

Wall Street Versus Private Equity Firms: The Taxation of Carried Interest

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According to a recent Wall Street Journal article, “in terms of paychecks, the good times continued to roll for private-equity professionals in 2007.” Total compensation, including salary, bonus and carried-interest distributions, rose 24% to \$340,000 for the median U.S. private-equity professional -- a category that includes venture capital, buyout and mezzanine professionals. These payouts made private equity the No. 1 destination for graduates of the nation's top business schools last year. At Harvard Business School, 13% of graduates opted for a job in private equity, ahead of investment banking. The same held true at Stanford Graduate School of Business, with 12% of the graduating business-school class heading for private-equity firms.<sup>1</sup>

So why is the largest percentage of the “best and the brightest” going to private equity firms instead of big Wall Street brokerage firms or start-up companies? Does the fact that a significant portion of their compensation package will be deferred and converted from ordinary income into long-term capital gain, saving potentially 20% in federal income taxes, enter into their decision? Given the current press about the taxation of capital interests of equity funds, this article compares the taxation of investment managers working for equity funds to those working for brokerage firms or start-up companies. The authors then weigh in on the debate as to whether equity fund managers should continue to benefit from capital gain treatment of a significant portion of their earnings.

### **How Private Equity Funds Work**

The investment fund typically is a partnership with limited partners (the investors that contribute capital to acquire fund assets) and a general partner (the fund manager). The general partner is also a partnership, consisting of individual partners with investment management expertise. The fund manager receives both management fees and an equity interest that entitles it

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<sup>1</sup> Cardoletti, Giada, “Private-Equity Pay Keeps Rising.” Wall Street Journal, October 3, 2007.

to a percentage (usually 20%) of the aggregate net gains on its investments. This interest is in part for services and in part for capital, referred to as the “carried interest” because the other investors “carry” the general partner. See Exhibit 1 for an example of a simple fund structure.

The tax rules for partnerships provide that the character of the partnership’s income passes through to its partners. Therefore, income from a carried interest will include long-term or short-term capital gain realized by the investment fund as it sells investment assets. The tax issues associated with this interest have recently come under scrutiny with the public offering of Blackstone, including the tax treatment upon receipt of a profits interest, the granting of profit interests to members of the general partner, and the pass-through of tax advantaged dividend and capital gain income.

#### *Taxation of the Receipt of a Profits Interest*

In a typical private equity fund, the general partner receives a profits interest in the partnership for services to be provided to the fund. For many years, the taxation of the receipt of a profits interest was uncertain. Until the 1971 decision in *Diamond*<sup>2</sup> practitioners believed that a profits interest for services was not taxable because of the parenthetical distinction of a profits interest in Section 721.

In *Diamond*, the taxpayer received a 60% profits interest in exchange for arranging debt financing on the partnership property. Three weeks after the property purchase closed, Diamond sold his partnership interest to a third party for \$40,000. The IRS argued that the \$40,000 represented compensation for services. The Tax Court agreed that the \$40,000 was compensation income. The Seventh Circuit affirmed, finding that the profits interest in question, having been sold for \$40,000 three weeks after the grant date, had a readily ascertainable fair

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<sup>2</sup> *Sol Diamond v. Commissioner*, 56 TC 530, 1971, aff’d 492 F. 2d 286, 7<sup>th</sup> Cir. 1974

market value. The court did acknowledge, however, that a profits interest may have only speculative value in other circumstances.

During the next twenty years, the IRS took very little action with regard to profit interests. Then, in 1990 the Tax Court ruled in *Campbell*<sup>3</sup> that the taxpayer should have included the fair market value of a residual profits interest for services in income when received. However, the case differed from *Diamond* because the profits interest in *Campbell* had no readily ascertainable fair market value. The Tax Court decision was reversed by the Eighth Circuit. The Court found that the profits interest had no fair market value at the time of receipt and, therefore, should not be included in income. The Court also found that Regulation Section 1.721-1(b)(1) provided “justification ... for treating service partners who receive profits interests differently than those who receive capital interests.”

Given the ruling in *Campbell*, the IRS issued Revenue Procedure 93-27<sup>4</sup> addressing the tax treatment of the receipt of a partnership profits interest. Revenue Procedure 93-27 held that the receipt of a profits interest for services is not taxable if the person receiving the interest is either a partner or anticipates becoming a partner. Under Regulation Section 1.721-1(b)(1), the receipt of a partnership capital interest for services provided to a partnership is taxable as compensation. The Revenue Procedure distinguishes the receipt of a profits interest, defined as “a partnership interest other than a capital interest” where a capital interest is identified as “an interest that would give the holder a share of the proceeds if the partnership’s assets were sold ... and then the proceeds were distributed in a complete liquidation of the partnership.”

If the general partner and its members qualify as “partners” of their respective entities for tax purposes, then pass-through treatment applies and they report their allocable share of the

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<sup>3</sup> *William Campbell v. Commissioner*, T.C. Memo 1990-162, rev'd on this issue, 943 F. 2d 815, 8<sup>th</sup> Cir., 1991

<sup>4</sup> Revenue Procedure 93-27, 1993-2 C.B. 343

fund income with its underlying character. Although Revenue Procedure 93-27 assumes that a person receiving a profits interest is a partner, usually the general partner and its members still contribute capital in order to solidify partner status for tax purposes.

After receiving the grant of the carried interest (profits interest), the general partner grants participations in the carried interest to current members of the general partner. The participations are granted for the same reason that the fund grants the general partner a profits interest, to retain the benefits of capital gains. The interests granted by the general partner to its members usually involve vesting restrictions. To clarify the tax treatment of unvested profits interest in a partnership, the IRS issued Revenue Procedure 2001-43<sup>5</sup>. Under this Revenue Procedure both the grant of a profits interest subject to vesting restrictions and the lapse of such restrictions are non-taxable events.

Proposed Regulations issued in May 2005 address the application of Section 83 to partnership interests received in connection with the performance of services<sup>6</sup>. The proposed regulations apply Section 83 to all partnership interests and do not distinguish between capital and profit interests. Consistent with Section 83, the proposed regulations provide that if a partnership interest is transferred for the performance of services and an election is not made under Section 83(b), then the recipient of the partnership interest is not treated as a partner until the interest becomes substantially vested. If the Section 83(b) election is made, then the recipient is treated as a partner.

The proposed regulations take a different position than Revenue Procedure 2001-43. The preamble to the proposed regulations indicates that upon adoption of the regulations, the IRS will

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<sup>5</sup> Revenue Procedure 2001-43, 2001-2 C.B. 191

<sup>6</sup> REG- 105346-03, Fed. Reg. 29675 (5/24/05)

finalize Notice 2005-43<sup>7</sup> repealing Revenue Procedures 93-27 and 2001-43. These rules would provide that the receipt of a profits interest would be governed by Section 83, resulting in immediate income recognition based on the fair market value of the interest. Provided that various requirements are met, however, a safe harbor election is available to have the profits interest taxed on the basis of the interest's liquidation value, effectively allowing a zero value for the carried interest at receipt.

At the end of the day, the MBA graduate is paid a salary and receives a profits interest in the general partner that is tied to the carried interest in the private equity fund. The employee is taxed at ordinary income rates on the salary and pays reduced rates on the dividend and capital gains income passed through from the equity fund.

### **What if you go to work for a Wall Street firm instead?**

If the newly minted MBA decides to accept a position at a Wall Street brokerage firm, formed as a corporation, then the compensation package is likely to include a base salary plus the potential for cash bonuses, nonqualified stock options, stock appreciation rights, and deferred compensation. This package offers little opportunity to convert ordinary income into capital gain and a number of the components are potentially subject to the new deferred compensation rules under Section 409A.

#### *Nonqualified Stock Options and Stock Appreciation Rights.*

A nonqualified stock option ("NSO") gives the employee the right to buy a specific number of shares of the employer's stock during a given time at a specified price. Assuming that the option does not have a readily ascertainable fair market value at grant, Section 83 applies to the transfer of property when the option is exercised. The excess of the fair market value of the stock over the option price on the date of exercise is taxed as ordinary compensation income.

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<sup>7</sup> IRS Notice 2005-43, 2005-24 I.R.B. 1221

A stock appreciation right (“SAR”) gives the employee the right to receive, either in cash or employer stock, the appreciation in the value of a specified number of shares of the employer’s stock over a certain period of time. One critical feature of a SAR is that it gives an employee the right to obtain the future appreciation in the employer's stock without risking any capital. Taxation occurs when the employee exercises the SAR. If the employee elects to receive the appreciation in the SARs in cash, the cash is taxable compensation income under Section 61 (a)(1). If the employee elects to receive the appreciation in the form of employer stock, then the stock received is taxable to the employee under Section 83(a) in an amount equal to the difference between the stock’s fair market value and the amount the employee paid for the stock. The employee has the same tax result regardless of whether the SARS are exercised for cash or employer stock: compensation income equal to the appreciation in the stock at the time of exercise.

Section 409A applies to both nonqualified stock options and stock appreciation rights unless they meet the safe harbor provisions under the final regulations. To meet the safe harbor provisions, NSOs and SARs must include the following three elements: (1) they must be granted for employer stock; (2) the exercise price (or, for stock appreciation rights, the price used to determine any appreciation) must never be less than the fair market value of the underlying shares at the time of grant; and (3) the stock right must not include additional deferral features.<sup>8</sup> Assuming that the NSOs and SARs granted by Wall Street brokerage firms will meet the safe harbor provisions, the compensation from these stock rights will be deferred until the rights are exercised.

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<sup>8</sup> Mischer, N. and D. Kahen. “Getting Up to Speed on the Final Regulations for Deferred Compensation.” *Tax Executive*. May/June 2007. Vol. 59, Issue 3, pages 267-278.  
Singer, S. “Deferred Compensation for Executives under Section 409A (Part II).” *The Tax Adviser*. August 2006, Vol. 37, Issue 8, pages 476-482.

## *Deferred Compensation Arrangements*

Both public and private companies use nonqualified deferred compensation arrangements to compensate executives and highly compensated employees for past, present and even future services. From the employee's perspective, he or she is only taxed on payments that are actually received under the agreement, allowing the deferred amount to grow on a pretax and tax deferred basis during the deferral period. From the employer's perspective, these arrangements are part of the package to attract and retain the people needed for the company to prosper and grow.

For the young MBA, the most important aspect of deferred compensation is the magic of tax-free compounding. Generally, the pretax amounts credited to the deferred compensation plan grow without reduction for taxes on the growth. This means the individual will receive a significantly larger amount than if he or she had taken the amount into income and then paid tax on the growth of the remaining amount. With the limitations on contributions and benefits under qualified retirement plans, deferred compensation arrangements have taken on a larger role in compensating highly paid employees.

Section 409A, enacted under the American Jobs Creation Act of 2004, provides additional requirements related to nonqualified deferred compensation plans.<sup>9</sup> For purposes of this discussion, we assume that the deferred compensation arrangements meet the requirements under 409A for continued deferral of compensation and tax-free growth.

Although deferred compensation arrangements provide significant tax benefits to the MBA graduate through tax deferral and tax free growth, ultimately the entire amount is taxed as ordinary income when received.

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<sup>9</sup> For a detailed discussion of Section 409A, see Mischer, N. and D. Kahen. "Getting Up to Speed on the Final Regulations for Deferred Compensation." *Tax Executive*. May/June 2007. Vol. 59, Issue 3, pages 267-278 and Singer, S. "Deferred Compensation for Executives under Section 409A (Part II). *The Tax Adviser*. August 2006, Vol. 37, Issue 8, pages 476-482.

## *Tax Treatment of Stock Options Issued for Both Services and Financial Risk*

In time, most investment managers make a capital investment in the general partner by purchasing a capital interest. When the general partner then grants a participative share of the carried interest to the investment manager, usually with vesting requirements, it can be viewed as a grant for both the capital investment and future services. This scenario is comparable to a start-up company that issues stock options to individuals who are both shareholders and service providers. In many cases, the stock option requires vesting or other service-related stipulations, similar to the carried interest agreement. When a clear differentiation is not made between the dual role of the individual as a shareholder and service provider, the tax treatment of the option is unclear.<sup>10</sup>

Section 83 applies to property received “in connection with the performance of services.” Regulation Section 1.83-3(f) provides that property transferred to an employee “in recognition of the performance of, or refraining from performance of, services is considered transferred in connection with the performance of services.” The phrase “in connection with the performance of services” does not necessarily mean that the individual is receiving the option as compensation for services in order for the rules under Section 83 to apply. Based on the case history, the only requirement for Section 83 to apply is that there is some type of relationship between the services performed and the property transferred.

In *Alves*<sup>11</sup> the taxpayer purchased stock in a start-up corporation for 10 cents per share in conjunction with his employment by the corporation. His employment agreement stated that the stock was being sold to the taxpayer in order to provide him with “an additional interest in the Company.” The agreement restricted Alves from selling a portion of the stock for either four or

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<sup>10</sup> Tuley, P. “Stock Warrants and Options: Compensation or Investment Sweetener?” *The Tax Advisor*, Nov. 2006, Vol. 27, Issue 11, pg. 634.

<sup>11</sup> *Lawrence J. Alves v. Commissioner*, 79TC 864 (1982), aff'd, 734 F2d 478 (9th Cir. 1984)

five years and required that he remain an employee. The court held that the stock was issued “in connection” with the performance of services, even though the taxpayer had paid for the stock. Therefore, because Alves did not make a Section 83(b) election, the increase in the stock’s value at the time the restrictions lapsed was taxable compensation income to him. Both the Tax Court and the Ninth Circuit held that the statute’s language did not require that the property be transferred as “compensation for the performance of services,” but only “in connection with the performance of services.”

The Ninth Circuit relied on the facts that Alves purchased the stock at the time he signed his employment agreement and that the stock restrictions were tied to his continued employment with the company. In spite of the fact that the stock was purchased, giving Alves an investment interest in the company, the increase in value from the time of the original purchase until the restrictions lapsed was compensation income. The court never considered a bifurcation of the value between the investment and compensation features.

The Tax Court in *Montelepre Systemed*<sup>12</sup> outlined four factors that the courts have used to determine whether property has been transferred in connection with the performance of services:

- “(1) whether the property right is granted at the time the employee or independent contractor signs his employment contract;
- (2) whether the property restrictions are linked explicitly to the employee's or independent contractor’s tenure with the employing company;
- (3) whether the consideration furnished by the employee or independent contractor in exchange for the transferred property is services; and
- (4) the employing company's intent in transferring the property.”

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<sup>12</sup> *Montelepre Systemed v. Commissioner*, TC Memo 1991-46 , aff’d on other issue (1992, CA5) 69 AFTR 2d 92-958

In *Mitchell*<sup>13</sup>, the Court held that warrants were issued in connection with the performance of services when an employer's statement indicated that the company issued stock warrants to Mitchell because:

“It was vital that Mitchell continue to serve as the Chief Executive Officer of the Company, and that this would best be accomplished by his expectation of becoming a substantial equity holder in the relatively near future. In addition, the Company's outside financial advisors, and potential investors approached with respect to the refinancing, were reluctant to finance or invest in the Company unless it was apparent that Mitchell's continued association was, as far as possible, assured by his ownership of a substantial equity-type interest in the Company.”

The only escape from Section 83 appears to be where the property is granted to shareholders in their capacity as shareholders. For example, in *Centel Communications*<sup>14</sup>, the company attempted to deduct compensation expense related to warrants issued to two shareholder/directors. The shareholders had provided loan guarantees to the company and the warrants were issued several years later in recognition of increased financial risks that they assumed from guaranteeing the loans. The Tax Court held the warrants were not issued "in connection with the performance of services." Therefore, no compensation deduction was allowed. The Court emphasized that the warrants were issued for the loan guarantees and noted that none of the individuals receiving warrants were in the business of making such guarantees.

Based on the interpretation of Section 83 by the courts and the statutory language, legislative history, and regulations, Section 83 applies to a wide range of property transfers arising from a service relationship. Moreover, the property does not have to be transferred as the direct quid pro quo for any specific services; rather, any bargain transfer of property occurring between the person who performed services and the person for whom the services are performed

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<sup>13</sup>*Harry H. Mitchell v. Commissioner*, TC Memo 1990-617, aff'd (1993, CA9) 992 F2d 1219, cert den (1993, S Ct) 510 US 861

<sup>14</sup>*Centel Communications v. Commissioner*, 92 TC 612, aff'd (1990, CA7) 67 AFTR 2d 91-373

will be prima facie subject to Section 83, absent strong evidence to the contrary. The current guidance suggests that even if property is issued in consideration for both services and financial risk, the entire amount will be subject to Section 83.<sup>15</sup>

At the end of the day, all the various methods of compensating the MBA graduate working for the publicly traded brokerage firm or the start-up company result in ordinary income to the individual. In many cases, the individual is providing the exact same investment management services to these corporate entities as he/she would be performing for the general partner of a private equity firm. So the question remains, why should the individual working for the general partner receive the tax benefits of capital gains rates on the carried interest?

### **Capital income or compensation?**

The question is whether the carried interest is compensation for services or whether it is a right to income or gain from capital. The distinction between compensation and a right to income or gain becomes difficult when both capital assets and an individual's investment knowledge are involved. With regard to a fund manager's carried interest, the argument can be made that regardless of the structure, the carried interest allocation involves the performance of services by skilled professionals whose investment knowledge generates capital income for fund investors. The allocation effectively aligns the investment managers' economic interests with those of the fund investors by basing their compensation on the fund return. Nevertheless, the managers are still performing services and the income should be taxed as ordinary compensation income.<sup>16</sup>

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<sup>15</sup> Tuley, P. "Stock Warrants and Options: Compensation or Investment Sweetener?" *The Tax Advisor*, Nov. 2006, Vol. 27, Issue 11, pg. 634.

<sup>16</sup> Report by the Joint Committee on Taxation. "Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues" Prepared for a Public Hearing before the House Committee on Ways and Means. September 6, 2007.

Certainly some aspects of the carried interest contract support compensation treatment. The time and effort clauses generally require the manager or key persons to perform services. The inclusion of hurdle rate restrictions, providing that carried interest payments are only made when the fund performance exceeds a hurdle rate, seem comparable to performance-based bonus compensation. A carried interest can also be compared to an option because it participates in future appreciation without the risk of loss. Even for fund managers' that contribute capital to the partnership, the income on the carried interest can be distinguished from the return on the capital interest.<sup>17</sup>

Alternatively, the carried interest arrangement can be viewed as a sharing by the fund manager and the investors of favorable tax treatment to minimize their aggregate tax. In a Wall Street Journal editorial, the Journal supports the current tax benefit for carried interest arguing that "carried interest is a long-term, risk-based investment income derived from future profits. Those profits are anything but a sure thing. Private equity managers get nothing from their equity holding until investors get all of their money back plus a negotiated return -- which is a lot different than an upfront fee or a guaranteed wage or salary that comes as a paycheck every two weeks."<sup>18</sup> However, one could argue that profits from stock options are not a sure thing either, even though the appreciation in the stock is taxed as ordinary income.

Interestingly, William Bowers, senior counsel in Treasury's Office of Tax Legislative Counsel, speaking to the District of Columbia Bar Taxation Section, reminded the audience that the current taxation of carried interests comes from a long-standing administrative tradition. He

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<sup>17</sup> Supra, note 16.

<sup>18</sup> "Assault on the Investor Class." Wall Street Journal, May 7, 2007, A14. For a complete discussion of the arguments for taxing carried interests as capital gains, see the Joint Committee on Taxation's report for a public hearing before the House Ways and Means Committee on September 6, 2007 entitled "Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I."

added, “For tax, labels matter.”<sup>19</sup> Since when does the Treasury worry about form over substance?

In addition to the fund managers being taxed at the lower capital gains rates, the allocation of partnership profits to the carried interest provides a benefit to the other fund partners. U.S. individual investors benefit from the carried interest structure due to the limitations on the deductibility of investment expenses. If the payment to the general partner was considered compensation, it would be deductible by the fund. As intrinsically passive entities, private equity funds do not pass through “trade or business” deductions to their U.S. individual investors. Since the fund is not considered engaged in a trade or business, the individual’s share of the allocated deduction would be treated as an investment expense under Section 212. Investment expenses are treated as miscellaneous itemized deductions and are only deductible to the extent they exceed 2% of the taxpayer’s adjusted gross income. The deduction is then subject to the overall limitation on itemized deductions and will be disallowed if the taxpayer is subject to alternative minimum tax.

Given these limitations, the carried interest structure is a “win-win” for both U.S. individual investors and the general partner. For the U.S. individual investors, the carried interest structure converts a potentially non-deductible expense into the equivalent of an income exclusion by reducing the amount of partnership income allocated to the individual partner. For the general partner, the allocation of partnership profits converts ordinary compensation income into capital gain.

The other fund investors’ greatest concern is that the fund does not engage in business. Individuals generally represent only a small percentage of the investors in private equity funds

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<sup>19</sup> Coder, J. “Carried Interest Tax Changes Meet resistance at D.C. Bar Meeting.” Tax Notes, October 1, 2007, pgs. 18-19.

with the largest investors being pension funds and foreign investors. Pension funds are tax exempt entities, so they pay no tax on interest, dividends and capital gains. The most significant tax issue for these entities is the avoidance of “unrelated business taxable income” (UBTI). Foreign investors also avoid U.S. tax on interest, dividends and capital gains. They seek to avoid “effectively connected” income that would be subject to U.S. tax. As long as the fund is not engaged in a trade or business and does not generate significant fee income, both tax-exempt entities and foreign investors are not likely to be subject to U.S. tax on the fund earnings. Therefore, the structure of the general partner payment as carried interest rather than compensation is not a major concern.

### **The Current Debate**

On November 1, 2007 the House Ways and Means Committee passed H.R. 3996, the *Temporary Tax Relief Act of 2007*. This bill included a provision to require investment fund managers to treat carried interest as ordinary income received in exchange for the performance of services to the extent that carried interest does not reflect a reasonable return on invested capital. The bill would continue to tax carried interest at capital gain tax rates to the extent that carried interest reflects a reasonable return on invested capital. The proposal was expected to raise \$25.62 billion over 10 years.<sup>20</sup>

Industry groups condemned the provision and it ultimately did not pass in the Senate. Douglas Lowenstein, president of the Private Equity Council, issued a statement warning that the provision "would make it more difficult for U.S. private equity firms to compete against foreign governments' sovereign wealth funds and overseas private equity firms .... And it could reduce the enormous returns earned by public pension funds, university endowments, charitable

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<sup>20</sup> House Ways and Means Committee Press Release “ Ways And Means Passes Responsible Tax Relief Bill Bill would keep AMT from hitting 23 million families, extend expiring provisions.” November 1, 2007.

foundations and other investors in private equity."<sup>21</sup> Senate Majority Leader Harry Reid correctly indicated that the Senate would not increase taxes on carried interest in 2007. In a discussion with industry representatives, Mr. Reid said "Given the difficulty in getting any legislation through the Senate and the little time left this year for moving other issues important to the American public, it is unclear whether there is sufficient time" to address the carried interest issue.<sup>22</sup>

The Senate first began looking at the issue in May 2007 when aides to members of the Senate Finance Committee held a briefing on the taxation of private equity and carried interest.<sup>23</sup> The briefing may have been incited by a 2006 study indicating that pay for venture capitalists would increase by 35% in 2006, with managing general partners earnings almost \$2 million. The study revealed that the average employee, including lower-level analysts, associates, and office managers as well as the top earners, was expected to be \$777,0000 in salary, bonus and investment profits. The study indicated that the majority of the increase was due to a significant increase in the carried interest.<sup>24</sup>

The possibility of taxing carried interest at ordinary rates created a lobbying frenzy by private equity firms, as the Washington Post (WP) reported:<sup>25</sup>

In response, private equity firms -- whose multibillion-dollar deals have created a class of superwealthy investors and taken some of America's large corporations private -- hired dozens of lobbyists, stepped up campaign contributions and lined up business allies to wage an unusually conspicuous lobbying blitz. Their argument was that higher taxes would run counter to accepted tax policy and slow economic growth.

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<sup>21</sup>Shreve, M. and D. Stamper. "Ways and Means Approves AMT Patch, Extenders Package." Tax Notes, Nov. 5, 2007, p. 551, 117 Tax Notes 551.

<sup>22</sup>Lueck, S. "Politics & Economics: New Private-Equity Bill Gains Ground in Congress." Wall Street Journal, October 10, 2007. Pg. A13.

<sup>23</sup>Lueck, S. "Higher Private-Equity Tax is Explored." Wall Street Journal, May 1, 2007, pg. A4.

<sup>24</sup>Buckman, R. "Tracking the Numbers / Street Sleuth: Venture Firms are Doling Out Large Pay Deals." Wall Street Journal, September 14, 2006, pg C1.

<sup>25</sup>Birnbaum, J. "Buyout Firms to Avoid a Tax Hike." *washingtonpost.com*, Oct. 9, 2007.

Considering the amount of tax revenue at stake for private equity managers, it's no small wonder that they "retained lobbyists and tax experts in large numbers from the best connected law firms and consultancies in Washington."<sup>26</sup>

### **Summary and Recommendation**

Private investment fund managers pay a smaller percentage in taxes on their income than their counterparts at investment banks and other corporations. Corporate employees are paid with a mix of cash, stock, stock options, and deferred compensation, all of which are taxed as ordinary income at rates up to 35%. Although the partnership structure technically provides for taxing the carried interest of equity managers at capital gains rates, the disparity between the tax treatments of investment managers performing the same services appears unfair. As Victor Fleischer, an associate professor at the University of Colorado Law School, testified before the Senate briefing, "We have some of the wealthiest workers in the country paying tax at a very low rate. That's what makes the issue so striking."<sup>27</sup>

Sadly, but indicative of the current tax policy, what has been missing from the carried interest debate is the lost art of political compromise. There is an easy compromise in the carried interest debate, by simply taxing the profit interest at one of the higher-tier capital gains tax rates (for example, collectibles are taxed at 28% and unrecaptured §1250 gains are taxed at 25%). A compromise rate would still preserve much of the incentive for carried interests and, to a great extent, mitigate private equity managers from manipulating the tax code to disguise a compensation payment as a profit interest. This is the lost art of bipartisan compromise that has been nearly absent within the Beltway for the last decade.

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<sup>26</sup>Birnbaum, J. "Senators Cautious on Plan for Equity Tax." *washingtonpost.com*, Sept. 4, 2007.

<sup>27</sup>Lueck, S. "Higher Private-Equity Tax is Explored." *Wall Street Journal*, May 1, 2007, pg. A4.

It is time for Congress to take a close look at the taxation of capital interests and finally acknowledge that these payments have a service related component that should be taxed as such. Even Assistant Treasury Secretary for Tax Policy Eric Solomon admitted that tax considerations motivated equity funds to organize as partnerships.<sup>28</sup> It's time to realign the allocation of resources by eliminating the tax distortion between Wall Street firms and private equity funds. The new MBA graduates will still be able put food on the table with their compensation taxed at higher rates and their decisions regarding employment will be based on economics that are not tax distorted.

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<sup>28</sup> Weiner, J. "Saving Private Equity." Tax Notes, October 22, 2007, pgs. 309-317.

Exhibit 1

