried interest loan the same as an actual interest-free loan. The Levin proposal goes overboard in taxing the carry more harshly than an actual loan. Current law misses the mark in the other direction by taxing the carry more lightly than an explicit loan. Finally, our modified approach also contains other benefits over the Levin Proposal. For instance, the Levin Proposal increases the “tax lock-in” effect over what it is under current law by increasing the tax rate on the managers’ realized carry profits. Our proposal favorably avoids this increase by maintaining the low capital gains rate on the realized carry profits.
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Introduction

Are the recent press clippings really true? Multi-millionaire investment fund managers pay tax on their hefty compensation at only a 15% rate while hard-working ordinary folks pay tax on their compensation at rates as high as 35%? Yes, indeed, our current tax system provides this upside-down result. Prompted by the recent press attention, this seeming anomaly has raised a firestorm in the legal academy and on Capitol Hill. In response, Representative Levin recently introduced a bill which would tax fund managers at the higher 35% rate on all their fund earnings. As a matter of basic fairness, this legislative response initially seems to make perfect sense. However, upon further reflection, we believe that the Levin proposal suffers several fatal defects. Unlike other commentators who reject the Levin proposal, though, we find the status quo equally unacceptable. We instead advocate a more moderate legislative fix, taxing only a specified portion of the managers’ income at the higher 35% rate. We rely on several missing pieces to the analysis, which, when taken into account, strongly support our approach as the most attractive solution to the carried interest problem.

As discussed more fully in Section I, the problem arises because a portion of a fund manager’s compensation takes the form of a profits interest in the fund. And under current law, this “carried interest” or “carry” is taxed as a regular partnership profits share, rather than compensation. So if the fund’s profits constitute long-term capital gain from the sale of stock (as they often do), the manager pays tax at the lower 15% capital gains rate. This raises the fairness critique since regular workers pay tax on their compensation at rates as high as 35%.

In response, tax policy analysts have considered two possible changes to the current treatment of carried interests. The most popular proposal would treat all amounts received under the carry as compensation income, subject to ordinary income tax rates. The Levin proposal adopts this response, as elaborated upon in Section II.A. The second approach would limit the compensation amount to a fixed interest rate of return on the amount of capital subject to the carried interest. As discussed more fully in Section II.B, the underlying theory is that managers implicitly borrow some of the fund’s capital for their own account¹ and that the compensation therefore is the lack of the customary interest charge for the use of another’s capital.

¹ This portion equals the carried profits percentage, typically 20%.
Despite its theoretic appeal and some active consideration, no commentator has yet to advocate adoption of the interest charge approach. We believe that several missing pieces to the analysis, including one appropriate modification to the approach, explain this failure to gain traction. By focusing on these missing links, Section III demonstrates why our modified interest charge approach best responds to the carried interest problem. Section III.A first discusses our important modification to the interest charge approach: we would treat the manager as making an interest payment on the implicit carried interest loan. In the absence of our modification, the interest charge approach suffers from several defects, including the double taxation of the compensation amount.\(^2\) As discussed in Section III.A, our interest expense adjustment neatly corrects these difficulties, and does so without sacrificing the ordinary rate taxation of the imputed compensation.\(^3\)

Section III.B then circles back to explain why our proposal is superior to the Levin proposal. This Section demonstrates our proposal’s greater compatibility with three important tax concepts: (1) the well-established principle that services performed in connection with one’s own investments do not generate taxable compensation; (2) the precept that close economic substitutes should be taxed the same; and (3) tax lock in, a leading justification for the capital gains preference. This Section also demonstrates an administrative advantage: the ability to limit the scope of the new regime through principled, rather than arbitrary, exemptions.

I. Brief Description of The Problem

The typical investment fund is structured as a partnership for tax purposes.\(^4\) Most of the fund’s working capital, typically 95-99%, comes from the passive investors who become limited partners.\(^5\) The fund

\(^2\) As discussed in Section III.A, the manager would first be taxed on its annual imputed compensation, and then again on the full amount of the carry profit when it is realized. In addition to such excess taxation, the unmodified interest charge approach taxes the carried interest more harshly than an actual loan. As discussed in Sections III.A and III.B.2, such harsher taxation of close economic substitutes is undesirable.

\(^3\) As discussed in Section III.A, the allowed interest expense could not be used to offset the imputed ordinary-rate compensation due to existing limits on the deductibility of investment interest expense.

\(^4\) This could be an actual (limited) partnership under state law, or alternatively a limited liability company (LLC) treated as a partnership for federal tax purposes. A tax partnership is not itself subject to federal income tax, in contrast to a corporation. Instead, partners individually report their share of partnership profits as realized by the partnership. I.R.C. § 702.

\(^5\) See, e.g., Aviva Aron-Dine, Center on Budget and Policy Priorities, An Analysis of the “Carried Interest” Controversy, available at http://www.cbpp.org/7-31-07tax.htm (managers typically contribute 1-5% of the capital in “private equity” funds); National Venture Capital Association, Venture Capital Fund Formation (investors typically contribute 95-99% of the capital in “venture capital” funds). Technically, the investors are “limited partners” only if the actual form of the fund is a state law limited partnership.
manager ("manager") contributes the remaining capital, and serves as the
general partner, performing services related to the fund’s investments in
portfolio companies. The manager itself typically also is a tax
partnership, comprised of the key individuals who actually manage the
fund’s investments.

The manager typically receives two types of compensation in
return for its services. First, it receives a fixed management fee based on a
percentage of invested capital, typically around 2%. The manager also
receives a “carried interest” or “carry,” which is determined based upon
the fund’s net profits, typically 20% of those profits. There is no dispute
over how the fixed management fee is treated for tax purposes. Everyone
agrees that this fee constitutes compensation to manager and must be
treated as ordinary income, subject to rates of up to 35%. There is,
however, no agreement on what is the appropriate tax treatment of the
carried interest.

Under current law, the carried interest is not treated as
compensation, but rather as the manager’s share of the partnership’s
profits. If these profits constitute a long-term capital gain from the sale
of stock (as they often do), then the manager reports the carried interest as
long-term capital gains and is subject to a maximum rate of 15%. Since

If the fund is formed as an LLC, the investors are passive non-managing “members” of
the LLC.

6 Technically again, the fund manager is the “general partner” only if the actual form is a
state law limited partnership. If the fund is formed as an LLC, the fund manager is the
“managing member.”

7 In addition to making the important buy and sell decisions, the fund manager also
might serve on the board of the portfolio company, serve as a strategic advisor etc. See,
e.g., National Venture Capital Association, Venture Capital Fund Formation, supra note 5.

8 Again, the actual form could be a state law partnership or an LLC taxable as a
partnership.

9 See, e.g., Victor Fleischer, Two and Twenty: Taxing Partnership Profits in Private
Equity Funds (forthcoming NYU Law Review 2008), currently available at
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=892440 (June 12, 2007 draft);
National Venture Capital Association, Venture Capital Fund Formation, supra note 5.

10 Id. The manager also receives a profits interest for any capital contributions. The
carried interest is in addition to the profits interest received for capital.

11 For excellent commentary regarding current law, including possible changes to the
current approach, see, e.g., Laura E. Cunningham, Taxing Partnership Interests
Exchanged for Services, 47 Tax L. Rev. 247 (1991); Fleischer, supra note 9; Mark
Gergen, Reforming Subchapter K, Compensating Service Partners, 48 Tax L. Rev. 69
(1992); Michael Knoll, The Taxation of Private Equity Carried Interests: Estimating the
Effects of Taxing Profits Interests as Ordinary Income, Institute for Law and Economics,
University of Pennsylvania Law School, Research Paper No. 07-20; Chris William
Sanchirico, The Tax Advantage to Paying Private Equity Fund Managers with Profit
Shares, Institute for Law and Economics, University of Pennsylvania Law School,
Research Paper No. 07-14; and Leo L. Schmolka, Taxing Partnership Interests
regular individual workers are subject to rates as high as 35%, the treatment of carried interests has raised a firestorm not only in the academy, but also on Capitol Hill.

To illustrate, consider the following basic facts that we will refer to throughout this article.

**Basic Facts:** The limited partners contribute $100 million cash to the partnership to invest in private equity. The manager and general partner, who does not initially contribute any capital to the partnership,\textsuperscript{12} will oversee the partnership investments in exchange for an annual management fee of 2% of the partnership’s net assets, plus 20% of the partnership’s net profits, if any. The partnership has no gains or losses in Year 1, but has $25 million in net long-term capital gains in Year 2 from the sale of stock, $5 million of which is allocated to the manager. In each of the following variations assume that:

i) each year the partnership has just enough ordinary income to pay the 2% management fee;\textsuperscript{13} and

ii) the relevant interest rate is 8%.

Under current law, each year the manager must report the annual $2,000,000 fixed fee as ordinary income. This amount is deductible by the partnership. Additionally, on the sale of the stock the partnership has a $25,000,000 profit, of which 20% or $5,000,000 is allocated to the manager as its “carry” share of the net profits, and is characterized as a long-term capital gain. Most observers find this latter characterization troubling. Why is it that these very highly compensated managers are taxed at a maximum rate of 15% on what appears to be, at first blush, compensation income while the rest of us pay taxes on our compensation at rates as high as 35%?

**II. The Proposed Solutions**

Over the past year, several commentators have argued that the current tax treatment of carried interests is inappropriate and should be

\textsuperscript{12} We make this assumption for ease of exposition. In actuality, the manager would contribute some portion of the capital. See note 5 and accompanying text supra.

\textsuperscript{13} Technically, the 2% management fee is a guaranteed payment under I.R.C. § 707(c) and, subject to I.R.C. § 263, is an ordinary deduction to the partnership. Since the partnership has ordinary income precisely equal to the guaranteed payment, the partnership has no net ordinary income for the year. See Reg. § 1.707-1(c) (Ex. 4) (demonstrating the netting of guaranteed payments against ordinary income, but not capital gains).
changed. The two most often proposed changes are: (i) treating all amounts received under the carried interest as ordinary compensation income, and (ii) imputing compensation to the manager each year in the amount equal to the rate of interest times the amount of capital subject to the carried interest.\footnote{A third possibility would require the fund manager to include the fair market value of the carried interest at receipt. This has not gained any real serious consideration due to valuation concerns. Since we share those valuation concerns, we set such possibility to the side, notwithstanding some potential theoretic appeal to such an approach. In addition, beyond valuation concerns, other arguments support taxation of something less than the full value as compensation. For instance, see the discussion of sweat equity on one’s own investments in Section III.B.1, and the discussion of tax consistency at Section III.B.2.}

A. The Levin Proposal: The All Ordinary Income Approach

The most popular proposal for dealing with carried interests is to characterize all amounts received under those interests as compensation income, subject to ordinary income tax rates.\footnote{E.g., Aron-Dine, supra note 5; Fleischer, supra note 9; Testimony of Joseph Bankman, Senate Finance Committee (July 31, 2007), available at http://www.senate.gov/~finance/hearings/testimony/2007test/073107testjb.pdf; and Testimony of Mark Gergen, Senate Finance Committee (July 11, 2007), available at http://www.senate.gov/~finance/hearings/testimony/2007test/071107testmg.pdf.} Representative Levin’s recent legislative proposal adopts this approach.\footnote{H.R. 2834 (110th Cong., 1st Sess), introduced by Representative Sander Levin on June 22, 2007.} The Levin Proposal deals only with the “character” of the income received under the carry (ordinary versus capital gains), not with when that income should be reported. Under this proposal, fund managers would report ordinary compensation income only if and when the partnership realizes a net profit. Applying the Levin Proposal to our Basic Facts, the manager would have $5,000,000 of compensation income in Year 2 as a result of the stock sale.

In addition to being very simple to apply, there are at least two theoretic arguments that can be made in support of this approach.\footnote{E.g., Aron-Dine, supra note 5. One might also favor this approach on practical grounds. See Fleischer, supra note 9. We discuss practical considerations at Section III.B.2 and III.B.4.} First, if one views a carried interest as nothing more than compensation for the manager’s services, one can argue that basic fairness demands this approach: amounts earned under the carried interest must be taxed at the same rates as those imposed on the compensation earned by others. Second, the preferential rate for capital gains is often justified as a way to encourage risky capital investments.\footnote{Note that this paper accepts the capital gains preference as a given under our current law. From a broader perspective, the carried interest problem highlights deeper...}
capital contributed by others (and not that contributed by the manager), there is no reason to apply the capital gains rates to the carry.\textsuperscript{19}

\textbf{B. The Interest Charge Approach}

Another approach that some commentators have considered is more limited in scope. It would require managers to report compensation annually, regardless of whether the fund makes a profit. The underlying justification for this approach is that the managers effectively borrow a portion of the fund’s capital\textsuperscript{20} for their own account without the customary interest charge and that this interest-free benefit should be currently taxed as compensation. Under this approach, the amount of compensation that the managers must report annually is determined by multiplying the rate of interest times the amount of capital subject to the carried interest.\textsuperscript{21} To illustrate, if we applied this interest charge approach to the Basic Facts, the manager would report $1,600,000 of compensation income for Year 1 and Year 2, calculated by multiplying the rate of interest (8\%) times the amount of capital subject to the carried interest ($20,000,000).\textsuperscript{22} In addition, in Year 2 the manager would report its actual $5,000,000 carry as long-term capital gain.

Theoretic support for this approach comes from the carry’s economic similarity to an interest-free loan from the fund investors to the manager in the amount of the capital subject to the carried interest. Indeed, the economics of the carried interest could be replicated by having the fund investors actually loan the manager the capital subject to the carry, and have the manager invest the loan proceeds in the fund.\textsuperscript{23} If so, the manager’s profit share and capital contribution percentage would be the same, and there would no longer be a carried interest.

difficulties from the taxation of different categories of income at different rates. Consideration of these deeper issues is beyond the scope of this paper.

\textsuperscript{19} Under this approach, managers still would receive capital gains on the portion of the investment profits related to their capital contribution percentage. See H.R. 2834, supra note 16, proposed § 710(c)(2) (exception for certain capital interests).

\textsuperscript{20} This portion equals the carried profits percentage.

\textsuperscript{21} For recent discussion of this possibility, see Fleischer, supra note 9. Prior to the current firestorm over the carry, Professor Schmolka raised such possibility regarding partnership profits interests more generally. Schmolka, supra note 11.

\textsuperscript{22} The amount of capital subject to the carried interest is the carried percentage, here 20\%, times the capital in the fund attributable to the investors ($100 million). Note that we have assumed the 8\% interest rate here. See Section III.B.1 infra for a discussion regarding the selection of the relevant interest rate.

\textsuperscript{23} In fact, it seems that the deals originally were structured as non-recourse loans. See Fleischer, supra note 9. For additional support in favor of this loan perspective, see the discussion infra at Section III.B how managers would avoid the harshness of the Levin proposal by simply restructuring the carry into an actual non-recourse loan. This would achieve a better tax result without changing the underlying economics.
The loan analogy supports the interest charge approach for several reasons. From the loan perspective, the carry’s compensation element stems from the absence of an interest charge for the manager’s use of the investors’ “loaned” capital. As such, the manager’s compensation is the foregone interest on the implicit interest-free loan, not the actual realized profits of the fund. It is useful to compare the results under the Levin Proposal and those under the interest charge approach in the case where the fund does not make a profit (i.e., either breaks even or loses money). Under the Levin Proposal, the manager would not report any compensation income with respect to the carry since the fund did not make a profit. Can we really say, though, that the manager has not received any compensation from the carry arrangement? In fact, the fund manager has received the same valuable right to the extra carried profits percentage regardless of how the fund performs. In this regard, consider a passive investor who purchases stock on credit. Such investor pays the same interest on the loan regardless of whether the stock yields a significant gain or fails to turn any profit at all. Similarly, the managers’ compensatory benefit equals the same foregone interest on the used capital regardless of the funds’ actual performance. In favorable contrast to the Levin proposal, then, the interest charge approach consistently imputes the same compensation income in this case as it does when the fund makes a profit.

In sum, the loan analogy highlights the significant under- and over-taxation flaws of the Levin proposal even if one accepts the stated justification that all compensation must be taxed at the ordinary rates. It undertaxes the manager when the fund breaks even or loses money. It overtaxes the manager when the carry income exceeds the interest it would have had to pay to borrow the invested funds. The loan analogy also unmasks shortcomings in the second argument made in favor of the Levin proposal: that fund managers have not risked their own capital with respect to the carry and therefore they should not benefit from the preferential rates afforded capital gains. But the tax law does not deny the capital gains preference on qualified investments purchased with borrowed funds, even where the debt is “non-recourse.”

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24 While there is no explicit loan in the case of the carried interest, the loan analogue perspective highlights the implicit borrowing element in the carried interest structure.
25 See discussion infra at note 53 as to why the interest return must be less than the full actual profits on the carry.
26 In theory, this might suggest an up-front inclusion equal to the value upon grant. This triggers the valuation concerns highlighted above in note 14. In addition, the value of the below-market loan is not the same as the value of the carried interest itself. See discussion regarding the return on the manager’s sweat equity at Section III.B.1.
27 Similarly, this approach would also result in too little tax where the fund is profitable, but at a level lower than the interest rate.
28 With non-recourse debt, the lender can look only to the value of the secured asset to satisfy the debt. The carried interest therefore is properly analogized to a non-recourse loan since the fund investors, not the fund manager, bears the loss if the investments lose
manager is viewed as borrowing funds from the investors and investing them, there is no reason that they should be denied benefits to which the other investors are entitled.

Finally, the loan perspective provides additional support for the interest charge approach apart from negating the stated justifications behind the Levin Proposal. For instance, the tax law already utilizes the interest charge approach in the case of an explicit interest-free compensatory loan. In favorable contrast to the Levin Proposal then, the interest charge approach would treat the carried interest structure and the explicit interest-free loan in similar fashion, consistent with their economic similarities.

III. The Modified Interest Charge Approach: Section 7872.

Notwithstanding the theoretic support for the interest charge approach, commentators to date have rejected it in favor of either the Levin Proposal or a do-nothing status quo. What explains this result? We believe the reason is that, as contemplated by other commentators, the interest charge approach contains significant shortcomings undercutting its appeal. There appear to be several missing pieces to the analysis, including one key modification, which, when taken into account, makes the interest charge approach the most attractive solution to the carried interest problem. Subpart A first discusses the important modification to the interest charge approach: we would treat the manager as making an interest payment on the implicit carried interest loan. Subpart B then circles back to compare our enhanced interest charge approach to the Levin proposal.

value. In the case of explicit non-recourse debt, taxpayers still receive the capital gains preference on qualified investments even though it is the lender who bears the risk of loss in such case. I.R.C. § 465 disallows certain deductions funded by non-recourse debt, but that is separate from the capital gain issue.

Current I.R.C. § 7872 imputes annual compensation equal to the loaned capital times the U.S. government’s borrowing rate. Note that I.R.C. § 7872 does not apply to the carried interest under current law. As noted above, the carried interest generally is treated consistent with its form as a partnership profits interest.

Under the Levin proposal, the carry and the explicit loan would be treated quite differently. All the carry profit would be treated as ordinary income under the carried interest structure. Only the interest element would be treated as ordinary income under the explicit loan. Regarding this important tax consistency point, we will need to make one key modification to the interest charge approach as contemplated by others. In particular, we must allow the fund manager an investment interest expense in the amount of the foregone interest. See Section III.A infra. See also Section III.B.2 infra for a deeper discussion of the problems related to the inconsistent treatment of close economic substitutes.
A. Improved Interest Charge Approach

As discussed above, the interest charge approach imputes compensation on the implicit interest-free loan from the fund investors to the fund manager. If the manager is deemed to have income from this interest-free loan, should not she also be given an interest expense in the same amount? Shouldn’t the manager be treated just as if she actually received compensation and used that compensation to pay the interest on the loan? Even though this seems rational, those who have suggested this approach say no. It is not exactly clear what their conclusion is based on. Possibly it is based on the fact that there is no actual loan, nor any actual interest payment. Or perhaps it is based on an underlying concern that if an interest expense were permitted, it would exactly offset the manager’s compensation, resulting in no net income to the manager. No matter what the rationale, we believe that denying the interest loan to the manager makes the interest charge approach extremely unappealing for at least two reasons.

First of all, under this regime, the manager will be overtaxed. The manager will first be taxed on its annual imputed compensation, and then again on the full amount of the carry profit when it is realized. In fact, this has the effect of taxing the manager’s compensation twice, once at ordinary rates and once at capital gains rates. To illustrate using our Basic

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31 See e.g., Testimony of Peter Orzag, Senate Finance Committee (July 11, 2007), footnote 23 (noting that advocates of the interest charge approach would not allow the interest deduction), available at http://www.cbo.gov/ftpdoc.cfm?index=8306&type=1. See also Fleischer, supra note 9, at n. 56 (“right tax policy here is to deny the [interest] deduction”; Schmolka, supra note 11, at 312 n. 105 (similarly concluding that there should not be any interest deduction).

32 Compare Schmolka, supra note 11, at 312 n. 105 (basing his disallowance, in part, on the lack of actual loan proceeds), and Fleischer, supra note 9, at n. 56 (basing his denial “on grounds that the loan proceeds are used to purchase or carry tax-advantaged property”).

33 Cf. Dean v. Commissioner, 35 T.C. 1083 (1961) (declining to impute the compensation on grounds that the offsetting interest expense results in no additional net income). See also, Howard Abrams, The Taxation of Carried Interests, 116 Tax Notes 183 (July 16, 2007) (arguing that in the case of an actual interest-free loan, the interest imputation offsets the compensation imputation).

34 Under Professor Schmolka’s formulation, the double taxation seems to be permanent since he would treat the offsetting interest as nondeductible personal interest. Under Professor Fleischer’s contemplation, the double taxation eventually might reverse itself. Professor Fleischer contemplates a possible basis increase in the partnership interest for the imputed compensation. See Fleischer, supra note 9 at n.70. If so, there would be an ultimate offset in that there would be less gain, or more loss, on sale. But this offset would not be triggered until a final sale of the partnership interest (and not just one investment therein). In addition, the offset might take the form of a capital loss on sale, which generally can offset only capital gains in the current and subsequent years. I.R.C. § 1211(b)(capital losses can offset only capital gains plus $3,000 of ordinary income); I.R.C. § 1212(b)(unused capital losses can be carried forward to subsequent years, but not back to prior years).
Facts, the manager would have compensation income in both Year 1 and Year 2 of $1,600,000, for a total of $3,200,000. In addition, the manager would also report $5,000,000 of capital gain income under the carried interest upon the fund’s stock sale. Therefore, the manager would have to report a total of $8,200,000 of income, even though its economic income is only $5,000,000. This is clearly an unfair, unwarranted result.

Second, for the well-advised taxpayer, these results would be very easy to avoid. Section 7872 prescribes rules for dealing with below market loans. Under this provision, if the partnership explicitly granted the manager an interest-free non-recourse loan in the amount of the capital subject to the carry, the manager would be treated as receiving compensation in the amount of the foregone interest AND as having an interest expense in precisely the same amount. As discussed in greater detail below, this disparate treatment of close economic equivalents is undesirable as well-advised taxpayers restructure their affairs to avoid the harsher result.

We believe, however, that modifying the interest charge approach to allow the interest expense (the “§ 7872 approach”) neatly resolves all competing concerns. The missing link is an existing code provision, § 163(d), whose application to this setting has not been fully appreciated. Under this provision, “investment interest” expense can be deducted only against “investment income.” This limitation already regulates the

35 In the case of an actual interest-free compensatory loan, the foregone interest is treated as first paid to the service provider as compensation, and then repaid to the service recipient as interest expense. I.R.C. § 7872(a)(1)(A) & (B). The latter interest expense imputation makes economic sense as it explains why the service provider does not in fact end up holding the initial compensation imputation as additional cash in hand. Note that this economic rationale applies equally as well to the implicit loan imbedded in the carried interest structure, which helps to explain the double taxation problem highlighted above. That is, the interest charge approach as currently contemplated imputes just a single payment made to the fund manager, which fails to account for the reality that there is no actual cash increase to the manager.

36 I.e., well-advised taxpayers would restructure the carry into an explicit interest free loan in order to receive the interest expense allowance. As such, the disallowance under the carry structure becomes a trap for the unwary or a penalty for those unable to restructure (e.g. on existing arrangements). It also imposes unnecessary transaction costs on those who do restructure the carry into a non-recourse loan. See discussion infra at Section III.B.2 for similar points regarding the choice between the interest charge approach and the Levin proposal.

37 Professor Abrams, for instance, notes that I.R.C. § 163(d) might defer the interest deduction in the case of an actual interest-free loan. But such reference is made only in a footnote attached to a textual statement that the compensation and interest will net out. Furthermore, there is no discussion of the key character role performed by Section 163(d), as discussed herein. Finally, the discussion relates only to the treatment of an actual loan, and does not connect § 163(d) to the carried interest itself. See Abrams, supra note 33.

38 I.R.C. § 163(d). Technically, the interest can be deducted only against “ordinary rate” investment income. But since the taxpayer can elect to treat capital gain income as
capital gains/ordinary income distinction at issue in the carried interest debate by prohibiting investment interest from offsetting compensation income. Furthermore, in the case of carried interests issued to managers of investment funds, the imputed interest expense must be, by definition, “investment interest.”\(^{39}\) With this limitation in mind, we can safely grant the imputed interest expense, secure in the knowledge that the fund manager cannot use it to offset the imputed compensation income.\(^{40}\) As demonstrated below, the § 7872 approach therefore insures taxation of the imputed compensation amount at the ordinary rates while also eliminating the over taxation problem.

Consider first the preservation of tax on the compensation at the ordinary rates. Recall our earlier example where the fund manager reported $1,600,000 of annual compensation income in both Years 1 and 2 under the interest charge approach. Our § 7872 approach would also impute an offsetting interest expense of $1,600,000 in each of those years. Due to the investment interest limitation, however, the fund manager would not be able to deduct the interest expense as an offset against the compensation. Assuming that the fund manager did not have any outside investment income, the Year 1 interest expense would go unused in that year. As such, the fund manager would pay tax on the imputed “ordinary” investment income, the taxpayer can use the investment interest expense as an offset against preferential rate investment income. I.R.C. § 163(d)(4)(B)(iii).

While there is no actual loan, the carried structure is equivalent to a loan from the investors to the manager, followed by a capital contribution of such amounts to the fund by the manager. As such, the interest should be treated as related to a loan used to fund investments. Hence, its designation as investment interest expense under the interest rules, which characterize interest based on the actual use of the funds. While the fund manager might like to claim that such imputed interest expense is “trade or business” interest expense to avoid the I.R.C. § 163(d) limit, this position would be inconsistent with the reporting of the stock sale gains as capital gain income (since trade or business gains do not qualify for the capital gains preference). I.R.C. § 1221(a)(1).

An interesting question concerns whether the compensation and interest imputations should also be done on the investors’ side of the transaction. On the investor’s side, there would be offsetting amounts of interest income and compensation expense. These amounts would not necessarily offset for tax purposes since investment management fees face certain limitations. For instance, I.R.C. § 67(a) permits the deduction of investment expenses only to the extent they exceed 2% of the taxpayers adjusted gross income. In addition, such investment expense is not allowed for purposes of the alternative minimum tax (AMT). I.R.C. § 56(b)(1)(A)(i). Such imputation therefore could harm some of the passive investors. (Many, but not all, of the investors are tax-exempt institutions that would not be affected one way or the other.) It might make sense to avoid the imputation on the investor side since the intent here is to tax an appropriate portion of the managers’ compensation, not to ensnare the investors in harsh, arbitrary disallowance provisions. For a critique of the AMT’s disallowance of similar expenses, see Prosmann v. Comm’r, T.C. Memo 1999-87 (while sympathetic to the unfair result, court felt constrained to follow the literal language of the statute). On the other hand, consistency with an actual loan would require such imputation.
compensation at the regular, ordinary tax rates in Year 1. The unused interest expense would be carried forward to subsequent year(s) until used against reported investment income.

Sticking with the same example, consider next how the § 7872 approach eliminates the double taxation problem. Under the original interest charge approach, we saw how the fund manager reported excess income of $3,200,000. Under the § 7872 approach, however, the fund manager has an offsetting investment interest expense in that exact amount. This expense can be used as a deduction against the realized carry profit. The fund manager therefore would pay tax on (i) $3,200,000 of compensation at the ordinary rates, and (ii) only $1,800,000 of carry profit at the capital gains rates, reflecting the excess return over the imputed compensation.

As demonstrated above, the § 7872 approach simultaneously alleviates the double taxation and preserves the desired ordinary income taxation of the imputed compensation. It also provides the desirable consistency with an actual interest-free loan. Related thereto, this approach also comports better with the underlying economics of the carried interest structure.

41 Our modified interest charge approach would not generate any additional income tax revenue from a fund manager who otherwise reports an offsetting amount of ordinary investment income (e.g., interest income). The fund manager would report more ordinary compensation income, but would use the deduction to offset investment income also subject to the ordinary rates. In this case, however, we are comforted that the fund manager would be paying tax at the regular higher rates on a significant amount of ordinary income. In sum, I.R.C. § 163(d) effectively insures a net reporting of ordinary income in an amount of the compensation imputation, even taking into account the interest deduction. Finally, note that the imputation would generate some employment tax revenue, especially the Medicare portion not subject to a wage cap. See discussion infra at note 67. The imputation also could cause some additional income tax liability by raising the fund manager’s adjusted gross income amount (AGI). A higher AGI could increase the tax liability by reducing other deductions, such as personal exemptions or un-reimbursed medical expenses.

42 The fund manager reported total income of $8,200,000 ($3,200,000 compensation plus $5,000,000 capital gain) but the fund manager received only $5,000,000 from the carry.

43 Note that the taxpayer does not have to use it against capital gain income if the taxpayer does not want to. The taxpayer can choose to pay the tax today at capital gains rates, and save the deduction for potential use against ordinary investment income later. See discussion at note 38 supra regarding how the expense is deductible only against ordinary rate investment income, with a taxpayer election to treat long-term capital gains and qualified dividends as ordinary income.

44 For year 2, the fund manager would report $1,600,000 of additional compensation, equaling $3,200,000 in the aggregate when combined with the year 1 compensation. The fund manager also would report $5,000,000 of capital gain with respect to the carry, but could offset that amount with the $3,200,000 investment interest expense.

45 Imputing the compensation income but not the interest expense drives a wedge between the underlying economics and the tax treatment. See note 35 supra.
B. Comparison of Our Improved § 7872 Approach to the Levin Proposal.

Section III.A demonstrated the improvement of our § 7872 approach upon prior formulations of the interest charge approach. This Section III.B now circles back to compare our enhanced interest charge approach to the Levin proposal. This Section first expands upon earlier discussion of two key defects of the Levin proposal: excess reporting of ordinary income, and the lack of tax consistency. This Section then introduces several new advantages of our § 7872 approach, relating to tax lock-in, and principled exemptions of many partnership arrangements.

1. Excess Reporting of Ordinary Income.

As discussed briefly in Section II.B above, the Levin Proposal goes too far by treating the entire carried interest return as ordinary income, rather than limiting the compensation inclusion to an interest rate return. This Section III.B.1 now takes a step back to develop further this integral point. As shown below, the Levin proposal suffers from an inconsistency regarding services performed in connection with one’s capital investments.

Let’s modify our earlier Basic Facts to assume now that the manager contributes all of the fund’s capital, thereby eliminating the passive investors. Under current law, the manager would report the entire $25 million stock profit in year 02 as long-term capital gain despite the fact that the gain is clearly a product of both the manager’s capital and its labor. Although one might argue that the tax law should bifurcate the return into its component parts, this has never been the done. It is well-established that if one performs services on one’s own behalf, the value of these services is not currently taxable. If this value is reflected in an increase in the value of the person’s assets, it will be taxed when those assets are sold, and will be characterized as gain (or loss) from those assets. This rule permits entrepreneurs to invest their services in their businesses on a pre-tax basis, an investment known as “sweat equity.”

It is interesting to note that the Levin Proposal would not change this result under these modified facts; it would simply follow the well-accepted principle that sweat equity does not generate compensation income even though it enhances the value of one’s capital investments.

[46] Recall how the manager performs a variety of services in connection with the fund’s investments. See note 7 and accompanying text supra. Note that the return on invested capital might be further subdivided into at least two additional categories: (i) a risk-free rate of return, and (ii) a risk premium.

[47] Similarly, where the manager invests less than 100% of the capital, the Levin proposal would not change the results on the profits related to the managers’ invested capital. See H.R. 2834, supra note 16, proposed § 710(c)(2) (exception for certain capital interests).
The Levin proposal seems to have lost sight of this well-accepted principle when it comes to the carried interest, however. Let’s return to our original Basic Facts where the passive investors contribute the capital, granting the manager a 20% carried interest. Just like under the modified facts, the $25 million stock profit in year 02 is comprised of multiple elements, including a return on sweat equity, and a return on invested capital.\(^48\) Here however, the Levin Proposal treats the manager’s entire return as ordinary income. It is difficult to reconcile this treatment with that given the sweat equity under the modified facts. It might appear at first that the manager’s failure to invest her own capital under the Basic Facts justifies treating the entire return as compensation. But this ignores two key interrelated points from Section II: (i) the carried interest is the economic equivalent of a non-recourse loan, and (ii) the use of borrowed funds does not negate the capital gains preference. To illustrate the latter point, assume the manager borrowed the invested capital on a non-recourse basis under the modified facts. The manager still would report the full $25 million profit as capital gain under the Levin proposal,\(^49\) even though others are bearing the risk of loss on the underlying invested capital.

These disparate outcomes significantly undercut the theoretic foundations of the Levin proposal’s treatment of carried interests. And while there is one meaningful economic difference between the original and modified examples, this distinction further highlights the greater appeal of our approach over the Levin proposal.\(^50\) As noted in Section II, the manager effectively receives an interest-free loan in exchange for services in the original case, suggesting that the appropriate response should target the foregone interest. Now armed with the additional benefit of our modified examples, we can see the further appeal of our § 7872 approach in that it provides consistency with the general treatment of sweat equity. That is, by limiting the compensation inclusion to the

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\(^{48}\) As noted above, the return on invested capital might be further subdivided into at least two additional categories: (i) a risk-free rate of return, and (ii) a risk premium.

\(^{49}\) As noted above in Section II.B, the capital gains preference is not denied where qualified investments are purchased with borrowed funds, even where the debt is “non-recourse.” If the manager actually borrowed 100% of the invested capital on a non-recourse basis, the manager might not be treated as the owner of the invested property for tax purposes. In this regard, recall that fund managers typically do invest some of their own capital. See note 5 supra and accompanying text.

\(^{50}\) Thus, we should be careful to avoid extending the results of the modified examples too far in the other direction. That is, it might seem at first that the lack of any compensation income under our modified examples supports the current law approach of no compensation income at all under our original carried interest example. This argument ignores the key economic difference discussed in the text: i.e., the provision of an interest-free loan to the manager in exchange for services. As such, compensation should be reported, but it should be based on the foregone interest rather than the full actual return.
foregone interest, our approach permits the fund manager to report her pro rata share of the return on the sweat equity as capital gains.\footnote{In addition, as discussed more fully below in Section III.B.2, our § 7872 approach also provides desirable consistency with the treatment of an actual no-interest loan from the investors to the manager.}

A final word concerns the selection of the interest rate. The interest charge approach might seem to require use of the actual borrowing rate on the implicit carried interest loan. Our § 7872 approach seemingly comes up short in this regard since § 7872 uses the government’s risk-free rate, and the carried interest loan is risky. We believe such critique misses the mark for several reasons, however. First, setting unobtainable perfection to the side, our § 7872 approach strikes a more moderate, reasonable compromise than either current law or the Levin proposal. By allowing complete avoidance of any compensation income on the carry, current law under-taxes the carried interest. In the other direction, the Levin Proposal overtaxes the carried interest by disallowing capital gains treatment on the entire return, including the manager’s pro rata share of the sweat equity component. In favorable contrast, then, our § 7872 approach favorably moderates between these two extremes.

Beyond its appeal as a compromise, our § 7872 approach treats the implicit carry loan the same as all other compensatory loans with below-market interest.\footnote{As reported in a recent front page article in the New York Times, this situation is in need of a workable compromise. [Add cite to July 2007 article.]} As such, if the interest rate under our § 7872 approach appears too low for the carry, this evidences a more general shortcoming in the current § 7872 interest rate.\footnote{Note that the true interest rate on the loan is less than the full return due to the managers’ sweat equity contribution.} The appropriate response, then, would be a more general increase to the § 7872 interest rate, or possibly an increased rate for non-recourse loans.\footnote{If so, such provision should also cover recourse loans coupled with an additional feature protecting the service provider against risk of loss (e.g., a “put” right entitling the service provider to sell the invested property back at the original purchase price if the property value declines).} As such, the interest rate issue really stands apart from the carried interest debate, and so we hereafter set it to the side.

2. **Tax Consistency with Close Economic Substitutes.**

Beyond trying to tax the “correct” amount of the carry as ordinary income, tax consistency supports our § 7872 approach over the Levin proposal. Under the Levin proposal, the carried interest structure could result in significantly more ordinary income than the equivalent actual loan structure.\footnote{While the fund manager could have less ordinary income under the Levin proposal if the fund does not perform well, fund managers should prefer the actual loan structure on}
proposal’s heavy handedness by recasting the form of the arrangement into an actual interest-free loan.\textsuperscript{56} Such restructuring would allow managers to report compensation as under our more limited § 7872 approach. The Levin Proposal’s excessive ordinary income result therefore would operate merely as a trap for the unwary, or perhaps as a potential transition charge on existing carried interest structures.\textsuperscript{57} Furthermore, this likely restructuring into an actual loan also undercuts the simplicity appeal of the Levin proposal.\textsuperscript{58}

In sum, close economic substitutes should be taxed consistently. Harsher taxation of one merely induces a formal restructuring into the other more tax-friendly form.\textsuperscript{59} By taxing the carried interest the same as the readily available loan alternative, our § 7872 approach has a significant consistency advantage over the Levin proposal.\textsuperscript{60}

3. \textbf{Tax Lock-in.}

As noted above, the carried interest debate has focused on a risky incentive justification for the capital gains preference even though it fails to adequately explain the preferential rate.\textsuperscript{61} Existing commentary therefore has failed to analyze how the alternative tax “lock-in”

\begin{itemize}
\item \textsuperscript{56} E.g., Fleischer, supra note 9; David Weisbach, The Taxation of Carried Interests in Private Equity Partnerships (July 2007) available at \url{www.privateequitycouncil.org/wordpress/wp-content/uploads/carried-interests-07-24-07-final.pdf}. As briefly noted in Section III.A, taxing one economic equivalent more harshly is not desirable as well-advised taxpayers structure their affairs into the more tax-friendly form.
\item \textsuperscript{57} Somewhat related to the latter point, the more limited interest charge approach has a lesser negative impact on existing arrangements structured under current law.
\item \textsuperscript{58} Recall the initial appeal of the Levin proposal in that it merely changes the character of otherwise reportable income. Given the potentially harsh results under the Levin proposal, taxpayers could be expected to restructure the carried interest into actual loans. As such, the Levin proposal would not be applied in fact. Apart from this, there might be deadweight loss as taxpayers incur restructuring costs in order to avoid the harsher Levin proposal. For additional analysis regarding the manageable complexity of our § 7872 approach, see Section III.B.4 infra.
\item \textsuperscript{59} See David Weisbach, An Efficiency Analysis of Line Drawing in Tax Law, 29 Journal of Legal Studies 71 (2000).
\item \textsuperscript{60} Similarly, as noted briefly in Section III.A, it has a consistency advantage over prior formulations of the interest charge approach.
\item \textsuperscript{61} See discussion supra at notes 18-19 and accompanying text (discussing why the Levin proposal might appeal) and note 27 and accompanying text (noting how taxpayers can receive capital gains rate even when they invest with funds from a non-recourse loan).
\end{itemize}
justification for the preference impacts the analysis. As discussed below, tax lock-in favors our § 7872 approach over the Levin proposal.

The lock-in effect has been described as “the most serious argument in favor of the capital gains preference.”62 It describes the reluctance of investors to sell appreciated assets because of the tax imposed on realized gains. As the tax increases, so does the lock-in effect. For this reason, a preferential rate for capital gains has been justified as a response to this lock-in effect: that is, by reducing the tax cost on realization, one reduces the tax distortion involved in the selling decision. As noted above, tax lock-in might be the most compelling justification for our capital gains preference.

By taxing the manager’s carry as compensation when the fund realizes a gain, the Levin proposal has the effect of significantly increasing the lock-in effect over what it is under current law. The party in control of selling the funds investments – the fund manager – is taxed at the higher ordinary rates, while only the passive investors benefit from the lower capital gains rate.64 In favorable contrast, our § 7872 approach does not change the treatment of the carry.65 Under our approach, the manager’s

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63 See id; see also Daniel Shaviro, Commentary, Uneasiness and Capital Gains, 48 Tax L. Rev. 393 (1993). In addition, the Supreme Court similarly has referred to tax lock in when analyzing the propriety of the preference in uncertain cases under the statute. E.g., Corn Products Refining v. Commissioner, 350 U.S. 46 (1955) (the capital gains preference “was intended to relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions”).
64 While managers might pay some attention to the investors’ taxes to enhance their after-tax returns, the managers’ own tax bill provides a more direct lock-in connection. In addition, even if managers heed investors’ tax preferences, the presence of many tax-exempt investors weakens such link.
65 Our proposal also might comport better with an alternate justification for the capital gains preference: the double taxation of corporate earnings. The corporate level tax arguably justifies the lower capital gains rate on stock sale gains and dividends. It therefore has been argued that the Levin Proposal would overtax the fund manager due to the imposition of a corporate level tax on the underlying portfolio companies in which the funds invest. [Add cites to Wall Street Journal editorial and op-ed article from July 2007]. In other words, the managers’ pretax return from the carried interest arguably already reflects some tax burden, in contrast to other compensation arrangements. Now this argument is somewhat overstated, especially in the case of start-up companies that have not yet generated much taxable income. Nonetheless, there does seem to be some validity to this critique under the Levin Proposal’s mandate to insure an effective 35% rate of taxation on all amounts received in connection with the managers’ performance of services. In this regard, note that the portfolio company does not receive a deduction for the compensation reported by the fund manager. Our § 7872 approach seems to render the double taxation critique irrelevant by shifting the focus to the foregone interest on the implicit carried interest loan.
compensation is determined annually and independent of the fund’s stock sale gains.  

4. **Limited Reach of Our § 7872 Approach: Principled Exemptions for Many Partnership Arrangements**

Recall the Levin proposal’s broad characterization of the entire carry as ordinary income. Under such an approach, principled consistency would require the same application in all partnerships where a service partner’s profit share exceeds her share of contributed capital. The Levin proposal avoids such a far-reaching application by limiting itself to specified “investment services partnerships.” But this unprincipled limitation has raised fair criticism that the proposal unfairly targets only specified industries. In favorable contrast, our § 7872 approach would exempt many partnership arrangements on principled grounds even where the profit and capital shares diverge. This enhances our proposal’s administrative ease without falling into the discriminatory critique. Section III.B.4(a) first considers partnerships conducting an active trade or business. Section III.B.4(b) then considers investment partnerships which provide the passive investors with a preferred return on their invested capital before the fund manager receives a carried interest.

a. **Exemption for Trade or Business Partnerships**

Under our § 7872 approach, we would exempt partnerships engaged in an active “trade or business.” There is no need to subject these partnerships to § 7872 because, if we did, the service partner would have matching amount(s) of compensation and interest expense not subject to the investment expense limitation above. The interest expense in this case would not be “investment interest”, but would be properly characterized as trade or business interest expense, which may be used to offset the imputed compensation income. For this reason we believe that the exemption for these partnerships is not arbitrary, but principled.  

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66 If anything, our proposal could decrease the lock-in effect. With our imputation of the investment interest expense, a manager might have excess interest expense blocked by § 163(d). If so, the fund manager could recognize additional gains without paying any tax. In the other direction, our proposal would increase the tax rate on realized gains in the case of a soft preferred return. This, however, would be pretty limited, as discussed in Section III.B.4(b)(ii).

67 See H.R. 2834, supra note 16, proposed § 710(a) (providing new rule “in the case of an investment services partnership interest”).

68 See e.g., Senator Schumer’s critique of the Levin Proposal on grounds that it unfairly targets only certain industries. Senator Charles K. Schumer, Opening Statement, Senate Finance Committee Hearing on Carried Interest Partnerships (July 11, 2007), reported at 2007 TNT 134-23.

69 Arguably one might want to impute the compensation in order to collect employment taxes. The employment taxes are less significant than the character issue under the income tax, especially given the salary cap on the larger social security portion. The
addition, recall also how the carried interest problem arose because the partnership reported its profits on a deferred basis at preferential rates. This is not the case with partnerships engaged in an active trade or business. Generally, they report their business income on an annual basis and this income is taxed at ordinary rates.

b. Carried Interest with a Preferred Return

Some funds provide the investors a preferred return on their invested capital before the fund manager is allocated any carry, a possibility we have so far ignored. This part now focuses on these returns for several reasons. In addition to highlighting how our proposal would operate in these situations, focusing on preferred returns should further minimize complexity concerns over our § 7872 approach.

i. “True” or “Hard” Preferred Return

Consider first the case of a “true” or “hard” preferred return: i.e., the investors first receive a return on their invested capital, with all profits thereafter shared between the manager and the investors taking into account the carried interest. To illustrate, suppose on our Basic Facts that profits were to be allocated in the following manner: (i) first, the investors would be allocated a cumulative 8% return on their contributed capital; and (ii) thereafter, the profits would be allocated 20% to the fund manager and 80% to investors. Under our § 7872 approach we would treat this type of carried interest as being analogous to an interest-bearing loan from the investors to the fund manager. And so long as the preferred return rate matches or exceeds the interest rate required under § 7872, no compensation needs to be imputed. In fact, compensation imputation here would provide an undesirable inconsistent treatment between the analogous carried interest and actual (interest-bearing) loan.

12.4% social security portion of the employment taxes are imposed only upon the first $97,500. The Medicare portion is imposed on all earnings, but only at a low 2.9% rate.

As discussed below, some arrangements provide the fund manager with a 100% “catchup” after the initial preferred return. See discussion in Section III.B.4(b)(ii) below.

The 80% would be shared by the investors pro rata in accordance with contributed capital.

That is, I.R.C. § 7872 would not apply in this case. Separately, note that the management fee presumably is higher in this case than it would be absent the preferred return. If so, there is additional ordinary income reported by the manager due to such increased fee. See Fleischer, supra note 9.

Also, there would be some potential inconsistency between an actual non-recourse loan and the carried interest if the preferred return were satisfied out of long-term capital gains. Under the carried interest structure, the fund manager would not report anything to the extent of the preferred return. Under the actual loan form, however, the fund manager would report matching amounts of long-term capital gain income and “investment interest” expense. This could be beneficial to the manager if she has other ordinary investment income. Our proposal does not create this inconsistency,
Finally, the preferred return possibility should help to minimize any complexity concerns over our § 7872 approach for two reasons. First, the regime would exempt a large number of arrangements from its requirements. Second, the compensation imputations in the cases where the regime would apply (no preferred return) are very similar to the calculations that must be done for non-tax purposes in the preferred return cases. As such, the industry accountants have familiarity with the calculations apart from the tax regime.

ii. “Soft” Preferred Return

Now let’s consider the case of a so-called “soft preferred return.” This is an arrangement where the investors are first allocated a preferred return. Once this benchmark has been met, however, the manager is then allocated 100% of the profits until the manager’s allocation is equal to its carry percentage of all profits (e.g., 20%). Thereafter, the manager would be entitled to its stated carry percentage. To illustrate, suppose in our Basic Facts, the investors were entitled to a soft preferred return of 8% and that during its first year of operations the fund had profits of, in the alternative, $800,000 or $2,000,000. In the case where the fund had profits of only $800,000, all of these profits would be allocated to the investors. Their soft return entitles them to a return of 8% of their invested capital, or $800,000, before the manager is entitled to any profits whatsoever. In the case where the fund has profits of $2,000,000, the first $800,000 would be allocated to the investors, the next $200,000 exclusively to the manager, and finally the remaining $1,000,000 would be allocated $800,000 to the investors and $200,000 to the manager.

How should our §7872 approach work in the case of the soft preferred return? On the one hand, the non-tax results are the same as the hard preferred return if the fund does not earn enough to pay the catch-up amount. On the other hand, if the fund earns enough to pay the catch-up amount, the non-tax results are the same as the initial example without any preferred return. In substance, the arrangement is akin to a conditional interest arrangement where interest is paid only if the fund does not make a profit in excess of the preferred return.

Based on our consistency analysis above, we might like to follow the current law treatment of an actual loan with such economic terms. The though, as it exists under current law. In addition, this inconsistency seems to be pretty narrow. We could achieve greater symmetry by requiring an imputation of interest expense along with a matching amount of partnership income to the fund manager. On balance, this probably is unnecessary given the limited scope.

73 From a non-tax perspective, there might be a time value of money difference if the preferred return and catchup profits are earned at different times (unless the agreement compensates the manager for any such deferred catchup).
current law treatment of such an actual loan is unclear, however.\textsuperscript{74} With such a clean slate, then, we recommend a wait and see approach that exempts the soft preferred return from our § 7872 approach unless and until the fund manager receives the catch-up allocation. At such time, any income allocated under the catch-up would be treated as ordinary compensation income.\textsuperscript{75} We take this approach for two reasons. From a substantive standpoint, the arrangement does provide the investors an interest return unless and until the catch-up provision is triggered. This approach also balances administrative concerns by exempting another category of transactions unless and until occurrence of the contingency.\textsuperscript{76}

\textbf{Conclusion}

The carried interest is best analyzed as an implicit loan from the investors to the fund manager in the amount of the invested capital subject to the carry. First, the manager receives the full economic return on that portion of the capital. Second, as suggested by other commentators, managers could avoid the harshness of the Levin proposal by restructuring the carry into an actual non-recourse loan. Commentators highlight this point since it would improve the managers’ tax results without altering the underlying economics. Finally, the “carried interest” term itself originated from its economic equivalence to an interest-free loan to the manager.\textsuperscript{77}

\textsuperscript{74} Proposed regulations under § 7872 reserved a place for contingent interest arrangements. Prop. Reg. § 1.7872-3(f). No guidance has been forthcoming since promulgation of the proposed regulations in the 1980s.

\textsuperscript{75} This might allow the fund manager some tax deferral compared to the original case without any preferred return. As highlighted in note 73 supra, however, the tax deferral benefit from the soft preferred return might be offset by an economic cost (i.e., a deferred payout without interest). In addition, the manager would have extra compensation income if the preferred return rate exceeded the § 7872 interest rate (or if the agreement compensated the manager for a deferred payout as suggested in the parenthetical in note 72 supra). In addition, presumably the management fee is somewhat higher here than in the original case without any preferred return at all, which generates some additional compensation income. Compare the discussion of a similar point with regard to the hard preferred return at note 72 supra. Collectively, there should be enough rough justice here to avoid the complexity of imposing a back interest charge on the delayed compensation imputation. A related issue is whether the fund manager should have just a single compensation inclusion or instead should have the same three reporting categories as in the original case without the preferred return (i.e., a compensation amount, a § 163(d) interest expense, and a share of partnership income). Pure consistency with the original case would require all three. On the other hand, providing just the compensation component would be simpler and would provide an additional offset to any deferral advantage compared to the base case.

\textsuperscript{76} Again, we pay homage to administrative ease here without sacrificing our underlying goals.

\textsuperscript{77} See Fleischer, supra note 9, for a good discussion of the historical origin of the carried interest term. Years ago, the arrangements were done on the basis of one investment at a time. In these situations, it was simpler to have the investors simply loan the manager the carried portion of the capital on a non-recourse basis along with a forgiveness of the
From this perspective, the Levin Proposal goes too far by targeting the full carried interest profits, rather than just any foregone interest. A more limited interest approach not only makes sound economic sense, it comports with the current treatment of an explicit loan under existing § 7872. The Levin proposal therefore goes overboard in taxing the carry more harshly than an actual loan. Similarly, current law misses the mark in the other direction by taxing the carry more lightly than an explicit loan. Our § 7872 approach therefore appeals as the appropriate response to the carried interest controversy.

In the case of an actual loan, § 7872 treats the recipient of an interest-free loan as if she actually received cash equal to the foregone interest and then used such cash to pay the interest on the loan. Thus, if the loan analogy were consistently applied to the carried interest, the manager should have an interest expense allowance in addition to the compensation income. Even though this seems rational, other commentators have concluded that the manager should be denied an interest expense deduction under the interest charge approach. We believe that this denial, along with some other missing pieces, explains why the interest charge approach has not yet been forcefully advocated despite the strong theoretic foundation above.

By denying an interest expense, the interest charge approach suffers from one of the key defects of the Levin Proposal: it results in harsher taxation of the carry than the equivalent actual loan. In addition, the manager is taxed twice on the foregone interest: once as compensation, and a second time as a realized carry profit. In order to correct these shortcomings, our § 7872 approach provides the interest expense allowance in addition to the compensation. Importantly, we do so in full recognition of the existing, but under appreciated, provision that permits “investment interest” expense to be deducted only against “investment income.” By blocking the use of the interest expense against the carry’s compensation element, this limitation under § 163(d) insures taxation of the compensation at the higher ordinary rates.

Beyond the above primary appeal, our § 7872 approach also contains significant secondary benefits over the Levin Proposal. First, allowing an interest expense provides principled grounds for exempting a substantial number of partnership arrangements. Our proposal’s limited scope also enhances its administrative appeal, and does so without resort to arbitrary exemptions as under the Levin proposal. Separately, the Levin Proposal increases the lock-in effect over what it is under current law by increasing the tax rate on the managers’ realized carry profits.

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customary interest charge. The investors therefore “were said to ‘carry’ the investment . . . since they bore the cost of capital.”
Our proposal neatly avoids this increased lock-in result by maintaining the current tax rate on the realized carry profits.78

In sum, some response to the carried interest controversy is appropriate given current law’s theoretic shortcomings and the intense public scrutiny. But despite some initial appeal, the Levin Proposal exceeds this mandate by targeting the entire carry profit. We advocate instead our § 7872 approach as a more moderate, better reasoned, and more consistent response to the carried interest problem.

78 In addition, as discussed at note 65 supra, the double taxation of corporate earnings arguably undercuts the Levin proposal imposition of the regular ordinary rates to the entire carry return. By shifting the focus to the foregone interest on the implicit loan, our approach renders irrelevant this double taxation critique.