Executive Summary

"The Taxation of Carried Interests In Private Equity Partnerships" July 2007*
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Holders of carried interests in private equity partnerships (as well as all other partnerships) are taxed on their share of partnership income. If the partnership has long-term capital gain, holders of carried interests are taxed on their shares of the long-term capital gain. Some have raised the argument that this "pass-through" treatment of capital gains income from carried interests creates an anomaly because the sponsors of private equity funds perform services for the partnership, and most service income is taxed as ordinary income. They have, therefore, proposed taxing income from carried interests in private equity partnerships as ordinary income.

These proposals are not consistent with basic principles of the tax law, including how capital gains are defined and how partnerships are taxed. They are misplaced for two reasons.

First, the labor involved in private equity investments is the same type of labor intrinsic to any investment or entrepreneurial activity. Private equity sponsors select the investments, arrange the financing, exercise control rights inherent in ownership of the portfolio companies, and eventually decide when to dispose of the assets. If the performance of these tasks were sufficient to deprive sponsors of capital gains treatment, capital gains treatment would not be available to any investor. For example, purchasing stock through a margin account involves combining capital, some portion of which is provided by third parties, and labor effort to make an investment. Even though much of the value may be created by the efforts of the investor to identify good stocks or other investments, the investor gets capital gains treatment. Similarly, entrepreneurs who use their ideas and efforts to form a company, are taxed at capital gains rates when they sell the company. For example, a founder of a company may contribute ideas and labor to create value and gets capital gains treatment when he sells the stock.

Private equity activity is very much like a combination of investment and entrepreneurship: it combines skill and effort to choose investments, restructure the company, and create value. The only difference is that private equity funds use limited partnership interests instead of debt to finance their activities. It is not a good idea, however, to change the treatment of private equity funds based on how they finance their activities or because they use a partnership. The long history of partnership tax rules shows that taxing partners differently than they would be taxed if they engaged in partnership activity directly is not wise.

Second, even if there were good reasons for changing the tax treatment of carried interests, the change would be complex and avoidable, imposing costs on all involved without raising any significant revenue. Any rule treating payments on carried interests as service income would require taxpayers and the government to accurately separate labor and capital income, a task which has proven difficult in other contexts. Any such rules would impose enormous complexity on the system. Moreover, because any rules would depend entirely on the use of a partnership structure instead of debt financing, they would be easily avoidable. The result would be less efficient economic structures and little or no change in tax revenues.

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