The Carried Interest Catastrophe

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Congress seems intent on taxing the labor component of carried interests as ordinary income. If that must be done, it should be simple and accurate. The method of taxation provided for under the current legislative proposal is neither.

In 1905 Albert Einstein published "On the Electrodynamics of Moving Bodies,"[1] his explanation of the theory of special relativity. That paper revolutionized humankind's understanding of the universe, linked time and space, and ushered in the Atomic Age. It required almost 31 pages of dense prose. Congress has proposed a change to the taxation of partners who contribute services to partnerships, with a statutory provision that runs 32 pages.[2]

How can that be? Income taxation is not nuclear physics, and yet the carried interest legislation is a horror of complexity. In my experience, extreme complexity is not caused by a bad answer to a good question, but by asking the wrong question. And so it is with the carried interest legislation.

If practicalities were no matter, a partner who contributed services to a partnership would recognize compensation income on the exchange in an amount equal to the value of the partnership interest received. Because that partner might contribute cash or property along with services, it could be difficult to separate the portion of the partnership interest received for the services as opposed to the portion received for the cash or property. Fortunately, because the law assumes equal values are exchanged in an arm's-length transaction,[3] rather than measure the value of the partnership interest received, we can measure the value of the services contributed. To be sure, putting a fair value on that labor can be difficult, but if practicalities were no matter that would be the right answer.

Once the service component is taxed, the partner would be treated as if he had received cash for the services. That cash is then treated as recontributed to the partnership. While there are some technical issues that arise from adopting that circular flow of cash analysis in the context of partnerships,[4] it actually is a familiar characterization: Whenever taxpayers transfer services or properties in a taxable exchange, each transferor is treated as receiving cash that is then treated as used to purchase the property acquired in the exchange. Indeed, every court to address the issue has held that the contribution of services to a partnership should be taxed in that manner.[5]

Because a contributor of services is taxed as if paid in cash followed by a contribution of that cash, there are no further tax implications of the transaction: A service partner's share of partnership profits, like any other partner's share of partnership profits, will be determined by reference to the activities of the partnership. In particular, if the partnership sells or exchanges a capital asset held for more than one year, each partner's share of the gain is treated as long-term capital gain, and that will remain true whether the partner contributed cash, property, or services to the venture. Therefore, if practicalities were no matter, taxation of a service partner would be handled at the time of contribution and no further difficulties would arise.

But practicalities do matter. In general, neither the value of the services contributed to a partnership nor the value of the partnership interest received in exchange can be valued objectively, and it is for that reason that courts have been willing to accept taxpayer arguments that partnership profits interests should be ascribed relatively little value.[6] Ultimately, the Service agreed that in most

[1]Albert Einstein, "On the Electrodynamics of Moving Bodies," 17 *Annalen der Physik* 891-921 (1905).

[2]H.R. 4213, 112th Cong., 2d Sess., section 412 (2010).

[3]*United States v. Davis*, 370 U.S. 65 (1962).

[4]In many cases, the deemed compensation will give rise to a partnership deduction. If that deduction can be allocated to the service-providing partner or to other taxable entities, the net result may be little income to the treasury. *See* Howard E. Abrams, "Taxation of Carried Interests," *Tax Notes*, July 16, 2007, p. 183, *Doc 2007-15317*, or *2007 TNT 137-43*. Significant revenue will be raised only to the extent the deduction is allocable to an exempt organization or other tax-indifferent party or by reason of the 2 percent haircut on investment deductions in section 67(a). *See generally* Michael Knoll, "The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of Taxing Profit Interests as Ordinary Income," 50 *Wm. & Mary L. Rev*. 115 (2008).

[5]*Diamond v. Commissioner*, 56 T.C. 530 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974); *accord Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991); *St. John v. United States*, 84-1 USTC para. 9158 (C.D. Ill. 1983); *Kilroy, Inc. v. Commissioner*, 47 T.C.M. 1749 (1984); *Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991). *See also National Oil Co. v. Commissioner*, 52 T.C.M. 1223 (1986); *Pacheco v. United States*, 912 F.2d 297 (9th Cir. 1990).

[6]*St. John v. United States*, 84-1 USTC para. 9158 (C.D. Ill. 1983); *Kilroy, Inc. v. Commissioner*, 47 T.C.M. 1749 (1984); *Campbell v.*

(Footnote continued on next page.)

cases the determination of the value of a profits interest is administratively unworkable, and so the government promulgated a rule allowing most taxpayers to treat the value as zero. Proposed regulations have been promulgated that continue and formalize that administrative solution.[7]

It is clear that Congress wishes to reverse that administrative position, and the obvious way to do so would be for Congress to provide that a partner who contributes services to a partnership is taxable on the value of the services contributed. As indicated above, the courts have already held that is the law, and there are express parallels in the statutory provisions governing family partnership[8] and S corporations.[9] To be sure, mandating valuation of services contributed to a partnership will result in some additional litigation, but it is litigation of a kind that already arises in a variety of familiar circumstances. At most, Congress need only expressly provide that the exchange of services for a partnership interest is a taxable event.[10]

If getting to the right answer would take a sentence, why does the carried interest proposal run 32 pages? The proposal attempts to impose compensation treatment on a service partner without having to value the services. How can that be done?

It can't. Much of the complexity in proposed section 710 lies in its attempt to distinguish returns on contributed services from returns on contributed capital. Of course, that is nothing but the valuation problem pushed from the time of contribution to the time of the partnership's earning; by pushing the problem forward, additional complexities arise. Some are technical and have been identified by many commentators.[11] Problems include the proper conversion of returns to labor becoming invested capital,[12] the proper treatment of partner borrowing,[13] the recharacterization of partnership distributions of property as sales,[14] and the proper correspondence of losses to past and future gains.[15]

There is also a conceptual problem that proposed section 710 answers only by ignoring it: the proper tax treatment of extraordinary returns. Consider, for example, a partner who contributes $10,000 worth of labor to a start-up partnership in exchange for a remote chance of eventual and substantial profit. That is, suppose there is a very great likelihood that the service partner will receive nothing and a small chance that the partner will receive $1 million. If the partner gets nothing, he gets no deduction for the labor contributed and lost. But if he gets the million, how should it be taxed? Under proposed section 710, it is treated entirely as compensation. But it is not compensation[16]; it is a return on a very risky investment (to be sure, an investment of labor rather than capital), and extraordinary returns to extraordinary risk are the touchstone of capital gains treatment.[17] Proposed section 710 would call all of the $1 million compensation, but calling a dog's tail a leg does not give the dog five legs.[18]

If the service provider joined a corporation rather than a partnership, this problematic taxation either would not occur or could be avoided. If a taxpayer contributes service in exchange for stock, the exchange generally is taxable immediately, and then sale of the stock qualifies for capital gain.[19] If ownership of the stock is restricted, the taxpayer can obtain the same taxation by filing an election under section 83(b).

Proposed section 710 also permits a service partner to file an election under section 83(b),[20] but what is particularly unfair in a provision full of unfairness is that this election does not take the service provider out of section 710. That is, the partner can be taxed at the time of contribution on the full value of the labor contributed to the venture and then still be subject to recharacterization of the distributive share as compensation when income is generated by the partnership.[21]

Commissioner, 943 F.2d 815 (8th Cir. 1991). *See also National Oil Co. v. Commissioner*, 52 T.C.M. 1223 (1986); *Pacheco v. United States*, 912 F.2d 297 (9th Cir. 1990).

[7]Prop. reg. sections 1.83-3(e) and 1.721-1(b)(1); *see also* Notice 2005-43, 2005-1 C.B. 1221, *Doc 2005-11236*, *2005 TNT 98-37*.

[8]*See* section 704(e)(2) (requiring that ''reasonable compensation'' be paid to the donor of a partnership interest if the donee is to be recognized fully as a partner).

[9]*See* section 1366(e) (authorizing adjustments to the taxation of S corporation shareholders if one or members of a family group do not receive reasonable compensation).

[10]Congress has enacted statutory provisions intended to do little more than tell courts (and the Service) that factual determinations have been made in correctly. *See*, *e.g.*, sections 183(a)-(c) (hobby losses) and 702(a)(2)(B) (disguised sales).

[11]*See, e.g.*, Stephen M. Breitstone, ''Carried Interest Bill — Impact on Real Estate Partnerships,'' *Tax Notes*, Mar. 8, 2010, p. 1219, *Doc 2010-3262*, or *2010 TNT 45-5*; Abrams, ''Taxation of Carried Interests: The Reform That Did Not Happen,'' 40 *Loyola U. Chi. Law J.* 197 (2009); Abrams, ''The Past Is Prologue: Carried Interests,'' 24 *Tax Mgmt. Real Estate J.* 23 (2008), *available at* http://ssrn.com/abstract=1085582; Michael L. Schler, ''Taxing Partnership Profits Interests as Compensation Income,'' *Tax Notes*, May 26, 2008, p. 829, *Doc 2008-9190*, or *2008 TNT 103-40*; Abrams, ''A Close Look at the Carried Interest Legislation,'' *Tax Notes*, Dec. 3, 2007, p. 961, *Doc 2007-25737*, or *2007 TNT 233-35*.

[12]Proposed section 710(d)(7)(A)(iii).

[13]Proposed section 710(d)(8). Out of an abundance of respect for the stratagems of tax lawyers, proposed section 710 denies ''qualified capital'' treatment to partnership loans that are fully recourse to a service provider. *See* proposed section 710(d)(8)(a). Unsurprisingly, the identical loan if recourse to a non-service-providing partner is treated as qualified capital of that partner, a heads-I-win, tails-you-lose provision.

[14]Proposed section 710(b)(5). This provision is particularly harsh: Distributed property should at most be tainted (as under section 735(a)). Acceleration of the gain seems punitive and requires valuation of property when no objective valuation is available, precisely what section 710 was intended to avoid.

[15]Proposed section 710(a)(2).

[16]*See* Abrams, ''Taxation of Carried Interests,'' *supra* note 4.

[17]*See* Abrams, ''Taxation of Carried Interests: The Reform That Did Not Happen,'' *supra* note 11, at 215-223.

[18]This observation often is ascribed to Abraham Lincoln.

[19]*See* section 83(a).

[20]Proposed section 710(d)(7)(A)(ii).

[21]Amounts included under section 83 at the time of contribution are treated under proposed section 710 as ''contributed capital,'' but that does not preclude the subsequent application of proposed section 710 to the service provider.

If taxing a service partner's labor component is so simple when done properly, why has Congress opted for the complex and imperfect rules in section 710? It is hard to know for sure, but one possibility is that several academics proposed alternatives to the valuation problem without actually drafting proposed legislation that would implement their proposals,[22] and in the abstract many things seem simple. There are, of course, other possible theories that explain the unnecessary complexity,[23] but nothing can justify Congress's proposal when a better alternative is so obvious.

Perhaps Congress is worried that immediate taxation of a service partner is overly harsh. Imposition of taxation on labor income usually is deferred until receipt of funds by the service provider. There are at least two possible responses to the burden that acceleration of income imposes on the service provider. The first is to force an immediate valuation of the labor component and then use that figure to taint subsequent income from the venture. Suppose, for example, that the labor component is worth $10,000. A revised section 710 could say that the first $10,000 of income to the service partner from the venture (whether from distributive share, sale of the partnership interest, or sale of a distributed asset) will be recharacterized as compensation income. This avoids acceleration of income to the service provider without permitting conversion of labor income into capital gain. The second alternative is to permit the service provider to elect out of proposed section 710 and into immediate taxation on the value of any services contributed to the venture. While this does not remove the complexity of proposed section 710, it will permit many taxpayers to avoid it by making the election, and it equalizes the taxation of service partners with shareholders who make elections under section 83(b).

A few commentators have argued against proposed section 710, not because it is overly complex or unfairly taxes a service partner, but because increasing the effective rate of tax on partnership income will reduce investments and job creation.[24] That conclusion presumably is true but the argument is misguided. Any imposition of an income tax reduces the incentives to work and to invest, but that is no truer for partnerships and their service partners than it is for corporations and their employees. The proper trade-off between the economic benefit of lower tax rates and the government's need for revenue permits no easy answer, but there is no reason to think that service providers to capital-intensive partnerships raise special concerns. Proposed section 710 is misguided because it badly accomplishes something that can be done much more simply and effectively (if it should be done at all). All tax laws should be fair and simple: Proposed section 710 should be rejected or rewritten not because partners are special, but precisely because they are not.

[22]*E.g.*, Victor Fleischer, ''Two and Twenty: Taxing Partnership Profits in Private Equity Funds,'' 83 *NYU L. Rev*. 1 (2008); Mark P. Gergen, ''Reforming Subchapter K: Compensating Service Partners,'' 48 *Tax L. Rev*. 68 (1992); Leo Schmolka, ''Taxing Partnership Interests Exchanged for Services: Let *Diamond/Campbell* Quietly Die,'' 47 *Tax L. Rev*. 287 (1991).

[23]*See* Abrams, ''Taxation of Carried Interests: The Reform That Did Not Happen,'' *supra* note 11, at 227 and n.149.

[24]*See, e.g.*, Diana Furchtgott-Roth, ''Skewing the Playing Field for Investment Partnerships,'' *Tax Notes*, June 14, 2010, p. 1291, *Doc 2010-12690*, or *2010 TNT 113-7*; David A. Weisbach, ''The Taxation of Carried Interests in Private Equity,'' 94 *Va. L. Rev.* 715 (2008).