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CARRIED INTERESTS, TAXATION, AND ENTREPRENEURSHIP

This report examines the recent controversy about the taxation of the carried interests of general partners in hedge funds and private equity funds.

Some policymakers have contended that the general partners in hedge funds and private equity funds are unfairly using certain provisions of the federal tax code and related Internal Revenue Service (IRS) regulations and interpretations to defer recognition of and lower the effective tax rate on the compensation paid to general partners from these funds. This occurs because some of the compensation comes from long-term capital gains.

However, these carried interest tax provisions encourage entrepreneurship by facilitating the pooling of capital and highly skilled labor in partnerships. Any tax code change designed to repeal these tax provisions may inadvertently damage small business formation, hamper the restructuring of ailing corporations, and slow economic growth.

What are Private Equity Funds? Private equity funds acquire and manage other businesses and sell them for long-term capital gains. Some private equity funds, known as **venture capital funds**, finance and manage infant firms and seek long-term capital gains by selling shares in such firms as they mature to other companies or to the public through initial public offerings (IPOs). Venture capital funds often provide financing to risky infant firms that are unable to borrow from banks or traditional capital markets.

Others, known as **buyout funds**, acquire established, but struggling firms. Buyout funds may change management, restructure operations, and sell unnecessary assets to improve the financial performance of acquired firms. Buyout funds often employ leveraged buyouts (LBOs). In a LBO, a buyout fund incurs significant debts to acquire all of the shares in a publicly traded corporation, uses the corporation's assets as collateral, and often sells some of the corporation's assets to pay off some of these debts. Buyout funds seek long-term capital gains by selling shares in restructured corporations to other companies or to the public through IPOs.

What are Hedge Funds? Hedge funds invest in a variety of assets. Some hedge funds take speculative positions on price trends in different asset markets. Others use complex strategies designed to offset price risks and earn profits however asset prices trend.

Partnership Taxation. Under U.S. tax law, the income earned by all partnerships except those with publicly traded interests is not taxed at the firm level. Instead, the income flows through the partnership and is taxed as the income of the individual partners. The characterization of income for tax purposes (e.g., ordinary income or capital gains) does not change when it flows through the partnership to the individual partners. The income earned by partnerships with publicly traded interests is taxed at the firm level as if such partnerships were corporations, unless 90 percent or more of the partnership's gross income is from passive investments such as dividends, interest, rents, capital gains, and royalties.

Carried Interests. Partnerships encourage entrepreneurship by facilitating the pooling of capital and highly skilled labor. Financial partners (i.e., investors that contribute money to a partnership) may grant an interest in profits of a partnership to active partners (i.e., highly skilled individuals that manage the partnership's business) without requiring a proportional capital contribution from them in exchange for the labor services of active partners. These grants are known as **profit interests**.

For example, two individuals – Rob and Pat – may invest $1 million each in a partnership to build an office building. Instead of paying a salary, they offer an experienced builder – Jen – a 1/3 interest in the partnership's profits. Jen completes the office building for $2 million during the first year. The partnership breaks even during the next three years, sells the office building for $3.5 million in the fourth year, and then is liquidated. The sale generates $1.5 million in long-term capital gains. After the capital contributions of Rob and Pat are returned upon liquidation, Rob, Pat, and Jen earn long-term capital gains of $500,000 each.

U.S. tax law allows Jen to defer the recognition of her compensation from the partnership until the building is sold and the partnership is liquidated in the fourth year.[1] Profit interests when deferred are known as **carried interests**.

Because the characterization of income does not change when it flows through a partnership, Jen is taxed at the lower capital gains rate when she realizes her carried interests in the long-term capital gains that the partnership generated. Through carried interests, active partners can build "sweat equity" in partnerships that will be taxed as capital gains rather than as ordinary income when their partnership is sold.

Moreover, most financial economists hold that the market price of any asset represents the present value of its future after-tax cash flows discounted by a rate that includes the risk-free real interest rate, the expected inflation rate, and an asset-specific risk factor. Since the present value of all future tax payments associated with any asset is already incorporated into its market price, the taxation of capital gains upon sale of any asset may be considered a form of double taxation on the same stream of investment income.

Entrepreneurship. There are significant differences between entrepreneurship and other types of labor. Entrepreneurship involves anticipating future market conditions, taking risks, and combining labor and capital in innovative ways to produce new, superior, or cheaper goods and services. Other types of labor may involve some of the three characteristics of entrepreneurship – vision, risk-taking, and innovation – but they are not essential as in entrepreneurship.

Because of the importance of entrepreneurship to productivity and economic growth, policymakers have given preferential tax treatment to some compensation for entrepreneurial activities. For example, profit interests make it easier for investors with money, but without specialized skills to form partnerships with highly skilled individuals to engage in entrepreneurial activities. Entrepreneurial income is contingent on success and is uncertain in value. Compensation in the form of future profit is riskier than receiving a regular salary. Policymakers have generally considered the ability of active partners to use carried interests to defer recognition and receive some compensation in the form of long-term capital gains as a reasonable "sweat equity" tax incentive to encourage highly skilled individuals to launch small businesses.

Fund Organization and Compensation. Nearly all hedge funds and private equity funds are organized as limited partnerships that have two kinds of partners: general and limited. General partners make investment decisions and manage a fund. Limited partners are institutional investors or wealthy individuals that own a small share of a fund, but do not have any role in its investment decisions or its management.

Typically, general partners own a share of between one percent and four percent of the funds that they manage. This is called "having skin in the game."

General partners receive performance-based compensation for their labor services to these funds from the limited partners. While actual compensation packages vary, general partners typically receive "two and twenty" (i.e., an annual management fee equal to 2 percent of the assets of the fund and a 20 percent interest in the profits of the fund). Management fees are paid in cash, while profit interests may be paid in cash or deferred.

Profit interests help to overcome potential agency problems by aligning the interests of the general partners with the interests of the limited partners in maximizing fund profits. Thus, profit interests serve an important economic function.

Growth of Funds. The number and size of both hedge funds and private equity funds have been growing. In 2006, hedge funds managed an estimated $1.4 trillion in assets worldwide, up from only $50 billion in 1990.[2]

In 2006, private equity funds managed an estimated $1 trillion in assets worldwide.[3] Buyout funds, the largest segment of this industry, made about 47 percent of all investment commitments by private equity funds between 1991 and 2004. Venture capital funds, the second largest segment, made another 24 percent of all investment commitments between 1991 and 2004.[4]

Metrick and Yasuda (2007) studied a sample of 94 venture capital funds and 144 buyout funds. In this sample, management fees generated over 60 percent of the expected revenue for fund managers, while income from carried interests accounted for the remainder. The present value of the carried interests was $8.98 per $100 invested in venture capital funds and $5.41 per $100 invested in buyout funds.[5]

Another study by Private Equity Intelligence (2006) of 1,016 private equity funds with inceptions from 1991 to 2004 over the period of 1991 to 2006 found these funds had distributed and unrealized gains of $440 billion after fees and carried interests, while general partners earned net carried interests of $78 billion.[6]

Unintended Consequences. Carried interests are deeply woven into the fabric of U.S. tax law. It would be very difficult to deny general partners in hedge funds and private equity funds the tax benefits of carried interests without fundamentally changing the taxation of all partnerships and other flow-through entities and eliminating the "sweat equity" tax incentive to create small businesses.

Partnerships and other flow-through entities are a very significant part of the U.S. economy. In 2002, there were 5.4 million partnerships, subchapter S corporations, Real Estate Investment Trust (REITs), and Regulated Investment Companies (RICs), accounting for 20.5 percent of all non-farm businesses in the United States. In 2002, these firms collected $6.26 trillion in business receipts, accounting for 30.2 percent of all non-farm business receipts in the United States.[7] Changing the tax law regarding carried interests could have profound, negative, and unintended consequences for partnerships and other flow-through entities.

Private equity funds have contributed to the sustained growth of productivity and real GDP in the United States during recent years by helping to launch new firms and to restructure existing firms, making them more competitive. Changing tax laws regarding carried interests may slow business incubation and restructuring.

Finally, hedge funds and private equity funds operate globally. Efforts to increase U.S. tax collections from their general partners may encourage funds to relocate operations offshore.

Conclusion. The tax provisions regarding carried interests encourage entrepreneurship through the pooling of capital and highly skilled labor. Recently, some policymakers have contended that general partners in hedge funds and private equity funds are unfairly using this provision to defer recognition of and lower the effective tax rate on their compensation.

However, general partners receive a large portion of their compensation from the long-term capital gains generated by their funds. Since the characterization of income does not change when it flows through a partnership, the general partners are merely paying the lower capital gains rate on their share of any long-term capital gains passed through these funds.

Taxing carried interests as ordinary income rather than as capital gains would eliminate the "sweat equity" tax incentive to create small businesses. The likely result would be a reduction in entrepreneurial activities including those associated with the restructuring of inefficient corporations. In turn, this reduction could deter business investment and slow economic growth.

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[1] In 1993, the Internal Revenue Service ruled that the receipt of a partnership profit interest generally is not a taxable event for the partnership or the partner. This does not apply if (1) the profit interest relates to a substantially certain and predictable stream of income such as high quality debt securities, (2) a partner disposes of his profit interest within two years of receipt, or (3) the profit interest is a limited partnership interest in a publicly trade partnership. See: Rev. Proc. 93-27 (1993-2 C.B. 343). However, a partnership capital interest received for labor services is includable in a partner's income under generally applicable rules relating to the receipt of property for the performance of services. A partnership capital interest entitles the receiving partner to a share of the proceeds if the partnership's assets were sold at fair market value and proceeds were distributed in the liquidation. See: Secs. 61 and 83; Treas. Reg. sec 1.721-1(b)(1).

[2] Treasury Assistant Secretary for Financial Markets Anthony W. Ryan, Remarks before the Managed Funds Association Conference (June 11, 2007). Found at: http://www.treasury.gov/press/releases/hp450.htm.

[3] Andrew Metrick and Ayako Yasuda, "The Economics of Private Equity Funds," (July 1, 2007). Found at http://ssrn.com/abstract=996334.

[4] Private Equity Intelligence, Ltd., "Value Creation and Carry Review," (2006). Found at: http://www.prequin.com/carry.aspx.
[5] Metrick and Yasuda (2007).
[6] Private Equity Intelligence, Ltd. (2006).
[7] Internal Revenue Service, *Statistics of Income* data. Percentage calculations by author.