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Original Paper

A Matter of Equity- The Taxation of Private Equity General Partners "Carried Interest"

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Abstract

The carried interest tax loophole has helped private equity to become one of the most lucrative sectors of the financial Industry. As private equity general partners are taxed at long term capital gains rates on partnership profits allocated to a carried interest, while the same amount of compensation structured as salary would be taxed at ordinary income rates. Thus, General Partners pay a top tax rate of 20% on their carried interest instead of the 37% they would pay if the compensation were structured as salary, which many economists and tax experts believe it actually is.

Keywords

tax, loopholes, credits, carried interest

1. Introduction

Private Equity funds managed 2.8 trillion in assets in 2017 Adam Smith's first Canon of Taxation is Equity and Fairness (Prequin, 2018), Similarly situated taxpayers should be taxed similarly according to the American Institute of Certified Public Accountants (AICPA). The favorable taxation of carried interest as it applies to private equity partnership profits is viewed as one of the most inequitable and egregious components of the Internal Revenue Code. In this paper we will examine the fairness of the taxation of carried interest as applied to private equity partnerships.

So, what was the genesis of this tax loophole?

In the sixteenth century merchants needed investors however investors were reluctant to finance the merchants as they were wary that the ships and cargo they financed would sail away and never return. To solve this problem the Venetian Government created a mechanism to protect both parties. The government created a contract between the investors and merchants. The investor would finance the merchandise and the ship for an 80% interest in the ultimate profit. The merchant would receive a 20% interest for his time and the risk of travel. No one would receive anything until the merchandise was sold. The contracts worked well as both parties would benefit by the safe transport of the merchandise (Armstrong, 2017).

In the 1920's oil speculators adopted the carried interest model to finance oil exploration. A partnership was formed, and a few partners would finance the exploration; purchasing the land, equipment and paying the day to day expenses of the venture. The remaining partners would actually dig the wells and explore for oil. Thus, these partners invested "sweat equity". If the partnership was sold the Internal Revenue Service would tax the profits of all the partners as capital gains, rather than ordinary income (MacGillis, 2016). In 1954, the carried interest exception became part of the Internal Revenue Code. The exception was designed to assist workers in speculative fields such as oil and gas drilling.

Overtime partnerships in other industries including private equity partnerships adopted this model, to take advantage of the beneficial capital gains rates (MacGillis, 2016). In 1954 Private Equity firms were in their infancy. Clearly, not a concern of Congress in the drafting of the carried interest rules.

2. An Overview: The Growth of Private Equity Partnerships in the United States

American Research and Development Corporation, which was founded in 1946, is considered the first private equity firm in the United States (Cohen, 2013). By the 1970's there were about 12 Private equity firms in the United States (Cohen, 2013). Interestingly, in the 1980's, Congress relaxed the rules on pension funds investing in private equity funds and lowered capital gains tax rates this led to a growth in private equity firms. During this decade some of the largest firms were created including Bain Capital, The Carlyle Group and The Blackstone Group (Loosvelt, 2009).

By 1994 Private equity funds managed $100 billion in assets. By 2017 the managed funds had grown to $2.8 trillion according to the Center on Tax Policy. Today private equity is one of the largest asset classes in the private capital sector (Heberlein, 2017). In the United States if you combine the number of employees of the top five private equity firms the aggregate number of people employed would rank second, only surpassed by the number of people employed by Walmart (Heberlein, 2017). Private Equity firms are a significant part of the United States economy which employ some of the wealthiest individuals in the world. However, many economists and policymakers believe that in part the success of private equity partnerships has been built upon an unfair tax loophole, carried interest.

3. Private Equity Firms -A Tax Savings Structure…or Loophole?

The typical private equity firm purchases controlling interests in companies and restructures the companies to make them more profitable and then sells the stock at a gain. The firms usually have a limited life of approximately 10 years (Rosensweig, 2009).

The private equity firms are usually structured as limited partnerships. The limited partnership interests are issued to the firms that provide the majority of the funding for the partnership. The limited partners are usually non-tax paying entities, such as pension funds and tax exempt not for profits. The limited partners typically provide 99% of the capital in return for an 80% interest in the limited partnership (MacGillis, 2016).

The general Partnership interests are issued to a "management group". The management group operates the limited partnership. The management group typically provides 1% of the capital and receives a 20% interest in the limited partnership. The 19% additional interest is awarded as compensation for managing all the activities of the limited partnership. The management group operates through a management company which does not own any interest in the partnership (Rosenzweig, 2009).

The management group hires the management company to purchase and restructure the companies' that the limited partnership invests in. The management company receives annual compensation equal to 2% of the value of the assets under management (Rosenzweig, 2009).

This limited partnership structure works extremely well for private equity general partners from a tax savings perspective. Partnerships were created as pass through entities for tax purposes. Therefore, the character of income, along ordinary versus capital gains tax rates, are determined at the partnership level. Thus, income retains its character when it passes through to the partners via their K-1 tax statements. Therefore, for tax purposes, the partnership itself is merely viewed as a reporting entity, not a taxable entity.

When the private equity limited partnerships resell the stock of the restructured investee companies at a gain, a tax consequence will be recognized. However, if the stock has been held for longer than three years, the gain will be classified at the preferred capital gain tax rate for the partnership. Subsequently, when the long-term capital gain income is passed through to the partners via the K-1 tax form, the gain will retain the long-term tax preference character. And, all the partners, are therefore afforded the lower capital gain tax rates on their individual taxes as the character of income is determined at the partnership level not the individual partner level.

Thus, the limited partners will receive the capital gains preferential tax rate on their income for the year. Additionally, the partners who provided 99% of the capital investment of the partnership and bore risk are eligible for the lower capital gains tax rates as a reward. However, the limited partners will also receive capital gains on their entire 20% interest even though their invested capital represents a mere 1% of the total investment. The additional 19% is characterized as compensation for managing the limited partnership.

Thus, by establishing a limited partnership, the general partners pay a much lower tax rate than they otherwise would were the tax loophole provision not provided within the Internal Revenue Code.

Ironically, the 19% interest is considered, "the carried interest" and thus provides the basis for the sanction tax preference item. The general partners contribute 1% of the capital and receive 20% of the capital gain. The 19% return is deemed earned by "sweat equity", a misnomer to say the least.

The general partners of private equity firms are encouraged to avail themselves of this tax rate advantage which, is an unintended consequence, of the initial provision. The original intent of the tax saving rule was to encourage oil field workers, who were doing dangerous, arduous and speculative work, to receive the preferential capital gains tax treatment as an incentive. And, once the partnership interest they received as compensation for their desired work, were sold at a gain, the taxes impact would be mitigated. It is ironic, that the oil field workers, who were taking a real risk, often receive no compensation as the partnership interest would be worthless requiring no tax saving provisions.

The general partners of private equity firms have little if any risk as they receive annual compensation of 2% of the value of the assets under their management. So, regardless of whether or not a gain is realized once the assets are sold, the partners are compensated for their time and expenses via the 2% annual payment. Thus, general partners of private equity firms are receiving huge tax breaks initially intended as compensation for workers. An unintended consequence of the Internal Revenue Code designed to reward workers engaging in actual sweat inducing activities is currently benefitting private equity managers who primary risk is a potential paper cut.

Ironically, in an attempt to circumvent the tax requirements for earned income, the private equity firms have overextended the oil drilling partnership model to its breaking point as they engage in a quest for tax reduction loopholes. Furthermore, as many of the limited partners are tax exempt entities, they are indifferent to the fact that the general partners are receiving a significant part of their compensation as capital gains rather than tax deductible salary, subject to the higher earned income tax rate for individuals (Burke, 2017).

4. Conclusion: Are Tax Loopholes an Unintended Consequence of a Complex Tax Policy?

The favorable taxation of the carried interest of private equity firms is not a sustainable tax policy. Whether this favorable tax loophole should be closed is subject to further discussion by Congress. Private equity firms are exploiting a tax rule that was designed to protect partners in oil exploration, and, as such, undermining the premise of a fair tax policy.

Noted economists have provided a myriad of well-developed theories supporting the closing of this loophole. Furthermore, C. Eugene Streule, a senior fellow of the Urban Institute, testified before *The House Ways and Means Committee* and stated, “The case for providing capital gains relief is relatively weak, resting primarily whether the administrative benefits of the simple partnership structure need to be maintained in this arena: it does not rest upon arguments favoring capital income, entrepreneurs or risk”. Victor Fleisher, Associate Professor, University of Illinois College of Law, wrote in the NYU Law Review in 2008, wrote; “By taking a portion of their pay in the form of partnership profits, fund managers defer income derived from their labor efforts and convert it from ordinary income to long term capital gain. This unintended quirk in the tax law allows some of the richest people in the country to incur taxes at a favored tax rate without having provided anything of equal value as a driver of the preferred rates.

Likewise, politicians from President Obama to President Trump have campaigned on the promise to close this and many of the egregious tax loopholes embedded in the Internal Revenue Code. Numerous bills have been introduced in Congress to close this loophole. The latest bill was introduced by Bill Pascrell and Tammy Baldwin in March 2019. This bill, as the ones before it, has not been seriously considered by congress.

The Carried Interest loophole has been exploited by the wealthiest individuals, the private equity partners, for far too long. Other than minor changes made to this loophole by the Tax Cuts and Jobs Act of 2017, we enter 2020 with the carried interest loophole intact and ready to be exploited in a new decade.

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