

Taxation of Private Equity Firms: Good Tax Policy or Just Income Redistribution by Congress?

By Raymond J. Elson and Leonard G. Weld

Raymond J. Elson and Leonard G. Weld examine whether carried interest should be taxed at the current 15-percent capital gains rate or as ordinary income.

One of the topics that will surely often arise in Congress during the next year is identifying new revenue sources to fund some worthwhile initiative. An easy target is upper-income taxpayers, *i.e.*, those earning seven-figure incomes are perceived as earning too much money. The House Ways and Means Committee passed legislation¹ on June 19, 2008, that relies on a controversial funding proposal that Republican lawmakers did not support. According to a spokesman for the Committee, Chairman Rangel's bill will offset the price tag with a provision taxing "carried interest" earned by fund managers as regular income rather than using the lower capital gains rate, and by repealing oil company tax incentives. By virtue of a private equity firm's (PEF) partnership structure, carried interest is only taxed once and at the much lower 15 percent federal capital gains tax rate available to individuals, rather than the highest ordinary federal income tax rate of 35 percent, plus any applicable state taxes.

New Legislation

The goal of the legislation is to ensure that the lower

Raymond J. Elson, D.B.A., CPA, is an Associate Professor of Accounting at Valdosta State University, in Valdosta, Georgia.

Leonard G. Weld, Ph.D., is a Professor of Accounting and Head of the Department of Accounting and Finance at Valdosta State University, in Valdosta, Georgia.

capital gains tax rate is not being inappropriately substituted for the ordinary tax rate on wages and earnings. Taxing carried interest as ordinary income results in increased tax revenues projected to be \$30.9² billion over 10 years. The bill would also deny Code Sec. 199³ benefits for major integrated oil and natural gas companies. Changes contained in the bill would affect taxes on hedge fund managers, integrated U.S. oil companies, credit card transactions and foreign firms subject to U.S. tax treaties and raise a total \$61.5 billion.⁴ However, the main target is clearly PEFs.

The move to change the taxation of carried interest has gained momentum because of the growing influence of PEFs in the marketplace and the large compensation earned by fund management personnel. For instance, Stephen A. Schwarzman, Chairman, CEO, and co-founder of the Blackstone Group received cash compensation of \$398 million in 2006 and \$350 million in 2007.⁵ In addition, the partners at Blackstone received approximately \$3.7 billion from the partnership's recent initial public offering.⁶

A Typical Transaction

PEFs are popular investment vehicles. A PEF such as Blackstone, Apollo Management, Texas Pacific Group (TPG) or Kolberg, Kravis, Roberts & Co. (KKR) is structured as a partnership in which investors, including PEF employees, become limited partners and the fund's

manager is general partner. A PEF raises money from real estate opportunity funds, pension funds, hedge funds, mezzanine funds, proprietary hedge funds and closed-end mutual funds, and uses it along with loans obtained from banks and other lenders to acquire a public company, often at a premium on its market price.⁷ The public company is then privatized by the PEF, which typically contributes approximately 15 percent of the purchase price.

Taking the company private allows the PEF to manage the acquired business without continual public scrutiny and reporting, including quarterly and annual financial reporting. A major challenge faced by the newly acquired entity is to service the debt used in its acquisition. One unpopular solution is to reduce costs by decreasing the work force. The PEF may sell underutilized assets or spin off underperforming divisions to raise money. Once the firm is “right sized,” the PEF (owner) sells the new entity for a profit either directly or through an initial public offering of stock.

The announced sale of Alltel to Verizon illustrates one way PEFs make money. A fund led by TPG and Goldman Sachs bought Alltel for \$25 billion and took it private. In June 2008, Verizon announced its intention to acquire Alltel from TPG/Goldman for \$28.1 billion.⁸

Who Gets What?

So, what is carried interest and should it be taxed at the current 15-percent capital gains rate or as ordinary income as proposed by some legislators? The investment fund manager (the PEF) receives two types of compensation. One is the management fee (generally two percent) which is paid based on the assets under management by the PEF. This fee generally pays for the day-to-day operations of the PEF.

The management fee is taxed as wage income at ordinary income rates up to as high as 35 percent. This is an immediate payment and is taxed as earned. Although carried

interest and its taxation receive the lion’s share of attention from Congress, the PEFs actually earn much more in fee income than carried interest. Carried interest is the amount paid to a PEF out of the profit from the sale of a business that was taken private. This concept is illustrated later in the article.

In a study recently reported in the WALL STREET JOURNAL,⁹ two Wharton finance professors (Drs. Andrew Metrick and Ayako Yasuda¹⁰) conclude that on average PEFs earn \$10.35 in management fees for every \$100 they manage. Carried interest for the same \$100 only contributes \$5.41. Their data comes from 144 buyout funds from 1992 through 2006.

Why the huge fee income? In the 1980s when leveraged buyouts began, deals were of modest size compared to current transactions. In 1980, there were four buyouts with a combined value of \$1.7 billion.¹¹ During the peak buyout year of 1988, there were 410 buyouts with an aggregate value of \$188 billion.¹² Table 1 summarizes the largest buyouts for 2006 and 2007. The cumulative total of these eight transactions is \$250.82 billion.

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Table 1. The Largest Recent Buyout Transactions

Target	Acquirer	Value (\$billions)	Announced	Status
TXU Corp	KKR & Co., TPG, Goldman Sachs Capital Partners	43.8	Feb. 26, 2007	Completed
Equity Office Properties Trust	Blackstone Real Estate Partners	38.89	Nov. 20, 2006	Completed
HCA Inc.	Bain Capital Inc., KKR & Co., Merrill Lynch Global Private Equity	32.68	July 24, 2006	Completed
Alltel Corp.	TPG Capital, Goldman Sachs Capital Partners	27.87	May 21, 2007	Completed
First Data Corp.	KKR & Co.	27.73	April 2, 2007	Completed
Harrah's Entertainment Inc.	Apollo Management, TPG	27.4	Oct. 2, 2006	Completed
Clear Channel Communications Inc	Bain Capital Inc, Thomas H. Lee Partners	26.44	Nov. 16, 2006	Completed
Hilton Hotels Corp.	Blackstone Group	26.01	July 3, 2007	Completed

Source: CNNMoney.com, Private Equity: The Beat Goes On, Grace Wong, July 4, 2007.

Even though the magnitude of the transactions has ballooned, the management fee percentage has remained stable at two percent. Blackstone only charges 1.5 percent on its assets under management, versus a more typical two percent. So far, this flow of revenue has proved relatively stable. Blackstone has \$102 billion in assets under management, so in its fourth-quarter earnings report it booked about \$1.553 billion for the year in management fees.¹³ How can PEFs continue to earn such fees from its limited partners? The simple answer is that they provide an exceptional return on investment. Average returns for funds managed by PEFs far exceed the average market return. From 1980 to 2005, the top quartile of private equity funds provided an annual return of 39.1 percent after all fees and the general partners' carried interest.¹⁴ The return on the S&P 500 over the same time period was 12.3 percent. These PEFs were consistent performers over that time period giving credence to the belief that they are superior investment managers.

The second type of compensation (in addition to a two-percent management fee) is a share of the profits generated by the assets under management. This second source of income is referred to as a performance fee, the carry or carried interest. The fund manager often receives 15 percent to 20 percent of profit earned from a successful transaction, such as the announced sale of Alltel to Verizon.

The 20-percent return does not come immediately to the PEF as the general partner of the fund. Common practice allows the limited partners to recover 100 percent of their investment and often a specific "hurdle rate" on their investment that must also be received by the limited partners before the PEF receives anything. For example, assume a fund with \$100 million invested by the limited partners with a hurdle rate of eight percent. The proceeds from the concluded venture are \$140 million. The first distribution is \$108 million to the limited partners. This is a return of investment (\$100 million) plus eight percent earnings (\$100 million \times 8% = \$8 million). The balance (\$140 - \$108 = \$32 million) is split between the limited partners and the PEF as general partner 80 percent/20 percent.

Taking the company private allows the PEF to manage the acquired business without continual public scrutiny and reporting, including quarterly and annual financial reporting.

Limited partners would receive \$25.6 million ($\$32 \times 80\% = \25.6) and the PEF receives \$6.4 million ($\$32 \times 20\% = \6.4).

However, the PEF as the general partner of a fund is not guaranteed a specific return. Daimler paid \$37 billion to acquire Chrysler in 1998 and recently sold it to Cerberus Capital Management (a PEF) for \$7.4 billion. However, Daimler won't receive \$7.4 billion. Daimler will only receive \$1.4 billion of Cerberus' capital contribution to the sale with the balance going to help finance Chrysler operations. Daimler also expects to have to cover another \$1.6 billion in Chrysler losses before

the deal closes. Daimler estimates that it will end up paying out about \$650 million to close the deal.¹⁵ If Cerberus Capital cannot fix the same problems that defeated Daimler, there will be no pay day for any partners.

Carried interest is currently taxed at the favored 15-percent capital gains rate rather than the tax rate applied to ordinary income (up to 35 percent). Since partnerships do not pay income taxes, carried interest passes through to the partners who pay capital gains tax on such income. The bill in Congress is to classify this compensation as income received for services provided and to tax it as ordinary income.

One of the common themes for this change is "fairness." Congressman Rangel seems to imply that private equity partners are manipulating the tax code to avoid paying their fair share of individual income taxes. Do very highly compensated individuals pay too little tax?

An analysis of which group of taxpayers pays the most taxes quickly dispels the notion that the rich don't pay enough taxes. The tables below are based on the most recent information (tax year 2004) available from the Congressional Budget Office.

Table 2 shows the top three income earning levels for 2004 and their share of the federal income tax burden. The top one percent of income earning households pay almost 37 percent of the total federal income tax collected. The top 10 percent of income earning households pay almost 71 percent of the income federal tax burden. Table 3 presents the in-

formation differently but again shows that the highest earning quintile of taxpayers pay over 85 percent of federal income taxes while the bottom two quintiles receive refunds.

Table 2. Cumulative Shares of Federal Income Tax for Tax Year 2004

Income Category	Percentage of Households	Share of Individual Income Tax
Top 1 %	1.0	36.70 %
Top 5 %	5.1	58.40 %
Top 10 %	10.3	70.80 %

Source: *Historical Federal Effective Tax Rates: 1979–2004*, Congressional Budget Office.

Table 3. Cumulative Shares of Federal Income Tax by Quintiles for Tax Year 2004

Income Category	Percentage of Households	Share of Individual Income Tax
Lowest Quintile	20.8	-2.90 % ¹
Second Quintile	19.4	-0.09 %
Middle Quintile	19.5	4.70 %
Fourth Quintile	19.6	13.80 %
Highest Quintile	20.3	85.30 %
	99.6	100.81

Source: *Historical Federal Effective Tax Rates: 1979–2004*, Congressional Budget Office.

¹ The negative tax figures are a result of refundable tax credits, such as the Earned Income Credit.

Existing Case Law

The classification of income as either ordinary income or gain from the disposition of an asset has a long history. In a 1941 U.S. Supreme Court case,¹⁶ the taxpayer received a lump-sum payment for a lease cancellation. The court did not argue that a lease cannot be considered “property” but the court did dispute the characterization of the lease cancellation payment as return of capital. The payment received by the taxpayer was classified as ordinary income simply replacing lost future rent receipts.

In *Gillette Motor Transport, Inc.*,¹⁷ the U.S. government assumed possession and control of the taxpayer’s property during the last 10 months of World War II. The taxpayer received a lump-sum settlement for the value of the property plus interest. The U.S. Supreme Court stated that even though the taxpayer had been deprived of his property and

rightly compensated does not answer the entirely different question of whether or not that transaction gives rise to a capital gain. The court’s opinion states, “[T]he purpose of Congress [was] to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year.” The court concluded that the payment received by the taxpayer was for the government’s right to use the property, which does not rise to the level of a capital asset. The payment was considered in the nature of rent and, therefore, ordinary income.

Courts have applied the same reasoning to recent cases when taxpayers attempt to claim capital gain status for proceeds from the sale of future lottery payments. Typical arguments are that the taxpayer has (1) sold a property right for a capital gain or (2) sold an investment in a \$2 lottery ticket for a capital gain. The courts have been unswerving in ruling against taxpayers. Courts have consistently held that a lump-sum amount that is received instead of a series of future payments, which would be ordinary income, does not convert ordinary income into capital gain.

At the partner level, appellate courts¹⁸ have not taxed partners when they receive a “profits interest” in activity of the partnership. This profits interest (separate from a capital interest in the partnership) represents the partner’s share of future profits earned by the partnership. Unless this interest has a readily determinable value, receipt of a profits interest does not result in a current tax liability, but is taxed when realized.¹⁹

Two Critical Questions

To apply the appropriate tax rate, the first question to answer is, “Is carried interest received because of services provided by the fund managers?” Compensation for services is clearly included in gross income and is taxed at ordinary income rates. However, fund managers already receive a two-percent fee based on the amount of assets under management. This is a fee charged for the opportunity to pool money with other investors and participate in billion dollar ventures. This fee provides the only guaranteed source of income for a PEF.

Carried interest is not simply a fee, but instead only results from profitable activities of the partnership.

That is, carried interest is paid to a PEF, as the general partner, from profits earned when the fund has disposed of a company taken private. If carried interest is not a fee, the second question is, "What is the proper classification of the asset that was sold?"

As the U.S. Supreme Court stated, just because the taxpayer sold property for a gain does not answer the question of how the gain should be taxed. It is not the property that gives rise to a capital gain, but the classification of that property. For example, the sale of an automobile out of inventory by a dealership results in ordinary income. If the individual taxpayer who bought the automobile later sells it to a friend, the result is a capital gain/loss. It is the use of the property by the taxpayer that determines the classification of the property as (in this case) either inventory or a capital asset.

Since partnerships do not pay income taxes, carried interest passes through to the partners who pay capital gains tax on such income.

fund that owns shares of many corporations. The proper classification of carried interest from this transaction should be as a capital gain from the sale of an asset held for investment.

A simple analogy is the purchase of a run-down house. Suppose several investors pool their money and buy a house in need of repairs. They agree to split the profit among themselves after paying for the repairs. The investors make repairs and put the house on the market for sale. The investors have no assurance that there will be a buyer when they complete the project. They have invested their money based on their knowledge of the local real estate market and economic conditions at the time of purchase. If the investors sell the house for a profit, they split the gain according to their agreement. The gain is taxed as a capital gain from the sale of an investment.

What Is the Proper Classification?

There are several possible structures for the disposition of the acquired company. One scenario is that a company is taken private, some assets are sold, operations are streamlined, and the company is returned to a profitable state. This takes place over several years. The company is then sold to another PEF or similar third party.

For example, Blackstone took Extended Stay America, Inc. private in May 2004 paying \$1.99 billion plus \$1.13 billion in debt. In April 2007, Lightstone Group agreed to buy Extended Stay Hotels from Blackstone Group for \$8 billion. This transaction appears to be the sale of an asset purchased as an investment. The asset is a "compound" asset in that it contains several parts, *i.e.*, Extended Stay owns multiple properties. But, essentially it is no different from the sale of a share in a mutual

Conclusion

When the acquisition and sale of a company generates a return on the money invested in the project, the reasonable classification is the sale of a capital asset. The PEF separately earns large fees that are properly taxed as ordinary income. However, the purchase and sale of an asset purchased for investment (be it a company, house, or share of stock) is a capital transaction and should be taxed at the favorable capital gain rates.

Is the legislation in Congress to change the taxation of carried interest good tax policy or just income redistribution? One possible reason Congress has for treating the receipt of carried interest as ordinary income is that PEF partners simply make too much money "and there ought to be a law" against a person making \$600 million a year. "Making the rich pay their fair share of taxes" is simply class warfare in its rudest form.

ENDNOTES

- ¹ The Alternative Minimum Tax Relief Bill of 2008 (H.R. 6275) passed by a 26-to-16 margin.
- ² *Senate Debate on Extenders Thwarted Again; Ways and Means to Consider AMT Bill*, TAX DAY, June 18, 2008, Item #C.1.
- ³ A deduction an amount equal to nine percent of the lesser of the qualified production

- activities income of the taxpayer for the tax year, or taxable income (determined without regard to this section) for the tax year.
- ⁴ *Ways and Means Approves AMT Patch with Revenue Offsets*, TAX DAY, JUNE 19, 2008, Item #C.1.
- ⁵ Peter Lattman, *Partners Score Big in 'Off' Year*, WALL ST. J., Mar. 13, 2008, at C3.

- ⁶ *Report: Blackstone may sidestep IPO taxes*, (July 13, 2007) at <http://money.cnn.com>.
- ⁷ Pension funds contributed approximately 40.3 percent of private equity funds in 2006. *Public Value: A Primer on Private Equity*, THE PRIVATE EQUITY COUNCIL, 2007, available at www.privateequitycouncil.org/wordpress/wp-content/uploads/pec_primer_layout_final.pdf.

⁸ Scott Moritz, *Verizon bets the house on wireless*, June 6, 2008, at <http://money.cnn.com/Fortune>.

⁹ Tennille Tracy, *It's the Fees, not the Profits*, WALL ST. J., Sept. 13, 2007, at C1.

¹⁰ A. Metrick and A. Yasuda, *The Economics of Private Equity Funds*, University of Pennsylvania, The Wharton School, Department of Finance (2007).

¹¹ *Note on Leveraged Buyouts*, Tuck School of Business at Dartmouth College, Sept. 30, 2003, at 1, available at <http://mba.tuck.dartmouth.edu/pecenter/research/pdfs/>

LBO_Note.pdf.

¹² *Id.*

¹³ Katie Benner, *Why Investors Should Steer Clear of Blackstone*, Mar. 10, 2008, available at http://money.cnn.com/2008/03/10/news/companies/benner_blackstone.fortune/index.htm?postversion=2008031105.

¹⁴ *Public Value: A Primer on Private Equity*, *supra* note 7.

¹⁵ Chris Isidore, *Daimler Pays to Dump Chrysler*, May 14, 2007, available at <http://money.cnn.com/2007/05/14/news/compa->

[nies/chrysler_sale/index.htm](http://money.cnn.com/2007/05/14/news/compa-nies/chrysler_sale/index.htm).

¹⁶ *W.M. Hort*, SCt, 41-1 USTC ¶9354, 313 US 28.

¹⁷ *Gillette Motor Transport, Inc.*, SCt, 60-2 USTC ¶9556, 364 US 130.

¹⁸ *S. Diamond*, CA-7, 74-1 USTC ¶9306, 492 F2d 286, *W.G. Campbell*, CA-8, 91-2 USTC ¶50,420, 943 F2d 815.

¹⁹ However, see Rev. Proc. 93-27, 1993-2 CB 343. The IRS says gross income includes the profits interest if it is a limited partnership interest in a publicly traded partnership.

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