Solving the Carried Interest Puzzle



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Abstract

Carried interest is a proportion of the investment return that private equity fund partnerships allocate to the fund's manager. In the United States and the United Kingdom, carried interest is treated as a capital gain for tax purposes. Many view treating carried interest as a capital gain as unfair, arguing that carried interest (or at least some portion thereof) should instead be treated as earnings from employment. Others vigorously defend the status quo. Both sides of the debate have put forward flawed arguments that obscure a satisfying solution to the carried interest puzzle.

The tax treatment of capital gains is advantageous in two key respects: reduced tax rates and deferred timing of taxation. A number of justifications have been put forward for offering these two tax preferences to capital gains. This paper examines the extent to which these justifications also apply to carried interest. The applicability of these reasons to carried interest would strengthen the argument to maintain the status quo of taxing carried interest as a capital gain. Conversely, the status quo is not defensible if these reasons fail to apply.

The analysis of this paper suggests that taxing carried interest at preferential rates is not supported by the reasons for taxing capital gains at preferential rates. However, taxing carried interest under the realisation principle is defensible, supported by the same valuation concerns that justify taxing capital gains upon realisation. As a result, two proposals to change the tax treatment of carried interest stand out as sensible solutions to the carried interest puzzle. The first is to tax carried interest as ordinary income upon realisation. The second, the cost-of-capital approach, puts the fund manager in the position of financial capital supplier and, therefore, a legitimate recipient of preferential capital gains treatment.

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BO . . . . . Buyout.

BVCA . . . . . British Venture Capital Association.

GP . . . . . General partner.

HMRC . . . . Her Majesty's Revenue and Customs (UK).

ITEPA . . . . Income Tax (Earnings and Pensions) Act 2003 (UK).

IRC . . . . . Title 26 of the United States Code, the Internal Revenue Code of 1986.

LP . . . . . Limited partner.

LPA . . . . . Limited Partnerships Act 1907 (UK).

PE . . . . . Private equity.

TCGA . . . . . Taxation of Chargeable Gains Act 1992 (UK).

VC . . . . . Venture capital.

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H.R.4213 - 111th Congress (2009-2010): Tax Extenders Act of 2009 / American Workers, State, and Business Relief Act of 2010 2

H.R.4016 - 112th Congress (2011-2012): Carried Interest Fairness Act of 2012 2

S.268 - 113th Congress (2013-2014): Cut Unjustified Tax Loopholes Act 2

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1 Introduction

Carried interest is a proportion of the investment return that private equity (PE) fund partnerships allocate to the fund's general partner (GP). GPs actively manage the fund's investments but generally do not commit more than a nominal amount of investment capital to the fund. By contrast, the fund's limited partners (LPs) are passive investors who contribute the fund's investment capital.

An increase in the value of a fund's capital is generally characterised as a capital gain for tax purposes in the United States and the United Kingdom.[1] In both countries, capital gains are taxed on a preferential basis compared to other elements of the tax base.[2] Moreover, the initial characterisation as a capital gain is maintained when the right to a proportion of fund appreciation is shifted between members of a partnership. In other words, the partnership structure allows a portion of the capital gain to be reallocated from LPs to a GP without losing its character as a capital gain for tax purposes. Consequently, preferential tax treatment afforded to capital gains generally applies to carried interest in the hands of the GP.

In the United States, the taxation of carried interest has attracted pronounced attention in recent years. Though lawmakers in every congressional session since 2007 have tried, none have succeeded in fundamentally changing how carried interest

[1] See section 2 for background.

[2] Tax preferences exist along two dimensions: rates (e.g., lower tax rates vis-à-vis labour income) and timing (e.g., taxation is deferred until a realisation event rather than upon accrual).

is taxed.[3] In 2017, the Trump administration increased the holding period required for carried interest to qualify for preferential long-term capital gains rates.[4] However, this change is largely superficial.[5] The Biden administration has proposed taxing carried interest as ordinary income, but this measure does not feature in the Build Back Better Act recently introduced in Congress.[6] Despite the persistence of the status quo, it seems unlikely that the tax treatment of carried interest will disappear from the political agenda any time soon.

The ongoing political saga accompanies an extensive debate within academic and policy circles. Many view the status quo (treating carried interest as a capital gain) as unfair, arguing that carried interest (or at least some portion thereof) should instead be treated as earnings from employment.[7] Others vigorously defend the status quo.[8] Both sides of the debate have put forward flawed arguments that obscure a satisfying solution.

This paper asks whether the status quo is defensible tax policy. In particular, this paper examines the reasons motivating the preferential tax treatment of capital gains and asks whether carried interest aligns with those reasons. The applicability of these reasons to carried interest would strengthen the argument to maintain

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3 H.R.2785, H.R.2834/S.1624, H.R.3970, H.R.3996, H.R.6275, 110th Congress; H.R.1935, H.R.4213, 111th Congress; H.R.4016, 112th Congress; S.268, H.R.1, 113th Congress; H.R.2889/S.1686, 114th Congress; H.R.2295, 115th Congress; H.R. 1735/S.781, S.1639, 116th Congress; H.R.1068/S.1598, S.2617, 117th Congress.

4 IRC §1061. In short, assets must be held for at least three years in order for the associated carried interest to be taxed at preferential long-term capital gains rates. Ordinarily, assets must be held for only one year in order for the capital gain to be taxed as a long-term capital gain.

5 PE fund investments typically mature over more than three years (the new holding period) anyway. Adam H Rosenzweig, "Not All Carried Interests Are Created Equal" (2009) 29(3) Northwestern Journal of International Law and Business 713, 733; Andrew Metrick and Ayako Yasuda, "The Economics of Private Equity Funds" (2010) 23(6) Review of Financial Studies 2303, 2318. See also Victor Fleischer, "Why Hedge Funds Don't Worry About Carried Interest Tax Rules" (The New York Times, 14 May 2014); James B Stewart, "A Tax Loophole for the Rich That Just Won't Die" (The New York Times, 10 November 2017).

6 The White House, Office of the Press Secretary, American Families Plan (28 April 2021); Office of Management and Budget, Budget of the U.S. Government - Fiscal Year 2022 (US Government Publishing Office 2021); H.R.5376 (117th Congress).

7 The seminal article that advances this position is Victor Fleischer, "Two and Twenty: Taxing Partnership Profits in Private Equity Funds" (2008) 83(1) New York University Law Review 1. See also Rosenzweig (n 5), 721-734.

8 E.g., Alan D Viard, "The Taxation of Carried Interest: Understanding the Issues" (2008) 61(3) National Tax Journal 445; David A Weisbach, "The Taxation of Carried Interests in Private Equity" (2008) 94(3) Virginia Law Review 715.

the status quo of taxing carried interest as a capital gain. Conversely, the status quo is not defensible if these reasons fail to apply. Such an approach has largely been overlooked in previous literature.

> In some sense, the "true culprit" behind the carried interest problem is the preferential long-term capital gains rate. Without such a preferential rate, there would be no difference between taxing the GP as a partner and taxing the GP as an employee, preempting the entire debate. Many have questioned the rationale behind a differential capital gains rate, but the preference is so well established as to be taken for granted here.[9]

Professor David Weisbach outright dismisses the possibility that examining the reasoning behind general capital gains tax preferences in the carried interest context would bear fruit:

> An alternative way to try to use the definition of capital gains is to argue that none of the reasons for a capital gains preference apply to carried interests. This, however, cannot convince anyone. Those who believe in the reasons for a broad-based capital gains preference will also believe that it should apply to private equity activity.[10]

Certainly we might expect that those believing carried interest merits tax preferences would look to lower rates and deferral as policy solutions—both of which the tax treatment of capital gains offers. Since capital gains tax preferences uncontroversially apply to the returns of LPs of PE funds, it is perhaps an instinctive policy choice to tax carried interest as a capital gain.[11] However, this does not imply that carried interest satisfies the arguments for the preferential tax treatment of capital gains.

We are missing an important piece of the puzzle by ignoring whether the justifications for capital gains tax preferences apply to carried interest. Indeed, the analysis of this paper suggests that taxing carried interest at preferential rates is not supported by the reasons for taxing capital gains at preferential rates. However,

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9 Harvard Law Review (Unsigned Note), "Taxing Partnership Profits Interests: The Carried Interest Problem" (2011) 124(7) Harvard Law Review 1773, 1780.

10 Weisbach (n 8), 744.

11 It is difficult to argue that capital gains tax treatment for the investment returns of the LPs as passive investors is inappropriate. As will be seen in section 5, nearly all policy proposals that have been put forward to change the status quo would leave the tax treatment applicable to the LPs partnership interest intact.

taxing carried interest under the realisation principle is defensible, supported by the same valuation concerns that justify taxing capital gains upon realisation. As a result, two proposals to change the tax treatment of carried interest stand out as sensible solutions to the carried interest puzzle.[12]

The rest of this paper is organised as follows. Section 2 provides essential information on the PE industry and carried interest to support the discussion in subsequent sections. Section 3 focuses on whether the rationales for taxing capital gains at lower rates than ordinary income apply to carried interest. Similarly, section 4 asks to what extent the grounds for taxing capital gains upon realisation apply to carried interest. With the rationales for the preferential tax treatment of capital gains assessed, Section 5 evaluates various policy solutions for carried interest that have been proposed in the literature. Section 6 concludes.

[12] These two policy solutions are (1) taxing carried interest as ordinary income upon realisation and (2) the cost-of-capital approach, which would require ordinary income taxation of forgone interest payments on a presumed loan from LPs to GPs. See section 5.

2 Background

2.1 Private Equity Funds

2.1.1 The Players

PE funds are collective investment vehicles that purchase ownership interests in privately held companies. PE funds are typically structured as limited partnerships.[13] Such partnerships are comprised of two types of partners: LPs and GPs.[14]

LPs are commonly non-taxable institutional investors (e.g., pension funds), but may also be high-net-worth individuals.[15] LPs provide nearly all of the fund's financial capital.[16] Specifically, LPs commit a certain amount of capital which the GP calls as needed while the fund makes its investments. The 'limited' status of LPs refers to the notion that they carry limited liability for a partnership's

[13] Metrick and Yasuda (n 5), 2304.

[14] E.g., 6 Del C. §17-101 (Delaware); LPA §4(2) (England).

[15] Metrick and Yasuda (n 5), 2304; Weisbach (n 8), 722; Paul Gompers and Josh Lerner, *The Venture Capital Cycle* (2nd edn, MIT Press 2004), 7; Chris William Sanchirico, "The Tax Advantage to Paying Private Equity Fund Managers with Profit Shares: What Is It? Why Is It Bad?" (2008) 75(3) University of Chicago Law Review 1071, 1124.

[16] GPs typically contribute only a very small proportion (e.g., one per cent) of the fund's capital. Victor Fleischer, "The Missing Preferred Return" (2005) 31(1) Journal of Corporation Law 77, 82; Fleischer (n 7), 9; Gompers and Lerner (n 15), 463. In the UK, the LPs structure the vast majority of their commitments as loans so that the GPs have 20 per cent of the fund's equity capital (even though it still a small notional amount). See HMRC, "Memorandum of Understanding Between the BVCA and HMRC on the Income Tax Treatment of Venture Capital and Private Equity Limited Partnerships and Carried Interest" in *Employment Related Securities Manual (ERSM30530)* (25 April 2022) §7.2.

debts and obligations (capped at the level of their investment in the partnership).[17] For LPs to maintain limited liability status, they are generally not permitted to be involved in the partnership's business.[18]

The GP of a given fund, on the other hand, carries unlimited liability for the partnership's debts and obligations.[19] The GP manages the partnership and determines the investment strategy of the fund.[20] The GP is itself often structured as a partnership, comprised of individual professionals affiliated with the sponsor PE firm as partners.[21] The sponsor PE firm is a company that specialises in creating and managing PE funds (including raising capital and identifying investment opportunities), and utilises its business development expertise to improve the performance of portfolio companies.[22]

2.1.2 The Game

A PE fund has a finite lifetime (generally ten years) established by the partnership agreement at the outset of the fund.[23] The fund invests in several portfolio companies during the early years of its life. A fund's objective is to earn a return on these investments by developing the portfolio companies to an exit stage where a sale or public offering occurs. The PE fund liquidates after all its investments have been exited.

PE funds vary in terms of investment strategy. The two main types of PE funds are venture capital (VC) funds and buyout (BO) funds.[24] VC funds invest in

17 E.g., 6 Del C. §17-303(a) and §17-607 (Delaware); LPA §§4(2)-(3A) (England).

18 E.g., 6 Del C. §17-303 (Delaware); LPA §§6(1)-(1A) (England).

19 I.e., the GP's own assets are exposed to satisfy the debts and obligations of the partnership. See, e.g., 6 Del C. §15-306 and §17-403(b) (Delaware); LPA §4(2) (England).

20 The GP of a fund is alternatively referred to as the 'service partner'. Harvard Law Review (Unsigned Note) (n 9), 1777.

21 Fleischer (n 7), 9; Viard (n 8), 446; Sanchirico (n 15), 1083.

22 "[GPs provide] a variety of services that are intended to increase the value of the portfolio company. They may decide on and carry out mergers, take a seat on the board of directors, change the company's financial structure and the compensation structure of its managers, and decide on lines of business to enter or exit." Viard (n 8), 446. See also Weisbach (n 8), 721. Examples of PE firms include The Blackstone Group, Kleiner Perkins, and Apax Partners.

23 Metrick and Yasuda (n 5), 2309; Viard (n 8), 446; Fleischer (n 16), 85; Gompers and Lerner (n 15), 378.

24 Metrick and Yasuda (n 5), 2303-2304. Other PE investment types include mezzanine funds and real estate funds. Andrew Metrick and Ayako Yasuda, "Venture Capital and Other

start-up and early-stage companies to grow the business. By contrast, BO funds obtain majority control of mature firms to increase their value by adjusting the business strategy and improving the efficiency of operations.

2.2 Carried Interest

A profitable exit delivers the main form of investment return to a PE fund: a gain realised on the sale of the portfolio company's shares.[25] If that was all to the story, the entire profit from an exit would be received by the LPs as a capital gain. However, to align the incentive of GPs with the return-maximising objective of LPs, GPs are allocated a proportion of the partnership's profits (i.e., investment returns above a return of capital).[26] This allocation is carried interest.[27] The proportion, or carry level, is typically 20 per cent of profits.[28] In addition to the carry level, there are three core concepts to understand the use of carried interest in practice: the carry basis, hurdle rates, and clawback provisions.[29]

First, the carry basis—the reference value by which to measure the fund's profits—is either 'committed capital' or 'investment capital'.[30] Committed capital equals investment capital (capital available for portfolio company investment) plus management fees paid to the GP (or a GP affiliate).[31] The vast majority of PE

Private Equity: a Survey: Venture Capital and Other Private Equity" (2011) 17(4) European Financial Management 619, 622; Fleischer (n 16), 90.

25 Some PE funds also receive dividends from relatively mature portfolio companies while held. In fact, dividend recapitalisations (portfolio companies taking on debt in order to distribute dividends) are becoming popular in recent years. Matthew Goldstein, "Private Equity Firms Return to Piling On Debt to Pay Dividends" (The New York Times, 20 February 2021).

26 Metrick and Yasuda (n 5), 2312-2313; Fleischer (n 7), 8; Viard (n 8), 453; Weisbach (n 8), 725; Gompers and Lerner (n 15), 24.

27 Alternatively referred to as the GP's 'carry', 'promote', or 'profits interest'.

28 In a study of 238 PE funds raised between 1993 and 2006, 95 per cent of VC funds and all BO funds had a 20-per-cent carry level. Metrick and Yasuda (n 5).

29 ibid, 2310.

30 ibid, 2309, 2312.

31 ibid, 2309-2312. The management fee is usually two per cent of the fund's committed capital annually (although this percentage may decrease after the initial investment period). Since the amount of investment capital is smaller than the amount of committed capital, using the former as the carry basis increases the amount of the return against which the carry level is applied.

funds use committed capital as the carry basis.[32]

Second, PE funds frequently stipulate that a carried interest may only arise to the GP after the LPs receive a return of their investment capital plus a certain hurdle rate (or preferred/priority return).[33] Hurdle rates are far more common in BO funds than in VC funds.[34]

Finally, a clawback provision is usually imposed if a fund permits the GP to receive distributions of carried interest over the fund's life as investments are exited.[35] A clawback requires the GP to return carried interest if sufficient profits fail to materialise on investments that are exited later than others. This mechanism is intended to ensure that carried interest is ultimately determined based on the fund's overall performance rather than on the performance of individual portfolio companies.

2.3 The Tax Treatment of Carried Interest

Partnerships are generally flow-through entities for tax purposes. As a result, PE funds structured as limited partnerships allow profits realised at the partnership level to be passed through and taxed in the hands of the partners according to their original character. As a result, capital gains arising at the partnership level are taxed as capital gains in the hands of the partners.[36]

[32] E.g., Metrick and Yasuda find 94 per cent of VC funds and 83 per cent of BO funds use a carry basis of committed capital, with the remainder using investment capital. Metrick and Yasuda (n 5).

[33] That said, most funds have a catch-up provision that allows the GP to receive a greater proportion (e.g., 100 per cent) of profits above the hurdle return. The catch-up provision applies until the GP attains a level of carried interest commensurate with the amount that would have been obtained on the fund's overall profits but for the hurdle rate, with the standard 20 per cent applying thereafter. ibid, 2312.

[34] E.g., Metrick and Yasuda find a hurdle rate was present in about 92 per cent of BO funds compared with 45 per cent of VC funds. A large majority of these funds set a hurdle rate of eight per cent. ibid. This is consistent with the observations of Fleischer (n 16), 86.

[35] Metrick and Yasuda (n 5), 2313; Weisbach (n 8), 723; Wonho Wilson Choi and others, "A Model of Private Equity Fund Compensation" in Franklin Allen and others (eds), *The Global Macro Economy and Finance* (Palgrave Macmillan 2012), 276.

[36] In the U.S., partnership income is determined at the partnership level and maintains its partnership-level character (e.g., as a capital gain) when allocated to partners in accordance with the terms of the partnership agreement. IRC §702(b) and §704(a) (US). Prior to July 8, 2015, UK partnership tax law worked in the same way. Today, separate provisions operate that can in certain circumstances mean that the timing of carried interest differs from the

Consequently, carried interest benefits from two advantages provided to capital gains. First, capital gains are taxed at reduced rates vis-à-vis ordinary income.[37] Second, partners in PE funds are generally taxed on their share of the profits only when a partnership-level realisation event (e.g., sale of shares of a portfolio company) occurs.[38] Offering reduced rates and deferral preferences to carried interest is argued to violate horizontal equity and neutrality considerations.[39] Furthermore, vertical equity concerns are raised, given that GPs would generally consist of earners of especially high incomes.[40]

disposition of an asset by the partnership. Moreover, the gain is generally set to the amount distributed, without regard to the amount of the partnership's gain or loss. Damien Crossley and Mark Baldwin, "Carried Interest Rules" in *Taxation of Partnerships and LLPs* (Sweet & Maxwell 2021) (particularly, 569-571); §59 and §103KA, TCGA (UK); §§809EZB-EZD, Income Tax Act 2007 (UK).

[37] In the United States, preferential rates apply to 'long-term' capital gains–those arising from assets held for at least one year. IRC §§1(a)-(d) and (h) (US). TCGA §1H(2) and §1I, Finance Act 2022 §2 (UK).

[38] IRC §702(a) (US); §59 TCGA (UK). See note 36. Alternatively, the partnership may distribute portfolio company shares to partners in lieu of selling them and distributing the proceeds. In the US, this could permit tax deferral until the partner disposes of the distributed shares. Gompers and Lerner 461-464; IRC §731(c)(3) and §732 (US). In the UK, carried interest arises (and is therefore subject to capital gains tax) whether or not the partnership makes a disposition. §809EZC, Income Tax Act 2007; §103KA TCGA (UK). See also Crossley and Baldwin (n 36), 571.

[39] Fleischer (n 7), 4-5; Weisbach (n 8), 740-741; Harvard Law Review (Unsigned Note) (n 9), 1779-1780.

[40] Fleischer (n 7), 5.

3

Preferential Taxation of Capital Gains: Lower Rates

Following the classic Haig-Simons approach to defining comprehensive income for tax purposes, a capital gain would be treated no differently than, say, labour income.[41] However, there is considerable debate over whether capital gains should be taxed at lower rates vis-à-vis other income.[42] Indeed, some have even argued that capital gains should be exempt from taxation altogether.[43] This paper does not intend to wade into this debate. Instead, the objective here is to assess whether carried interest should benefit from the reduced taxation of capital gains by asking whether the reasons that support this tax preference also apply to carried interest.

There are six main reasons for lower capital gains tax rates.[44] These are (1) increasing savings and investment, (2) improving the allocation of capital, (3) integrating corporate and shareholder taxation, (4) increasing entrepreneurship and

41 Noel B Cunningham and Deborah H Schenk, "The Case for a Capital Gains Preference" (1993) 48(3) Tax Law Review 319, 322-325.

42 ibid; George R Zodrow, "Economic Analyses of Capital Gains Taxation: Realizations, Revenues, Efficiency and Equity" (1993) 48(3) Tax Law Review 419; Jane Gravelle, "Capital Gains Taxes" in *The Economic Effects of Taxing Capital Income* (MIT Press 1994); Leonard Burman, *The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed* (Brookings Institution Press 1999).

43 E.g., see Cunningham and Schenk (n 41), 325-327.

44 ibid, 328-380; Zodrow (n 42), 464-484.

innovation, (5) mitigating the impact of inflation, and (6) mitigating the lock-in effect and bunching. Each of these reasons is discussed in turn below.

3.1 Savings and Investment

The first argument for reduced taxation of capital gains is that it increases savings, and therefore productive investment and economic growth.[45] To understand this argument, we begin by describing the market for financial capital using the basic economic concepts of supply and demand. On the supply side of the market, savers offer financial capital to earn a return on their savings. On the demand side of the market, businesses pay to use financial capital to undertake investments. The rate of return required by savers is the cost of capital for the business.[46] For returns that take the form of a capital gain, capital gains taxation drives a wedge between the return that savers receive and the price that businesses pay. As a result, these economic agents' savings and investment decisions will generally be distorted, reducing welfare.

The extent to which savings and investment are affected depends on the incidence of the tax.[47] In principle, if savers bore the entirety of the tax, the cost of capital for businesses would not change, but the overall amount of financial capital supplied would decrease (i.e., savers would respond to a lower effective rate of return from saving by providing less financial capital in the market). As a result, fewer investment projects could be undertaken. By contrast, if businesses bore the entirety of the tax[48], they would need to offer a higher return to savers in order to offset the tax. This means that some investment projects that would have been viable absent taxation will be forgone. Overall, productive investment would fall whether the tax is borne by supply or demand (or some combination of the two). It is therefore argued that reducing capital gains taxes should lessen the negative effect on investment.

[45] Cunningham and Schenk (n 41), 377-380; Zodrow (n 42), 470-471; Burman (n 42), 52-54.

[46] Gompers and Lerner (n 15), 34-35. See also Alan J Auerbach, "Taxation and Corporate Financial Policy" in *Handbook of Public Economics* (Elsevier 2002) vol 3.

[47] Don Fullerton and Gilbert E Metcalf, "Tax Incidence" in *Handbook of Public Economics* (Elsevier 2002) vol 4.

[48] I.e., savers require the same after-tax return regardless of the tax rate.

It is easy to see how the preceding discussion could apply to the relationship between LPs and portfolio companies in the case of VC funds, with LPs representing financial capital supply and portfolio companies representing financial capital demand.[49] Moreover, capital gains are the standard form of return arising when the fund exits an investment (a sale or disposition of the portfolio company).[50] If lower capital gains tax rates are motivated by savings and investment concerns, it would be hard to argue that the capital gains of LPs are undeserving of this preference (even though it is ultimately irrelevant to LPs that are non-taxable institutional investors[51]).

The role of GPs within this model is less obvious. On the one hand, the GP can be viewed as an extension of supply. The GP is responsible for raising and pooling funds, investment sourcing, selection, monitoring, and divestment, and performing administrative functions of the fund (e.g., reporting to LPs).[52] On the other hand, the GP can just as readily be viewed as an extension of demand, given its role in advising and developing portfolio companies. However, whether a GP performs functions associated with either supply or demand is ultimately not important for locating the GP in this framework.

GPs are best viewed as financial intermediaries that are neither on the supply nor the demand side of the market for financial capital.[53] Apart from token amounts, GPs do not offer up their own savings to earn a return and therefore cannot reasonably be viewed as a supplier of financial capital. Likewise, GPs are not the end-users of financial capital—those who need it to undertake some business enterprise—and so cannot represent demand. Since GPs represent neither supply nor demand for financial capital, it is not sensible to suggest that the savings and investment rationale could justify the taxation of carried interest as a capital gain.

[49] By contrast, the savings and investment rationale is not relevant in most BO fund cases where new financial capital is not sought.
[50] Fleischer (n 7), 15.
[51] See subsection 2.1.1.
[52] Some of these functions may be performed by the fund sponsor or a management company affiliated with the GP.
[53] Metrick and Yasuda (n 24), 621.

One might counter by arguing that the activities of the GP support the overarching savings and investment objective of a capital gains tax preference by easing market frictions. In particular, financial intermediaries increase savings and investment activity by reducing information, enforcement, and transaction costs.[54]

There are a number of problems with this argument. First, to argue that financial intermediation activities warrant reduced taxation is akin to arguing that cost-reducing behaviour—i.e., profit-seeking behaviour—should bear less tax. Ultimately, this argument runs counter to any revenue-raising or redistributional purposes of an income tax. Second, easing market frictions is different than easing the distortionary effects of taxation. Unlike taxes, market frictions only impede the realisation of welfare gains rather than erase welfare entirely (deadweight losses). Since welfare is still in principle attainable, there are likely better alternatives (e.g., advancements in technology) to offset market frictions directly. Third, it is difficult to suggest that tax relief for financial intermediaries should only be available to those structured as partnerships. Finally, the same sort of financial market frictions would conceivably arise even in countries without a capital gains tax, so it is hard to see how lower capital gains tax rates in countries with a capital gains tax form a reasonable policy solution.

A second means of approaching this argument is to suggest that income from the performance of financial intermediation services by the GP should be taxed at a lower rate, presuming such taxes are passed along to LPs as costs of accessing financial intermediation services.[55] The counterpoints above remain relevant. It is questionable whether taxes should distort business activity in favour of financial services (and only those services offered through partnerships) relative to the provision of other goods and services.

In either case, it would seem quite a stretch to suggest that the savings and investment rationale for reduced capital gains tax rates is intended to extend beyond

[54] Ross Levine, "Finance and Growth: Theory and Evidence" in *Handbook of Economic Growth* (Elsevier 2005) vol 1A.

[55] Whether the GP can pass along taxes is a question of incidence in the market for financial services.

the financial capital market to the financial services market. There is little reason to think capital gains tax preferences are an appropriately targeted policy instrument to effect a tax reduction for financial intermediation.[56]

3.2 Capital Allocation

Certain assets, including shares of businesses in capital-intensive industries (e.g., manufacturing, natural resources, real estate) and start-up companies, are likely to offer returns in the form of capital gains.[57] Consequently, another rationale favouring preferential capital gains taxation emerges: to encourage the supply of financial capital to these enterprises over others. One predominant strain of this rationale is that investors should be encouraged to provide financial capital to riskier ventures.[58] In this context, lower capital gains tax rates are ultimately intended to foster innovation and generate economic growth.[59]

The capital allocation rationale is focused on the supply (saver) side of the market for financial capital. Unlike the savings and investment rationale outlined above, however, this rationale is not concerned with whether the overall supply of financial capital increases. Instead, this rationale relates to whether financial capital is channelled to its most productive use. As a result, the effect on the *relative* rate of return amongst various savings alternatives becomes important. The effect on the relative rate of return will depend not only on the incidence of capital taxation but also on the extent to which capital gains are taxed more lightly than other returns to capital (e.g., interest, dividends).

First, should we expect lower tax rates on capital gains to improve the allocation of LPs capital? There are good reasons to be sceptical. It is unlikely LPs bear the brunt of the capital gains tax due to the availability of substitute savings

[56] As noted, it begs the question of why only certain costs of financial intermediation (i.e., carried interest, but not management fees–see note 31) of partnerships should be preferentially taxed.
[57] Zodrow (n 42), 468.
[58] Burman (n 42), 67-69
[59] See Zodrow (n 42), 477-478.

opportunities.[60] Moreover, lower capital gains rates make no difference to the non-taxable investors that represent a significant source of PE financial capital.[61] For such investors, the returns to capital, whether interest, dividends, or capital gains, are treated neutrally (i.e., face the same tax rate of zero). If the capital allocation rationale can be questioned even in the case of the LPs as capital suppliers, that does not bode well for reasoning that the GP's profits interest should be treated the same way.

Even so, it has been argued that taxing the carried interest of GPs at capital gains rates promotes risk-taking and innovation.[62] Since the GP is not a supplier of financial capital, one is forced to argue that lower capital gains rates indirectly improve the allocation of LPs capital by reducing financial intermediation costs.[63] This may be superficially compelling, as information problems requiring intermediation are perhaps more prevalent in the PE context than for other asset classes.[64] Yet, consistent with the discussion above, it is unclear why alleviating information costs would give rise to a capital gain over other forms of return. It seems unlikely that the capital allocation rationale supports the taxation of carried interest as a capital gain on this basis alone.

3.3 Integration of Corporate and Shareholder Taxes

A third argument for taxing capital gains lightly is to alleviate the double taxation of business income earned within a corporation. Generally, income earned by a corporation is taxed once at the corporate level and again as a dividend (if distributed) or a capital gain (if retained and the share sold) in the hands of the

60 I.e., the incidence of the tax is not likely to fall on savers because they are better positioned to respond (more elastic). E.g., see Gompers and Lerner (n 15), 34-35. One potential explanation for this is the international mobility of financial capital.

61 See subsection 2.1.1.

62 E.g., Diana Furchtgott-Roth, "Skewing the Playing Field for Investment Partnerships" (2010) 127 Tax Notes 1291, 1292.

63 The burden of the tax would need to be passed to the LPs as the consumer of financial services. See note 55.

64 Gompers and Lerner (n 15), 24.

shareholder. As a result, income earned by a corporation is taxed more heavily than if it was earned by the shareholder directly. Two types of distortions arise from this double taxation: debt is favoured over equity and the unincorporated sector is favoured over the incorporated sector.[65] The debt-equity distortion occurs because interest payments on debt financing are deductible to the corporation (i.e., not subject to the corporate income tax), while equity financing is non-deductible.[66] The business form distortion occurs because the corporate income tax only applies to corporations. The integration rationale for capital gains preferences ultimately hopes to mitigate these distortions of the corporate income tax by ensuring that income is taxed to the same degree whether or not it is earned by a corporation.

In one sense, the integration argument can be viewed as a manifestation of the capital allocation rationale.[67] That is, to the extent the return to corporate equity is reduced by the corporate income tax[68], LPs might be encouraged to shift capital to other savings instruments (corporate debt, unincorporated businesses). However, the same argument cannot be made in respect of GPs, as they are not suppliers of financial capital. One could instead argue that the corporate tax increases the costs of the GP's financial intermediation services that are passed along to the LPs.[69] As discussed, it is difficult to claim that reducing financial intermediation costs for partnerships is an intentional or coherent objective of capital gains tax preferences.

A few other observations make the corporate integration argument less compelling in the PE context. First, the debt-equity distortion of the corporate income tax, rather than being purely welfare-reducing by incentivising companies to take on more debt than they otherwise would, can in fact be integral to the investment

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65 Cunningham and Schenk (n 41), 331-337; Burman (n 42), 76; Gravelle (n 42), 142; Zodrow (n 42), 481-484.

66 IRC §163 (US), Corporation Tax Act 2009 §297 (UK).

67 While the capital allocation argument presented earlier focuses on distortions that depend on the extent to which an asset's returns take the form of a capital gain, the integration argument focuses on the distortions of incorporation more generally. The relationship to the capital allocation argument is easy to see, as incorporation results in the returns to a business taking the form of a capital gain on shares (via retained earnings). See Gravelle (n 42), 126.

68 I.e., the return on portfolio company investments.

69 Viard presents an argument in this vein, suggesting the corporate income tax substitutes for an implicit payroll tax for the GPs. However, the incidence implications of taxing the GP are not discussed. Viard (n 8), 454-456. See also notes 55 and 63.

strategy of a fund. In particular, PE is often a pathway for leveraged recapitalisations (i.e., *increased* debt) in the case of BO funds.[70] Second, in the case of VC, debt is often unavailable for risk and uncertainty reasons (especially if the company has little tangible capital to offer as collateral).[71]

More generally, while VC portfolio companies are subject to corporate income taxes, they are less likely to be income-generating, and therefore taxable. Arguably, this means there is no corporate tax to integrate. One could argue that true integration would mean that tax losses should be passed along (or credited) to shareholders, but it is difficult to imagine how the capital gains tax regime could serve as a mechanism to accommodate this.[72]

3.4 Entrepreneurship and Innovation

Another rationale for low capital gains tax rates relates to stimulating the demand side of the market for financial capital. Specifically, low capital gains tax rates could incentivise entrepreneurs and inventors to start companies, as the return to founder's stock would be a capital gain.[73] It has been argued that carried interest is rightly taxed as a capital gain on this basis. That is, since managers obtain carried interest for enhancing the value of innovative portfolio companies, it should be treated like the 'sweat equity' of entrepreneurs.[74]

However, this rationale does not support taxing carried interest as a capital gain. First, PE funds generally do not start companies. BO funds acquire mature companies and VC funds finance start-ups and early-stage companies after their foundation.[75] To suggest otherwise confuses the extensive margin (company creation)

[70] See note 25.

[71] Gompers and Lerner (n 15), 157-158.

[72] Zodrow (n 42), 481-482

[73] James M Poterba, "Capital Gains Tax Policy Toward Entrepreneurship" (1989) 42(3) National Tax Journal 375.

[74] See Donald Marron, Goldilocks Meets Private Equity: Taxing Carried Interest Just Right (Urban Institute and Brookings Institution Tax Policy Center 2016), 2. E.g., Weisbach (n 8), 730.

[75] Data collected by Gompers and Lerner suggest less than 10 per cent of VC financing is attributable to seed and start-up financing rounds, with the remainder attributable to later stages of company development. Seed and start-up financing is often preceded by angel investment and family and friends. Gompers and Lerner (n 15), 186, 200; Zodrow (n 42),

with the intensive margin (company development).[76] Once one moves from the extensive margin to the intensive margin, the argument can be framed to apply to virtually any labour effort that increases the value of a corporation. If one counters by suggesting that only particularly risky labour effort deserves special tax treatment, the question of how the returns to human capital should be taxed devolves into an unanswerable question of how 'risky' the labour is.

Second, the comparison to entrepreneurial sweat equity ignores the fact that a sole entrepreneur typically owns the entire balance of equity (i.e., invested capital) in their enterprise at the outset, regardless of how negligible, and is thus entitled to capital gains treatment on any appreciation in the value of their stake in the business.[77] This is not the case for fund managers, who are entitled to receive a return that is disproportionate to the level of financial capital they supply.

3.5 Inflation

Lower taxation of capital gains is also justified as a way of offsetting the distortionary effects of inflation.[78] In particular, taxing nominal capital gains increases the effective tax rate paid on capital gains.[79] In principle, inflation merely exacerbates the other arguments presented in this section rather than providing a clear independent argument favouring preferential capital gains tax rates.

3.6 The Lock-in Effect and Bunching

Finally, lower capital gains rates can be viewed as compensating for the flaws of taxation upon realisation rather than upon accrual.[80] In particular, both the

480-481.

76 That said, as Professor Sanchirico rightly argues, it is difficult to understand why company formation should be incentivised over the development of existing firms. Sanchirico (n 15), 1136-1137

77 By contrast, the tax benefit of carried interest depends on the existence of a marginal rate gap between *multiple* parties (the LPs and GPs). An entrepreneur's return on 'sweat equity' does not depend others' tax attributes. ibid, 1135-1145. See also Chris William Sanchirico, "Taxing Carry: The Problematic Analogy to 'Sweat Equity'" (2007) 117 Tax Notes 239.

78 Gravelle (n 42), 124.

79 Burman (n 42), 45-48; Gravelle (n 42), 130-136.

80 Realisation-based taxation means that accumulated capital gains are taxed upon the disposal of the underlying asset instead of at the time they accrue. Rationales for this timing preference

lock-in effect and bunching problems are predominant reasons given in support of lower capital gains tax rates.[81]

First, the lock-in effect hypothesises that taxpayers can be deterred from disposing of their assets due to triggering taxes on the gains, impeding efficient portfolio reallocation. As with other supply-side arguments, the lock-in effect theoretically affects LPs as capital providers. In practice, the lock-in effect should become irrelevant to LPs as they relinquish investment decision-making responsibility to GPs.[82]

However, as a proportion of profits is shared with GPs, GPs could become susceptible to the lock-in effect. That said, there are a number of reasons to think that the lock-in effect would be unimportant to GPs. First, the lock-in effect is only particularly worrisome given the availability of escaping capital gains tax liability at death in the United States and United Kingdom.[83] Death is not relevant to GPs, which as discussed[84], are generally partnerships themselves. Second, PE funds have a finite, pre-determined life after which they are expected to liquidate.[85] Third, carried interests determined on the basis of the whole-of-fund return (e.g., those funds with a clawback mechanism[86]) circumvent lock-in effects on individual portfolio companies. Finally, PE funds are not a one-shot game. Since PE firms generally raise multiple funds over decades, maintaining a good reputation matters.[87] If the lock-in effect compromises optimal portfolio company exit strategies, this would presumably harm the ability of a given firm to raise successive funds. Overall, it seems reasonable to expect the lock-in effect to have limited relevance in the PE context.

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are discussed in the next section.

81 Charles C Holt and John P Shelton, "The Lock-in Effect of the Capital Gains Tax" (1962) 15(4) National Tax Journal 337, 351-352; Rosenzweig (n 5), 725-726; Fleischer (n 7), 43; Cunningham and Schenk (n 41), 328-330; Gravelle (n 42), 151.

82 Moreover, the lock-in effect would not apply to any non-taxable LPs in the first place. See subsection 2.1.1.

83 I.e., due to the step-up in cost basis ('death uplift') if an asset is held until death. IRC §1014 (US); TCGA §62(1) (UK). Gravelle (n 42), 125, 138; Holt and Shelton (n 81), 352.

84 See subsection 2.1.1.

85 See subsection 2.1.2.

86 See subsection 2.2.

87 Gompers and Lerner (n 15), 63.

Second, bunching relates to the notion that accumulated gains may push a taxpayer into a tax bracket that they would not ordinarily find themselves.[88] Practically, however, bunching should not be a factor with respect to carried interest. Carried interest sums are large enough to expect that top tax rate thresholds would be surpassed whether or not profits occur upon portfolio company disposition or as they accrue.[89] In any case, GPs would also usually be composed of top-rate taxpayers in the absence of any carried interest.[90]

3.7 Conclusion

The justifications for lower capital gains tax rates do not support the taxation of carried interest as a capital gain. In most cases, this conclusion largely follows from the fact that GPs are financial intermediaries rather than suppliers or consumers of financial capital. Indeed, to argue that the rationales for lower capital gains tax rates support the taxation of carried interest as a capital gain requires making assumptions about tax incidence and the nature of returns to financial intermediation. It is difficult to imagine policymakers contemplate this indirect argument when establishing broad capital gains tax preferences.

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88 Alternatively stated, due to progressivity, accumulated gains could be taxed at a higher rate than they would have if instead they had been taxed as they accrued.

89 Metrick and Yasuda (n 5), 2307, 2328.

90 Fleischer (n 7), 5. Similarly, bunching would not be a concern for LPs. Most LPs are non-taxable and the remainder would often be high-net-worth individuals already paying top rate taxes. See subsection 2.1.1.

4

Preferential Taxation of Capital Gains: Taxation Upon Realisation

In addition to preferential tax rates, capital gains also receive preferential timing of taxation. Specifically, capital gains are taxed upon realisation (i.e., when an asset giving rise to a capital gain is sold or otherwise disposed of).[91] This treatment differs from the conceptual benchmark, whereby gains would instead be taxed as they accrue.[92] Deferring tax liability in this way provides an advantage to taxpayers by lowering their effective tax rate (due to the time value of money).[93]

The departure from accrual taxation for capital gains is effectively due to two reasons: (1) liquidity problems and (2) valuation problems.[94] These two

[91] This is not just a United States and United Kingdom phenomenon. 'All OECD countries that tax capital gains do so on realisation.' Michelle Harding, *Taxation of Dividend, Interest, and Capital Gain Income* (OECD Taxation Working Papers, no. 19, OECD 2013), 32. Indeed, as Professor Auerbach observed over 30 years ago, '[v]irtually every country that taxes income imposes a capital gains tax only upon the realization of gains rather than on accrual.' Alan J Auerbach, "Retrospective Capital Gains Taxation" (1991) 81(1) American Economic Review 167, 167.

[92] E.g., under a definition of income that follows the Haig-Simons approach. See note 41. See Burman (n 42), 132; Noel B Cunningham and Deborah H Schenk, "Taxation without Realization: A Revolutionary Approach to Ownership" (1992) 47(4) Tax Law Review 725, 747.

[93] Gravelle (n 42), 132-133.

[94] Cunningham and Schenk (n 41), 348-349; Auerbach (n 91), 168; Cunningham and Schenk (n 92), 742-746. Administration and compliance problems could be considered a third possible reason, but as such issues stem from liquidity and valuation problems they will not be discussed separately here.

problems, and their relevance in the PE context, are discussed in more detail in the following subsections.

4.1 Liquidity

Liquidity problems refer to situations where taxpayers are forced to sell the underlying assets giving rise to a capital gains tax liability in order to pay the tax.[95] Liquidity problems are a concern with an accrual-based capital gains tax. Unlike a realisation-based capital gains tax, which would often arise once an asset is sold for cash, the taxpayer is less likely to have sufficient cash on hand to satisfy their tax liability.

However, whether a taxpayer has a limited cash balance is not a sufficient condition to establish if special tax treatment is warranted. In the case of especially well-off individuals, the composition of assets held—i.e., the extent to which assets are held in cash or other relatively liquid forms—is more likely to be at the taxpayer's discretion.[96] By contrast, liquidity problems are particularly concerning in other cases where an indivisible (or poorly divisible[97]) asset represents a significant portion of a taxpayer's wealth. For instance, it is undesirable if an accrual-based capital gains tax would force small business owners to lose control of their company, farmers to sell their farmland (or portions thereof), or homeowners to sell their only residence.[98]

For this reason, liquidity problems are difficult to justify in the PE fund context. As discussed earlier, LPs are generally non-taxable institutional investors and high-net-worth individuals, and GPs would typically consist of relatively high-income individuals.[99]

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95 Auerbach (n 91), 168.

96 Emmanuel Saez and Gabriel Zucman, *The Triumph of Injustice: How the Rich Dodge Taxes and How to Make Them Pay* (WW Norton & Company 2020), 152.

97 E.g., if the functionality of an asset depends on its scale.

98 Glen Loutzenhiser and Elizabeth Mann, "Liquidity Issues: Solutions for the Asset Rich, Cash Poor" (2021) 42(3) Fiscal Studies 651.

99 See subsection 2.1.1.

4.2 Valuation

Accrual-based capital gains taxation requires periodic (annual) measurement of the value of an asset in order to calculate the tax base (i.e., the change in the value of the asset). While publicly traded assets (e.g., shares traded on an exchange) can easily be valued at any given point in time, there is typically no market from which a sound valuation can be readily drawn for other types of assets.[100] Shares of privately held businesses are an example of such difficult-to-value assets.[101] Valuation uncertainty raises the potential for administration and compliance challenges. For example, since there is more latitude to question the valuation method, a tax administration may be more likely to dispute (justifiably or not) valuations of difficult-to-value assets.[102] In any case, taxpayers would almost certainly incur costs to regularly appraise their assets. Realisation-based capital gains taxation largely resolves valuation problems generated by accrual taxation. Under taxation upon realisation, the capital gain of an asset can generally be determined from the difference between the price at which it is sold and the price it was acquired for.

The portfolio companies of PE funds are privately held companies. As such, the shares of these companies—particularly in the VC context, given heightened uncertainty about company prospects—are precisely the type of assets the valuation explanation behind realisation-based taxation has in mind. Since carried interest is a percentage of the growth in value of a PE fund's portfolio[103], it seems appropriate for it to be taxed at the same time that the remainder of portfolio growth would be taxed as a capital gain to LPs.

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[100] Burman (n 42), 132.

[101] Auerbach (n 91), 177; Cunningham and Schenk (n 92), 800.

[102] Fleischer (n 7), 37 (footnote 156).

[103] Another way of looking at carried interest is that it effectively represents a call option on 20 per cent of the value of a PE fund's portfolio. Derivatives, like call options, on difficult-to-value assets exacerbate valuation problems. ibid, 52; Harvard Law Review (Unsigned Note), "Taxing Private Equity Carried Interest Using an Incentive Stock Option Analogy" (2008) 121(1) Harvard Law Review 846, 853-856.

4.3 Conclusion

While the liquidity rationale for taxation upon realisation does not support taxing carried interest as a capital gain, the valuation rationale is rather compelling. Consequently, it is reasonable to conclude that deferring the taxation of carried interest, consistent with the realisation basis of capital gains taxation, is a defensible policy approach.

5 Policy Solutions

As one might expect out of such a hotly debated issue, a considerable variety of policy proposals have been offered as solutions to the carried interest puzzle. This section undertakes an assessment of these policy options to determine how well they align with the conclusions drawn from the previous two sections.

The policy options can be categorised into three main types: (1) taxing carried interest as a capital gain; (2) taxing carried interest as ordinary income; or (3) separating carried interest into a capital gain component and an ordinary income component (bifurcation). Several variants of each of these types are analysed.

5.1 Tax Carried Interest as a Capital Gain

5.1.1 Status Quo (United States)

First, we observe that the United States considers carried interest to be a capital gain generally entitled to preferential long-term capital gains tax rates.[104] This outcome is clearly not supported by the rationales for lower capital gains tax rates in general. However, on the timing aspect of the taxation of carried interest, the status quo is more sensible. Generally, taxation is deferred until a partnership-level realisation event (e.g., a sale of shares of a portfolio company) occurs.[105] The valuation

[104] See notes 4 and 37.
[105] See subsection 2.3.

justification for realisation-based taxation can be called on to defend this outcome.

That said, extending deferral beyond what could be considered a partnership-level realisation event is not justifiable. Under certain circumstances, the U.S. rules permit the partnership to distribute shares of portfolio companies to the partners without triggering taxation.[106] If 20 per cent of a fund's capital growth (i.e., the carried interest) can effectively be settled with a distribution of shares, this signals that the value of the carried interest is easily ascertainable at that time.

5.1.2 Modified Capital Gains Tax Rate (United Kingdom)

At a very high level, the tax treatment of carried interest in the United Kingdom is like that of the United States. In particular, carried interest is taxed as a capital gain on a deferred basis. However, the tax treatment of carried interest in the United Kingdom differs significantly enough to warrant discussion as a separate variant.

The main difference is in the United Kingdom's application of capital gains tax rates. In 2016, the United Kingdom reduced its general capital gains tax rates by eight percentage points.[107] Importantly, these reductions do not apply to carried interest. The effect of this change is that the tax rate applicable to carried interest falls in between those applying to capital gains and those applying to ordinary income.

In some sense, the eight-percentage-point gap between carried interest and other gains is consistent with the notion that the tax treatment of carried interest cannot be justified by the same rationales that support lower capital gains tax rates more broadly. The UK government's budget messaging is suggestive (albeit perhaps an oversight):

> Budget 2016 announces that, from 6 April 2016, the higher rate of Capital Gains Tax (CGT) will be reduced from 28% to 20%, and the basic rate will be reduced from 18% to 10%. There will be an 8 percentage point surcharge on these new rates for carried interest and for gains on residential property. *This will ensure that CGT provides an incentive to invest in companies over property.*[108]

[106] See note 38.
[107] Finance Act 2016, §83. See also TCGA §1H (UK).
[108] HM Treasury, *Budget 2016* (16 March 2016), 48. Emphasis added.

That said, it is unclear whether the tax rates on carried interest continue to be too generous. An extreme version of the UK-type approach would match carried interest tax rates with ordinary income rates while maintaining the character of carried interest as a capital gain (to maintain the advantage of taxation upon realisation). Such an approach has been put forward as a policy option in the U.S. context.[109] However, providing capital gains characterisation might still be too generous given capital gains escape payroll tax liability.[110]

The timing aspect of the UK-type approach is more straightforward. By maintaining the treatment as a capital gain, the realisation principle is generally preserved in accordance with the preceding analysis.[111]

5.2 Tax Carried Interest as Ordinary Income

5.2.1 Taxation Upon Realisation

Generally, this approach would see carried interest be considered service income taxable at ordinary income tax rates, regardless of the character of the underlying income.[112] By characterising carried interest as ordinary income, this approach resolves the matter of whether the preceding policy option continues to be too generous in terms of rates. Moreover, it maintains the realisation principle as if the carried interest were a capital gain, which is supported by the valuation justification for deferred taxation.

A variant of this approach would be to attribute 100 per cent of the return on capital invested by the LPs to the LPs, irrespective of the fact that 20 per cent is

[109] Rosenzweig (n 5) proposes treating carried interest as a capital gain subject to the same tax rates that apply to ordinary income. In the U.S. context, this could be achieved by deeming carried interest to be a short-term capital gain.

[110] Due to the non-application of payroll taxes (informally, the Social Security, Medicare, and Unemployment Insurance taxes), though potentially offset by the application of the 3.8 per cent net investment income tax, a capital gain could still be treated advantageously relative to employment income in the United States. See IRC §1411; §§3101-3128 (Federal Insurance Contributions Act); §§3301-3311 (Federal Unemployment Tax Act). See also Marron (n 74), 14-15. In the UK, National Insurance Contribution liability is avoided when the recipient pays initial unrestricted market value (the value being established on the same terms as LPs) for their carried interest on acquisition. ITEPA §420 et seq.; HMRC (n 16). See also note 16.

[111] See also note 38.

[112] Fleischer (n 7), 51-52.

allocated to the GPs as carried interest.[113] This amount would be fully taxed as a capital gain in the hands of the LPs. In conjunction, carried interest received by the GP would be taxed as ordinary income, but explicitly deductible to the LPs. This variant takes a fund-level view of the total tax burden. Specifically, the goal is to ensure that the overall tax paid by both the GPs and the LPs is the same as the status quo, but that the tax burden is more appropriately split between the fund managers and passive investors (see Table 5.1).[114] This variant would also be supported by the preceding analysis.

Table 5.1: Tax Treatment of $100 of PE Fund Gains with 20% Carried Interest

	Capital Gains	**Ordinary Income**
Status Quo		
GP	20	0
LPs	80	0
Total	100	0
Fleischer 2008 Variant		
GP	0	20
LPs	80	0
Total	80	20
Marron 2016 Variant		
GP	0	20
LPs	100	-20
Total	100	0

* Reproduced and adapted from Marron (n 74), Table 1.

5.2.2 Corporate Developers

Alternatively, PE funds could be treated as 'developers', such that *no* PE fund return would be characterised as a capital gain.[115] Specifically, this proposal would deem profits from the purchase, development, and resale of portfolio companies (with the intention of earning a profit) as business income.[116] As a result, these returns would be subject to ordinary income tax rates, whether they are allocated

[113] Marron (n 74).

[114] I.e., such an approach would neutralise tax arbitrage between GPs and LPs, while maintaining appropriate treatment of taxable LPs. ibid, 11.

[115] Steven Rosenthal, "Taxing Private Equity Funds as Corporate 'Developers'" (2013) 138 Tax Notes 361.

[116] ibid, 366.

to LPs as a return on capital or to GPs as carried interest. The intention of this proposal is to make the tax treatment of PE returns consistent with the treatment of securities traders and dealers or real estate developers.[117]

This proposal can be viewed as an extreme take on the ordinary income approach, reaching beyond the tax treatment of carried interest. As the returns to capital earned by LPs as passive investors would also be re-characterised, it cannot be supported without questioning the rationales for capital gains treatment writ large.[118]

5.3 Bifurcation

5.3.1 Taxation Upon Grant

The first bifurcation variant would impose taxation on the value of the partnership profits interest as ordinary income when it is received by the GP.[119]

There is some precedent for ordinary income taxation upon grant of equity-based compensation. In the U.S., this treatment would be analogous to the tax treatment of receipt of shares as compensation or the treatment of non-qualified (i.e., non-concessionary) stock options with a *readily ascertainable market value*.[120] In fact, in *Diamond*, it was held that the receipt of a partnership profits interest in exchange for services was subject to taxation upon its receipt (where the value was easily determined by a sale of the profits interest soon after receipt).[121]

This approach recognises that the GP is compensated with something of value when the LPs offer them a portion of their potential investment return. As noted,

[117] I.e., those carrying on a trade. In this case, the trade would be defined as the development of corporations.

[118] As stated previously, the intent of this paper is not to take a position in this debate.

[119] See Lee A Sheppard, "Blackstone Proves Carried Interests Can Be Valued" (2007) 115 Tax Notes 1236. This variant has limited relevance in the United Kingdom context given the current structure of most funds. See note 16.

[120] IRC §83(e)(3); Fleischer (n 7), 54-55. However, most non-qualified stock options do not have a readily ascertainable market value. Harvard Law Review (Unsigned Note) (n 103), 849-855.

[121] *Diamond v. Commissioner*. That said, *Campbell v. Commissioner* later decided that partnership profits interests were *not* taxable at grant, because the profits interests were speculative and *without* fair market value. This later position is clearly mistaken in one crucial respect: while a profits interest may have little to no *intrinsic* value, this is not the same as having zero value. Certainly, a profits interest has a positive, though difficult to measure, time value.

tax systems would generally consider treating such in-kind payments as ordinary income.[122] Gains arising from holding the property afterwards would be rightly treated as a capital gain and be subject to preferential rates.

However, there is a problem—one very much connected to the valuation rationale favouring capital gains deferral. The valuation of most PE profits interests at the time they are granted is questionable at best and entirely speculative at worst.[123]

5.3.2 Cost of Capital

The cost-of-capital approach draws upon the economic equivalence between a carried interest and a hypothetical interest-free, non-recourse loan provided by the LPs to the GP for investment in the fund.[124] Specifically, this approach would require an amount representing forgiven interest on the implicit loan received by the GP (e.g., interest on a loan of 20 per cent of the fund's financial capital) to be taxed as ordinary income to the GP on an annual basis.[125]

Since this approach notionally converts a GP from a negligible financial capital supplier to a proportionate financial capital supplier, the rationales for preferential capital gains rates become applicable as if the GP was simply a passive investor. Furthermore, the cost-of-capital approach would not disturb the timing of taxation of carried interest, consistent with the valuation justification for taxation upon realisation.

However, one could view the cost-of-capital approach as replacing one valuation problem (the value of a partnership profits interest) with another (the value of forgone interest). For instance, in the United States, the rules that determine the treatment of compensatory loans with below-market interest rates use prescribed rates that would be much lower than the true market interest rate on the implicit

[122] Fleischer (n 7), 16-17.
[123] ibid, 52.
[124] ibid, 52-54. See also Noel B Cunningham and Mitchell L Engler, "The Carried Interest Controversy: Let's Not Get Carried Away" (2008) 61 Tax Law Review 121.
[125] Harvard Law Review (Unsigned Note) (n 9) endorses the cost-of-capital approach but proposes that tax liability on the imputed interest be deferred until the fund's investments are exited. This is intended to resolve liquidity issues, which as discussed earlier, are not particularly important in the PE fund context.

loan given its non-recourse nature and the relative risk of the underlying asset.[126] However, this problem does not seem insurmountable.[127]

5.3.3 Fixed Proportions

One policy approach proposed in the United States would partially re-characterise carried interest as ordinary income using a fixed ratio.[128] Specifically, this means that a fixed percentage (e.g., 75 per cent) of carried interest would be treated as ordinary income, with the remainder (e.g., 25 per cent) retaining its partnership-level character (i.e., as a capital gain).

As this approach represents a weighted average of the capital gains rate and the ordinary income tax rate, it can be regarded as essentially equivalent to the Modified Capital Gains Tax Rate variant discussed above.

5.4 Targeting the PE Industry

As a separate matter, there is a question as to whether a policy solution should be made to target only the PE industry or apply to partnership profits interests writ large.[129] While some of the proposals identified above are inherently narrowly focused in this way, others could be applied narrowly or broadly depending on whether there are good policy reasons for doing so.

The targeted nature of recent proposals in the United States[130] and the approach taken in the United Kingdom appear to be driven by the relatively high profile of

[126] Fleischer (n 7), 53; IRC §7872.

[127] H.R.1 (113th Congress) proposed that the applicable forgone interest rate be based on the federal long-term rate for the last month of the calendar year plus 10 percentage points. IRC §1274(d)(1). This could be viewed as effectively incorporating a hurdle rate, and therefore particularly appropriate for BO funds. See subsection 2.2.

[128] E.g., H.R.3970 (110th Congress). The return from any actual capital contributions made by the carried interest holder would be exempt from re-characterisation.

[129] Rosenzweig (n 5), 726-728.

[130] E.g., S.2617 (117th Congress), which proposes new rules that generally apply only to businesses engaged in raising capital and investing in securities.

fund manager compensation and political viability.[131] These motives do not seem like principled reasons for the narrowness of a given policy solution. That said, since the preceding analysis of the applicability of the justifications for capital gains preferences to carried interest relies to a great extent on industry-specific context, this paper is unable to opine on whether policy solutions should be more broadly applied.

5.5 Conclusion

The examination of the reasons for general capital gains preferences as they apply to the taxation of carried interest allows us to rank various policy solutions (see Table 5.2). Overall, it is fair to conclude that the status quo in the United States is the least defensible of the policy options. Other proposals (i.e., corporate developers, taxation upon grant) also do not well align with the analysis from previous sections. On this front, the approach taken in the United Kingdom represents a better policy alternative.

Fortunately, there are two proposals that fully accord with the analysis of whether carried interest should be taxed like a capital gain. These are (1) taxing carried interest as ordinary income upon realisation and (2) the cost-of-capital approach. Interestingly, these two approaches could be combined through a tax election.[132] This offers a 'talent-revealing' trade-off to GPs: either (a) accept deferred ordinary income tax treatment on the entire amount of carried interest or (b) pay ordinary income taxes sooner on an amount of forgone interest to obtain the prospect of capital gains treatment on the remainder of the carried interest on a deferred basis.[133]

[131] Professor Fleischer argues that 'the increased use of partnership profits as a method of executive compensation in the context of private investment funds suggests the need for reform' and further suggests that other industry sectors that commonly use partnership structures, such as real estate and natural resources, would likely oppose broader reform. Fleischer (n 7), 16-17, 58.

[132] ibid, 54-55. That is, the default rule would be to treat carried interest as ordinary income upon realisation but permit PE funds to elect into the cost-of-capital approach.

[133] ibid.

Table 5.2: Comparison of Carried Interest Policy Solutions

Proposal	Rates	Timing
Tax Carried Interest as a Capital Gain		
Status Quo (United States)	✗	—
Modified Capital Gains Tax Rate (United Kingdom)	—	✓
Tax Carried Interest as Ordinary Income		
Taxation Upon Realisation	✓	✓
Corporate Developers	✗	✓
Bifurcation		
Taxation Upon Grant	✓	✗
Cost of Capital	✓	✓
Fixed Proportions	—	✓

6
Conclusion

The tax treatment of capital gains is advantageous in two respects: reduced tax rates and deferred timing of taxation. This paper has examined the extent to which carried interest satisfies the arguments for these tax preferences. Taxing carried interest at preferential rates is not supported by the reasons for taxing capital gains at preferential rates. However, taxing carried interest under the realisation principle is defensible, supported by the same valuation concerns that justify taxing capital gains upon realisation.

Armed with this argument, two proposals to change the tax treatment of carried interest stand out as sensible. The first is to tax carried interest as ordinary income upon realisation. The second, the cost-of-capital approach, puts the GP in the position of financial capital supplier and, therefore, a legitimate recipient of preferential capital gains treatment. Professor Fleischer proposed both as potential policy options over a decade ago.[134] The original analysis of this paper suggests that they are indeed satisfying solutions to the carried interest puzzle.

[134] Fleischer (n 7).

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