The Carried Interest Controversy: Let’s Not Get Carried Away

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INTRODUCTION

Are the recent press stories really true? Do multi-millionaire investment fund managers pay tax on their hefty compensation at only a 15% rate while hard-working ordinary folks pay tax on their compensation at rates as high as 35%? Indeed, the current tax system does provide this upside-down result. Prompted by press attention, this seeming anomaly raised a firestorm in the legal academy and on Capitol Hill. In response, Representative Sander Levin introduced a bill that would tax fund managers at the higher ordinary income rate on all their fund earnings. This legislative response initially seems to make perfect sense on fairness grounds. Upon further reflection, however, we believe the proposal has several fatal defects. Unlike some other commentators who reject the Levin proposal, however, we find the status quo equally unacceptable. Instead we advocate a more moderate legislative fix, taxing only a specified portion of the managers’ income at the higher 35% rate.

As discussed more fully in Part II, the problem arises because a portion of a fund manager’s compensation takes the form of a profits interest in the fund. Under current law, this “carried interest” or

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“carry” is taxed as a regular partnership profits share, rather than compensation. If the fund’s profits constitute long-term capital gains from the sale of stock (as they often do), the manager pays tax at the 15% capital gains rate, rather than the rate on compensation, which can be as high as 35%.

In response, tax policy analysts have considered two possible changes to the current treatment of carried interests. The most popular proposal would treat all amounts received under the carry as compensation income, subject to ordinary income tax rates. The Levin proposal adopts this response. The second approach would limit the compensation amount to a fixed interest rate of return on the amount of capital subject to the carried interest. The underlying theory is that managers implicitly borrow some of the fund’s capital for their own account and that the compensation therefore is the lack of the customary interest charge for the use of another’s capital.

Despite its theoretical appeal and some active consideration, no commentator has yet to advocate adoption of the interest charge approach. We believe that a problem with this approach helps to explain this failure to gain traction. Section IV.A discusses our important modification to the interest charge approach: We would treat the manager as making an interest payment on the implicit carried interest loan. In the absence of this modification, the interest charge approach suffers from several defects, including the double taxation of the compensation amount. An interest expense adjustment corrects these difficulties, and does so without sacrificing the ordinary rate taxation of the imputed compensation.

Section IV.B then circles back to explain why our proposal is superior to the Levin proposal. It demonstrates our proposal’s greater compatibility with three important tax concepts: (1) the well-established principle that services performed in connection with one’s own investments do not generate taxable compensation; (2) the precept that close economic substitutes should be taxed the same; and (3) tax

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5 IRC § 702(a), (b).
6 IRC § 702(b); § 1(h) (maximum capital gains rate of 15%).
7 H.R. 2834, note 3.
8 For a recent discussion of this possibility, see, e.g., Victor Fleischer, Two and Twenty: Taxing Partnership Profits in Private Equity Funds 83 NYU L. Rev. 1.
9 This portion equals the carried profits percentage, typically 20%.
10 The manager first would be taxed on its annual imputed compensation, and then again on the full amount of the carry profit when it is realized. In addition to this excess taxation, the unmodified interest charge approach would tax the carried interest more harshly than an actual loan would be taxed. As discussed in Section IV.A and Subsection IV.B.2, such harsher taxation of close economic substitutes is undesirable.
11 The allowed interest expense could not be used to offset the imputed ordinary-rate compensation due to existing limits on the deductibility of investment interest expense. See Section IV.A.

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lock in, a leading justification for the capital gains preference. We also demonstrate an administrative advantage: the ability to limit the scope of the new regime through principled, rather than arbitrary, exemptions.

II. BRIEF DESCRIPTION OF THE PROBLEM

The typical investment fund is structured as a partnership for tax purposes. Most of the fund’s working capital, typically 95-99%, comes from the passive investors who become limited partners. The fund manager (“manager”) contributes the remaining capital, and serves as the general partner, performing services related to the fund’s investments in portfolio companies. The manager itself typically also is a tax partnership, comprised of the key individuals who actually manage the fund’s investments.

The manager typically receives two types of compensation in return for its services. First, it receives a fixed management fee based on a percentage of invested capital, typically around 2%. The manager also receives a carried interest, typically 20% of the fund’s net profits. There is no dispute over how the fixed management fee is treated for tax purposes: It constitutes compensation to the manager and must be treated as ordinary income, subject to rates of up to 35%. There is, however, no agreement on the appropriate tax treatment of the carried interest.

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12 This could be an actual (limited) partnership under state law, or alternatively a limited liability company (LLC) treated as a partnership for federal tax purposes. A tax partnership is not itself subject to federal income tax, in contrast to a corporation. IRC § 701. Instead, partners individually report their share of partnership profits as realized by the partnership. Id. § 702.

13 See, e.g., Aviva Aron-Dine, Ctr. on Budget and Policy Priorities, An Analysis of the “Carried Interest” Controversy 6, available at http://www.cbpp.org/7-31-07tax.pdf (managers typically contribute 1-5% of the capital in “private equity” funds); Nat’l Venture Capital Ass’n, Venture Capital Fund Formation 1, available at http://nvca.org/pdf/VC_Fund_Formation.pdf (investors typically contribute 95-99% of the capital in “venture capital” funds). Technically, the investors are limited partners only if the fund is a state law limited partnership. If the fund is formed as an LLC, the investors are passive nonmanaging members of the LLC.

14 The fund manager is the general partner in a state law limited partnership, and is the managing member of an LLC.

15 In addition to making the important buy and sell decisions, the fund manager also might serve on the board of the portfolio company, serve as a strategic advisor or the like. See, e.g., Nat’l Venture Capital Ass’n, note 13, at 1.

16 Id.; Fleischer, note 8, at 3.

17 See id. The manager also receives a profits interest for any capital contributions. The carried interest is in addition to the profits interest received for contributed capital.

18 See, e.g., Fleischer, note 8, at 10.
Under current law, the carried interest is not treated as compensation, but rather as the manager’s share of the partnership’s profits. If the profits constitute a long-term capital gain from the sale of stock (as they often do), the manager reports the carried interest as long-term capital gain subject to a maximum rate of 15%.

To illustrate, consider the following facts that we refer to throughout the Article.

Basic Facts: The limited partners contribute $100 million cash to the partnership to invest in private equity. The manager and general partner, who does not initially contribute any capital to the partnership, oversees the partnership investments in exchange for an annual management fee of 2% of the partnership’s net assets, plus 20% of the partnership’s net profits, if any. The partnership has no gains or losses in Year 1, but has $25 million of net long-term capital gain in Year 2 from the sale of stock. In the following variations assume that each year the partnership has just enough income to pay the 2% management fee. Assume the relevant interest rate is 8%.

Under current law, the manager must report the annual $2 million fixed fee as ordinary income. Additionally, on the sale of the stock

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20 IRC § 702(a), (b).

21 We make this assumption for ease of exposition. Usually, the manager would contribute some portion of the capital. See note 13 and accompanying text.

22 The 2% management fee is a guaranteed payment under § 707(c).

23 On the investor’s side, management fees for private equity and venture capital funds generally are treated as § 212 “investment” expenses, rather than § 162 expenses. E.g., Alan T. Frankel, Charles J. Vallone & James R. Lisa, Venture Capital: Financial and Tax Considerations, The CPA Journal, Aug. 2003, at 60; Fred F. Murray, Uncertainties Increase for Taxation of Private Equity Investments, Daily Tax Report (BNA), June 27, 2007, at J-1; Andrew Needham, A Guide to Planning for Private Equity Funds and Portfolio Investments (pt. 1), 95 Tax Notes 1215 (May 20, 2002). Stephen Hamilton, Tax Aspects of Private Equity, Venture Capital and Hedge Funds (July 2006), available at www.drinkerbiddle.com/publications/Detail.aspx?pub=59. Section 212 expenses need to be separately stated at the partnership level since they might be disallowed to certain taxpayers based on their individual circumstances. IRC § 702(a)(7); Reg. § 1.702-1(a)(8)(i). See note 52 for a discussion of the limits on § 212 expenses. For a possible contrary view that the fees generally might be classified as § 162 expenses, see Sanchirico, note 19. Existing case law seems to support § 162 expense treatment only in the (atypical) case where the fund invests in operating partnership entities (rather than operating corporate entities). See, e.g., Higgins v. Commissioner, 312 U.S. 212 (1941), Bell v. Commissioner, 200 F.3d 545 (8th Cir. 2000).
the partnership has a $25 million profit, of which 20% or $5 million is allocated to the manager as its "carry" share of the net profits, and is characterized as a long-term capital gain.

III. PROPOSED SOLUTIONS

Over the past year, several commentators have argued that the current tax treatment of carried interests is inappropriate and should be changed. Why is it that these very highly compensated managers are taxed at a maximum rate of 15% on what appears to be, at first blush, compensation income while the rest of us pay taxes on our compensation at rates as high as 35%? The two most often proposed changes are: (1) treating all amounts received under the carried interest as ordinary compensation income, or (2) imputing compensation to the manager each year in the amount equal to the rate of interest times the amount of capital subject to the carried interest.

A. The Levin Proposal: The All Ordinary Income Approach

The most popular proposal is to characterize all amounts received under carried interests as compensation income, subject to ordinary income tax rates. Representative Levin's recent legislative proposal adopts this approach. The Levin proposal deals only with the "character" of the income received under the carry (ordinary versus capital gains), not with when that income should be reported. Fund managers would report ordinary compensation income only if and when the partnership realizes a net profit. Applying the Levin Proposal to the basic facts, the manager would have $5 million of compensation income in Year 2 as a result of the stock sale.

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25 A third possibility would require the fund manager to include the fair market value of the carried interest at receipt. See Aron-Dine, note 13, at 10. This has not gained any serious consideration due to valuation concerns. Id. In addition to such valuation concerns, other arguments support taxation of something less than the full value as compensation. See Subsection IV.B.1 (discussing sweat equity on one's own investments) and Subsection IV.B.2 (discussing tax consistency).

26 E.g., Aron-Dine, note 13, at 8-13; Fleischer, note 8; Gergen, note 24; Bankman, note 24.

27 H.R. 2834, note 3.

28 Id.
In addition to being very simple to apply, there are at least two arguments that can be made in support of this approach. First, if one views a carried interest as nothing more than compensation for the manager's services, one can argue that basic fairness demands this approach: Amounts earned under the carried interest should be taxed at the same rates as those imposed on the compensation earned by others. Second, the preferential rate for capital gains often is justified as a way to encourage risky capital investments. Since the carry relates only to the capital contributed by others (and not that contributed by the manager), there is no reason to apply the capital gains rates to the carry.

B. The Interest Charge Approach

Another approach that some commentators have considered is more limited in scope. It would require managers to report compensation annually, regardless of whether the fund makes a profit, equal to the rate of interest times the amount of capital subject to the carried interest. To illustrate, this approach under the basic facts, the manager would report $1.6 million of compensation income for both Year 1 and Year 2 (the rate of interest (8%) x the amount of capital subject to the carried interest ($20 million)). In Year 2 the manager would report its actual $5 million carry as long-term capital gain.

Support for this approach comes from the carry's economic similarity to an interest-free loan from the fund investors to the manager in the amount of the capital subject to the carried interest. Indeed, the economics of the carried interest could be replicated by having the fund investors actually loan the manager the capital subject to the carry, and have the manager invest the loan proceeds in the fund.

29 E.g., Aron-Dine, note 13, at 2. One also might favor this approach on practical grounds. See Fleischer, note 8, at 57. We discuss practical considerations at Subsections IV.B.2 and III.B.4.
30 See, e.g., Noel B. Cunningham & Deborah H. Schenk, The Case for a Capital Gains Preference, 48 Tax L. Rev. 319, 341 (1993). This Article takes the capital gains preference as a given. From a broader perspective, the carried interest problem highlights the difficulties arising from the taxation of different categories of income at different rates. Consideration of these issues is beyond the scope of this Article.
31 Under this approach, managers would receive capital gains on the portion of the investment profits related to their capital contribution percentage. See H.R. 2834, note 3 (proposed § 710(c)(2) exception for certain capital interests).
32 For recent discussion of this possibility, see Fleischer, note 8, at 31-32, 43-44. For a similar suggestion with respect to partnership profits generally, see Schmolka, note 19, at 307-08.
33 See Subsection IV.B.1 for a discussion of the relevant interest rate.
34 For additional support in favor of this loan perspective, see Section III.B (discussing how managers could avoid the harshness of the Levin proposal by simply restructuring the
The manager’s profit share and capital contribution percentage would be the same, but there no longer would be a carried interest.

The loan analogy supports the interest charge approach for several reasons. From the loan perspective, the carry’s compensation element stems from the absence of an interest charge for the manager’s use of the investors’ “loaned” capital. As such, the manager’s compensation is the forgone interest on the implicit interest-free loan, not the actual realized profits of the fund. It is useful to compare the results under the Levin proposal and those under the interest charge approach in the case where the fund does not make a profit (that is, either breaks even or loses money). Under the Levin proposal, the manager would not report any compensation income with respect to the carry since the fund did not make a profit. That assumes that the manager has not received any compensation from the carry arrangement. In fact, however, the fund manager has received the same valuable right to the extra carried profits percentage regardless of how the fund performs. Consider a passive investor who purchases stock on credit. Such investor pays the same interest on the loan regardless of whether the stock yields a significant gain or fails to turn any profit at all. Similarly, the managers’ compensatory benefit equals the forgone interest on the “borrowed” capital regardless of the funds’ actual performance. In favorable contrast to the Levin proposal, then, the interest charge approach consistently imputes the same compensation income in this case as it does when the fund makes a profit.

In sum, the loan analogy highlights the significant under- and overtaxation flaws of the Levin proposal even if one accepts the stated justification that all compensation must be taxed at the ordinary rates. It undertaxes the manager when the fund breaks even or loses money. It overtaxes the manager when the carry income exceeds the interest

35 The tax law already utilizes the interest charge approach in the case of an explicit interest-free compensatory loan. IRC § 7872 imputes annual compensation equal to the loaned capital times the U.S. government’s borrowing rate. Section 7872 does not apply to the carried interest under current law. IRC § 7872(c). The carried interest generally is treated consistent with its form as a partnership profits interest. In favorable contrast to the Levin Proposal then, the interest charge approach would treat the carried interest structure and the explicit interest-free loan in similar fashion, consistent with their economic similarities.

36 See discussion at note 65 as to why the interest return must be less than the full actual profits on the carry.

37 H.R. 2834, note 3, at § 1.

38 This might suggest an up-front inclusion equal to the value upon grant, which would trigger the valuation concerns noted in note 25. In addition, the value of the below-market loan is not the same as the value of the carried interest itself. See Subsection IV.B.1 (discussing the return on the manager’s sweat equity).
it would have had to pay to borrow the invested funds.\textsuperscript{39} The loan analogy also unmasks shortcomings in the second argument made in favor of the Levin proposal: That fund managers have not risked their own capital with respect to the carry and therefore they should not benefit from the preferential rates afforded capital gains.\textsuperscript{40} But the tax law does not deny the capital gains preference on qualified investments purchased with borrowed funds, even where the debt is nonrecourse.\textsuperscript{41} To the extent that the manager is viewed as borrowing funds from the investors and investing them, there is no reason that it should be denied benefits to which the other investors are entitled.

IV. THE MODIFIED INTEREST CHARGE APPROACH: SECTION 7872

Despite the theoretical appeal of the interest charge approach, commentators to date have rejected it in favor of either the Levin proposal or a do-nothing status quo.\textsuperscript{42} What explains this result? We believe the reason is that the interest charge approach as contemplated by other commentators contains significant shortcomings. There appear to be several missing pieces to the analysis; one key modification makes the interest charge approach the most attractive solution to the carried interest problem. The next Section discusses our modification to the interest charge approach: We would treat the manager as making an interest payment on the implicit carried interest loan. The following Section then circles back to compare our enhanced interest charge approach to the Levin proposal.

A. Improved Interest Charge Approach

As discussed above, the interest charge approach imputes compensation on the implicit interest-free loan from the fund investors to the fund manager. If the manager is deemed to have income from this interest-free loan, should it also be given an interest expense in the same amount? Shouldn’t the manager be treated as if it actually received compensation, which it used to pay the interest on the loan?

\textsuperscript{39} Similarly, this approach also would result in too little tax where the fund is profitable, but at a level lower than the interest rate.

\textsuperscript{40} E.g., Aron-Dine, note 13, at 5-8.

\textsuperscript{41} The carried interest is properly analogized to a nonrecourse loan since the fund investors, not the fund manager, bears the loss if the investments lose value. In the case of explicit nonrecourse debt, taxpayers still receive the capital gains preference on qualified investments even though it is the lender who bears the risk of loss in such case. IRC § 465 disallows certain deductions funded by nonrecourse debt, but that is separate from the capital gain issue.

Even though this seems rational, those who have suggested this approach say no. It is not exactly clear on what their conclusion is based. Possibly it is the fact that there is no actual loan, nor any actual interest payment. Or perhaps it is based on a concern that if an interest expense were permitted, it would exactly offset the manager’s compensation, resulting in no net income to the manager. No matter what the rationale, we believe that denying the interest deduction to the manager makes the interest charge approach extremely unappealing for at least two reasons.

First, if there is no deduction, the manager would be overtaxed. The manager would be taxed on its annual imputed compensation, and again on the full amount of the carry profit when it is realized. In fact, this has the effect of taxing the manager’s compensation twice, once at ordinary rates and once at capital gains rates. To illustrate using the basic facts, the manager would have compensation income in both Year 1 and Year 2 of $1.6 million for a total of $3.2 million. In addition, the manager also would report $5 million of capital gain under the carried interest upon the fund’s stock sale. Therefore, the manager would have to report a total of $8.2 million of income, even though its economic income is only $5 million. This is clearly an unfair, unwarranted result.

See, e.g., Statement of Peter R. Orszag, The Taxation of Carried Interest, S. Fin. Comm. 1, 15 n.22 (2007), available at http://www.cbo.gov/ftpdoc.cfm?index=8306&type=1 (noting that advocates of the interest charge approach would not allow the interest deduction); see also Fleischer, note 8 (June 12, 2007 draft explicitly stated that the “right tax policy here is to deny the [interest] deduction”; later drafts deleted the explicit statement but provide that a fund manager should receive an increase to her partnership basis for the imputed compensation, which makes sense only if the manager is denied an interest deduction); Schmolka, note 19, at 312 n.105 (similarly concluding that there should not be an interest deduction).

See Schmolka, note 19, at 312 n.105 (basing his disallowance, in part, on the lack of actual loan proceeds).

Cf. Dean v. Commissioner, 35 T.C. 1083 (1961) (declining to impute compensation on grounds that the offsetting interest expense results in no additional net income). See Howard E. Abrams, The Taxation of Carried Interests, 116 Tax Notes 183, 186 (July 16, 2007) (arguing that in the case of an actual interest-free loan, the interest imputation offsets the compensation imputation).

Under Schmolka’s formulation, the double taxation seems to be permanent since he would treat the offsetting interest as nondeductible personal interest. See Schmolka, note 19, at 312 n.105. Under Fleischer’s view, the double taxation eventually might reverse itself. He contemplates a basis increase in the partnership interest for the imputed compensation. Fleischer, note 8, at 27 n.115. If so, there would be an ultimate offset in that there would be less gain, or more loss, but this offset would not be triggered until a final sale of the partnership interest (and not just one investment therein). In addition, the offset might take the form of a capital loss on sale, which generally can offset only capital gains in the current and subsequent years. IRC § 1211(b) (capital losses can offset only capital gains plus $3,000 of ordinary income), § 1212(b) (unused capital losses can be carried forward to subsequent years, but not back to prior years).
Second, for the well-advised taxpayer, these results would be very easy to avoid. Section 7872 prescribes rules for dealing with below-market loans. Under this provision, if the partnership explicitly granted the manager an interest-free nonrecourse loan in the amount of the capital subject to the carry, the manager would be treated as receiving compensation in the amount of the forgone interest and as having an interest expense in precisely the same amount. As discussed in greater detail below, this disparate treatment of close economic equivalents is undesirable as well-advised taxpayers would restructure their affairs to avoid the harsher result.

Modifying the interest charge approach to allow the interest expense (the "§ 7872 approach") neatly resolves all competing concerns. The missing link is § 163(d), whose application to this setting has not been fully appreciated. Under this provision, investment interest expense can be deducted only against investment income. This limitation already regulates the capital gains/ordinary income distinction at issue in the carried interest debate by prohibiting investment interest from offsetting compensation income. In the case of carried interests issued to managers of investment funds, the imputed interest expense, by definition, must be "investment interest." With this limitation in

In the case of an actual interest-free compensatory loan, the forgone interest is treated as first paid to the service provider as compensation, and then repaid to the service recipient as interest expense. IRC § 7872(a)(1)(A), (B). The latter interest expense imputation makes economic sense as it explains why the service provider does not in fact end up holding the initial compensation imputation as additional cash in hand. This economic rationale applies equally as well to the implicit loan imbedded in the carried interest structure, which helps to explain the double taxation problem. That is, the interest charge approach as currently contemplated imputes just a single payment made to the fund manager, which fails to account for the reality that there is no actual cash increase to the manager.

Since well-advised taxpayers would restructure the carry as an explicit interest-free loan, the disallowance of a deduction under the carry structure becomes a trap for the unwary or a penalty for those unable to restructure (for example, on existing arrangements). It also imposes unnecessary transaction costs on those who do restructure the carry into a nonrecourse loan. See discussion at Subsection III.B.2 for similar points regarding the choice between the interest charge approach and the Levin proposal.

Abrams, for instance, notes that § 163(d) might defer the interest deduction in the case of an actual interest-free loan, without reference to the key character role performed by § 163(d). See Abrams, note 45, at 186 n.23. The discussion relates only to the treatment of an actual loan, and not to the carried interest itself.

IRC § 163(d). Technically, the interest can be deducted only against "ordinary rate" investment income. But since the taxpayer can elect to treat capital gain income as "ordinary" investment income, the taxpayer can use the investment interest expense as an offset against preferential rate investment income. IRC § 163(d)(4)(B)(iii).

The carried structure is equivalent to a loan from the investors to the manager, followed by a capital contribution of such amount to the fund by the manager. As such, the interest should be treated as arising from a loan used to fund investments—hence, its designation as investment interest expense under the interest rules that characterize interest based on the actual use of the funds. While the fund manager might like to claim that such imputed interest expense is trade or business interest expense to avoid the § 163(d) limit,
mind, we can safely grant the imputed interest expense, secure in the
knowledge that the fund manager cannot use it to offset the imputed
compensation income.\textsuperscript{52} As demonstrated below, the § 7872 approach
therefore insures taxation of the imputed compensation amount at the
ordinary rates while also eliminating the overtaxation problem.

Consider first the preservation of tax on the compensation at the
ordinary rates. Recall the basic facts where the fund manager re-
ported $1.6 million of annual compensation income in both Years 1
and 2. The § 7872 approach also would impute an offsetting interest
expense of $1.6 million in each of those years. Due to the investment
interest limitation, however, the fund manager would not be able to
deduct the interest expense as an offset against the compensation.
Assuming that the fund manager did not have any outside investment
income, the Year 1 interest expense would go unused. As such, the
fund manager would pay tax on the imputed compensation at ordi-
nary tax rates in Year 1.\textsuperscript{53} The unused interest expense would be car-
rried forward to subsequent year(s) until used against reported
investment income.\textsuperscript{54}

\textsuperscript{52} Consistency with an actual loan requires a similar imputation on the investors' side of
the transaction of interest income and compensation expense. These amounts would not
necessarily offset for tax purposes since investment management fees face certain limita-
tions. For example, § 67(a) permits the deduction of investment expenses only to the ex-
tent they exceed 2% of the taxpayer's adjusted gross income. In addition, such investment
expense is not allowed for purposes of the alternative minimum tax. IRC § 56(b)(1)(A)(i).
(Many, but not all, of the investors are tax-exempt institutions that would not be affected
one way or the other.) The current limitations on investment management fees provide
some protection against a tax arbitrage benefit in the form of offsetting long-term capital
gain income and ordinary fee expense. See note 23 (discussing whether the management
fees should be treated as § 212 investment fees or § 162 fees). The investment manage-
ment fee limitations, however, do not necessarily correlate well with the possible character
arbitrage since the limitations permanently disallow some (or all) of the fee to the extent
applicable, and have no impact where not applicable. Favorably contrast in this regard the
greater character responsiveness of § 163(d) to investment interest expense. Thus, beyond
the specific focus of this Article, it might be worthwhile to consider revamping the § 212
limits more along the lines of § 163(d).

\textsuperscript{53} Our modified interest charge approach would not generate any additional revenue
from a fund manager who otherwise reports an offsetting amount of ordinary investment
income (for example, interest income). The fund manager would report ordinary compen-
sation income, and would use the deduction to offset the investment income also subject to
the ordinary rates. Section 163(d) effectively insures a net reporting of ordinary income in
an amount of the compensation imputation, even taking into account the interest deduc-
tion. Note that the imputation would generate some employment tax revenue, especially
the Medicare portion not subject to a wage cap. See discussion at note 79. The imputation
also could cause some additional income tax liability by raising the fund manager's AGI.
A higher AGI could increase the tax liability by reducing other deductions, such as per-
sonal exemptions or unreimbursed medical expenses. IRC § 151(d)(3), 213(a).

\textsuperscript{54} IRC § 163(d)(2).
Consider next how the § 7872 approach eliminates the double taxation problem. Under the original interest charge approach, the fund manager would report excess income of $3.2 million.\textsuperscript{55} Under the § 7872 approach, however, the fund manager ultimately has an offsetting investment interest expense in that exact amount. If the manager did not previously have investment income against which to offset the investment expense, it can be used as a deduction against the realized carry profit.\textsuperscript{56} The fund manager therefore would pay tax on (1) $3.2 million of compensation at the ordinary rates in Years 1 and 2, and (2) only $1.8 million of carry profit at the capital gains rates ($5 million of profit—$3.2 investment interest expense), reflecting the excess return over the imputed compensation. If the fund manager had sufficient investment income in Years 1 and 2, there would be $3.2 million of compensation income (instead of the $3.2 of investment income the manager otherwise would have had) and $5 million of capital gain.

As demonstrated above, the § 7872 approach simultaneously alleviates the double taxation and preserves the ordinary income taxation of the imputed compensation. It also provides the desirable consistency with an actual interest-free loan, and comports better with the underlying economics of the carried interest structure.\textsuperscript{57}

\textbf{B. Comparison of the Improved § 7872 Approach to the Levin Proposal}

The prior Section demonstrated how the § 7872 approach improves upon prior formulations of the interest charge approach. This Section now circles back to compare our enhanced interest charge approach to the Levin proposal, by expanding on two key defects of the Levin proposal: excess reporting of ordinary income, and the lack of tax consistency. This Section then introduces several other advantages of our § 7872 approach, relating to tax lock-in and principled exemptions of many partnership arrangements.

\textsuperscript{55} The fund manager reported total income of $8.2 million ($3.2 million compensation plus $5 million capital gain) but the fund manager received only $5 million from the carry.

\textsuperscript{56} The taxpayer can offset investment interest against capital gain but the quid pro quo is that the amount offset is not subject to preferential rates. IRC §§ 1(h)(2), 163(d)(4)(B)(iii). Note that the taxpayer does not have to use it against the capital gain income if the taxpayer does not want to. The taxpayer can choose to pay the tax today at capital gains rates, and save the deduction for potential use against ordinary investment income later.

\textsuperscript{57} Imputing the compensation income but not the interest expense drives a wedge between the underlying economics and the tax treatment. See note 47.
1. *Excess Reporting of Ordinary Income*

The Levin proposal goes too far by treating the entire carried interest return as ordinary income, rather than limiting the compensation inclusion to an interest rate return. As shown below, the Levin proposal suffers from an inconsistency regarding services performed in connection with one's capital investments.

Modify the basic facts to assume now that the manager contributes all of the fund's capital, thereby eliminating the passive investors. Under current law, the manager would report the entire $25 million stock profit in Year 2 as long-term capital gain despite the fact that the gain is clearly a product of both the manager's capital and its labor. Although one might argue that the tax law should bifurcate the return into its component parts, this has never been done. It is well-established that if one performs services on one's own behalf, the value of these services is not currently taxable. If the services are reflected in an increase in the value of the person's assets, it will be taxed when the assets are sold, and will be characterized as gain (or loss) from those assets. This rule permits entrepreneurs to invest their services in their businesses on a pretax basis, an investment known as "sweat equity." The Levin proposal would not change this result; it would simply follow the well-accepted principle that sweat equity does not generate compensation income even though it enhances the value of one's capital investments.

The Levin proposal seems to have lost sight of this well-accepted principle when it comes to a carried interest, however. Return to the basic facts where the passive investors contribute the capital, granting the manager a 20% carried interest. Just as under the modified facts, the $25 million stock profit in Year 2 is comprised of multiple elements, including a return on sweat equity, and a return on invested capital. Here however, the Levin proposal treats the manager's entire return as ordinary income. It is difficult to reconcile this treatment with that given the sweat equity under the modified facts. It might appear at first that the manager's failure to invest her own capital justifies treating the entire return as compensation. But this ignores two key interrelated points: (1) the carried interest is the economic

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59 Recall that the manager performs a variety of services in connection with the fund's investments. See note 15 and accompanying text. Note that the return on invested capital might be further subdivided into at least two additional categories: a risk-free rate of return and a risk premium.
60 Similarly, where the manager invests less than 100% of the capital, the Levin proposal would not change the results on the profits related to the managers' invested capital. See H.R. 2834, note 3, § 1(a) (proposed IRC § 710(c)(2) exception for certain capital interests).
equivalent of a nonrecourse\textsuperscript{61} loan, and (2) the use of borrowed funds does not negate the capital gains preference. Assume the manager borrowed the invested capital on a nonrecourse basis under the modified facts. The manager still would report the full $25 million profit as capital gain under the Levin proposal,\textsuperscript{62} even though others are bearing the risk of loss on the underlying invested capital. This disparate outcome significantly undercuts the theoretical foundation of the Levin proposal's treatment of carried interests.

While there is one meaningful economic difference between the original and modified examples, this distinction further highlights the greater appeal of our approach over the Levin proposal.\textsuperscript{63} In the original basic facts, the manager effectively receives an interest-free loan in exchange for services, suggesting that the appropriate response should target the forgone interest. In the modified example the manager provides her own capital and thus the return is on sweat equity. The appeal of our § 7872 approach is that by limiting the compensation inclusion to the forgone interest, our approach permits the fund manager to report her pro rata share of the return on the sweat equity as capital gains.\textsuperscript{64}

\textsuperscript{61} Alternatively, the carry could be viewed as the economic equivalent of an option and taxed under § 83. See e.g., Reg. § 1.83-3(a)(2), (7)(Ex.2). At least one commentator favors this characterization. Michael L. Schler, Taxing Partnership Profits Interests as Compensation Income, 119 Tax Notes 829 (May 26, 2008). Characterizing the carry as an option is certainly plausible and deserves further consideration. It is interesting to note that under proposed regulations, a carry would be subject to § 83. These regulations, however, do not treat a carry as an option, but rather as an interest in the partnership, resulting in tax consequences very similar to current law. See Prop. Reg. §§ 1.83-3(f), 1.721-1(b).

\textsuperscript{62} The capital gains preference is not denied where qualified investments are purchased with borrowed funds, even where the debt is nonrecourse. For case law supporting this result even where the taxpayer actually borrowed 100% of the invested capital on a nonrecourse basis, see Commissioner v. Tufts, 461 U.S. 300 (1983); Mayerson v. Commissioner, 47 T.C. 340 (1966).

\textsuperscript{63} Thus, we should be careful to avoid extending the results of the modified examples too far in the other direction. That is, it might seem at first that the lack of any compensation income under our modified examples supports the current law approach of no compensation income at all under our original carried interest example. This argument ignores the key economic difference discussed in the text: that is, the provision of an interest-free loan to the manager in exchange for services. As such, compensation should be reported, but it should be based on the forgone interest rather than the full actual return.

\textsuperscript{64} The tax benefit to sweat equity is the conversion of ordinary income to capital gains assuming that the compensation must be capitalized where the services enhance the value of a long-term capital asset. Since the \textit{Indopco} regulations (Reg. § 1.263-4, -5) allow expensing for certain services that enhance the value of long-term capital assets, Chris Sanchirico argues that the sweat equity argument is misplaced. See Sanchirico, note 19. We nonetheless follow the classic sweat equity characterization in the text since (1) the \textit{Indopco} regulations deviate from the theoretically correct approach of required capitalization, and (2) sweat equity remains tax-advantaged even under the generous noncapitalization rules. This results since taxpayers receive an implicit deduction for the sweat equity without regard to the possible limitations on explicit § 212 expenses. See note 52 for a discussion of the limitations on investment management fees.
A final word concerns the selection of the interest rate. The interest charge approach might seem to require use of the actual borrowing rate on the implicit carried interest loan. The § 7872 approach seemingly comes up short in this regard since it uses the government’s risk-free rate, and the carried interest loan is risky. We believe such critique misses the mark for several reasons. First, setting unobtainable perfection to the side, the § 7872 approach strikes a more moderate, reasonable compromise than either current law or the Levin proposal. By allowing complete avoidance of any compensation income on the carry, current law undertaxes the carried interest. In the other direction, the Levin proposal overtaxes the carried interest by disallowing capital gains treatment on the entire return, including the manager’s pro rata share of the sweat equity component. In contrast, then, the § 7872 approach favorably moderates between these two extremes. Furthermore, the § 7872 approach treats the implicit carry loan the same as all other compensatory loans with below-market interest. If the interest rate under our approach appears too low for the carry, this evidences a more general shortcoming in the current § 7872 interest rate. The appropriate response, then, would be a more general increase to the § 7872 interest rate, or possibly an increased rate for nonrecourse loans. Thus, the interest rate issue stands apart from the carried interest debate, and so we set it to the side.

2. Tax Consistency with Close Economic Substitutes

Beyond trying to tax the “correct” amount of the carry as ordinary income, tax consistency supports the § 7872 approach over the Levin proposal. Under the Levin proposal, the carried interest structure could result in significantly more ordinary income than the equivalent actual loan structure. As noted by others, managers could avoid the

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65 It might seem that the true interest rate on the “loan” should equal 100% of the profits on the carry since the “lender” bears the full risk of loss on the capital investment underlying the carry. If so, at least theoretically, the interest charge approach might seem to converge with the Levin approach. The true interest rate should be less than the full profits, however, since the fund manager is using his “sweat equity” to add value to all of the fund’s invested capital, including the portion that the manager is deemed to have borrowed. Therefore, if the carry is conceptualized as a loan, at least a portion of the carry should be treated as capital gain.

66 If so, such provision also should cover recourse loans coupled with an additional feature protecting the service provider against risk of loss (for example, a put entitling the service provider to sell the invested property back at the original purchase price if the property value declines).

67 While the fund manager could have less ordinary income under the Levin proposal if the fund does not perform well, fund managers should prefer the actual loan structure on balance because it imputes interest at only the risk-free rate. Thus, on an ex ante basis, the loan structure should be expected to provide a smaller ordinary income inclusion. Matters are a little more complicated in that the loan structure could require earlier compensation
Levin proposal's heavy handedness by recasting the form of the arrangement into an actual interest-free loan. Such restructuring would allow managers to report compensation the same as under our more limited § 7872 approach. The Levin proposal's excessive ordinary income result therefore would operate merely as a trap for the unwary, or perhaps as a potential transition charge on existing carried interest structures. Furthermore, this likely restructuring into an actual loan undercut the simplicity appeal of the Levin proposal.

In sum, close economic substitutes should be taxed consistently. Harsher taxation of one merely induces a formal restructuring into the other more tax-friendly form. By taxing the carried interest the same as the readily available loan alternative, the § 7872 approach has a significant consistency advantage over the Levin proposal.

3. Tax Lock-in

As noted above, the carried interest debate has focused on a risky incentive justification for the capital gains preference even though it fails to adequately explain the preferential rate. Existing commentary therefore has failed to analyze how the alternative tax "lock-in" justification for the preference impacts the analysis. As discussed be-

inclusions due to the annual imputation (versus only upon realization under the Levin proposal). This might be offset in whole or in part, however, by the annual imputation of the investment interest expense.

E.g., Fleischer, note 8; Weisbach, note 4. Taxing an economic equivalent more harshly is not desirable as well-advised taxpayers structure their affairs into the more tax-friendly form.

Subsequent to such commentary, Rep. Charles Rangel introduced a bill that, inter alia, would extend the Levin ordinary income approach to invested capital "attributable to the proceeds of any loan or other advance made or guaranteed, directly or indirectly, by any partner or the partnership." H.R. 3970, 110th Cong. (2007), Proposed Section § 710(c)(2)(D)(i). While this provision responds to the restructuring critique, it further misses the mark by selectively denying capital gains to a very narrow category of debt-financed investments (that is, only "investment services partnership interests" financed with impermissible debt). For a similar "discriminatory" critique of the Levin proposal, and analysis as to why our proposal avoids such arbitrariness, see Subsection IV.B.4.

The transition charge arises since it might be difficult to modify existing arrangements. Somewhat related to the latter point, the more limited interest charge approach has a lesser negative impact on existing arrangements structured under current law. In addition, there might be a deadweight loss as taxpayers incur restructuring costs in order to avoid the harsher Levin proposal. For additional analysis regarding the manageable complexity of our §7872 approach, see Subsection III.B.4.

See David A. Weisbach, An Efficiency Analysis of Line Drawing in The Tax Law, 29 J. Legal Stud. 71, 92 (2000) (concluding that lines should be drawn to tax items like their closest substitutes).

Similarly, it has a consistency advantage over prior formulations of the interest charge approach.

See notes 40-41 and accompanying text.
low, the lock-in concern favors the § 7872 approach over the Levin proposal.

The lock-in effect has been described as "[t]he most serious argument in favor of the capital gains preference." It refers to the reluctance of investors to sell appreciated assets because of the tax imposed on realized gains. As the tax increases, so does the lock-in effect. A preferential rate for capital gains has been justified as a response because by reducing the tax cost on realization, one reduces the tax distortion involved in the selling decision.

By taxing the manager’s carry as compensation when the fund realizes a gain, the Levin proposal has the effect of significantly increasing the lock-in effect under current law. Because the party in control of selling the funds investments—the fund manager—would be taxed at the higher ordinary rates, while the passive investors would benefit from the lower capital gains rate, one would expect fewer sales. In favorable contrast, our § 7872 approach does not change the treatment of the carry. Under our approach, the manager’s compensa-

74 Cunningham & Schenk, note 30, at 344; see also Daniel N. Shaviro, Commentary, Uneasiness and Capital Gains, 48 Tax L. Rev. 393, 396-404 (1993) (discussing the lock-in effect). In addition, the Supreme Court similarly has referred to tax lock-in when analyzing the propriety of the preference in uncertain cases under the statute. E.g., Corn Prods. Refining Co. v. Commissioner, 350 U.S. 46, 52 (1955) (the capital gains preference was intended “to relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions,” quoting Burnet v. Harmel, 287 U.S. 103, 106 (1932)).

75 Cunningham & Schenk, note 30, at 344.

76 While managers might pay some attention to the investors’ taxes to enhance their after-tax returns, there might be some slippage due to either (1) difficulties in reconciling the desires of investors with different tax profiles or (2) agency costs (for example, favoring their own tax circumstances over the investors). As to the latter issue, it is unclear the extent to which investors discipline managers for failure to minimize taxes. Cf. the literature highlighting the agency cost advantages of taxing the corporate entity itself rather than the investors. E.g., Hideki Kanda & Saul Levmore, Taxes, Agency Costs, and the Price of Incorporation, 77 Va. L. Rev. 211 (1991). As such, the managers’ own tax bill provides a more direct lock-in connection. In addition, even if managers heed investors’ tax preferences, the presence of many tax-exempt investors weakens such link.

77 Our proposal also might comport better with an alternate justification for the capital gains preference: the double taxation of corporate earnings. The corporate level tax arguably justifies the lower capital gains rate on stock sale gains and dividends. Therefore the Levin proposal might overtax the fund manager due to the imposition of a corporate level tax on the underlying portfolio companies in which the funds invest. See Steve Forbes, Private Equity, Public Benefits, Wall St. J., July 25, 2007, at A14. In other words, the managers’ pretax return from the carried interest arguably already reflects some tax burden, in contrast to other compensation arrangements. Although this argument is somewhat overstated, especially in the case of start-up companies that have not yet generated much taxable income, there does seem to be some validity to this critique due to the Levin proposal’s mandate to insure an effective 35% rate of taxation on all amounts received in connection with the managers’ performance of services. Note that the Levin proposal does not provide for a deduction to the portfolio company for the compensation reported by the
4. **Limited Reach of the § 7872 Approach: Principled Exemptions for Many Partnership Arrangements**

Under the Levin proposal's broad characterization of the entire carry as ordinary income, principled consistency would require the same application in all partnerships where a service partner's profit share exceeds her share of contributed capital. The Levin proposal avoids such a far-reaching application by limiting itself to specified "investment services partnerships." But this limitation has raised criticism that the proposal unfairly targets only specified industries. In favorable contrast, the § 7872 approach could provide for general application to all partnerships with divergent profit and capital shares, along with principled exemptions to minimize complexity concerns. This enhances our proposal's administrative ease without running afoul of the discriminatory critique. We consider below two situations that result in the exemption of certain partnerships—partnerships conducting an active trade or business, and investment partnerships

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78 If anything, our proposal could decrease the lock-in effect. With the imputation of the investment interest expense, a manager might have excess interest expense blocked by § 163(d). If so, the fund manager could recognize additional gains without paying any tax. In the other direction, our proposal would increase the tax rate on realized gains in the case of a soft preferred return. This, however, would be limited. See text accompanying notes 87-90.

79 See H.R. 2834, note 3, at § 1 (proposed § 710(a) providing new rule "[i]n the case of . . . an investment services partnership interest").

80 See, e.g., Senator Charles K. Schumer, Opening Statement, Senate Finance Committee Hearing on Carried Interest Partnerships (July 11, 2007), 2007 TNT 134-23 (July 12, 2007), available in LEXIS, Tax Analysts File (reporting Senator Schumer's critique of the Levin proposal on grounds that it unfairly targets only certain industries). As reported in front page articles in the New York Times and the Wall Street Journal in the past year, this situation is in need of a workable compromise. Raymond Hernandez & Stephen Labaton, In Opposing Tax Plan, Schumer Supports Wall Street over Party, N.Y. Times, July 30, 2007, at A11 (reporting that Senator Schumer agreed that the wealthiest should bear much of the burden of new tax increases but opposed to a tax increase limited to hedge funds and private equity firms leaving out industries such as energy and real estate); Sarah Lueck, Jesse Drucker & Brody Mullins, Congress Hunts for Tax Targets Among the Rich: Revenue Search Looks Beyond Private Equity: "The Tip of the Iceberg"?, Wall St. J., June 22, 2007, at A1 (reporting that Congress is reconsidering the tax advantages enjoyed by big wealth generators such as hedge funds, oil companies, and arcane investment vehicles); Jenny Anderson & Andrew R. Sorkin, Congress Weighs End to Tax Break for Hedge Funds, N.Y. Times, June 21, 2007, at A13 (reporting that the tax increase could include venture capital firms, real estate partnerships, and many oil and gas companies, in addition to hedge funds and private equity firms).

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that provide the passive investors with a preferred return on their invested capital before the fund manager receives a carried interest.

a. Exemption for Trade or Business Partnerships

Under the § 7872 approach, we would exempt any partnership engaged in an active "trade or business." There is no need to subject these partnerships to § 7872 because, if we did, the service partner would have matching amount(s) of compensation and interest expense not subject to the investment expense limitation above. The interest expense in this case would not be "investment interest," but would be properly characterized as trade or business interest expense (following the proceeds of the loan), which may be used to offset the imputed compensation income. Thus, the exemption for these partnerships is not arbitrary, but principled. Furthermore, the specific issue of concern with respect to carried interests—the partnership reporting its profits on a deferred basis at preferential rates—is not the case with partnerships engaged in an active trade or business. Generally, they report their business income on an annual basis and this income is taxed at ordinary rates.

b. Carried Interest with a Preferred Return

Some funds provide the investors a preferred return on their invested capital before the fund manager is allocated any carry, a possibility we have so far ignored. We now focus on these returns both to highlight how our proposal would operate in these situations, and to further demonstrate how our § 7872 approach minimizes complexity concerns.

Consider first the case of a "true" or "hard" preferred return: that is, the investors first receive a return on their invested capital, with all of their capital being returned with interest before the fund manager is allocated any of the carried interest.

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81 See IRC § 7872(i)(1)(c); Reg. § 1.7872-5T(b)(14), (c)(3) (providing an exemption for below-market loans without significant tax effect due to, inter alia, offsetting items of income and deduction). This exemption should address concerns that the § 7872 approach would require complicated calculations in a myriad of typical partnership scenarios. See Weisbach, note 4. The existing § 7872 exemption takes into account compliance costs. Reg. § 1.7872-5T(c)(3)(iii). Finally, the § 7872 approach could limit its application to situations where the divergent capital and profit sharing ratios are attributable to the performance of services. See IRC § 7872(c)(1)(B) (specifically covering compensation-related loans).

82 Arguably the compensation should still be imputed so that it is subjected to employment taxes like other earned income. The employment taxes are less significant than the character issue under the income tax, especially given the salary cap on the larger Social Security portion. See IRC §§ 3101(a), 3111(a) (imposing the 12.4% Social Security tax only upon the first $97,500); §§ 3101(b), 3111(b) (imposing the 2.9% Medicare tax on all earnings).

profits thereafter shared between the manager and the investors taking into account the carried interest.\textsuperscript{84} To illustrate, suppose on the basic facts that profits were to be allocated in the following manner: first, the investors would be allocated a cumulative 8\% return on their contributed capital, and thereafter, the profits would be allocated 20\% to the fund manager and 80\% to investors.\textsuperscript{85} Under the \$7872 approach we would treat this type of carried interest as being analogous to an interest-bearing loan from the investors to the fund manager. And so long as the preferred return rate matches or exceeds the interest rate required under \$7872, no compensation needs to be imputed. In fact, compensation imputation in this case would provide an undesirable inconsistent treatment between the analogous carried interest and actual (interest-bearing) loan.\textsuperscript{86}

The preferred return possibility should help to minimize any complexity concerns over the \$7872 approach for two reasons. First, the regime would exempt a large number of arrangements from its requirements. Second, the compensation imputations in the cases where the regime would apply (no preferred return) are very similar to the calculations that must be done for nontax purposes in the preferred return cases. As such, the industry accountants have familiarity with the calculations apart from the tax regime.

The so-called “soft preferred return”\textsuperscript{87} is an arrangement where the investors are first allocated a preferred return. Once this benchmark has been met, however, the manager is then allocated 100\% of the profits until the manager’s allocation is equal to its carry percentage of all profits (for example, 20\%). Thereafter, the manager would be entitled to its stated carry percentage. To illustrate, suppose in the basic facts, the investors were entitled to a soft preferred return of 8\% and

\textsuperscript{84} As discussed below, some arrangements provide the fund manager with a 100\% “catchup” after the initial preferred return.

\textsuperscript{85} The 80\% would be shared by the investors pro rata in accordance with contributed capital.

\textsuperscript{86} The management fee presumably would be higher in this case than it would be absent the preferred return. If so, there would be additional ordinary income reported by the manager. See Fleischer, note 8.

Also, there would be some potential inconsistency between an actual nonrecourse loan and the carried interest if the preferred return were satisfied out of long-term capital gains. Under the carried interest structure, the fund manager would not report anything to the extent of the preferred return. Under the actual loan form, however, the fund manager would report matching amounts of long-term capital gain income and “investment interest” expense. This could be beneficial to the manager if it has other ordinary investment income. Our proposal does not create this inconsistency, though, as it exists under current law. In addition, this inconsistency is quite narrow. We could achieve greater symmetry by requiring an imputation of interest expense along with a matching amount of partnership income to the fund manager. On balance, this probably is unnecessary given the limited scope.

\textsuperscript{87} See Fleischer, note 8, at 22.
that during its first year of operations the fund had profits of, in the alternative, $800,000 or $2 million. In the case where the fund had profits of only $800,000, all profits would be allocated to the investors—their soft return entitles them to a return of 8% of their invested capital, or $800,000, before the manager is entitled to any profits whatsoever. In the case where the fund has profits of $2 million, the first $800,000 would be allocated to the investors, the next $200,000 exclusively to the manager, and the remaining $1 million would be allocated $800,000 to the investors and $200,000 to the manager. Under our § 7872 approach the nontax results are the same as the hard preferred return if the fund does not earn enough to pay the catch-up amount. On the other hand, if the fund earns enough to pay the catch-up amount, the nontax results are the same as the initial example without any preferred return. In substance, the arrangement is akin to a conditional interest arrangement where interest is paid only if the fund does not make a profit in excess of the preferred return.

Based on our consistency analysis above, it might be preferable to follow the current law treatment of an actual loan with such economic terms. The current law treatment of such an actual loan is unclear, however. With such a clean slate, then, we recommend a wait-and-see approach that exempts the soft preferred return from the § 7872 approach unless and until the fund manager receives the catch-up allocation. At such time, any income allocated under the catch-up would be treated as ordinary compensation income. We take this

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88 From a nontax perspective, there might be a time value of money difference if the preferred return and catchup profits are earned at different times (unless the agreement compensates the manager for any such deferred catchup).

89 Proposed regulations under § 7872 reserved a place for contingent interest arrangements. Prop. Reg. § 1.7872-3(f). No guidance has been forthcoming since promulgation of the proposed regulations in the 1980's.

90 This might allow the fund manager some tax deferral compared to the original case without any preferred return. As highlighted in note 88, however, the tax deferral benefit from the soft preferred return might be offset by an economic cost (that is, a deferred payout without interest). In addition, the manager would have extra compensation income if the preferred return rate exceeded the § 7872 interest rate (or if the agreement compensated the manager for a deferred payout as suggested in note 88). In addition, presumably the management fee is somewhat higher here than in the original case without any preferred return at all, which generates some additional compensation income. Compare the discussion of a similar point with regard to the hard preferred return at note 86. Collectively, there should be enough rough justice here to avoid the complexity of imposing a back interest charge on the delayed compensation imputation. A related issue is whether the fund manager should have just a single compensation inclusion or instead should have the same three reporting categories as in the original case without the preferred return (for example, a compensation amount, a § 163(d) interest expense, and a share of partnership income). Consistency with the original case would require all three. On the other hand, providing just the compensation component would be simpler and would provide an additional offset to any deferral advantage compared to the base case.
approach for two reasons. From a substantive standpoint, the arrangement does provide the investors an interest return unless and until the catch-up provision is triggered. This approach also balances administrative concerns by exempting another category of transactions unless and until occurrence of the contingency.

V. CONCLUSION

The carried interest is best analyzed as an implicit loan from the investors to the fund manager in the amount of the invested capital subject to the carry. First, the manager receives the full economic return on that portion of the capital. Second, as suggested by other commentators, managers could avoid the harshness of the Levin proposal by restructuring the carry into an actual nonrecourse loan. Commentators highlight this point since it would improve the managers' tax results without materially altering the underlying economics.91 From this perspective, the Levin proposal goes too far by targeting the full carried interest profits, rather than just any forgone interest. A more limited interest approach not only makes sound economic sense, it comports with the current treatment of an explicit loan under existing § 7872. Similarly, current law misses the mark in the other direction by taxing the carry more lightly than an explicit loan. The § 7872 approach avoids both problems.

In the case of an actual loan, § 7872 treats the recipient of an interest-free loan as if it actually received cash equal to the forgone interest and then used such cash to pay the interest on the loan. Thus, if the loan analogy were consistently applied to the carried interest, the manager should have an interest expense allowance in addition to the compensation income.

By denying an interest expense, the interest charge approach suffers from one of the key defects of the Levin proposal: it results in harsher taxation of the carry than the equivalent actual loan. In addition, the manager is taxed twice on the forgone interest: once as compensation, and a second time as a realized carry profit. In order to correct these shortcomings, our § 7872 approach provides the interest expense allowance in addition to the compensation. Importantly, we do so in full recognition of the existing provision that permits “investment interest” expense to be deducted only against “investment income.” By blocking the use of the interest expense against the carry’s compensation element, this limitation under § 163(d) insures taxation of the compensation at the higher ordinary rates.

The § 7872 approach also contains significant secondary benefits over the Levin proposal. First, allowing an interest expense provides principled grounds for exempting a substantial number of partnership arrangements. Our proposal's limited scope also enhances its administrative appeal, and does so without resort to arbitrary exemptions as under the Levin proposal. Separately, the Levin proposal increases the lock-in effect over what it is under current law by increasing the tax rate on the managers' realized carry profits. Our proposal avoids this increased lock-in result by maintaining the current tax rate on the realized carry profits.

In sum, some response to the carried interest controversy is appropriate given current law's shortcomings and the intense public scrutiny. But despite some initial appeal, the Levin proposal exceeds this mandate by targeting the entire carry profit. We advocate instead our § 7872 approach as a more moderate, better reasoned, and more consistent response to the carried interest problem.