

**PRESENT LAW AND ANALYSIS
RELATING TO TAX TREATMENT OF
PARTNERSHIP CARRIED INTERESTS**

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
on July 11, 2007

Prepared by the Staff
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CONTENTS

	<u>Page</u>
INTRODUCTION AND SUMMARY	1
I. BACKGROUND	2
II. PRESENT LAW – CARRIED INTERESTS AND COMPENSATION OF INDIVIDUALS.....	5
A. Tax Rates Applicable to Ordinary Income, Capital Gains, and Dividends of Individuals.....	5
B. Tax Treatment of the Receipt of a Partnership Profits Interest for Services	6
C. Tax Treatment of Property Transferred in Connection with the Performance of Services	8
D. Tax Treatment of Nonqualified Deferred Compensation	12
1. Nonqualified deferred compensation.....	12
2. Tax treatment of service provider	12
3. Timing of the service recipient’s deduction.....	16
4. Employment taxes and reporting	17
E. Self-Employment Tax Treatment of Partners.....	18
III. PRESENT LAW – TAXATION OF BUSINESS ENTITIES.....	20
A. Tax Treatment of Partnerships and Partners	20
B. Treatment of Publicly Traded Partnerships	24
C. Comparison to Corporations and to Other Business Entities.....	25
1. Tax treatment of corporations.....	25
2. Tax treatment of other business entities.....	26
IV. ECONOMIC DATA	31
V. LEGISLATIVE PROPOSALS IN THE 110 TH CONGRESS.....	41
VI. FEDERAL TAX ISSUES AND ANALYSIS.....	45

INTRODUCTION AND SUMMARY

The Senate Committee on Finance has scheduled a public hearing on July 11, 2007, on the Federal tax issues surrounding the use of partnership carried interests. This document,¹ prepared by the staff of the Joint Committee on Taxation, includes a description of present law and analysis of Federal tax issues relating to partnership carried interests.

Part One provides background information about carried interests and going-public transactions of partnerships involved in private equity, hedge fund, venture capital fund, and similar alternative asset management and financial advisory business activities. Part Two describes present law relating to Federal tax rates for individuals, tax treatment of partnership profits interests for services, and tax rules relating to compensation and employment tax. Part Three describes present law relating to taxation of partners and partnerships, including publicly traded partnerships, and compares the tax treatment of taxable corporations and of passthrough and untaxed entities. Part Four provides economic data relating to partnerships, and to private equity, venture capital, and hedge funds, and certain carried interests. Part Five describes recent legislative proposals. Part Six provides a description and analysis of Federal tax issues relating to carried interests.

¹ This document may be cited as follows: Joint Committee on Taxation, “*Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests*,” (JCX-41-07), July 10, 2007. This document is available on the internet at www.house.gov/jct.

I. BACKGROUND

Over the past several decades, private equity funds, venture capital funds, hedge funds, and similar alternative investment vehicles² have attracted large amounts of capital investment from institutional investors such as pension funds and educational and charitable institution endowments, as well as from wealthy individual investors. These investors become limited partners in the funds, which are generally structured as partnerships. Some of the funds are established in offshore jurisdictions as well as in the U.S.³ The assets invested in these funds generally are managed by groups of individuals who contribute a relatively small amount of capital to the fund (in relation to amounts of capital contributed by the investors) and who provide investment expertise in selecting, managing, and disposing of fund assets.

It is a common practice for managers of the funds to receive fees, such as management fees, and also to receive “carried interests.” A carried interest generally is a right to receive a percentage of fund profits without an obligation to contribute to the capital to the fund. Income from a carried interest may take the form of capital gain realized as the underlying fund sells off investment assets. In the case of a fund that is a partnership, the carried interest may be structured as a partnership profits interest, under which the partner has a right to receive a percentage of partnership profits, but does not have an obligation to contribute capital to the partnership, nor a right to partnership assets on liquidation of the partnership.⁴ The carried interest may be subject to a hurdle rate, so that the profits percentage is payable only after the fund has returned a specified rate or amount to the investors. The carried interest may also be subject to a “clawback” provision, under which the recipient partner must repay amounts previously received if, in a later year, agreed profit targets in the fund being managed are not met. The combination of a management fee and a carried interest has been referred to as “two and twenty,” referring to the practice of providing the fund managers a fee at two percent of capital and a carried interest at 20 percent of overall partnership profits.

There are variations on the structure of the income of fund managers. For example, with respect to management fees, some fund managers do not receive a management fee and instead receive only a carried interest. In such cases, the fund manager receives a larger carried interest than the manager would have otherwise received. In other cases, the fund manager is entitled to

² These types of funds have differing investment strategies. These are briefly described in the Economic Data section of this document.

³ Lynnley Browning, “A Hamptons for Hedge Funds: Offshore Tax Breaks Lure Money Managers,” *New York Times*, July 1, 2007.

⁴ As income is earned by the partnership but is not yet distributed to the partner with the profits interest, the partner’s share of these earnings is credited to his capital account. However, the capital account is debited when the earnings are distributed to the partner. Thus, the partner does not have rights in liquidation of the partnership once his profit share is distributed to him. Under a partnership profits interest, a partner generally does not have an obligation to contribute to the partnership’s capital if the partnership experiences losses.

an annual management fee, but elects to defer receipt of the management fee until a later year, or to convert the fee to another arrangement.

Techniques for deferring the management fee are also used with respect to the fund manager's carried interest. Sometimes, in lieu of a carried interest, the fund manager's right to income is structured as a contractual right on the part of the fund manager to receive additional fees as opposed to an equity interest in the fund. Income received by the fund manager under this alternative, non-equity method of structuring the carried interest is ordinary income from the performance of services. When the non-equity method of structuring the carried interest is used, it is common for the fund manager to enter into a deferred compensation agreement with the fund with respect to the additional fee income. For example, if the carried interest is structured as a fee that is based on a percentage of the profits realized by the fund each year, the arrangement might further allow the fund manager to elect to defer the fees that are earned by the fund manager in a particular year to a later year.

Recent news reports have publicized transactions in which partnerships involved in private equity, hedge fund, venture capital fund, and similar alternative asset management and financial advisory business activities have made their interests available on an exchange or market.⁵ The publicity surrounding these transactions, and their large dollar value, have drawn attention to issues relating to the tax rules governing the transactions and the manner in which amounts are paid out of these businesses.

While the details of the transactions differ, in general, they involve a public offering of (or making a market for) units in a partnership. Following the public offering, partnership units are traded on an exchange, such as the New York Stock Exchange. Generally, the publicly traded partnership is a holding partnership which, through lower-tier partnerships and corporations, has an interest in operating entities. The lower-tier partnerships and corporations serve to allocate income and, in the case of lower-tier corporations, to convert a variety of types of income received to dividends (or interest) when distributed.⁶ The operating entities conduct

⁵ Reuters, "Blackstone I.P.O. in June," *New York Times*, June 13, 2007; Jenny Anderson, "Scrutiny on Tax Rates that Fund Managers Pay," *New York Times*, June 13, 2007; Jenny Anderson, "Blackstone Founders Prepare to Count their Billions," *New York Times*, June 12, 2007; Michael J. de la Merced, "Fortress Goes Public, a First for Hedge Funds Inside U.S.," *New York Times*, Feb. 9, 2007; Bloomberg, "Hedge Fund is Planning Public Offering," *New York Times*, Nov. 9, 2006; Randall Smith, "Goldman Takes 'Private' Equity to a New Level," *Wall Street Journal*, May 24, 2007; "Oaktree to List on New Goldman Market, Reports Say," *New York Times*, May 11, 2007; Tom Petruno, "A Market for Private Stock Sales," *Los Angeles Times*, May 11, 2007.

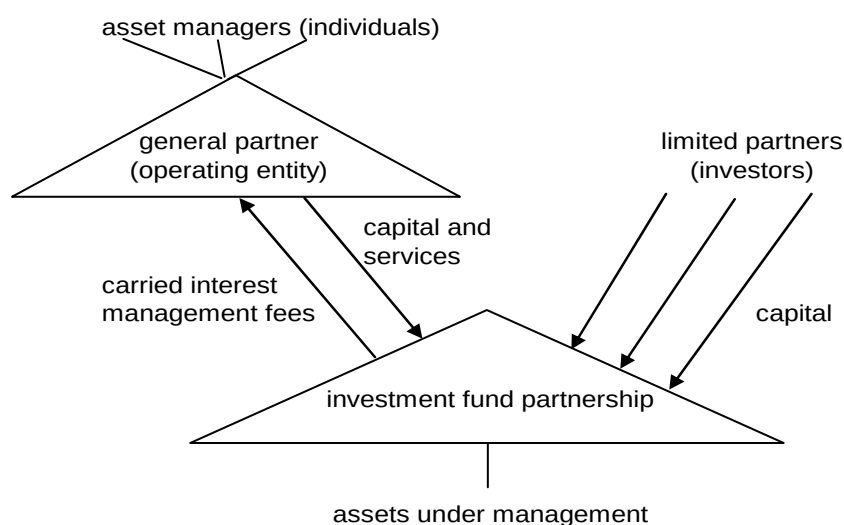
⁶ The going-public transaction may involve the establishment of a tax receivables agreement. Under this agreement, goodwill or other intangible assets of the asset management business that are amortizable for tax purposes are transferred to a lower-tier partnership or sold to a lower-tier corporation, often using proceeds of the public offering of partnership units. As the goodwill or other intangibles are amortized, generating tax deductions, typically 85 percent of the tax savings attributable to the deductions is paid to the contributors of the management business.

businesses involved in asset management and investment advisory activities with respect to funds such as private equity funds and hedge funds.⁷

The Federal tax aspects of these arrangements raise several issues. A core question is whether a carried interest received by an asset management business should be viewed as a form of compensation for services, or whether it is more similar to an interest in capital. The Federal income tax treatment of partnership profits interests for services (of which carried interests can be an example) has evolved through litigation and Internal Revenue Service positions. Carried interests and similar arrangements may also raise issues relating to the application of tax rules governing compensation, such as the rules governing the receipt of property for services and deferred compensation (which affect both the timing and the character of income). Valuing carried interests may be difficult in many situations. Some approaches to taxing carried interests may necessitate some mechanism for preventing double taxation of partnership income. These arrangements may also raise issues relating to the application of employment tax rules. The use of alternatives to carried interests raises the issue of whether comparable tax treatment would be appropriate.

Federal tax issues are also raised with respect to the tax treatment of publicly traded partnerships and the implications of carried interests in that context. While partnerships are pass-through entities for tax purposes, corporations are subject to tax at the entity level. Publicly traded partnerships are generally subject to tax as corporations (with certain exceptions), because of concern over erosion of the corporate tax base. This issue is raised when businesses not previously conducted by publicly traded partnerships go public in partnership form. A related issue of stripping earnings from the corporate tax base arises to the extent income received by a publicly traded partnership is passed through a corporation that might substantially reduce or eliminate its corporate tax through the use of deductions or credits.

Private Investment Fund Structure



⁷ A schematic depiction is provided at the end of this section of this document.

II. PRESENT LAW – CARRIED INTERESTS AND COMPENSATION OF INDIVIDUALS

A. Tax Rates Applicable to Ordinary Income, Capital Gains, and Dividends of Individuals

Ordinary income tax rates

An individual subject to Federal income tax generally pays tax at graduated rates on taxable income. The tax rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer's income increases. For 2007, the tax rates range from 10 percent to 35 percent.

In addition, under present law, individuals are liable for an alternative minimum tax to the extent the tentative minimum tax exceeds the regular tax liability. The tentative minimum tax is computed at rates of 26 and 28 percent on an expanded tax base.

Capital gains and dividends rates

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. Any net capital gain of an individual is taxed at maximum rates lower than the rates applicable to ordinary income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, (5) certain U.S. publications, (6) certain commodity derivative financial instruments, (7) hedging transactions, and (8) business supplies. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain.

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to \$3,000 of ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

A separate rate structure applies to capital gains and dividends. Under present law, for 2007, the maximum rate of tax on the adjusted net capital gain of an individual is 15 percent. In addition, any adjusted net capital gain otherwise taxed at a 10- or 15-percent rate is taxed at a five-percent rate. These rates apply for purposes of both the regular tax and the alternative minimum tax.

For 2007, dividends received by an individual from domestic corporations and qualified foreign corporations generally are taxed at the same rates that apply to adjusted net capital gain.

B. Tax Treatment of the Receipt of a Partnership Profits Interest for Services

A profits interest in a partnership is the right to receive future profits in the partnership but does not generally include any right to receive money or other property upon the immediate liquidation of the partnership. Although the Internal Revenue Code does not specifically address the treatment of the receipt of a profits interest in a partnership in exchange for the performance of services, a taxpayer receiving a profits interest for performing services generally has not been taxable upon the receipt of the partnership interest.⁸

In 1993, the Internal Revenue Service, referring to the results of cases it had litigated, specifically ruled that the receipt of a partnership profits interests for services generally is not a taxable event for the partnership or the partner.⁹ Under the ruling, this treatment does not apply, however, if: (1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease; (2) within two years of receipt, the partner disposes of the profits interest; or (3) the profits interest is a limited partnership interest in a publicly traded partnership. A more recent ruling¹⁰ clarifies that this result applies provided the service partner takes into income his distributive share of partnership income, and the partnership does not deduct any amount either on grant or on vesting of the profits interest.¹¹

By contrast, a partnership capital interest received for services is includable in the partner's income under generally applicable rules relating the receipt of property for the performance of services.¹² A partnership capital interest for this purpose is an interest that would

⁸ Only a handful of cases have ruled on this issue. Though one case required the value to be included currently, where value was easily determined by a sale of the profits interest soon after receipt (*Diamond v. Commissioner*, 56 T. C. (1971), *aff'd* 492 F. 2d 286 (7th Cir, 1974))⁸, a more recent case concluded that partnership profits interests were not includable on receipt, because the profits interests were speculative and without fair market value (*Campbell v. Commissioner* (943 F. 2d. 815 (8th Cir. 1991))).

⁹ Rev. Proc. 93-27, 1993-2 C.B. 343, citing the *Diamond* and *Campbell* cases, *supra*.

¹⁰ Rev. Proc. 2001-43 (2001-2 C.B. 191).

¹¹ A similar result would occur under the 'safe harbor' election of proposed regulations regarding the application of section 83 to the compensatory transfer of a partnership interest. REG-105346-03, 70 Fed. Reg. 29675 (May 24, 2005). These proposed regulations are described in the section of this document entitled Tax Treatment of Property Transferred in Connection with the Performance of Services.

¹² Secs. 61 and 83; Treas. Reg. sec. 1.721-1(b)(1)); see *U.S. v. Frazell*, 335 F.2d 487 (5th Cir. 1964), *cert denied*, 380 U.S. 961 (1965).

entitle the receiving partner to a share of the proceeds if the partnership's assets were sold at fair market value and the proceeds were distributed in liquidation.¹³

A partner holding a partnership interest includes in income its distributive share (whether or not actually distributed) of partnership items of income and gain, including capital gain eligible for the lower income tax rates. A partner's basis in the partnership interest is increased by any amount of gain thus included and is decreased by losses. These basis adjustments prevent double taxation of partnership income to the partner, preserving the partnership's tax status as a passthrough entity. Amounts distributed to the partner by the partnership are taxed to the extent the amount exceeds the partner's basis in the partnership interest.

¹³ Rev. Proc. 93-27, 1993-2 C.B. 343.

C. Tax Treatment of Property Transferred in Connection with the Performance of Services

In general

Section 83 governs the amount and timing of income and deductions attributable to transfers of property in connection with the performance of services. If property is transferred in connection with the performance of services, the person performing the services (the “service provider”) generally must recognize income for the taxable year in which the property is first substantially vested (i.e., transferable or not subject to a substantial risk of forfeiture). The amount includible in the service provider’s income is the excess of the fair market value of the property over the amount (if any) paid for the property.

Under section 83(b), even if the property is not vested at the time of transfer, the service provider may nevertheless elect within 30 days of the transfer to recognize income for the taxable year of the transfer. Such an election is referred to as a “section 83(b) election.” The service provider makes an election by filing with the IRS a written statement that includes the fair market value of the property at the time of transfer and the amount (if any) paid for the property. The service provider must also provide a copy of the statement to the service recipient.

Under section 83, a deduction is allowed to the person for whom such services are performed (the “service recipient”) equal to the amount included in gross income by the service provider.¹⁴ The deduction is allowed for the taxable year of the service recipient in which or with which ends the taxable year for which the amount is included in the service provider’s income.

A transfer of property occurs when a person acquires a beneficial ownership interest in such property. The term “property” is defined very broadly for purposes of section 83.¹⁵ Property includes real and personal property, but does not include money or an unfunded and unsecured promise to pay money in the future.

Property is subject to a substantial risk of forfeiture if the individual’s right to the property is conditioned on the future performance of substantial services (such as full-time services for two years or more) or on the nonperformance of services (such as a noncompete requirement). In addition, a substantial risk of forfeiture exists if the right to the property is subject to a condition other than the performance of services, provided that the condition relates to a purpose of the transfer and there is a substantial possibility that the property will be forfeited if the condition does not occur. Risks that do not fall within this legal definition, such as the risk that the property will decline in value, do not result in a substantial risk of forfeiture. Whether a substantial risk of forfeiture exists depends on the facts and circumstances, including whether the service requirement or other condition will in fact be enforced. Property that is subject to a

¹⁴ Sec. 83(h).

¹⁵ Treas. Reg. sec. 1.83-3(e). This definition in part reflects previous IRS rulings on nonqualified deferred compensation.

substantial risk of forfeiture is referred to as nonvested property; property that is not (or is no longer) subject to a substantial risk of forfeiture is referred to as vested property.

Property is considered transferable if a person can transfer his or her interest in the property to anyone other than the transferor from whom the property was received. However, property is not considered transferable if the transferee's rights in the property are subject to a substantial risk of forfeiture. A temporary restriction on the transferability of property (called a "lapse" restriction) is disregarded in determining the value of the property for purposes of section 83. A permanent restriction on the transferability of property (a "nonlapse" restriction) is taken into account in determining the value of the property.

Compensatory stock

Stock may be granted to an employee (or other service provider) without restrictions in the sense that the stock is fully vested and transferable. In some cases, the employee is granted "restricted" stock in the sense that the stock must be forfeited or sold back to the company in certain circumstances. For example, an employee may receive stock that is subject to a substantial risk of forfeiture because of a requirement that the stock be forfeited if the employee terminates employment within five years. Stock that is subject to a substantial risk of forfeiture is referred to as nonvested stock; stock that is not (or is no longer) subject to a substantial risk of forfeiture is referred to as vested stock.

Stock that is granted to an employee (or other service provider) is subject to the rules that apply under section 83 to transfers of property in connection with the performance of services. Accordingly, if vested stock is transferred to an employee, the excess of the fair market value of the stock, over the amount, if any, the employee pays for the stock is includible in the employee's income for the year in which the transfer occurs. The amount includible in the income of the employee is generally deductible by the employer for the taxable year of the employer in which the employee's taxable year of inclusion ends.

If nonvested stock is transferred to an employee (or other service provider), no amount is includible in income as a result of the transfer unless the employee makes a section 83(b) election. Otherwise, the excess of the fair market value of the stock at the time of vesting, over the amount, if any, the employee pays for the stock is includible in the employee's income for the year in which vesting occurs, and the .

In the case of an employee, the amount includible in income under section 83 is also subject to income tax withholding and to social security tax (subject to the social security wage base) and Medicare tax and must be reported on a Form W-2. In the case of an individual who is not an employee, the amount includible in income under section 83 must be reported on a Form 1099.

Compensatory stock options

A stock option is the right to purchase stock at a specified price (or at a price determined under a specified formula) at a specified time or during a specified period. Stock options granted to employees or other service providers are considered to be compensation for services. There are two general types of compensation-related stock options under the Code: nonqualified

options (which are subject to section 83) and statutory options (which are subject to special tax rules under section 421). Statutory options include incentive stock options (described in section 422) and options provided under an employee stock purchase plan (described in section 423). Nonqualified options are any other options (other than statutory options) granted in connection with the performance of services.

The income taxation of a nonqualified option is determined under section 83 and depends on whether the option has a readily ascertainable fair market value when granted. A nonqualified option has a readily ascertainable fair market value if (1) the option is actively traded on an established market, or (2) the option is transferable, it is immediately exercisable in full, the option and the stock subject to the option are not subject to any restriction or condition that has a significant effect on the value of the option, and the fair market value of the option privilege is readily ascertainable. The option privilege is the opportunity to benefit from increases in the value of the stock during the option period without risking capital.

If an individual receives a nonqualified option that has a readily ascertainable fair market value at the time the option is granted (which is generally not the case), the excess of the fair market value of the option over the amount, if any, paid for the option is includible in the recipient's gross income as ordinary income in the first taxable year in which the option is either transferable or is not subject to a substantial risk of forfeiture (or, if the taxpayer makes a section 83(b) election, in the taxable year in which the option is granted). When such an option is later exercised, no amount is includible in the gross income of the option recipient due to the exercise of the option.

If the nonqualified option does not have a readily ascertainable fair market value at the time of grant (which is generally the case), no amount is includible in the gross income of the recipient with respect to the option until the recipient exercises the option. The transfer of stock on exercise of the option is subject to the general rules of section 83. That is, if vested stock is received on exercise of the option, the excess of the fair market value of the stock over the option price is includible in the recipient's gross income as ordinary income in the taxable year in which the option is exercised. If the stock received on exercise of the option is not vested, the excess of the fair market value of the stock at the time of vesting over the option price is includible in the recipient's income for the year in which vesting occurs (unless the recipient elects to make a section 83(b) election).

In the case of an employee, the amount includible in income under section 83 with respect to nonqualified stock options is also subject to income tax withholding and to social security tax (subject to the social security wage base) and Medicare tax and must be reported on a Form W-2. In the case of an individual who is not an employee, the amount includible in income under section 83 must be reported on a Form 1099.

A compensation expense deduction equal to the amount of ordinary income included in the gross income of the option recipient is generally allowable to the employer for the taxable year of the employer in which the recipient's taxable year of inclusion ends.

Proposed regulations on compensatory transfer of a partnership interest

The Department of Treasury has issued proposed regulations regarding the application of section 83 to the compensatory transfer of a partnership interest.¹⁶ The proposed regulations provide that a partnership interest is “property” for purposes of section 83. Thus, a compensatory transfer of a partnership interest is includible in the service provider’s gross income at the time that it first becomes substantially vested (or, in the case of a nonvested partnership interest, at the time of grant if a section 83(b) election is made).

However, the proposed regulations also contain a rule that permits a partnership and a partner to elect a safe harbor under which the fair market value of a compensatory partnership interest is treated as being equal to the liquidation value of that interest. Therefore, under the proposed regulations, the grant of a vested profits interest in a partnership (or, if a section 83(b) election is made, the grant of a nonvested profits interest) results in no income inclusion under section 83 because the fair market value of the property received by the service provider is zero. The proposed safe harbor is subject to a number of conditions. For example, the election cannot be made retroactively and must apply to all compensatory partnership transfers that occur during the period that the election is in effect.

¹⁶ 70 Fed. Reg. 29675 (May 24, 2005).

D. Tax Treatment of Nonqualified Deferred Compensation

1. Nonqualified deferred compensation

Deferred compensation occurs when the payment of compensation to a service provider is deferred for more than a short period after the compensation is earned (i.e., the time when the services giving rise to the compensation are performed). Payment is generally deferred until some specified event, such as the service provider's death, disability, or other termination of services, or until a specified time in the future, such as five or ten years.

The Code provides tax-favored treatment for certain types of employer-sponsored deferred compensation arrangements that are designed primarily to provide employees with retirement income. These arrangements include qualified defined contribution and defined benefit pension plans (sec. 401(a)), qualified annuities (sec. 403(a)), tax-sheltered annuities (sec. 403(b)), savings incentive match plans for employees or "SIMPLE" plans (sec. 408(p)), simplified employee pensions or "SEPs" (sec. 408(k)), and eligible deferred compensation plans of State or local government employers (sec. 457(b)). For simplicity, these plans are referred to collectively here as "qualified employer plans." A nonqualified deferred compensation arrangement is generally any deferred compensation arrangement that is not one of these qualified employer plans.

Nonqualified deferred compensation arrangements are contractual arrangements between a service recipient (e.g., an employer or a hedge fund) and a service provider (e.g., an employee or a hedge fund manager) covered by the arrangement. Such arrangements are structured in whatever form achieves the goals of the parties; as a result, they vary greatly in design. Considerations that may affect the structure of the arrangement are the current and future income needs of the service provider, the desired tax treatment of deferred amounts, and the desire for assurance that deferred amounts will in fact be paid.

2. Tax treatment of service provider

In general

The American Jobs Creation Act of 2004¹⁷ added section 409A to the Code which provides specific rules governing the tax treatment of nonqualified deferred compensation.¹⁸ Prior to section 409A, there were no rules that specifically governed the tax treatment of nonqualified deferred compensation. In determining the tax treatment of nonqualified deferred compensation prior to enactment of section 409A, a variety of tax principles and Code provisions were relevant, including the doctrine of constructive receipt, the economic benefit doctrine, the provisions of section 83 relating generally to transfers of property in connection with the performance of services, and provisions relating specifically to nonexempt employee trusts (sec. 402(b)) and nonqualified employee annuities (sec. 403(c)). Section 409A does not override

¹⁷ Pub. L. No. 108-357 (2004).

¹⁸ Section 409A generally applies to amounts deferred after December 31, 2004.

these tax principles and Code provisions. Thus, they are relevant in determining the tax treatment of nonqualified deferred compensation and are discussed below. Section 409A does not prevent the inclusion of amounts in gross income under any provision or rule of law earlier than the time provided under its rules.

Under section 409A, unless certain requirements are satisfied, amounts deferred under a nonqualified deferred compensation plan are currently includible in income to the extent not subject to a substantial risk of forfeiture. The requirements imposed under section 409A affect the way that nonqualified deferred compensation arrangements are now commonly structured.

General income inclusion rules

If the nonqualified deferred compensation arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received under section 451 (unless earlier income inclusion applies under section 409A).¹⁹ Income is constructively received when it is credited to an individual's account, set apart, or otherwise made available so that it may be drawn on at any time.²⁰ Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. A requirement to relinquish a valuable right in order to make withdrawals is generally treated as a substantial limitation or restriction.

In general, an arrangement is considered funded if there has been a transfer of property under section 83. Section 83 provides rules for the tax treatment of property transferred in connection with the performance of services and generally applies to a funded nonqualified deferred compensation arrangement.²¹ (See section II.C of this document for a discussion of section 83.)

The economic benefit doctrine is based on the broad definition of gross income in the Code (sec. 61), which includes income in whatever form paid. Under the economic benefit doctrine, if an individual receives any economic or financial benefit or property as compensation for services, the value of the benefit or property is includible in the individual's gross income. For example, courts have applied the economic benefit doctrine to the receipt of stock options or the receipt of an interest in a trust.²² A concept related to economic benefit is the cash

¹⁹ Treas. Reg. secs. 1.451-1 and 1.451-2.

²⁰ Compensation that is constructively received is includible in income regardless of whether the requirements of section 409A are met.

²¹ Special rules apply under the Code in the case of nonexempt employee trusts and nonqualified employee annuities (i.e., trusts and annuities not meeting the requirements applicable to qualified retirement plans and annuities). Secs. 402(b) and 403(c). These provisions apply rules similar to those under section 83. Although these Code provisions predate the enactment of section 83 in 1969, they were amended at that time to reflect the enactment of section 83.

²² *Commissioner v. Smith*, 324 U.S. 177 (1945); *E.T. Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (1952).

equivalency doctrine.²³ Under this doctrine, if the right to receive a payment in the future is reduced to writing and is transferable, such as in the case of a note or a bond, the right is considered to be the equivalent of cash and the value of the right is includible in gross income.²⁴

Section 409A

Under section 409A, all amounts deferred by a service provider under a nonqualified deferred compensation plan²⁵ for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture²⁶ and not previously included in gross income, unless certain requirements are satisfied. If the requirements of section 409A are not satisfied, in addition to current income inclusion, interest at the rate applicable to underpayments of tax plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to a 20-percent additional tax.

Under regulations, the term “service provider” includes an individual, corporation, subchapter S corporation, partnership, personal service corporation (as defined in sec. 269A(b)(1)), noncorporate entity that would be a personal service corporation if it were a corporation, or qualified personal service corporation (as defined in sec. 448(d)(2)) for any taxable year in which such individual or entity accounts for gross income from the performance of services under the cash receipts and disbursements method of accounting.²⁷ Section 409A does not apply to a service provider that provides significant services to at least two service recipients that are not related to each other or the service provider. This exclusion does not apply to a service provider who is an employee or a director of a corporation (or similar position in the

²³ In the case of nonqualified deferred compensation arrangements, these doctrines have largely been codified in the Code provisions discussed herein. However, because many of the legal precedents related to nonqualified deferred compensation predate these Code provisions, the economic benefit and cash equivalency doctrines are sometimes considered in analyzing the tax treatment of nonqualified deferred compensation.

²⁴ See, e.g., *Cowden v. Commissioner*, 289 F.2d 20 (5th Cir. 1961).

²⁵ A plan includes an agreement or arrangement, including an agreement or arrangement that includes one person. Amounts deferred also include actual or notional earnings.

²⁶ As under section 83, the rights of a person to compensation are subject to a substantial risk of forfeiture if the person’s rights to such compensation are conditioned upon the performance of substantial services by any individual.

²⁷ Treas. Reg. Sec. 1.409A-1(f)(1).

case of an entity that is not a corporation).²⁸ In addition, the exclusion does not apply to a fund manager.²⁹

For purposes of section 409A, a nonqualified deferred compensation plan is any plan that provides for the deferral of compensation other than a qualified employer plan³⁰ or any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan.

The regulations also provide that certain other types of plans are not considered deferred compensation, and thus are not subject to section 409A. For example, if a service recipient transfers property to a service provider, there is no deferral of compensation merely because the value of the property is either not includible in income under section 83 by reason of the property being substantially nonvested or is includible in income because of a valid section 83(b) election.³¹ Special rules apply in the case of stock options.³²

Under section 409A, distributions from a nonqualified deferred compensation plan may be allowed only upon separation from service (as determined by the Secretary), death, a specified time (or pursuant to a fixed schedule), change in control of a corporation (to the extent provided by the Secretary), occurrence of an unforeseeable emergency, or if the participant becomes disabled. A nonqualified deferred compensation plan may not allow distributions other than upon the permissible distribution events and, except as provided in regulations by the Secretary, may not permit acceleration of a distribution. In the case of a specified employee who separates from service, distributions may not be made earlier than six months after the date of the separation from service or upon death. Specified employees are key employees³³ of publicly-traded corporations.

²⁸ Treas. Reg. Sec. 1.409A-1(f)(2).

²⁹ The exclusion does not apply to the extent that a service provider provides management services to a service recipient, and management services means services that involve the actual or de facto direction or control of the financial or operational aspects of a trade or business of the service recipient or investment management or advisory services provided to a service recipient whose primary trade or business includes the investment of financial assets, such as a hedge fund. Treas. Reg. Sec. 1.409A-1(f)(2)(iv).

³⁰ A qualified employer plan means a qualified retirement plan, tax-deferred annuity, simplified employee pension, and SIMPLE. A qualified governmental excess benefit arrangement (sec. 415(m)) is a qualified employer plan. An eligible deferred compensation plan (sec. 457(b)) is also a qualified employer plan. A tax-exempt or governmental deferred compensation plan that is not an eligible deferred compensation plan is not a qualified employer plan.

³¹ Treas. Reg. Sec. 1.409A-1(b)(6).

³² Treas. Reg. Sec. 1.409A-1(b)(5).

³³ Key employees are defined in section 416(i) and generally include officers (limited to 50 employees) having annual compensation greater than \$145,000 (in 2007), five percent owners, and one percent owners having annual compensation from the employer greater than \$150,000.

Section 409A requires that a plan must provide that compensation for services performed during a taxable year may be deferred at the participant's election only if the election to defer is made no later than the close of the preceding taxable year, or at such other time as provided in Treasury regulations. In the case of any performance-based compensation based on services performed over a period of at least 12 months, such election may be made no later than six months before the end of the service period. The time and form of distributions must be specified at the time of initial deferral. A plan may allow changes in the time and form of distributions subject to certain requirements.

In the case of assets set aside (directly or indirectly) in a trust (or other arrangement determined by the Secretary) for purposes of paying nonqualified deferred compensation, such assets are treated as property transferred in connection with the performance of services under section 83 (whether or not such assets are available to satisfy the claims of general creditors) at the time set aside if such assets (or trust or other arrangement) are located outside of the United States or at the time transferred if such assets (or trust or other arrangement) are subsequently transferred outside of the United States. Any subsequent increases in the value of, or any earnings with respect to, such assets are treated as additional transfers of property.

3. Timing of the service recipient's deduction

Special statutory provisions govern the timing of the deduction for nonqualified deferred compensation, regardless of whether the arrangement covers employees or nonemployees and regardless of whether the arrangement is funded or unfunded.³⁴ Under these provisions, the amount of nonqualified deferred compensation that is includible in the income of the service provider is deductible by the service recipient for the taxable year in which the amount is includible in the service provider's income.³⁵

³⁴ Secs. 404(a)(5), (b) and (d) and sec. 83(h).

³⁵ In the case of a publicly held corporation, no deduction is allowed for a taxable year for remuneration with respect to a covered employee to the extent that the remuneration exceeds \$1 million. Code sec. 162(m). The Code defines the term "covered employee" in part by reference to Federal securities law. In light of changes to Federal securities law, the Internal Revenue Service interprets the term covered employee as the principal executive officer of the taxpayer as of the close of the taxable year or the 3 most highly compensated employees of the taxpayer for the taxable year whose compensation must be disclosed to the taxpayer's shareholders (other than the principal executive officer or the principal financial officer). Notice 2007-49, 2007-25 I.R.B. 1429. For purposes of the deduction limit, remuneration generally includes all remuneration for which a deduction is otherwise allowable, although commission-based compensation and certain performance-based compensation are not subject to the limit. Remuneration does not include compensation for which a deduction is allowable after a covered employee ceases to be a covered employee. Thus, the deduction limitation often does not apply to deferred compensation that is otherwise subject to the deduction limitation (e.g., is not performance-based compensation) because the payment of the compensation is deferred until after termination of employment.

4. Employment taxes and reporting

In the case of an employee, nonqualified deferred compensation is generally considered wages both for purposes of income tax withholding and for purposes of taxes under the Federal Insurance Contributions Act (“FICA”), consisting of social security tax and Medicare tax. However, the income tax withholding rules and social security and Medicare tax rules that apply to nonqualified deferred compensation are not the same.

In the case of an employee, nonqualified deferred compensation is generally subject to income tax withholding at the time it is includible in the employee’s income as discussed above. In addition, amounts includible in income are required to be reported on the employee’s Form W-2 for the year includible in income. Income tax withholding and Form W-2 reporting are required even if the employee has already terminated employment. Income tax withholding and Form W-2 reporting are required when amounts are includible in income even if no actual payments are made to the employee.³⁶

In the case of a service provider who is not an employee, nonqualified deferred compensation amounts includible in income generally are required to be reported in a Form 1099 for the year includible in income. Income tax withholding generally does not apply to such amounts.

The Code provides special rules for applying social security and Medicare taxes to nonqualified deferred compensation of employees.³⁷ In general, nonqualified deferred compensation is subject to social security and Medicare tax when it is earned (i.e., when services are performed), unless the nonqualified deferred compensation is subject to a substantial risk of forfeiture. If nonqualified deferred compensation is subject to a substantial risk of forfeiture, it is subject to social security and Medicare tax when the risk of forfeiture is removed (i.e., when the right to the nonqualified deferred compensation vests). This treatment is not affected by the timing of income inclusion.

In the case of a self-employed individual, nonqualified deferred compensation amounts that are includible in income are also taken into account in determining net earnings from self-employment for social security and Medicare tax purposes unless an exception applies.

³⁶ The required income tax withholding is accomplished by withholding income taxes from other wages paid to the employee in the same year.

³⁷ Because nonqualified deferred compensation arrangements generally cover only highly paid employees, the other compensation paid to the employee during the year generally exceeds the social security wage base. In that case, nonqualified deferred compensation amounts are subject only to Medicare tax.

E. Self-Employment Tax Treatment of Partners

As part of the financing for Social Security and Medicare benefits, a tax is imposed on the wages of an individual received with respect to his or her employment under the Federal Insurance Contributions Act (“FICA”).³⁸ A similar tax is imposed on the net earnings from self-employment of an individual under the Self-Employment Contributions Act “SECA”) ³⁹

The FICA tax has two components. Under the old-age, survivors, and disability insurance component (“OASDI”), the rate of tax is 12.40 percent, half of which is imposed on the employer, and the other half of which is imposed on the employee.⁴⁰ The amount of wages subject to this component is capped at \$97,500 for 2007. Under the hospital insurance component (“HI”), the rate is 2.90 percent, also split equally between the employer and the employee. The amount of wages subject to the HI component of the tax is not capped. The wages of individuals employed by a business in any form (for example, a C corporation) generally are subject to the FICA tax.⁴¹

The SECA tax mirrors the FICA tax, and the SECA rate is the combined employer and employee rate for FICA taxes. Thus, the SECA tax has two components. Under the OASDI component, the rate of tax is 12.40 percent and the amount of earnings subject to this component is capped at \$97,500 (for 2007). Under the HI component, the rate is 2.90 percent, and the amount of self-employment income subject to the HI component is not capped.

For SECA tax purposes, net earnings from self-employment means the gross income derived by an individual from any trade or business carried on by the individual, less the deductions attributable to the trade or business that are allowed under the self-employment tax rules⁴². Specified types of income or loss are excluded, such as rentals from real estate in certain

³⁸ See Chapter 21 of the Code.

³⁹ Sec. 1401.

⁴⁰ Secs. 3101 and 3111.

⁴¹ S corporation shareholders who are employees of the S corporation are subject to FICA taxes. A considerable body of case law has addressed the issue of whether amounts paid to S corporation shareholder-employees are reasonable compensation for services and therefore are wages subject to FICA tax or are properly characterized as another type of income (typically, dividends) and therefore not subject to FICA tax.

⁴² For purposes of determining net earnings from self-employment, taxpayers are permitted a deduction from net earnings from self-employment equal to the product of the taxpayer’s net earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent), i.e., 7.65 percent of net earnings. This deduction reflects the fact that the FICA rates apply to an employee’s wages, which do not include FICA taxes paid by the employer, whereas a self-employed individual’s net earnings are economically the equivalent of an employee’s wages plus the employer share of FICA taxes. The deduction is intended to provide parity between FICA and SECA taxes. In addition, self-employed individuals may deduct one-half of self-employment taxes for income tax purposes (sec. 164(f)).

circumstances, dividends and interest, and gains or loss from the sale or exchange of a capital asset or from timber, certain minerals, or other property that is neither inventory nor held primarily for sale to customers.

For an individual who is a partner in a partnership, the net earnings from self-employment generally include the partner's distributive share (whether or not distributed) of income or loss from any trade or business carried on by the partnership (excluding specified types of income, such as rents and dividends, as described above). This rule applies to individuals who are general partners. A special rule applies for limited partners of a partnership.⁴³ In determining a limited partner's net earnings from self-employment, an exclusion is provided for his or her distributive share of partnership income or loss. The exclusion does not apply with respect to guaranteed payments to the limited partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.

⁴³ Sec. 1402(a)(13). For this purpose, limited partner status is determined under State law. Issues have arisen under present law as to the proper SECA tax treatment of individuals who may be limited partners under State law but who participate in the management and operation of the partnership.

III. PRESENT LAW - TAXATION OF BUSINESS ENTITIES

A. Tax Treatment of Partnerships and Partners

Passthrough treatment

A partnership generally is not treated as a taxable entity (except for certain publicly traded partnerships), but rather, is treated as a pass-through entity. Income earned by a partnership, whether distributed or not, is taxed to the partners.⁴⁴ The character of partnership items passes through to the partners, as if the items were realized directly by the partners.⁴⁵ The items of income, gain, loss, deduction or credit of a partnership generally are taken into account by a partner as allocated under the terms of the partnership agreement (or in accordance with the partners' interests in the partnership if the agreement does not provide for an allocation), so long as the allocation has substantial economic effect.⁴⁶

Basis in a partnership interest

A partner's basis in its partnership interest is separate from the partnership's basis in partnership property. The basis of a partnership interest acquired by a contribution of property (including money) to the partnership is equal to the sum of the amount of money and the contributing partner's adjusted basis for the property at the time of contribution, reduced by gain (if any) recognized by the contributing partner.⁴⁷ The basis of a partnership interest acquired by transfer is generally its cost.⁴⁸

Adjustments to the basis of a partnership interest are made to take account of the partner's distributive share of income and loss of the partnership, and to take account of distributions by the partnership to the partner, during the taxable year. The basis of the partnership interest is increased by the partner's distributive share of taxable and tax-exempt income of the partnership.⁴⁹ The basis of the partnership interest is decreased by (1) the amount of money distributed to the partner and the partner's basis in property distributed, and (2) the

⁴⁴ Section 701.

⁴⁵ Section 702.

⁴⁶ Section 704(a) and (b).

⁴⁷ Sections 705(a) and 722.

⁴⁸ Sections 742 and 1012.

⁴⁹ Section 705(a)(1). The basis is also increased by the excess of deductions for depletion over the basis of the property subject to depletion, if the partnership has an interest in such property.

partner's distributive share of partnership losses and of nondeductible expenditures that are not properly chargeable to capital account.⁵⁰

Partnership's basis in its property; section 754 election

A partnership that acquires property by contribution from a partner has an adjusted basis in the property equal to the contributing partner's adjusted basis in the property.⁵¹ A partnership that acquires property by purchase generally has a cost basis in the property.

In the event of a transfer of a partnership interest by sale or exchange (or on the death of a partner), the basis of partnership property is adjusted if the partnership has a section 754 election in effect, or if the partnership has a substantial built-in loss⁵² immediately after the transfer.⁵³ The partnership increases the adjusted basis of partnership property by the amount by which the transferee's basis in its partnership interest exceeds its proportionate share of the adjusted basis of partnership property. The partnership decreases the adjusted basis of partnership property by the amount by which the transferee's proportionate share of the adjusted basis of partnership property exceeds the transferee's basis in its partnership interest. These adjustments are made with respect to the transferee partner. They are intended to adjust the basis of partnership property to approximate the result of a direct purchase of the property by the transferee partner. Thus, the adjusted basis of partnership property generally is stepped up when a partner acquires a partnership interest by transfer at a price that exceeds the amount of its proportionate share of the adjusted basis of partnership property.

Partnership distributions generally tax-free

In the case of a distribution by a partnership, no gain or loss is recognized by the partnership on a distribution to a partner of property, including money.⁵⁴ A partner generally is permitted to receive distributions of partnership property without recognition of gain or loss.⁵⁵

⁵⁰ Sections 705(a)(2) and 733. The basis is also decreased (but not below zero) by certain depletion deductions (sec. 705. Special rules may apply under regulations in the case of a partnership termination (sec. 705(b)).

⁵¹ Section 723.

⁵² For this purpose, a substantial built-in loss exists if the partnership's adjusted basis in partnership property exceeds by more than \$250,000 the fair market value of the property (sec. 734(d)). An alternative rule providing for loss deferral for the transferee partner applies in the case of an electing investment partnership that would otherwise be treated as having a substantial built-in loss (sec. 734(e)).

⁵³ Sections 743 and 754. Similar rules apply with respect to adjustments to the basis of partnership property in the case of a distribution of partnership property to a partner (sec. 734).

⁵⁴ Section 731(b). Adjustments to the basis of the partnership's property in the event of a distribution may be required if the partnership has made a section 754 election or if there is a substantial basis reduction with respect to the distribution (sec. 734).

⁵⁵ Section 731(a)(1) and (c).

Several exceptions to this partner nonrecognition rule apply. Gain is recognized by the distributee partner to the extent that any money (and the fair market value of marketable securities) distributed exceeds the partner's adjusted basis in its partnership interest immediately before the distribution. Loss is recognized by the distributee partner when only money and unrealized receivables and inventory are received in a liquidating distribution in which the amount of money and the adjusted basis of the receivables and inventory does not exceed the partner's adjusted basis in its partnership interest.⁵⁶ Gain or loss may be recognized by the distributee partner in the case of certain disproportionate distributions involving inventory and unrealized receivables,⁵⁷ or in the case of certain distributions relating to contributed property.⁵⁸ In addition, if a partner engages in a transaction with a partnership other than in its capacity as a member of the partnership, the transaction generally is considered as occurring between the partnership and one who is not a partner.⁵⁹

Contributions to a partnership generally tax-free

No gain or loss is recognized by a partnership, or by any of its partners, on the contribution of property to the partnership in exchange for an interest in the partnership.⁶⁰ This rule of nonrecognition does not apply in the case of a partnership interest received in exchange for services (which are not considered property).

Transactions between partner and partnership

If a partner engages in a transaction with a partnership other than in his capacity as a member of the partnership, the transaction may be considered as occurring between the partnership and a person that is not a partner.⁶¹ In general, this rule applies if a partner performs services for a partnership, and there is a related direct or indirect allocation and distribution to the partner, and the performance of the services and the allocation and distribution (when viewed

⁵⁶ Section 731(a)(2).

⁵⁷ Section 751(b).

⁵⁸ Sections 704(c) and 737.

⁵⁹ Section 707.

⁶⁰ Section 721. This nonrecognition rule does not apply to the transfer of property to a partnership that would be an investment company if it were a corporation (sec. 721(b)). If, in connection with the contribution to the partnership, there is a related direct or indirect transfer of money or other property by the partnership to a partner, the transfers may be treated as a taxable sale or exchange between partners or between the partnership and one who is not a partner (sec. 707).

⁶¹ Section 707(a).

together) are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership.⁶²

A separate rule governs the tax treatment of guaranteed payments to partners. Under the rule for guaranteed payments, to the extent they are determined without regard to the income of the partnership, payments to a partner for services are considered as made to one who is not a member of the partnership, but only for purposes of inclusion of gross income and deduction of compensation expense (subject to capitalization rules).⁶³

⁶² Section 707(a)(2)(A). A similar rule applies in the case in which a partner transfers property to the partnership.

⁶³ Section 707(c). A similar rule applies in the case of guaranteed payments for the use of capital.

B. Treatment of Publicly Traded Partnerships

Present Law

Under present law, a publicly traded partnership generally is treated as a corporation for Federal tax purposes (sec. 7704(a)). For this purpose, a publicly traded partnership means any partnership if interests in the partnership are traded on an established securities market, or interests in the partnership are readily tradable on a secondary market (or the substantial equivalent thereof).

An exception from corporate treatment is provided for certain publicly traded partnerships, 90 percent or more of whose gross income is qualifying income (sec. 7704(c)(2)). However, this exception does not apply to any partnership that would be described in section 851(a) if it were a domestic corporation, which includes a corporation registered under the Investment Company Act of 1940 as a management company or unit investment trust.

Qualifying income includes interest, dividends, and gains from the disposition of a capital asset (or of property described in section 1231(b)) that is held for the production of income that is qualifying income. Qualifying income also includes rents from real property, gains from the sale or other disposition of real property, and income and gains from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber). It also includes income and gains from commodities (not described in section 1221(a)(1)) or futures, options, or forward contracts with respect to such commodities (including foreign currency transactions of a commodity pool) in the case of partnership, a principal activity of which is the buying and selling of such commodities, futures, options or forward contracts.

The rules generally treating publicly traded partnerships as corporations were enacted in 1987 to address concern about long-term erosion of the corporate tax base. At that time, Congress stated, “[t]o the extent that activities would otherwise be conducted in corporate form, and earnings would be subject to two levels of tax (at the corporate and shareholder levels), the growth of publicly traded partnerships engaged in such activities tends to jeopardize the corporate tax base.” (H.R. Rep. No. 100-391, 100th Cong., 1st Sess. 1065.) Referring to recent tax law changes affecting corporations, the Congress stated, “[t]hese changes reflect an intent to preserve the corporate level tax. The committee is concerned that the intent of these changes is being circumvented by the growth of publicly traded partnerships that are taking advantage of an unintended opportunity for reincorporation and elective integration of the corporate and shareholder levels of tax.” (H.R. Rep. No. 100-391, 100th Cong., 1st Sess. 1066.)

C. Comparison to Corporations and to Other Business Entities

1. Tax treatment of corporations

Corporation is a taxable entity

Income of a corporation is subject to Federal income tax at the corporate level. The top statutory marginal rate of tax on income of a corporation is 35 percent. The rate of tax on corporate capital gains is the same as that for ordinary income.

A corporation is generally recognized as an entity separate from its investors, that may receive income from business or other activities and that may make distributions to investors in the form of dividends to its shareholders, or interest to holders of its indebtedness.

Distributions by a corporation to shareholders generally taxable

Amounts distributed by a corporation to its shareholders as a dividend out of the corporation's earnings and profits generally are taxable to shareholders and not deductible by the corporation. Currently, the individual income tax rate on dividends is the same as the rate of tax on capital gains, generally 15 percent for 2007, in the case of qualified dividends.

If the shareholder is itself a corporation, however, the dividend is eligible for a dividends-received deduction of 70 percent to 100 percent, depending on the percentage of the recipient corporation's ownership of the payor corporation.⁶⁴ Distributions paid with respect to stock that exceed the amount of the paying corporation's current or accumulated earnings and profits are treated as nontaxable return of capital to the shareholders. To the extent such distributions exceed a shareholder's stock basis, the distribution is treated as capital gain.⁶⁵ A distribution may also be treated as capital gain to a shareholder, such that the shareholder can recover its basis in the stock before realizing taxable income, if it is treated as a sale of the shareholder's stock, due to a termination, substantially disproportionate redemption (as defined), or other reduction in the shareholder's interest in the corporation that causes the transaction to be not essentially equivalent to a dividend.⁶⁶

A distribution of appreciated property by a corporation to its shareholders is generally taxable to the corporation as if it had sold the property at fair market value and recognized

⁶⁴ In general, the dividends-received deduction is 70 percent if the corporate shareholder owns less than 20 percent of the stock of the distributing corporation; 80 percent if the corporate shareholder owns at least 20 percent and less than 80 percent of the stock of the distributing corporation; and 100 percent if the corporate shareholder owns 80-percent or more of the stock of the distributing corporation and the dividend is paid out of earnings and profits of a year or years when such ownership requirement was met. Section 243.

⁶⁵ Section 301(c).

⁶⁶ Section 302.

taxable income from the sale.⁶⁷ The shareholders are taxed on the amount realized based on the fair market value of the property distributed.

Contributions to a corporation generally tax-free

No gain or loss is recognized if property is transferred to a corporation solely in exchange for stock of the corporation, and immediately after the exchange, the contributing persons are in control of the corporation.⁶⁸ For this purpose, control means the ownership of stock with at least 80 percent of the total combined voting power of all classes of voting stock, and at least 80 percent of the total number of shares of all other classes of the corporation's stock.⁶⁹

Deductions against corporate income such as interest and amortization of intangibles

A corporation, like other business entities, may generally deduct amounts paid or accrued as interest on debt.⁷⁰ A deduction is permitted for other ordinary and necessary business expenses, including compensation paid for services, rents or royalties for the use of tangible or intangible property. Like other business entities, a corporation is also entitled to deduct depreciation or amortization with respect to purchased property.⁷¹ Present law provides a deduction for 15-year straight-line amortization of goodwill and certain other intangible assets that are purchased by the taxpayer.⁷²

2. Tax treatment of other business entities

In general

In addition to partnerships, the Code provides for several other types of entities that generally are not taxed at the entity level.⁷³ However, those that allow public shareholders to

⁶⁷ Section 311.

⁶⁸ Sections 351.

⁶⁹ Section 368(c).

⁷⁰ Section 163.

⁷¹ Section 167. Section 1239 requires that the sale of depreciable assets that would otherwise produce capital gain to the seller will result in ordinary income if the sale is directly or indirectly between related parties (as defined).

⁷² Section 197. Under anti-churning rules, no amortization deduction is allowed for assets that are acquired from a related party that held or used them within a specified time period prior to enactment of this deduction in 1993, and that were previously nonamortizable. Sec. 197(f)(9). Sales of these intangibles are also subject to the related party sale rules of section 1239.

⁷³ The mechanisms for eliminating tax at the entity level differ among the types of entities. The entities are referred to here generally as "non-taxed" entities. They do not all pass through the character of the income received; and some are subject to corporate level tax to the extent they do not either distribute their income or designate undistributed income as currently taxable to their beneficial interest holders.

invest in a vehicle that is not subject to entity-level tax generally are subject to restrictions regarding their structure, nature of income, nature of assets, and ownership of other entities. These limits reduce the potential for indirectly deriving non-permitted types of income through a related or controlled entity. Some of the restrictions limit the potential for extracting earnings of a taxable corporation as deductible amounts that reduce corporate-level tax when paid to the non-taxed entity.

S corporations

In general, an S corporation is not subject to corporate-level income tax on its items of income and loss. Instead, an S corporation passes through its items of income and loss to its shareholders. Each shareholder takes into account separately his or her pro rata share of these items on his or her individual income tax return. To prevent double taxation of these items, each shareholder's basis in the stock of the S corporation is increased by the amount included in income (including tax-exempt income) and is decreased by the amount of any losses (including nondeductible losses) taken into account.

Eligibility to elect S corporation status is limited. To elect, a corporation must be a domestic corporation which does not have (1) more than 100 shareholders; (2) as a shareholder, a person who is not an individual (other than certain trusts or estates and certain exempt organizations that, except for ESOPs, generally are taxable on their share of S corporation income); (3) a nonresident alien as a shareholder; or (4) more than one class of stock.

Trusts

Regulations governing the classification of entities as trusts or corporations provide that trusts generally do not have associates (for example, shareholders) or an objective to carry on business for profit. Thus, a trust cannot generally conduct an active business of any kind, nor can it engage in the purchase and sale of assets for profit.

A grantor trust is a trust whose grantor has retained the right to exercise certain powers over the trust. A grantor trust is not treated as a separate taxable entity. Instead, the grantor is treated as the owner of the trust's property and is subject to tax on trust income.

Regulated investment companies

A regulated investment company ("RIC") is an entity that receives most of its income from passive investments in stock and securities, currencies and similar instruments; in common parlance, a mutual fund. A RIC must be an electing domestic corporation that, at all times during the taxable year, is registered under the Investment Company Act of 1940 as a management company or as a unit investment trust, or that has elected to be treated as a business development company under that Act. A RIC also is subject to specific requirements with respect to the source of its income and the nature of its assets.

A RIC is an untaxed entity because it deducts dividends paid to shareholders in computing its taxable income. The dividends generally are included in the RIC shareholders' income. Thus, distributed income of a RIC is taxed only at the shareholder level, not at the regulated investment company level. A RIC generally is required to distribute at least 90 percent

of its income during the taxable year as dividends to shareholders. A RIC is subject to detailed restrictions on permitted assets and investments.⁷⁴

If RIC stock is “stapled” to the stock of another entity (such that an interest in one changes hands together with the interest in the other) and if such “stapled” stock represents more than 50 percent in value of the beneficial ownership of each of the entities, then the two entities are treated as one.⁷⁵ These rules limit the degree to which the shareholders of the RIC may derive income that would not be qualifying income for the RIC indirectly through a related entity, while retaining RIC status for the amounts of income that do qualify. These rules also provide a limit on the extent to which a RIC that is commonly owned with a taxable corporation might extract business income from the corporation in the form of interest or other deductible payments, or by causing the corporation to bear expenses of the RIC’s operations.

Real estate investment trusts

A real estate investment trust (“REIT”) is an entity that derives most of its income from passive real-estate-related investments. A REIT must satisfy a number of tests on an annual basis that relate to the entity’s organizational structure, the source of its income, and the nature of its assets. If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to its investors each year generally is treated as a dividend deductible by the REIT and includible in income by its investors. In this manner, the distributed income of the REIT is not taxed at the entity level. The distributed income is taxed only at the investor level. A REIT generally is required to distribute 90 percent of its income (other than net capital gain) to its investors before the end of its taxable year.

In order for an entity to qualify as a REIT, at least 95 percent of its gross income generally must be derived from certain passive sources (the “95-percent income test”). In addition, at least 75 percent of its income generally must be from certain real estate sources (the “75-percent income test”), including rents from real property (as defined) and gain from the sale or other disposition of real property. Amounts received as impermissible “tenant services income” are not treated as rents from real property.⁷⁶ In general, such amounts are for services

⁷⁴ At least 50 percent of the assets of a RIC must consist of (i) cash and cash items, Government securities, securities of other RICs, and (ii) any other securities, provided that for purposes of this 50-percent calculation, they must be securities as to which the RIC owns not more than 10 percent of the outstanding voting securities of any one issuer and that are not greater in value than 5 percent of the assets of the RIC. Not more than 25 percent of RIC assets may be invested in (i) the securities of any one issuer (other than certain government securities or securities of other RICs), (ii) securities (other than of other RICs) of two or more issuers which the taxpayer controls (defined as 20 percent of the voting power or value of the issuer) and that are engaged in the same or similar lines of business, or (iii) securities of one or more qualified publicly traded partnerships.

⁷⁵ Section 269B. These stapled stock restrictions also generally apply to real estate investment trusts (REITs).

⁷⁶ A REIT is not treated as providing services that produce impermissible tenant services income if such services are provided by an independent contractor from whom the REIT does not derive or receive any income. An independent contractor is defined as a person who does not own, directly or

rendered to tenants that are not “customarily furnished” in connection with the rental of real property.

Rents from real property, for purposes of the 95-percent and 75-percent income tests, generally do not include any amount received or accrued from any person in which the REIT owns, directly or indirectly, 10 percent or more of the vote or value.⁷⁷ An exception applies to rents received from a taxable REIT subsidiary (“TRS”) if at least 90 percent of the leased space of the property is rented to persons other than a TRS or certain related persons, and if the rents from the TRS are substantially comparable to unrelated party rents.⁷⁸ A TRS may conduct business or receive income from activities that would generate non-qualifying income if conducted by the REIT that owns the TRS securities. However, a REIT may hold no more than 20 percent of the value of its total assets in securities of a TRS.⁷⁹ Transactions between a TRS and a REIT are subject to a number of specified rules that are intended to prevent the TRS (taxable as a separate corporate entity) from shifting taxable income from its activities to the non-taxed REIT, or from absorbing more than its share of expenses. Under one such rule, a 100-percent excise tax is imposed on rents, deductions, or interest paid by a TRS to a REIT, to the extent such items would exceed an arm’s length amount as determined under section 482.⁸⁰

Real estate mortgage investment conduits

A real estate mortgage investment conduit is an entity used for securitizing mortgages on real estate.⁸¹ A real estate mortgage investment conduit is not subject to tax at the entity level (except for a 100-percent excise tax on prohibited transactions, which include the receipt of compensation for services or other non-permitted income). Income or loss of the real estate mortgage investment conduit is taken into account by the holders of interests in the real estate mortgage investment conduit. Real estate mortgage investment conduits are subject to restrictions on organizational structure, income, assets, and permitted transactions.

Cooperatives

There are several types of cooperatives, including tax-exempt farmers' cooperatives and other corporations operating on a cooperative basis. In determining its taxable income, a

indirectly, more than 35 percent of the shares of the REIT. Also, no more than 35 percent of the total shares of stock of an independent contractor (or of the interests in net assets or net profits, if not a corporation) can be owned directly or indirectly by persons owning 35 percent or more of the interests in the REIT.

⁷⁷ Sec. 856(d)(2)(B).

⁷⁸ Sec. 856(d)(8).

⁷⁹ Section 856(c)((4)(B)(ii).

⁸⁰ If the excise tax applies, then the item is not reallocated back to the TRS under section 482.

⁸¹ Section 860A.

cooperative does not take into account the amount of patronage dividends to patrons of the cooperative. The cooperative deducts other distributions, including dividends paid on capital stock, and amounts distributed on a patronage basis to patrons during the taxable year. Patrons of the cooperative include in their income the amount of patronage dividends and other distributions made on a patronage basis. Thus, these amounts are subject to tax in the hands of the patrons, but not in the hands of the cooperative. To this extent, a cooperative is treated as a passthrough entity.

A cooperative can be a publicly traded entity; however, only patrons are entitled to the benefits of the pass-through treatment through the dividends paid deduction. To the extent the earnings of the cooperative are allocated or distributed to public shareholders that are not dealing with the cooperative patrons, the cooperative is subject to corporate level tax.

IV. ECONOMIC DATA

In general

Many types of investment partnerships exist, including hedge funds and private equity funds (of which venture capital funds can be considered a subset). Hedge funds and private equity funds typically differ in their investment strategies. Hedge funds generally invest in very liquid assets and seek to profit from correcting inefficiencies (pricing mistakes) in capital markets. This is often referred to as “financial arbitrage.” Private equity funds generally invest in highly illiquid assets, buying stakes in companies and seeking to restructure them. However, they are similar in many respects. Both typically collect large commitments of private capital from investors (often at least \$1 million). Both typically compensate managers with a fixed fee component and some percentage of the fund’s return. It is this percentage component that is referred to as a carried interest. However, there is a broader universe of contexts in which carried interests for managers may be used. This includes not only hedge funds and private equity funds but also real estate partnerships or any partnership engaged in any business activity, in which managers’ interests are aligned with those of investors by sharing of returns from the activity.

Table 1 below provides data regarding partnerships generally. The remainder of the data in this section relate to the narrower group of hedge, private equity, and similar funds.

Partnership assets

In 2005 as part of tax return filing requirements, partnerships reported assets with book value of more than \$13.7 trillion. Table 1 shows the tabulation by self-reported NAICS industry code, and provides further detail for the finance and insurance and real estate industries. Together these two industries account for 57.3 percent of all partnership returns and 78.4 percent of all reported partnership assets, with securities, commodity contracts, and other financial investments partnerships representing the largest concentration.

Table 1.– Partnerships Assets by NAICS Code of Principal Business Activity, 2005
Assets in Millions of Dollars

	Number of Returns	Total Assets Reported ¹	Percent of Returns	Percent of Total Assets Reported
Industry				
Ag, Forestry, Fishing, and Hunting	127,605	\$110,982	4.6	0.8
Mining	28,205	\$172,751	1.0	1.3
Utilities	2,897	\$218,555	0.1	1.6
Construction	182,153	\$270,316	6.6	2.0
Manufacturing	44,828	\$421,831	1.6	3.1
Wholesale Trade	48,178	\$122,503	1.7	0.9
Retail Trade	141,798	\$108,370	5.1	0.8
Transportation & Warehousing	42,162	\$132,050	1.5	1.0
Information	37,438	\$543,831	1.4	4.0
Finance & Insurance	287,958	\$7,658,566	10.4	55.8
Depository Credit Intermediation	210	\$10,739	*	0.1
Nondepository Credit Intermediation	11,656	\$211,267	0.4	1.5
Activities Related to Credit	3,068	\$26,570	0.1	0.2
Securities, Commodity Contracts, & Other Fin. Investments	219,171	\$6,493,379	7.9	47.3
Insurance Carriers & Related Activities	11,354	\$19,756	0.4	0.1
Funds, Trusts, & Other Financial Vehicles	42,499	\$896,855	1.5	6.5
Real Estate, Rental, and Leasing	1,295,948	\$3,100,978	46.9	22.6
Real Estate	1,264,422	\$2,992,558	45.8	21.8
Rental and Leasing Services	31,148	\$98,227	1.1	0.7
Lessors of Nonfinancial Intangible Assets (Except Copyrights)	379	\$10,192	*	0.1
Professional, Scientific, & Technical Svcs.	170,245	\$131,302	6.2	1.0
Management of Companies (Holding Cos.)	24,966	\$372,757	0.9	2.7
Admin and Support & Waste Management & Remediation	48,069	\$36,029	1.7	0.3
Educational Services	10,563	\$3,352	0.4	*
Health Care and Social Assistance	59,981	\$79,166	2.2	0.6
Arts, Entertainment, and Recreation	49,267	\$65,870	1.8	0.5
Accommodation and Food Services	96,004	\$169,545	3.5	1.2
Other Services	61,631	\$14,535	2.2	0.1
Not Allocable	3,729	\$967	0.1	*
All	2,763,625	\$13,734,256	100.0	100.0

* Indicates less than 0.1 percent.

¹ A partnership is generally required to report balance sheet information if it has total receipts of \$250,000 or more and total assets of \$600,000 or more.

Source: IRS Statistics of Income tabulations by JCT staff

Hedge funds

While estimates vary, one commonly cited source estimates that hedge funds controlled an estimated \$1.46 trillion in assets worldwide as of the end of 2006, up from an estimated \$1.1

trillion at the end of 2005 and \$973 billion at the end of 2004.⁸² The largest 100 funds alone managed \$1 trillion, or 69 percent of the fund industry's assets compared with 65 percent in 2005 and 58 percent the previous year. The industry has experienced substantial growth; in 1990, hedge funds investments amounted to less than \$50 billion.

The literature on hedge funds' performance is relatively limited. Four main reasons have been suggested for this.⁸³ First, hedge funds are not required to disclose their performance. Any available information is based on the sample of firms that voluntarily release information, and therefore, may not be representative of the industry as a whole. Second, performance should be adjusted for market exposure, which can vary tremendously over a short period of time. Monthly return data may not adequately reflect the true market risks of the fund. Third, hedge funds are often exposed to risks that have high incidence with low probability. While volatility in any given time frame may appear low, there might be a higher probability of the fund losing all its assets. Finally, hedge funds exhibit serial correlation, that is, the return of a fund during one month provides information about the return over the next month. This can arise if managers use their discretion to present a picture of low risk and consistent performance.⁸⁴ The average monthly return for hedge funds in December is more than twice what it is for the rest of the year.⁸⁵

A common way to deal with these concerns is to evaluate hedge fund investments based on their relative risk-adjusted performance. A widely used index of the hedge fund industry, the Credit Suisse/Tremont Hedge Fund index, had an average annual return of 10.8 percent from January 1994 through the middle of 2006. The Standard & Poor's 500 would have earned 10.3 percent. However, the hedge fund index is much less volatile (7.8 percent versus 14.5 percent)

⁸² Hedge Fund Research in Britt Erica Tunick "Hedge Fund 100" AlphaMagazine.com, June 12, 2007, available at <http://www.alphamagazine.com/article.aspx?articleID=1372539>. Treasury Assistant Secretary for Financial Markets, Anthony Ryan, placed the amount at \$1.4 trillion in remarks before the Managed Funds Association Conference, June 11, 2007, available at <http://www.treas.gov/press/releases/hp450.htm>. Jickling and Marples, "Taxation of Hedge Fund and Private Equity Managers," July 5, 2007 put the number at \$1.2 trillion. Rene M. Stulz, "Hedge Funds: Past, Present, and Future." *Journal of Economic Perspectives*, 21, Spring 2007, pp. 175-194, notes that larger estimates exist of up to \$2.17 trillion as of 2005 from a survey by Hedgefundmanager and Advent. Hedgefund.net estimates the assets at \$2.401 trillion as of the end of the first quarter of 2007, up from \$2.154 trillion at the end of 2006. Hedgefund.net, "HFN Hedge Fund Industry Asset Flow/Performance Report, First Quarter Ending March 31, 2007," sample pages available at http://www.hedgefund.net/reports/Q1_2007_Asset_Flow_Report_sample.pdf

⁸³ Stulz, "Hedge Funds: Past, Present, and Future."

⁸⁴ Mila Getmansky, Andrew W. Lo, and Igor Makarov, "An Econometric Model of Serial Correlation and Illiquidity in Hedge Fund Returns," *Journal of Financial Economics*, 74, 2004, pp. 529-609.

⁸⁵ Vikas Agarwal, Nicole M. Boyson, and Narayan Y. Naik, "Why is Santa so Kind to Hedge Funds? The December Return Puzzle!" available at Social Science Resource Network: <http://ssrn.com/abstract=891621>.

because of the hedging strategies of hedge funds. Consequently, an investor who could have invested in the hedge fund index would have done almost twice as well as the S&P 500 index investor, per unit of volatility. Research generally concludes that hedge fund managers deliver returns net of their fees that are at least as good on average as alternative investments with similar market risk exposure. The question is how much better they do and whether these returns persist.⁸⁶

Private equity funds, including venture capital, buyout, and other types of funds

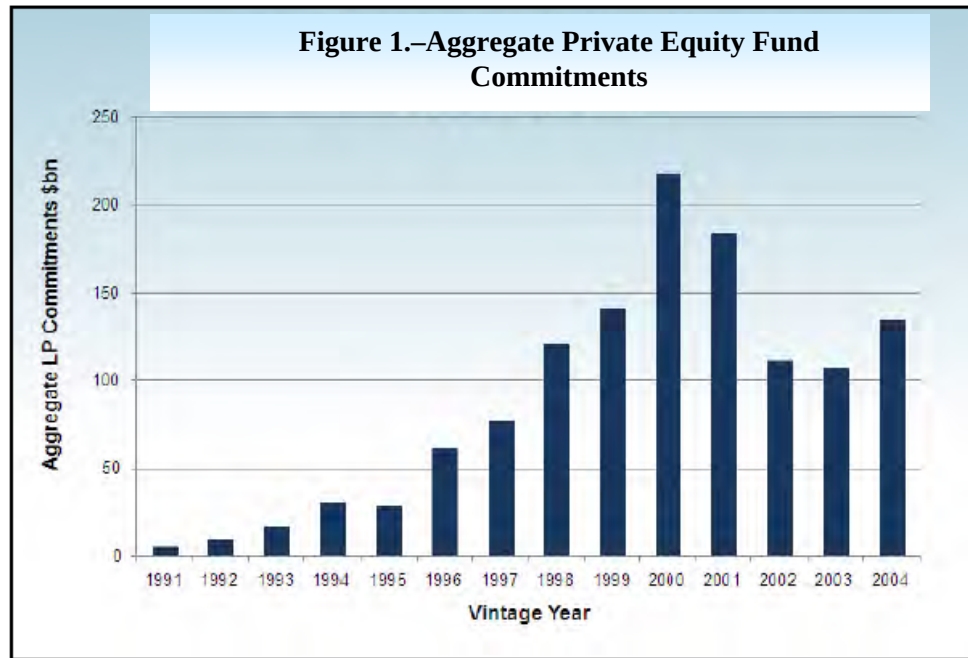
Private equity funds manage approximately \$1 trillion of capital globally.⁸⁷ The thirteen largest of these funds manage an estimated \$374 billion in assets under management.⁸⁸ These funds typically buy stakes in companies to restructure their capital, management, and organization. Restructuring may be accomplished through a variety of financing alternatives including buyout, mezzanine capital, venture capital, growth capital, turnaround and/or recapitalization funds. A buyout fund typically contributes the equity portion of a heavily leveraged, or debt-financed, acquisition. Mezzanine capital is a broad term that refers to unsecured, high-yield, subordinated debt often coupled with an equity component. Venture capital funds generally provide cash in exchange for equity stakes in new companies whose limited operating history may restrict their access to other capital markets. However, venture capital funds may also make investments in companies at various stages of the business life cycle. Growth capital describes funds that provide financing for expansion beyond a certain critical mass. Funds that specialize in later stage investing may be known as turnaround or recapitalization funds.

Private equity funds typically operate by collecting capital commitments from investors. These are promises to make funds available for investment. These commitments may then be called upon to make investments when opportunities arise. The investments generally include leverage, which can increase the size of the investment beyond the amount of equity capital. Figure 1 below shows the aggregate commitments by investors to private equity funds by year the fund was established (vintage year).

⁸⁶ A more detailed discussion is available in Stulz, “Hedge Funds: Past, Present and Future.”

⁸⁷ Andrew Metrick and Ayako Yasuda, “The Economics of Private Equity Funds,” (July 1, 2007). Available at Social Science Research Network: <http://ssrn.com/abstract=996334>. The Congressional Research Service places the figure at over \$1 trillion raised in the last 10 years. Mark Jickling and Donald J. Marples, “Taxation of Hedge Fund and Private Equity Managers,” July 5, 2007.

⁸⁸ “Who’s Who in Private Equity,” *The Wall Street Journal Online*, <http://online.wsj.com/public/resources/documents/info-pequity0607-12.html?printVersion=true>



Source: Private Equity Intelligence, Ltd.

Buyout funds constitute the largest segment of private equity funds, with nearly half of all investment commitments between 1991 and 2004. Buyout transactions can exceed partners' commitments of capital because buyout funds often assume substantial debt financing as well. This accompanying debt can leverage the investment of buyout equity funds to permit total investments several times this base. Venture capital funds are the other main type of private equity. Together buyout and venture capital funds represent about 70 percent of all private equity funds raised globally between 1991 and 2004.⁸⁹ Table 2 contains estimates of the amount of private equity fundraising raised by each type of fund since 1998.

⁸⁹ Private Equity Intelligence, Ltd. 2006 "Value Creation and Carry Review", available at <http://www.preqin.com/carry.aspx>

Table 2.–Trends in Private Equity Investing

Year	Venture Capital Funds		Buyout Funds*	
	No. Funds	Millions of Dollars Raised	No. Funds	Millions of Dollars Raised
1998	297	31,350.9	185	74,064.7
1999	459	61,910.7	172	70,500.3
2000	653	106,933.2	180	86,826.2
2001	331	40,713.0	147	59,821.0
2002	172	3,820.4	86	24,831.4
2003	146	10,707.8	91	28,952.8
2004	203	18,557.1	139	51,236.4
2005	214	28,001.8	178	96,087.4
2006	200	28,596.5	138	102,940.7

Source: Thomson Financial/National Venture Capital Association.

* This category also includes mezzanine, turnaround, and recapitalization funds.

Not all funds raised by private equity funds find suitable investment opportunities. To use the industry's terminology, not all capital commitments (funds raised) are called (invested). Thus, amounts raised will not equal actual investments made. In any given year, funds committed in prior years may be called in subsequent years resulting in larger sums invested than raised (compare Tables 1 and 2 for 2002), or funds committed that year may not find investments that year resulting in smaller sums invested than raised (as in 2006). Table 3 shows data on actual amounts invested for venture capital funds only. Similar data is unavailable for buyout funds.

Both venture capital fundraising and investing peaked in 2000 and slowed down dramatically thereafter. While buyout fundraising also slowed down following the 2000-2001 recession, it has experienced a resurgence, significantly surpassing the amount raised in 1998, in contrast to venture capital funds.

Table 3.–Venture Capital Investments

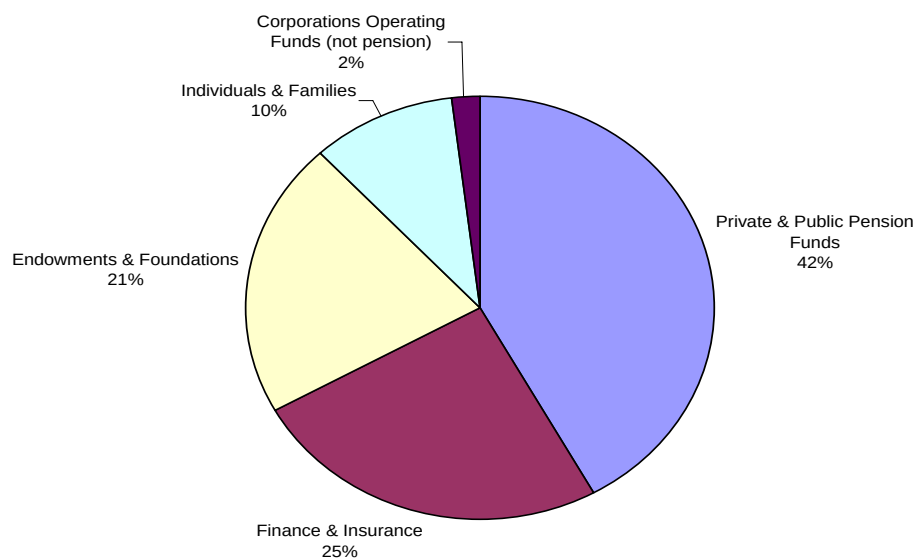
Year	Number of Deals	Average per Deal Millions of Dollars	Amount Invested Millions of Dollars
1998	3,736	5.8	21,660.2
1999	5,608	9.9	55,337.0
2000	8,104	13.2	106,762.7
2001	4,667	9.0	42,084.8
2002	3,148	7.1	22,185.7
2003	2,949	6.8	19,897.8
2004	3,094	7.3	22,610.8
2005	3,170	7.4	23,450.8
2006	3,591	7.4	26,441.9

Source: MoneyTree Report by PriceWaterhouseCoopers and National Venture Capital Association based on data by Thomson Financial – Updated 5/7/07

Venture capital by type of investor

For venture capital funds, data are available on the sources of funds by type of investor. Data for 2003 suggest that the largest sources of funding for venture capital funds are private and public pension funds, which are responsible for more than two-fifths of all commitments globally. Finance and insurance companies represent one-quarter of investment in all funds, followed closely by endowments and foundations. Individuals, including managers' own contributions are responsible for 10 percent of commitments. Non-pension corporate funds provide the balance of venture capital funding. No comparable publicly available data were found for other types of private equity funds.

Figure 2.—Investors in Venture Capital Funds



Source: 2004 National Venture Capital Association Yearbook

Carried interests in private equity

A recent study on a sample of 94 venture capital funds and 144 buyout funds estimates the present value of expected revenue to fund managers, both in the form of fixed management fees and the variable component including carried interests.⁹⁰ In this sample, over 60 percent of expected revenue is derived from fixed management fees, while income from carried interests

⁹⁰ Metrick and Yasuda, "The Economics of Private Equity Funds." Because funds make investments and partners earn revenue spread out over the typical ten-year lifetime of the fund, Metrick and Yasuda express all outlays in present value terms, as of the inception date of the fund using a discount rate of five percent.

represents approximately one-third of the total revenue to the private equity funds' general partners.

These numbers represent the present value of what the general partners can expect to receive as a percentage of invested funds. For the venture capital firms, each \$100 of invested funds will generate an estimated \$8.98 in present value of carried interest and estimated total revenue of \$23.78 in present value. The data above are expressed in present value terms. One reason for this is the timing of revenue. While various fees are earned over the lifetime of the fund, the payments under the carried interests are made generally towards the end of the life of the fund, as investment gains are realized.

Table 4 reports summary information for the estimates of carried interest from this sample. While buyout funds earn less per dollar invested relative to venture capital funds, they raise nearly four times the amount of capital on average to garner more carried interest and total revenue per partner.

Table 4.–Present Value of Partner Revenue

Present Value of:	Mean of 94 Venture Capital Funds	Mean of 144 Buyout Funds
Carry per \$100 invested (\$)	8.98	5.41
Fees per \$100 (\$)	14.80	11.91
Total revenue per \$100 (\$)	23.78	17.37
Fund Size (\$ Millions)	322.00	1,238.00

Source: Calculations based on Metrick and Yasuda “The Economics of Private Equity Funds.” Detail may not add to total due to rounding.

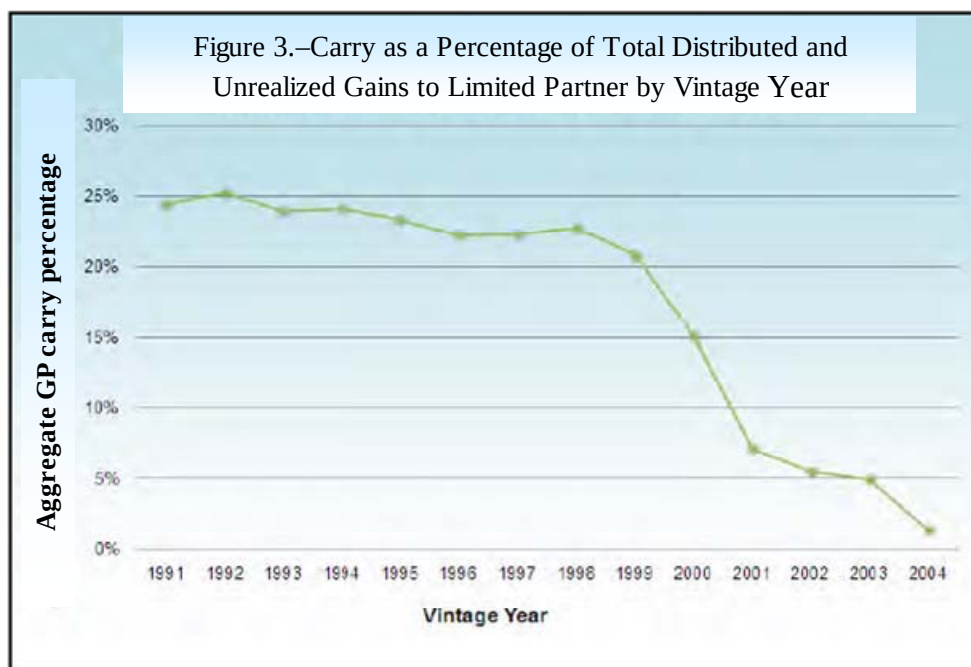
Another study estimates the value created by private equity firms and the corresponding carried interests for a much larger sample of 1,016 funds over the period 1991 through 2006 for private equity funds with vintages from 1991 to 2004.⁹¹ These funds delivered total distributed and unrealized gains of \$440 billion after fees and carry, and general partners earned a net carry of \$78 billion, \$24 billion in the prior 12 months alone.⁹²

Carry is only paid to fund managers upon distributed gains; therefore, it is weighted towards older funds. Of the \$78 billion of aggregate carried interests paid to date, only \$18 billion has been received by managers of funds with vintages from 1999 onwards. Figure 3 below shows aggregate carry to date expressed as a percentage of this total by vintage year. For the older vintages, carry is nearly 25 percent of the net value added for limited partners, as

⁹¹ Private Equity Intelligence, Ltd. (2006), *supra*.

⁹² Estimates of total distributed and unrealized gains for limited partners and carry earned by general partners to date are based on the most recent data available for these funds. Most funds in this study report data as of March 31, 2006.

expected given the standard 20 percent carry share (20 percent being one-quarter of the remaining 80 percent). For newer funds, carry represents a smaller percentage of the total distributed and unrealized gains.



Only about 40 percent of funds generated carried interest for partners, as can be seen in Table 5. However, one might expect this number to grow as more funds mature. Nevertheless, looking at only mature funds with vintages from 1991 to 1997 (for whose partners the gains should largely be realized), 70 percent of the funds generated net gains for limited partners and carried interests for general partners, 10 percent generated net gains for limited partners but failed to meet the hurdle rate required to generate carried interests for general partners, and 20 percent failed to deliver net gains.

Among those funds that generated carried interests, amounts are concentrated in a small group of larger funds. Fewer than 10 percent of the funds (151 out of 1,673 in this study) have earned more than \$100 million in total carry.

Table 5.—General Partner Carry Earned to Date Number of Funds, Vintages 1991 through 2004							
Carry Earned (\$)	US Venture	Europe Venture	US Buyout	Europe Buyout	Real Estate	Other Funds	Total
0	385	97	185	85	92	167	1,011
1-49 million	144	28	114	18	28	73	405
50 million to 99 million	27	3	38	6	11	21	106
100 million to 199 million	23	1	18	11	8	9	70
200 million to 499 million	10	1	35	12	5	6	69
500 million to 999 million	5	0	1	1	0	1	8
1 billion or more	3	0	0	0	0	1	4
Total	597	130	391	133	144	278	1,673

Source: Private Equity Intelligence, Ltd. “Value Creation & Carry in Private Equity, 1991-2006.”

V. LEGISLATIVE PROPOSALS IN THE 110TH CONGRESS

S. 1624 (introduced by Senator Baucus and Senator Grassley)

The bill provides generally that the exception from corporate treatment for a publicly traded partnership, 90 percent or more of whose gross income is qualifying income, does not apply in the case of a partnership that directly or indirectly derives income from investment adviser services or related asset management services. Thus, such a partnership is treated as a corporation for Federal tax purposes and is subject to the corporate income tax.

Under the bill, the exception from corporate treatment for a publicly traded partnership does not apply to any partnership that, directly or indirectly, has any item of income or gain (including capital gains or dividends), the rights to which are derived from services provided by any person as an investment adviser, as defined in the Investment Advisers Act of 1940, or as a person associated with an investment adviser, as defined in that Act. Further, the exception from corporate treatment does not apply to a partnership that, directly or indirectly, has any item of income or gain (including capital gains or dividends), the rights to which are derived from asset management services provided by an investment adviser, a person associated with an investment adviser, or any person related to either, in connection with the management of assets with respect to which investment adviser services were provided. For purposes of the bill, these determinations are made without regard to whether the person is required to register as an investment adviser under the Investment Advisers Act of 1940. In the absence of regulatory guidance as to the definition of a related person, it is intended that the definition of a related person in section 197(f)(9)(C)(i) apply.

For example, a publicly traded partnership that has income (including capital gains or dividend income) from a profits interest in a partnership, the rights to which income are derived from the performance of services by any person as an investment adviser, is treated as a corporation for Federal tax purposes under the bill. As a further example, a publicly traded partnership that receives a dividend from a corporation that receives or accrues income, the rights to which are derived from services provided by any person as an investment adviser, is treated as a corporation for Federal tax purposes under the bill.

Under the Investment Advisers Act of 1940 definition, an investment adviser means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities. Under this definition, exceptions are provided in the case of certain banks, certain brokers or dealers, as well as certain others, provided criteria specified in that Act are met. These exceptions apply for purposes of the bill. No inference is intended that income from activities described in the exceptions is qualifying income for purposes of section 7704.

The bill generally is effective for taxable years of a partnership beginning on or after June 14, 2007.

Under a transition rule for certain partnerships, the bill applies for taxable years beginning on or after June 14, 2012. The transition rule applies in the case of a partnership the interests in which on June 14, 2007, were traded on an established securities market, or were readily tradable on a secondary market (or the substantial equivalent thereof). In addition, the transition rule generally applies in the case of a partnership which, on or before June 14, 2007, filed a registration statement with the Securities and Exchange Commission under section 6 of the Securities Act of 1933 (15 U.S.C. 77f) that was required solely by reason of an initial public offering of interests in the partnership. However, the transition rule does not apply if the registration statement is filed with respect to securities that are to be issued on a delayed or continuous basis (pursuant to Rule 415 under the Securities Act of 1933). Thus, a shelf registration on or before June 14, 2007, of interests in a partnership does not cause the partnership to be eligible for the transition rule. Rather, in the case of such a partnership, the bill is effective for taxable years of the partnership beginning on or after June 14, 2007.

H.R. 2834 (introduced by Messrs. Levin, Rangel, Stark, McDermott, Lewis of Georgia, Neal, Pomeroy, Larson of Connecticut, Blumenauer, Kind, Pascrell, Frank of Massachussets, and Mrs. Jones of Ohio)

The bill generally treats net income from an investment services partnership interest as ordinary income for the performance of services. Thus, the bill recharacterizes the partner's distributive share of income from the partnership, regardless of whether such income would otherwise be treated as capital gain, dividend income, or any other type of income. Such income is taxed at ordinary income rates and is subject to self-employment tax.

Net income means, with respect to an investment services partnership interest, the excess (if any) of (1) all items of income and taken into account by the partner with respect to the partnership interest for the partnership taxable year, over (2) all items of deduction and loss taken into account by the partner with respect to the partnership interest for the partnership taxable year.

The bill provides that an investment services partnership interest is a partnership interest held by any person who provides (directly or indirectly), in the course of the active conduct of a trade or business, a substantial quantity of services to the partnership. The services are: (1) advising the partnership as to the value of a specified asset; (2) advising the partnership as to the advisability of investing in, purchasing, or selling any specified asset; (3) managing, acquiring, or disposing of any specified asset; (4) arranging financing with respect to acquiring specified assets; (5) any activity in support of any of the foregoing services.

For this purpose, specified assets means securities (as defined), real estate, commodities (as defined), or options or derivative contracts with respect to such securities, real estate, or commodities. A security for this purpose means a (1) share of corporate stock, (2) partnership interest or beneficial ownership interest in a widely held or publicly traded partnership or trust, (3) note, bond, debenture, or other evidence of indebtedness, (4) interest rate, currency, or equity notional principal contract, (5) interest in, or derivative financial instrument in, any such security or any currency (regardless of whether section 1256 applies to the contract), and (6) position that is not such a security and is a hedge with respect to such a security and is clearly identified. A commodity for this purpose means a (1) commodity that is actively traded, (2) notional principal

contract with respect to such a commodity, (3) interest in, or derivative financial instrument in, such a commodity, and (4) position that is not such a commodity and is a hedge with respect to such a commodity and is clearly identified.

The bill provides an exception to recharacterization as ordinary income for performance of services in the case of the portion of the partner's distributive share of partnership items with respect to the partner's invested capital. Invested capital means the fair market value at the time of contribution of any money or other property contributed to the partnership. The exception applies provided that the partnership makes reasonable allocation of partnership items between the portion of the partner's distributive share attributable to invested capital and the remaining portion. An allocation is not treated as reasonable if it would result in the allocation of a greater portion of income to invested capital than any other partner not providing services would have been allocated with respect to the same amount of invested capital.

The bill provides rules for the treatment of losses with respect to an investment services partnership interest, as well as for disposition of all or a portion of such a partnership interest and distributions of partnership property with respect to such a partnership interest. Consistently with the general rule providing that net income with respect to such a partnership interest is ordinary income for the performance of services, the bill provides that net loss with respect to such a partnership interest (to the extent not disallowed) is treated as ordinary loss. For this purpose, net loss means, with respect to an investment services partnership interest, the excess (if any) of (1) all items of deduction and loss taken into account by the partner with respect to the partnership interest for the partnership taxable year, over (2) all items of income and taken into account by the partner with respect to the partnership interest for the partnership taxable year. The net loss is allowed for a partnership taxable year, however, only to the extent that the loss does not exceed the excess (if any) of (1) aggregate net income with respect to the partnership interest for prior partnership taxable years, over (2) the aggregate net loss with respect to the partnership interest not disallowed for prior partnership years. Any net loss that is not allowed for the partnership taxable year is carried forward to the next partnership taxable year. Notwithstanding the present-law rule that the basis of a partnership interest generally is reduced by the partner's distributive share of partnership losses and deductions (sec. 705(a)(2)), the bill provides that no adjustment is made to the basis of a partnership interest on account of a net loss that is not allowed for the partnership taxable year. When any such net loss that is carried forward is allowed in a subsequent year, the adjustment is made to the basis of the partnership interest.

On the disposition of an investment service partnership interest, gain is treated as ordinary income for the performance of services, notwithstanding the present-law rule that gain or loss from the disposition of a partnership interest generally is considered as capital gain or loss (sec. 741). Loss on the disposition of an investment service partnership interest is treated as ordinary loss, but only to the extent of the amount by which aggregate net income previously treated as ordinary exceeds aggregate net loss previously allowed as ordinary under the bill.

On the distribution of appreciated property by a partnership to a partner with respect to an investment services partnership interest, the present-law rule providing that no gain or loss generally is recognized to a partnership on a distribution to a partner of property or money does not apply. Rather, the partnership recognizes gain as if the partnership had sold the property at

its fair market value at the time of the distribution. For this purpose, appreciated property means property with respect to which gain would be realized if sold by the partnership at the time of distribution.

Under the bill, net income from an investment services partnership interest is subject to self-employment tax. Net income from an investment services partnership interest is derived from the performance by a person of a substantial quantity of services to the partnership in the course of the active conduct of a trade or business. This income falls within the definition of net earnings from self-employment, which generally includes a partner's distributive share (whether or not distributed) of income or loss from any trade or business carried on by the partnership (sec. 1402(a)), with certain exclusions. Because net income from an investment services partnership is treated as ordinary income for the performance of services, the present-law exception for gain or loss from the sale or exchange of a capital asset does not apply, even though the net income from the investment service partnership interest might otherwise be characterized as capital gain. The bill also provides that, in the case of a limited partner, the present-law exclusion for limited partners does not apply to any income treated as ordinary income from an investment services partnership interest that is received by an individual who provides a substantial quantity of the specified services.

Under the bill, a publicly traded partnership, more than 10 percent of whose gross income consists of net income from an investment services partnership interest, is treated as a corporation for Federal tax purposes under section 7704. The present-law exception to corporate treatment for a publicly traded partnership, 90 percent or more of whose gross income is qualifying income within the meaning of section 7704(c)(2), does not apply, because net income from an investment services partnership interest is not qualifying income within the meaning of section 7704(c)(2).

H.R. 2785 (introduced by Mr. Welch)

The bill is the same as S. 1624, except that it is effective for taxable years of a partnership beginning after June 20, 2007 (the date of introduction).

VI. FEDERAL TAX ISSUES AND ANALYSIS

Tax issues relating to carried interests⁹³

Capital income or compensation

The use of carried interests in asset management businesses raises conceptual questions under the income tax rules. The primary question is whether the carried interest is a form of compensation for services, or whether it is more similar to an interest in capital.

Historically, labor income of individuals has generally been taxed at ordinary rates, while some forms of capital income⁹⁴ have generally been taxed at lower rates.⁹⁵ In addition, labor income generally is subject to employment tax. In 2007, for individuals generally, the top rate of tax on capital gain is 15 percent, while the top rate on ordinary income is 35 percent. This rate differential is thought to be a motivating factor in taxpayers' choice to structure income as a carried interest that can give rise to capital gain rather than as fees or other compensation subject to tax at ordinary rates. Carried interests may also permit deferral of income compared to alternative structures.

In many cases, it is fairly clear whether money is paid for services rendered, on the one hand, or for the use of capital as equity or debt, on the other hand. This distinction can become more difficult in a business activity involving capital assets and individuals' investment expertise with respect to the capital assets. The use of carried interests is not limited to asset management businesses, but can extend to any business in which investors desire to align the interests of

⁹³ As described in the Background section of this document, a carried interest can be structured as a partnership profits interest. Generally, a partnership profits interest gives the partner a right to receive a percentage of a partnership's profits without an obligation to contribute to partnership capital and without a right to partnership assets on liquidation. Income from a carried interest may take the form of capital gain realized from an investment fund that is a partnership as the fund sells off investment assets.

⁹⁴ In general, capital income taxed at lower rates has historically included capital gain. Qualifying dividend income of individuals has been taxed at the same maximum rate as capital gain since 2003. This treatment is scheduled to expire at the end of 2010, as are the current maximum rates for both ordinary income and capital gain. However, during the 1970's, income from services was taxed at a maximum rate of 50 percent while investment income, including dividends, but not including capital gain, was taxed at a higher maximum rate of 70 percent. As an exception to the generalization that capital gains have historically been taxed at a rate lower than labor income, for taxable years beginning in 1988, 1989, and 1990, the maximum tax rates of individuals on all income, ordinary as well as capital gain, was 28 percent.

⁹⁵ When labor income and capital income are taxed at the same rates, then issues of the character of income (i.e., whether capital or ordinary) are much less significant. Some distinctions between capital and ordinary income would remain, however, even if the tax rate differential were eliminated. Unlike ordinary income treatment, capital gain treatment entitles investors to tax-free return of basis to the extent of basis in the asset. Another difference between ordinary and capital gain treatment is that capital losses are subject to a limitation on deductibility against ordinary income. Issues of timing (i.e., when income is taxed) are not affected by setting capital and ordinary income rates at the same level.

managers with those of investors by using positive investment yield as the measure of managers' income (though the loss of fund capital does not usually require the manager to contribute capital to the fund). However, this discussion is focused on carried interests used in asset management businesses, a feature of which is that investment yield may include income taxed at lower rates.

Issues relating to the distinction between gains and earnings from investment in property, on the one hand, and income from the performance of services or from other types of businesses, on the other hand, can be found in many areas other than the asset management and investment advisory business. The distinction has been a general source of complexity.⁹⁶ Distinctions have been established legislatively for tax purposes in some instances, such as in the case of self-created copyrights.⁹⁷

In analyzing this distinction in the context of management of investment funds (such as a private equity, venture capital, or hedge fund), it could be said that an investment management business with respect to an investment fund requires the manager to contribute some capital, and the carried interest arrangement is merely a financing by the other investors of the managers' capital investment in the fund. Consequently, it would be conceptually appropriate for the manager's income to have the character of capital gain. By the same token, an analogy can be drawn to other types of businesses in which an owner contributes "sweat equity" and is treated as having an interest that gives rise to capital gain.⁹⁸

On the other hand, it can be argued that such a carried interest arrangement primarily involves the performance of services by individuals whose professional skill generates capital income for investors in the fund. While these individuals' economic interests are aligned with those of the fund investors to the extent their compensation is based on the positive investment yield of the fund, the individuals are nevertheless performing services. An analogy to performance-based compensation also applies when the carried interest provides that amounts become payable only when a hurdle rate is exceeded. This type of argument would suggest that income from a carried interest, under which the investment manager contributes no capital to the fund, resembles compensation for services. This is the case even though income generated by

⁹⁶ See, e.g., *Comm'r v. Jose Ferrer*, 304 F.2d 125 (2d Cir, 1962), *rev'g* 35 T.C. 617 (1961), involving a disputed distinction between compensation for acting services, on the one hand, and capital gain from the disposition of property rights in the resulting productions, on the other. See also Bittker and Lokken, *Federal Income Taxation of Income, Estates, and Gifts*, (Third Edition, 1999) p. 3-73.

⁹⁷ See, e.g., section 1221(a)(3)(A), providing that certain copyrights and other property in the hands of a taxpayer whose personal efforts created the property are not a capital asset and thus are not eligible for capital gain treatment; section 751 (gain on sale of a partnership interest is not capital gain to extent it reflects certain unrealized receivables, including certain rights to payment for services); section 7701(e)(1) (providing for recharacterization of a services contract as a lease in certain situations).

⁹⁸ See Victor Fleisher, "Two and Twenty: Taxing Partnership Profits in Private Equity Funds," Legal Studies Research Paper Series, Working Paper no. 06-27, March 11, 2007, revised June 12, 2007.

the carried interest is capital gain and dividend income, for instance.⁹⁹ Income from a carried interest can be distinguished from the service provider's separate return on capital that he contributes to the business, under this view.

Another way of viewing the issue is to ask whether or not the activities engaged in by fund managers should be given an incentive through the tax law in the form of preferential tax rates on their income. On the one hand, it can be argued that (depending on the investment strategy of the fund, and other factors), fund managers may be increasing the efficiency of the economy by restructuring businesses in which they invest so as to maximize their value, or for some types of funds, may be making financial markets more efficient. On the other hand, some might say that the funds' investment strategy as determined by the fund managers may serve to strip out value from the businesses in which the fund invests for the benefit of fund investors but without added value or increased productivity in the economy. It could also be said that, regardless of whether the activities are desirable, no tax incentive is needed for the activity, and that any tax subsidy would be a windfall to persons who would conduct the activity regardless of whether a preferential tax rate applies.

If the income from a carried interest is treated as compensation subject to tax as ordinary income, an important question is the timing and amount of the income. The Internal Revenue Service currently takes the position that the receipt of a partnership profits interest is not generally a taxable event to the partner or to the partnership unless unusual circumstances indicate the interest is easy to value and it is held for a relatively short time. As acknowledged by the Internal Revenue Service in taking this position, however, courts have reasoned that the value of the profits interest for services should be included in income on receipt.¹⁰⁰ The Internal Revenue Service has proposed regulations attempting to mesh conceptually inconsistent present-law statutory rules that provide, on the one hand, that contributions of property to a partnership in exchange for a partnership interest are not taxable, and on the other hand, that property received for services is generally included in income at its fair market value.¹⁰¹

An obstacle to the practical application of the approach of taxation of profits interests on receipt has been that valuation of partnership profits interests has proved factually difficult. The valuation difficulty arises because the profits interest depends on the future profitability of a business which may be extremely speculative, where, as is often the case, there is no current public market for interests in the partnership that would aid valuation at the time the profits interest is granted. Difficulty of valuation would be an issue at the time a nonpublicly traded partnership profits interest is received by the partner, even if the partnership later goes public,

⁹⁹ Capital gain and dividend income of a partnership retains its character as such for tax purposes in the hands of the partners, i.e., the individual managers. This passthrough treatment is described in the section of this pamphlet entitled Tax Treatment of Partnerships and Partners.

¹⁰⁰ This is described in the section of this document entitled Tax Treatment of the Receipt of a Partnership Profits Interest for Services.

¹⁰¹ This is described in the section of this document entitled Tax Treatment of Property Transferred in Connection with the Performance of Services.

establishing a market value for partnership interests at that later time.¹⁰² A further difficult aspect of this approach is that if a profits interest were taxed to a partner on receipt of the interest, the partnership rules would require addition of a potentially complex mechanism to prevent double taxation when profits are later realized.¹⁰³

If, alternatively, the timing of the compensation is not considered to be at the time of receipt of the profits interest, but rather, as the partner's share of partnership profits is realized, other issues arise. The idea that a partner's distributive share of capital gain and dividend income can be recharacterized as compensation could be viewed as inconsistent with the notion of a partnership as an aggregate of its partners. A partner should not be considered as an employee of the partnership, but rather, as a participant in a joint venture with the other partners, under this view. On the other hand, it could be argued that the partner is performing services measured by capital income, whether he is providing those services to a third party through a partnership in which he is a partner, or simply as an individual performing these services for a third party. The interposition of a partnership does not change the nature of the income as services income, under this view. It could also be argued that this approach avoids the practical obstacles to imposing tax on partnership profits interests on receipt.

Employment tax

A corollary issue relates to the employment tax treatment of payments of income received under a carried interest. Because capital gain income is not subject to employment taxes, the desire to avoid the application of the 2.9 percent hospital insurance tax (which is not subject to an income cap) may be one reason that taxpayers wish to structure payments as carried interests. However, to the extent such interests are viewed as payments for compensation, failing to subject them to employment taxes, while other compensation is subject to such taxes, can lead to distortion and economic inefficiency. Thus, if carried interests are viewed as properly characterized as compensation for services, it would be consistent with the general tax treatment of such compensation to apply employment taxes.

¹⁰² The recent going public transactions have generally involved formation of new entities to hold carried interests that were established in earlier years. While some have argued that valuation techniques have been created that help to determine value in the absence of market value, it is also argued that these valuation techniques are subject to volatility and other assumptions and may not be particularly accurate. See Lee A. Sheppard, "Blackstone Proves Carried Interests Can Be Valued," *Tax Notes*, June 25, 2007, 1236.

¹⁰³ Presumably, the value of a partnership profits interest depends on the size and timing of the expected future income stream from the profits interest. Under an approach taxing the value of a profits interest on receipt, this value would be the amount realized by the partner. Because partnership distributions generally are not taxed, except, for example, if money distributed to a partner exceeds the partner's adjusted basis in its interest, adding to the partner's basis the amount realized on a taxable receipt of a profits interest may not fully prevent double taxation of the partner's share of later-realized partnership income.

Alternatives to carried interests; application of deferred compensation rules

Alternatives to carried interests that provide economic benefits similar to partnership profits interests may also be used to provide compensation for fund managers. In considering the tax treatment of carried interests, it may be appropriate to consider the alternative arrangements and whether they are sufficiently comparable that similar tax treatment should apply to them.

One alternative is to seek to limit currently taxable compensation income by using two classes of stock with differing rights and, consequently, differing values (for example, common stock and convertible preferred stock). For example, in the context of specific buyout or venture capital transactions involving corporations, managers may make a small equity investment in exchange for stock said to have little immediate value but with a potential for participation in future appreciation, while investors take a different type of stock interest for their investment. The managers may then make an election to include the low or zero asserted value of its stock interest in income when received, leaving the upside to be taxed as capital gain. This may produce a structure comparable to the preferred return of investor partners and may eventually give the manager partners a right to participate in the upside of an investment in a partnership structure.¹⁰⁴

In some cases, as an alternative to the use of a partnership profits interest, fund managers' interests may be structured as a contractual arrangement to pay compensation based on the profits of the fund. In such cases, the issue of proper characterization of the income as capital or ordinary does not arise, as the income is compensation for services. In such cases, however, the compensation may be deferred (as may be the typical two percent up-front management fee where there is also a carried interest). Questions have been raised as to whether deferral of the compensation for management services is appropriate.¹⁰⁵

It may be argued that the deferral opportunities for fund managers are no different than for individuals providing services, such as key corporate executives. In the corporate context, however, it is argued that there is some tension between paying current compensation and allowing executives to defer compensation, because the corporation is not entitled to a deduction for deferred compensation until it is includible in the gross income of the employee. It is argued that this tension is not present in the case of fund managers, either because funds are established in offshore jurisdictions and do not pay a corporate-level tax in the United States, or because

¹⁰⁴ See, Ronald J. Gilson and David M. Schizer, "Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock," Practising Law Institute, Tax and Estate Planning Course Handbook Series, Tax Law and Practice, No. 9062 (2006). There may be disadvantages to applying this structure to replicate an investment partnership that would make multiple investments through a single entity.

¹⁰⁵ See Jenny Anderson, "Managers Use Hedge Funds as Big I.R.A.'s," *New York Times*, April 17, 2007. See also section 536 of H.R. 1591 (An act making emergency supplemental appropriations for the fiscal year ending September 30, 2007, and for other purposes), as passed by the Senate, which contains a provision that would generally impose a \$1million annual limit on nonqualified deferred compensation.

investors are tax-exempt or otherwise not subject to U.S. tax and are indifferent as to the availability of a tax deduction for compensation. On the other hand, it is pointed out that the tension in the corporate context is often more theoretical than real, because many corporations have net operating losses and do not currently pay taxes, there may be a business purpose to allow the deferral (such as the desire to provide a retention incentive), and because the employer may wish to accommodate the desire of the employee for deferral in order to attract and retain qualified executives.

Some have raised the issue that there may be less compliance in the fund manager context, especially if there are foreign payors. On the other hand, the significant consequences of failing to comply with section 409A (current income inclusion, plus an additional 20-percent tax, plus interest) may provide sufficient incentive for compliance, at least if there is a belief that detection of noncompliance by the IRS is reasonably likely.

Deferral and conversion of fees

In some circumstances, taxpayers may seek to convert management fees, which are generally subject to tax as ordinary income, to an arrangement that achieves deferral of income recognition, or conversion to capital gain treatment, or both. Under these arrangements, tax issues may be raised. Exchanging or relinquishing a right to a fee may raise issues under the rules requiring current inclusion of the value of property transferred in connection with the performance of services, if the person entitled to the fee receives a right constituting property in the exchange. In the partnership context, the transaction, and the arrangement in lieu of the fee, may implicate the guaranteed payment rules, or the rules treating services performed by a partner when there is a related direct or indirect allocation and distribution to the partner as a transaction between the partnership and a person who is not a partner.

Loan approach to taxing carried interests

Another approach to the tax treatment of carried interests is to view the managers' carried interest as a loan of a percentage of the invested capital, made by the investors to the managers, and to consider the possibility that the parties might directly structure such a loan. One possible legislative approach has been suggested that would view the carried interest as such a loan and, to the extent that any interest charged by the investors for this loan, in the form of their preferred return rate, is below an "adequate" interest rate, would tax the non-charged interest as compensation to the managing partner. It is argued that that this approach would anticipate the possibility that if all the income from a manager's carried interest were taxed as ordinary income, the parties could restructure the carried interest to the form of a loan, claiming that the "borrowed" capital should be viewed as capital invested by the managing partner, and the return on it entitled to capital gain.¹⁰⁶

¹⁰⁶ Victor Fleischer, "Two and Twenty: Taxing Partnership Profits in Private Equity Funds," Legal Research Paper Series, Working Paper Number 06-27 (March, 2006, revised June 12, 2007). The paper refers to this approach as the "Cost of Capital" approach. The paper does not conclude that this approach should be adopted legislatively. However, the paper considers the possibility of self-help adoption of such an approach, which it considers "perfectly acceptable from a tax policy viewpoint."

One significant issue under such an approach is identifying an appropriate market interest rate against which to measure the “bargain” compensation element. It has been suggested that the applicable Federal rate (“AFR”), a U.S. Treasury debt-based rate, be used as a measure of “adequate” interest.¹⁰⁷ Because the fund investments are frequently risky enough that very high rates of return are contemplated, the use of a Treasury debt rate, generally considered to be a “risk-free” rate, may not be appropriate. A managing partner that provided such a rate would avoid any ordinary income treatment. It could also be argued that the yield may be so much higher than the AFR that this return cannot be interest, but rather is some other form of earnings.

An additional conceptual issue relating to this approach is whether it is appropriate to treat an interest in a venture that is acquired with non-recourse debt from the venture or its investors, as an interest that was “purchased” at the time the debt was incurred.¹⁰⁸

Tax issues relating to publicly traded partnerships

Another question involves whether, as a matter of tax policy, a business that derives income from asset management and investment advisory services and that takes the form of a publicly traded partnership should be subject to tax as a corporation.¹⁰⁹ In an income tax system with a corporate income tax, Congress has enacted rules limiting passthrough (and untaxed) entity treatment. Passthrough and untaxed entities (such as partnerships, S corporations, mutual funds, and real estate investment trusts) are subject to significant restrictions under the tax rules that either prohibit public tradeability of interests (or make it impracticable), or limit the permitted income, assets, structure, and activities of the entity while permitting its interests to be publicly traded. Publicly traded partnerships generally are subject to tax as corporations (with certain exceptions), because they are considered to resemble corporations in that both have access to capital markets through issuance of traded interests in the entity.

It can be said that an asset management business tends to generate income such as capital gains and dividend income that is treated as qualifying income of a publicly traded partnership, and thus falls within the bounds of the present-law exception to corporate treatment of publicly traded partnerships. Arguably, nothing in the rules or their legislative history specifically excludes this type of business, but rather, the types of qualifying income listed in the statute

¹⁰⁷ Victor Fleischer, *op cit.* Section 7872 uses the AFR as the rate against which to measure when stated interest is inadequate in certain situations, with the result that additional interest will be imputed if it has not been stated. However, section 7872 only imputes interest at the AFR.

¹⁰⁸ Compare Treas. Reg. Sec. 1.83-3(a)(2), which states: “[I]f the amount paid for the transfer of property is an indebtedness secured by the transferred property, on which there is no personal liability to pay all or a substantial part of such indebtedness, such transaction may be in substance the same as the grant of an option.”

¹⁰⁹ This analysis applies whether the business derives any income from these activities, or alternatively, derives more than a certain portion of its income from these activities. Under present law, an exception to corporate treatment of publicly traded partnerships applies if at least 90 percent of the partnership’s income is qualifying income, including such income as dividends, interest, and capital gain, but does not include compensation for services.

explicitly include these, without any requirement to look through lower-tier entities or to investigate the fundamental nature of the income.

On the other hand, it can be argued that, when the limitations on eligibility for passthrough treatment of publicly traded partnerships were enacted in 1987, only a few types of businesses had taken the form of publicly traded partnerships. The types of income that those businesses generated served to make up the listed qualifying income, without any intent to extend the publicly traded partnership form to other types of business. Rather, the concern was to limit the use of publicly traded partnerships so as to prevent disincorporation and erosion of the corporate tax base. Consequently, it may be inconsistent with the tax policy, and the purpose, of the publicly traded partnership tax rules to permit passthrough treatment to a publicly traded partnership with such income.

Tax issues relating to corporate earnings stripping

A related issue involves the inclusion in a partnership structure of corporations that receive income that is not qualifying income under the publicly traded partnership rules, and that distribute it in the form of qualifying income such as dividends or interest. For example, a publicly traded partnership may own a corporation that receives income in the form of management fees, and distributes income to the publicly traded partnership as dividends.¹¹⁰ Such a structure is not explicitly prohibited under the statutory rules, and may not be inconsistent with the purpose of the tax rules to prevent erosion of the corporate tax base if such income is subject to tax in the hands of the recipient corporation.

On the other hand, the arrangement may be inconsistent with the purpose of the publicly traded partnership rules if the income is subject to little or no tax at the corporate level, and is paid to a publicly traded partnership that is a passthrough entity. In this circumstance, the income is not subject to corporate income tax, even if its original character (management fees, in the above example) was not that of qualifying income for the publicly traded partnership. A corporation may be subject to little or no tax if it has substantial deductions to offset its income. There may be a potential for related party transactions such as interest paid to the partnership, or costs borne by the corporation that benefit the partnership, to reduce the corporate level tax.¹¹¹ By comparison, other publicly-traded non-taxed entities such as RICs and REITs are subject to restrictions limiting the potential for such transactions.¹¹² If untaxed (or lightly taxed) corporate

¹¹⁰ Such a corporation is known as a “blocker” corporation, for blocking non-qualifying income from the upper-tier entity (in this case, the publicly traded partnership). This document does not address the use of blockers in contexts other than by publicly traded partnerships.

¹¹¹ In the case of an asset management business with substantial goodwill or other intangibles, such intangibles can be transferred to the corporation so that the deductions for amortization of goodwill can offset management fee income received by the corporation. In this situation, the corporation's tax on the management fee income may be reduced by deductions for amortizable intangibles.

¹¹² See discussion under “Comparison to Corporations and Other Business Entities,” *supra*.

income is distributed to a publicly traded partnership that is treated as a passthrough entity for tax purposes, concerns about stripping the corporate income are raised.

It can be said that a rule requiring identification of corporations which are lightly taxed, or even defining what it means to be lightly taxed, would be inadministrable or excessively complex. On the other hand, the concern could arguably be addressed by rules designed to prevent corporate earnings stripping applied only through corporations in which a publicly traded partnership has a substantial ownership interest, or from which the partnership receives a non-de minimis amount of such income.

Below is a simplified diagram of a possible structure in which a corporation could receive income that is not qualifying income for a publicly traded partnership and could distribute dividends to the partnership. Other structures could be used.

Publicly Traded Partnership Investment Fund Structure

