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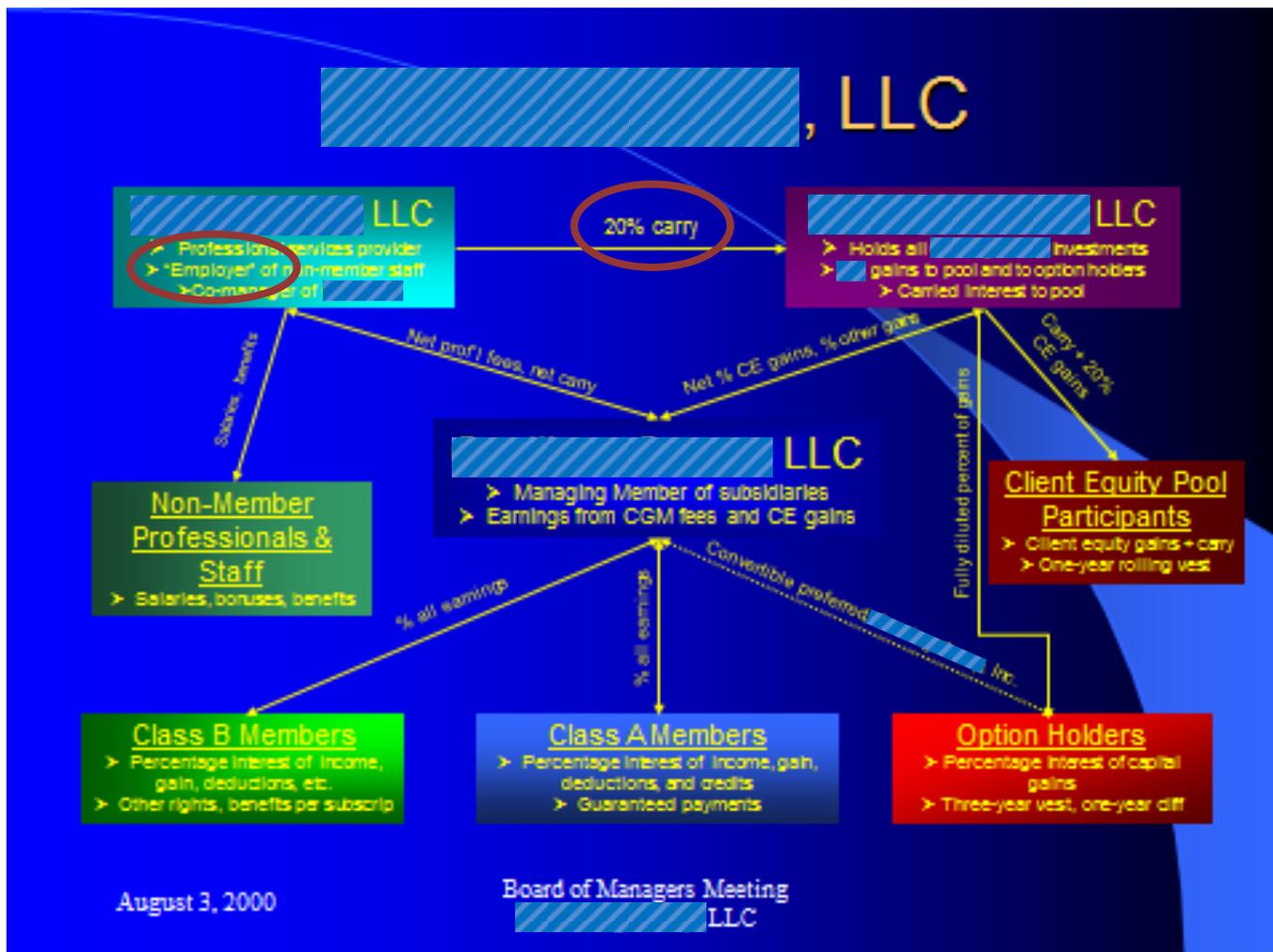
2014 Chapman Law Review Symposium

**Business Tax Reform: Emerging Issues
in the Taxation of U.S. Entities**

**CARING ABOUT CARRIED INTERESTS
AND THE PARTNERS WHO CARRY THEM**

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March 14, 2014



According to a 2007 CBO report to Congress, private equity funds manage around \$1 trillion in structures like this. Hedge funds \$1 trillion more.



Subchapter K Basics

SECTION 704. PARTNER'S DISTRIBUTIVE SHARE.

(a) EFFECT OF PARTNERSHIP AGREEMENT.—A partner's distributive share of income, gain, loss, deduction or credit shall, except as otherwise provided in this chapter, be determined by the partnership agreement.

SECTION 702. INCOME AND CREDITS OF PARTNER.

(b) CHARACTER OF ITEMS CONSTITUTING DISTRIBUTIVE SHARE.—The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share...shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

SECTION 721. NONRECOGNITION OF GAIN OR LOSS ON CONTRIBUTION.

(a) GENERAL RULE.—No 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.

SECTION 83. PROPERTY TRANSFERRED IN CONNECTION WITH PERFORMANCE OF SERVICES.

(a) GENERAL RULE.—If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the [fair market value of such property] shall be included in the gross income of the person who performed such services....



Profits interests, capital interests, and compensation for services

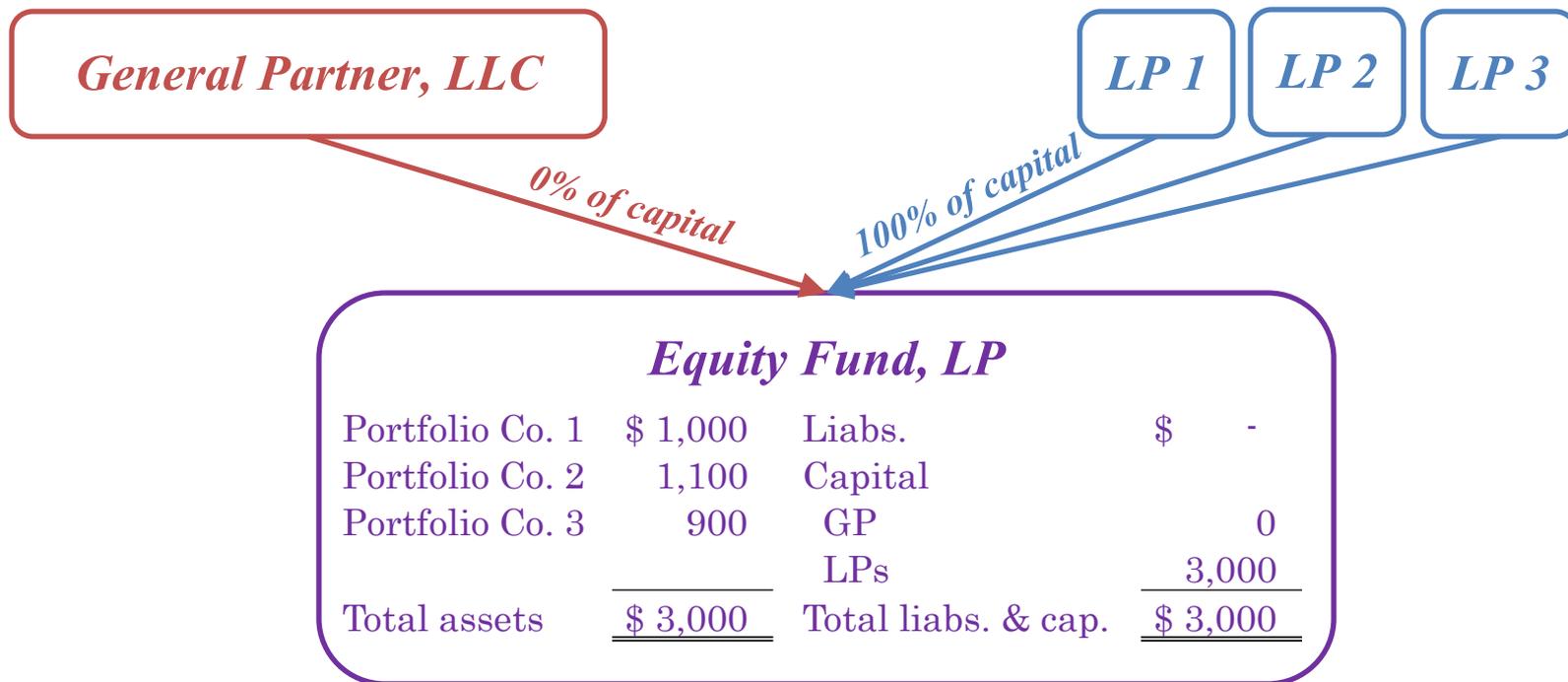
- *Diamond v. Commissioner*, 492 F.2d 286 (7th Cir. 1974)
 - Section 721 does not apply, but Section 61 does
 - Readily determinable value
 - Tax cost outside basis, future allocations, Section 731(a)(2) loss

- *Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991)
 - Section 721 still not applicable, but now Section 83
 - Speculative value

- Rev. Proc. 93-27 / Rev. Proc. 2001-43 / *Crescent Holdings* (2013)
 - Capital interest (liquidation value) is income upon receipt
 - Profits interest (no liquidation value) is not income (so long as value not readily determinable)



The “Two and Twenty”



Section 704(a) agreement:

- GP is paid 2% of the capital as a management fee regardless, generally, of the fund’s performance. This is clearly compensation, recognized as gross ordinary income and probably also as net earnings from self-employment (“NESE”).
- GP is also allocated 20% of any gains recognized on the disposition of a portfolio company. By reason of Section 702, the character of this gain is the same to GP as it is to the partnership. Thus, if the gain is long-term capital gain, GP recognizes a 20% share, subject to the preferential Section 1(h) rate and not included in NESE. *But should it be?*



On the one hand...

- A “pure” profits interest should not give rise to immediate income.
 - While the profits interest might have an ascertainable fair market value, and is certainly property, the partner is actually entitled to nothing from the partnership under economic effect principles.
 - Furthermore, the problem of the double-inclusion of initial value and later distributive share (though offset by a loss at liquidation) seems unfair.
- It is the essence of the economic partnership that the sum is greater than its parts.
 - The GP could not raise the same amount of capital alone, or maybe could not have access to the opportunity to engage in the activity without the participation of partners. (Diamond did not have the option to purchase the building; Kargman owned that option.)
 - The LPs do not have the skill needed to select and manage investments, or maybe could not take advantage of an opportunity without the participation of partners. (Kargman could not finance his acquisition of the building without Diamond’s help.)





On the other hand...

- There has long been a distinction between gain derived from capital and gain derived from labor.
 - Both are clearly forms of income and the Sixteenth Amendment allows Congress to tax both (*Eisner v. Macomber*, *Glenshaw Glass*).
 - However, Congress has chosen to tax them differently, generally subjecting gains derived from labor to a higher rate than gains derived from capital (e.g., Sec. 1(h)).
- So is the GP's carried interest (the "20" in "2 and 20") gain derived from labor or is it gain derived from capital?
 - Per Section 702 (character pass-through), the carried interest seems pretty clearly to be gain derived from capital (and thus subject to the preferential treatment).
 - But isn't the GP being allocated this carry solely by reason of his skill and services to the venture? Isn't it really a product of the GP's labor? If so, then those gains should *not* be permitted the preferential rate.

SECTION 1. TAX IMPOSED.

(a) MARRIED INDIVIDUALS FILING JOINT RETURNS .
hereby imposed on the taxable income of—

(1) every married individual (as defined in section 6013, and jointly with his spouse under section 6013, and



Trade or business

- One tempting solution would be to conclude that the venture fund is engaged in a trade or business activity rather than merely investment management.
 - If the fund itself is engaged in a trade or business activity, then perhaps its gains are the profits of that activity – i.e., gains from labor rather than capital.
 - However, this would probably also require that the portfolio companies it holds be considered its “inventory.”
- Trade or business vs. investment management
 - The phrase “trade or business” is used in hundreds of Code sections and Treasury Regulations, appearing almost 6,000 times, yet there is no clear or consistent definition (*Groetziner*).
 - Typically, however, the activities of a venture fund (identifying, negotiating, financing, managing, liquidating) are considered *investment* activities no matter how regular and continuous (*Higgins, Whipple*), and not trade or business activities.
 - A 2011 decision, *Dagres*, found that a venture fund GP was engaged in a trade or business with respect to the services it provided to the fund, yet that did not alter the character of its distributive share (its carry).
 - A 2013 decision, *Sun Capital*, found that a venture fund itself was engaged in a trade or business activity, yet the First Circuit limited the holding (probably) to ERISA.

SECTION 162. TRADE OR BUSINESS EXPENSES.

(a) IN GENERAL.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *



Reasonable compensation, rebuttable presumption

- Reasonable compensation

- Already in the context of C and S corporations there is substantial authority for determining whether the compensation payable to a shareholder-employer is “reasonable.”

| | | | |
|---------|---|--|--|
| ations) | 7 | Compensation of officers (see instructions—attach Form 1125-E) | |
| | 8 | Salaries and wages (less employment credits) | |

- One approach would be to determine this amount, subtract any 707(a)(1) or 707(c) payments already recognized by the GP, and call the rest ordinary NESE.

- This approach might do violence to the GP’s actual gain from capital, however.

- Rebuttable presumption

- Instead, a presumption could be made that all allocations to the GP were ordinary NESE.

- The GP would then have the burden of rebutting the presumption by showing that some portion of its distributive share was a gain from capital rather than labor.

- All of the legislative proposals thus far have taken this approach.



Legislative proposals

- Since 2007, there has been at least one proposal each year to re-characterize a carried interest as ordinary income in one way or another.
 - Levin and Rangel (2007): All income allocated to a partner with respect to services involving investment-type assets would be ordinary NESE.
 - Rangel (2008) then Levin (2009): Substantially as above.
 - Obama (FY 2010 Revenue Proposal): As above, but adding that a disposition of the interest itself would also result in ordinary income rather than capital gain (Section 741/751).
 - American Jobs and Closing Tax Loopholes Act of 2010: A “blended rate” concept, probably as a compromise.
 - Subsequent versions, in 2011 and 2012, abandoned the blended rate, and went even farther in excruciating detail regarding the segregation of the ordinary (labor) portion of a carry from its capital portion. (See, Sowell, Carried Interest: Line Drawing, Tax Notes Nov. 2013.)
- The 2014 Camp Proposal
 - “Recharacterization account” – Accrued by the GP by applying a rate to invested capital. Allocation would be ordinary NESE to this extent of this account.
 - Clever, but decidedly artificial.



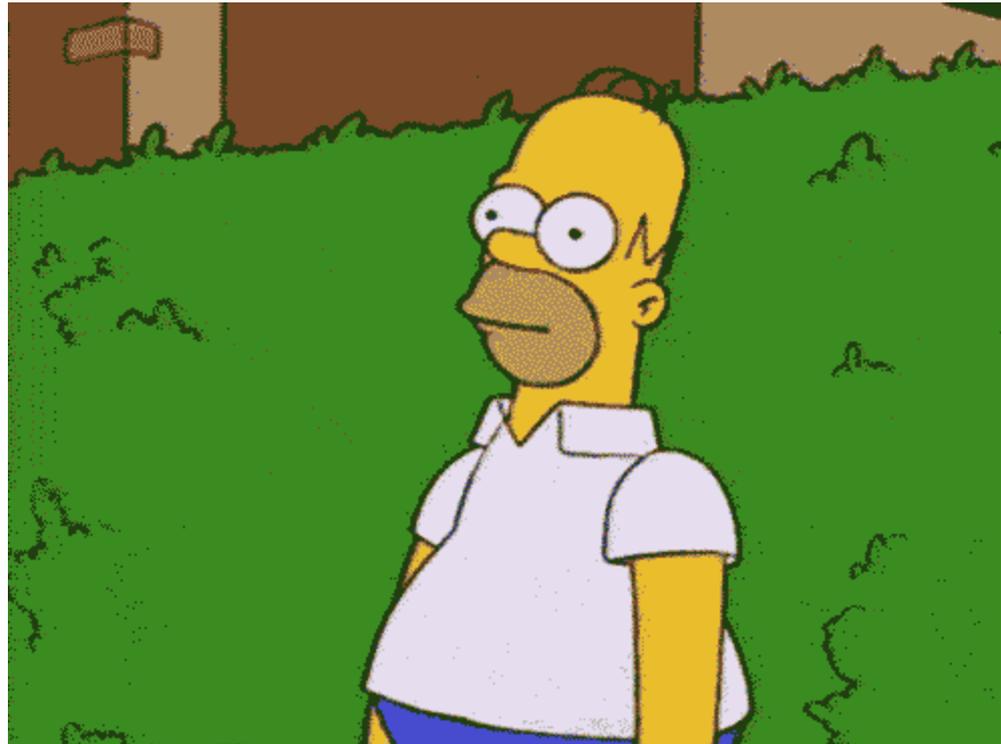


2014 CHAPMAN LAW REVIEW SYMPOSIUM

Caring about Carried Interests and the Partners who Carry Them

What now?

Run away!



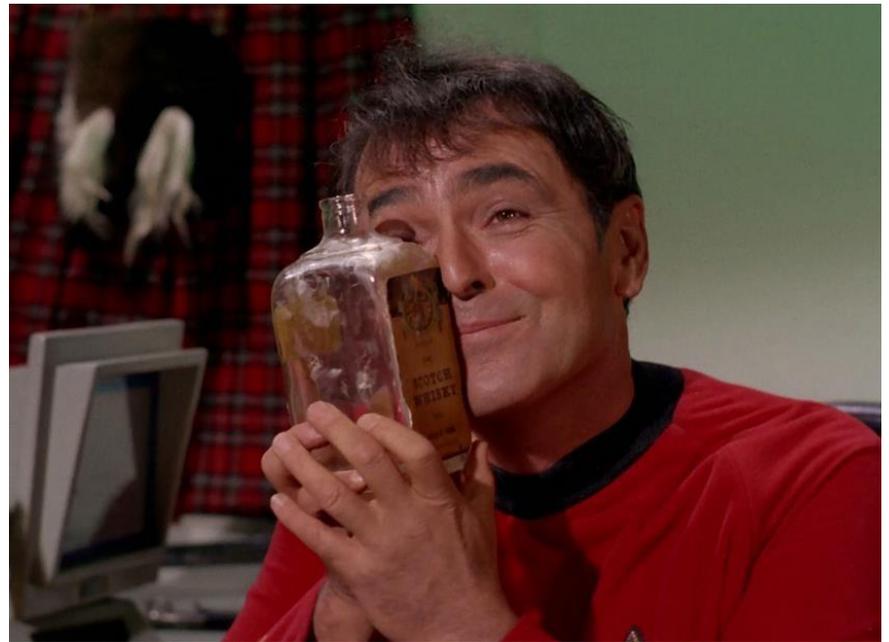


What now?



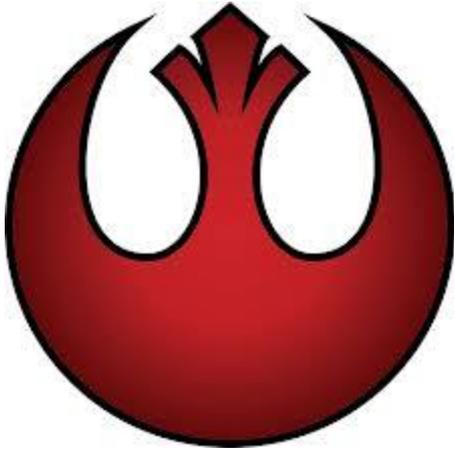
Abandon ye all logic?

Seek solace in an old friend?





Maybe...



- **Be a rebel: Reasonable compensation?**
 - Backed by considerable authority, including lots of case law.
 - Methodology needed to account for GP's actual capital gains, however.

- **Duck, regroup: Trade or business?**

- *Dagres* and *Sun Capital* cases suggest a modern evolution in the “trade or business” concept, at least in the context of investing and investment management.
- *Sun Capital* is promising, but its authority limited; also doesn't resolve “inventory” issue.

