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Hon. JOHN THUNE,
U.S. Senator, South Dakota

Hon. BENJAMIN L. CARDIN
U.S. Senator, Maryland

Tax Reform Working Group on Business Income Tax,
U.S. Senate Committee on Finance,
The Capitol,
Washington, D.C.

Re: Comments in Respect of Certain Aspects of the Taxation of "Carried Interest."

Dear Senators John Thune and Benjamin L. Cardin:

We are pleased to submit, on behalf of Neuberger Berman Group LLC ("Neuberger Berman"), this statement to the Business Income Tax Bipartisan Working Group established by the Senate Finance Committee Chairman and the Ranking Member of the Senate Finance Committee in response to the request for comments from the public and stakeholders on the United States income tax code. Neuberger Berman welcomes the opportunity to address certain significant tax issues relevant to it, and thanks the Chairman and the Ranking Member for the development of the working groups to promote tax reform.

Neuberger Berman writes to address particular issues that have been raised with respect to the tax treatment of what is commonly referred to as "carried interest." Neuberger Berman recognizes and agrees that all income earned as compensation for personal services should be taxed on the same basis. However, any change to the treatment of carried interest should not change the tax treatment of gains attributable to the value of an enterprise, which have historically, and quite properly been classified as capital gains.

Many of the concerns raised about the tax treatment of carried interest can be traced to the basic dichotomy under principles of U.S. federal tax law between the taxation of compensation for the provision of services (generally treated as ordinary income) and the taxation of gain recognized on the disposition of an equity interest in an entity (frequently treated as a capital gain, subject to a favorable tax rate).[1] Although, as explained in more detail below, the incentive to convert compensation income into capital gain is also present for businesses conducted in the corporate form, the issue is particularly significant in the partnership context. Neuberger Berman believes that the best approach for new legislation is to require that

[1] The capital gain treatment also applies to an equity interest received initially as compensation for services, provided that the receipt of the interest is included in income.

individuals who render services to an enterprise receive market rate compensation, taxed as ordinary income, for those services. This is both fair to all taxpayers and sound tax policy.

Under this approach, the business owner who receives a salary, guaranteed payment or allocative share of ordinary income would generally be entitled to capital gain treatment on his or her sale of the equity interest in their enterprise. If, however, the arrangement has been structured to recognize primarily capital gain and avoid ordinary income treatment for the value of the services rendered, recharaterization of a portion of the capital gain as ordinary income may be appropriate. All stakeholders involved in this issue appreciate that determining how to make such a recharacterization is difficult. To facilitate the discussion, this statement offers a possible method which should satisfy the tax policy goals described here, although it is also clear that there are other approaches as well.

Neuberger Berman's History and Business

Neuberger Berman was founded in 1939 to manage money for high net worth individuals and families. In 1950, the firm began serving retail investors with the introduction of a no-load mutual fund and, in 1971, began managing separate accounts for institutional investors. Neuberger Berman became a public company in 1999 and was acquired four years later by Lehman Brothers. In 2003, Lehman Brothers also acquired Lincoln Capital, a Chicago-based fixed income firm, and Crossroads, a Dallas-based private equity fund of funds manager. These businesses and Neuberger Berman were integrated and managed as part of the Lehman Brothers Investment Management Division.

In September 2008, Lehman Brothers filed a voluntary petition under Chapter 11 of the U.S. Bankruptcy Code. Rather than let its historic business dissipate, the managers of Neuberger Berman banded together to acquire (through Neuberger Berman) a majority interest in Neuberger Berman's business and the fixed income and certain alternative asset management businesses of Lehman Brothers' Investment Management Division. In May 2009, Neuberger Berman became an independent, employee-controlled firm with a 51% employee ownership stake, and the remaining 49% was held by Lehman Brothers.

Over time, Neuberger Berman used the earnings of the business to liquidate the equity interests held by Lehman Brothers, with the final payment being made on December 31, 2014. The employee-owners of Neuberger Berman have, thus, successfully converted the former Lehman Brothers' asset management business from a branch of a bankrupt financial institution into a large, profitable and valuable independent going concern. The employee-owners' efforts have been translated directly into the goodwill and going concern value of the active business activities of Neuberger Berman, and the value of the employee-owners' equity interests in Neuberger Berman directly reflect this success in building a valuable enterprise.

Neuberger Berman's investment platform consists of 42 distinct investment teams who manage over 100 investment strategies across equity, fixed income and alternative asset classes. Neuberger Berman's investment teams are supported by a 46 person in-house global research

department, a centralized trading platform, and a risk management oversight team. Neuberger Berman's products are offered to clients through a variety of vehicles including mutual funds, UCITS funds, separate accounts, sub-advised funds and private funds. Neuberger Berman earns substantially all of its revenues from investment advisory fees, most of which are recurring and based upon a traditional measure of assets under management. Of the approximately $1.7 billion in revenue received for 2013, approximately 95% is reported as ordinary income for federal income tax purposes.

As of December 31, 2014, Neuberger Berman had more than 2,100 employees worldwide. Although compensation arrangements vary, all employees receive salaries or other compensation commensurate with market rates for similarly situated employees in the investment management industry. The compensation reflects the competition for talent among the many managers in the industry and is determined without regard to the amount of equity owned in the firm.

Neuberger Berman is structured as an LLC that is taxed as a partnership for U.S. federal income tax purposes. Neuberger Berman is currently owned exclusively by its employees (or former employees). As part of the compensation structure for its employees, Neuberger Berman offers selected employees equity interests (generally profits interests), which are subject to vesting over time, restrictive covenants and other terms and conditions. The equity interests that employees receive represent true equity in Neuberger Berman's active asset management business. Each partner is allocated a share of the firm's income, and pays tax on that income at ordinary rates: operating distributions are made to the extent decided by the board, and the employees' equity interests are repurchased at an agreed appraised value upon retirement, termination, or the occurrence of certain other events. The valuation of the units is based on Neuberger Berman's ongoing enterprise value. The structure of the interests, and the ownership of the interests by the employees, does not differ from the equity arrangements of other active businesses—the employees' ownership of their equity interests does not reflect any special priority for participation in "upside" gain or other priority distributions such as may be found in private equity funds (or similar funds).

As discussed in more detail below, Neuberger Berman believes that the concerns motivating various proposals regarding the tax treatment of carried interest do not apply to businesses organized similar to Neuberger Berman (which are structures not uncommon in many fields of business and are generally reflective of employee-owned businesses). Neuberger Berman believes any proposal regarding carried interest should have a carefully circumscribed scope, to ensure that such proposal does not improperly recharacterize gain which is appropriately treated as capital gain derived from the sale of an equity interest in an active business (and not comparable to interest or compensation income) as ordinary income.

Legal Background

As noted above, the favorable tax rate for capital gain provides an incentive to structure arrangements that may mask compensation income. This issue is particularly acute due to the

application of well-established rules governing the taxation of partners and partnerships contained in Subtitle A, Chapter 1, Subchapter K ("Subchapter K") of the Internal Revenue Code of 1986, as amended (the "Code").

Basic Principles of Federal Tax Law on Compensation for Services and Equity Interests

It is well-established—and indeed, likely one of the most fundamental principles of U.S. federal income tax law— that compensation paid for services is income to the recipient and is generally taxed at rates applicable to ordinary income.[2] Is it equally well-established, however, that the sale of capital assets, including such as stock of corporations or equity interests in partnerships and LLCs, is subject to separate treatment and historically preferential tax rates.[3] In fact, the entitlement to the preferred capital gain rate on the sale of a capital asset is undisputed even if the capital asset was received initially as compensation for services.[4] This so-called "sweat equity"—where an entrepreneur provides services to try to build a business over the long term, and expects to reap the reward of any success through increases in the value of his or her equity—is an extremely common feature in many forms of enterprise (including technology start-ups, medical research companies and investment managers).

In the corporate context, the tax treatment of "sweat equity" received in the form of stock is well settled. Indeed, the apparently clear dichotomy between compensation for services and capital gain on the sale of equity applies even where such a clear line might not be easy to justify. The receipt (or vesting) of the stock will result in ordinary income based upon the value of the stock at the appropriate time, but the sale of the stock will result in capital gain or loss. This rule applies even if the stock is issued to the service provider when the enterprise begins and has little value, or if the class of stock being offered is subordinate to other classes of preferred stock and also has little value. In either case, the fundamental tax policy of insuring that services and equity each receive an appropriate return is also present. The stock received may be all (or substantially all) of the compensation the service provider is going to receive. In effect, a "sweat equity" recipient is permitted to forgo current compensation to receive more rewards later as the business does well, and thereby convert this forgone current compensation (which would have been taxed at ordinary income tax rates) into capital gain. An argument for

[2] The current maximum U.S. federal ordinary income tax rate applicable to individuals is 39.6%. *See* Section 1 of the Code.

[3] Long-term capital gains (gains arising from the sale of capital assets held for more than one year) and qualifying dividends of individuals are generally subject to a current maximum U.S. federal income tax rate of 20%. *See* Section 1(h) of the Code. There are certain exceptions to this preferential treatment for, among other things, capital gains attributable to the recapture of depreciation and amortization. *See* Sections 1245 and 1250 of the Code.

[4] The tax rules are more complicated if the capital asset is subject to vesting or substantial risk of forfeiture. *See* Section 83 of the Code.

permitting this trade-off is that the parties to the transaction generally have conflicting interests (both economic and tax) and therefore this arms-length bargain should be respected.[5]

The concerns about this dichotomy between compensation income and capital gain are heightened when applied to carried interests in the partnership context. The current structure of the partnership provisions make it relatively easy to characterize the income attributable to services as capital gain, and therefore potentially permit an inappropriate conversion of compensation income into capital gain.

Characterization of Partnership Income

The general rule treating entrepreneurs contributing services and know-how to a partnership as receiving equity eligible for capital gains treatment is based on a foundational principle of Subchapter K. In particular, one of the fundamental features of the treatment of partnerships, as reflected in the basic tax treatment of partnership items specified in Subchapter K, is that the characterization of the income earned at the partnership level is preserved when this income is allocated to the partners. In other words, if the partnership holds corporate stock and receives a dividend, this dividend income is allocated to the partners, and the partners report this income as dividend income on their own separate tax returns. Any special tax rates (such as the special "qualified dividend income" rate, or any dividends received deductions) that any of the partners are entitled to with respect to dividend income will be applied to the dividend income allocated to such partner from the partnership.[6] Similarly, if a partnership sells a capital asset such partnership had held for longer than one year, the gain on the sale is treated as long-term capital gain when allocated to the partners—thus, individual partners of the partnership are entitled to the beneficial long-term capital gain rate with respect to allocations of this gain.

Treatment of Payments Made for the Provision of Services to Partnerships

There has been some historical development to the question of the provision of services by partners to partnerships before the current debates over carried interest. Prior to 1954, payments to individual partners were never treated as salary. Instead, all payments to partners were treated as distributions by this partnership. In 1954, Congress added a rule that specified the tax treatment of certain payments made in exchange for the provision of services—so-called "guaranteed payments" for services.[7] Although this provision did operate to create special rules

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[5] The individual who gives up compensation surrenders current wealth for future wealth. The corporation (and therefore the other shareholders) give up a current tax deduction. This argument has its limits: it is inapplicable to wholly or family owned enterprises. It may also be less potent if all of the shareholders other than the entrepreneur are tax exempt.

[6] *See* Section 702(a)(5), (b) of the Code.

[7] *See* Section 707(c) of the Code.

for certain compensatory payments to partners, it only applied with respect to payments made without regard to the partnership's income.

To prevent further tax avoidance whereby partnerships would pay service providers by calling them partners and allocating gross income to them, Congress added Section 707(a)(2)(A).[8] This section treats a payment to a partner as one made to a non-partner if (1) a partner performs services for a partnership, (2) there is a related allocation or distribution of income, and (3) when viewed together, the services and allocation are properly characterized as between the partnership and a non-partner.

Although Section 707(a)(2)(A) was enacted to reduce "conversion" of what should be compensation income into capital gains, the scope of Section 707(a)(2)(A) is ambiguous and thought by taxpayers to be fairly limited. The Joint Committee on Taxation report explaining Section 707(c)(2)(A) had set forth six different factors to be considered in whether Section 707(a)(2)(A) should apply, where the most important factor listed is "whether the payment is subject to an appreciable risk as to amount"—tying the applicability of Section 707(a)(2)(A) to whether cash flow to be paid to a partner is subject to the entrepreneurial risk of the partnership.[9] The other five factors are also generally tied, to some extent, to whether the partner's entitlement to the payments is connected to, and exposed to, the economic activity and risk of the partnership itself, or whether it appears more similar to payments made to independent third party service providers.[10]

Carried Interest

Background

With this background, we turn to the notion of "carried interest," and how the carried interest arrangements of certain funds taxed as partnerships applies the basic principles of tax law set forth above (including the rules of Subchapter K) to achieve results that some commentators have suggested are inappropriate. A carried interest is generally an interest in a private equity, venture capital, buyout, or similar fund held by the manager of the fund that gives the manager a right to a significant percentage of the profits of the fund (traditionally 20%), generally where the overall profitability of the fund exceeds a certain benchmark rate that is promised to the limited partners in the fund. This carried interest is generally given to the manager of the fund (sometimes held through special purpose vehicles) and is separate from

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[8] All section references are to the Internal Revenue Code in effect for the year in issue, unless otherwise indicated.

[9] General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (H.R. 4170, 98th Congress; Public Law 98-369), JCS-41-84, at 227. The Joint Committee noted that "[p]artners extract the profits of the partnership with reference to the business success of the venture, while third parties generally receive payments which are not subject to this risk." *Id.*

[10] *Id.* at 228-229.

other compensatory arrangements given to the manager—for instance, a manager frequently also earns a management fee based on the size of the investments—and is granted to the manager as part of the package provided to it in exchange for its management of the fund. In particular, the manager does not generally invest a significant amount of capital as a precondition to the receipt of the carried interest.[11]

The management fee is generally (and appropriately) treated as compensation income paid to the manager. Often, the management fee is sufficient to cover costs, rather than provide adequate compensation for the value of the services performed.[12] The carried interest, however, is treated as a partnership interest in the fund, and any economic payments on allocations made on the carried interest are treated for tax purposes as allocations of the underlying income of the fund. This can be quite significant—if the treatment of the carried interest is respected, then the 20% allocation that the manager receives will preserve the same character as the income has in the hands of the fund itself. Thus, to the extent the fund generated its profits through the sale of capital assets (which is very common for many private equity, venture capital, buyout or similar funds), the capital gain character will be preserved, and the income on the carried interest earned by the manager will be capital gain. This has the potential to subject the manager's income on the carried interest to a significantly lower tax rate than if the income was compensation for services.

A number of commentators have argued that returns to carried interests should be taxed as ordinary compensation income, and these claims have prompted close congressional scrutiny and a number of legislative proposals.[13] The critics' theory is that the fund manager performs services for the partnership in exchange for the carried interest.[14] They argue, therefore, that the carried interest should be taxed similarly to risky compensation given to other service providers, such as stock, stock options, or royalties. In particular, the tax law treats carried interests better than other types of risky compensation because it defers taxation until the gains are realized and

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[11] In many cases, some amount of capital is, in fact, invested by the manager, but such amount is generally small compared to the investment by the limited partners.

[12] This is in contrast to a traditional investment management fee. In general, such investment management fees are measured by a percentage of assets under management. Thus, as the assets appreciate in value, the fees increase, providing appropriate compensation for the services rendered. For most funds, the management fees are determined based upon the amount invested, without regard to whether the investments of the fund increase or decrease in value.

[13] *See, e.g.*, Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1 (2008); Howard E. Abrams, *The Carried Interest Catastrophe*, 129 TAX NOTES 523 (2010); Darryll K. Jones, *Sophistry, Situational Ethics, and the Taxation of the Carried Interest*, 29 NW. J. INT'L L. & BUS. 675 (2009); Philip F. Postlewaite, *The Taxation of Compensatory Profits Interests: The Blind Men and the Elephant*, 29 NW. J. INT'L L. & BUS. 763 (2009); and Adam H. Rosenzweig, *Not All Carried Interests are Created Equal*, 29 NW. J. INT'L L. & BUS. 713 (2009).

[14] *See, e.g.*, Fleischer, *supra*, at 43.

because it taxes the income generally as capital gain. This preferential treatment, they argue, is not justified, and they have proposed a number of different reforms.

Equity Compensation Generally

However, in a wide variety of fields of business, equity of an entity is provided to a service provider (whether the equity is in the form of partnership interests or corporate stock), as a form of compensation to a partner providing services or know-how to the entity. As discussed above, the gain that will be recognized by the service provider can be taxed as long-term capital gain at preferential rates—a result entirely consistent with the intent of Congress.

For instance, in many circumstances, a partnership will be formed by multiple parties, where some parties receive the "sweat equity" while providing services, while other parties provide the capital necessary to convert the work of the service partners into an active and productive business. The partners work to develop and expand the business and, upon sale, all properly recognize capital gain due to the fact they sold, together, a business operation. Real estate and natural resource investments have also historically been accepted as perfectly reasonable situations where a service provider partner can receive "sweat equity." Also, of course, in much more basic situations such as employee-owned businesses, there should be little doubt that equity compensation is appropriately used to incentivize the employee-owners. A significant factor in these business arrangement is that the holder of the "sweat equity" also receives a substantial return taxes as ordinary income, either through market fees, guaranteed payments or other direct compensation or through a share of the ordinary income generated by the business.

It should be without doubt that the recipient of equity in a partnership, at least where the partnership is itself directly operating an active business, or where the partnership is of the common form discussed above (with "sweat equity" partners and capital partners), should have the capital gain treatment of the equity respected. The principles justifying the tax treatment of equity compensation given to employees or officers of a corporation—including the capital gain preference on sale or other exit—should apply equally where the active business happens to be conducted in a tax partnership. The concerns that various commentators have raised with respect to carried interest appear limited to certain types of partnerships and certain activities—namely, private equity, venture capital, buyout or similar funds, where the funds make capital investments in various other entities engaged in a variety of business activities, and where the equity compensation provided to the manager is similar to pure compensation for the successful management of the capital invested by the other partners.

Line-Drawing

Distinguishing between those forms of partnership equity compensation that raise no objections, and those forms that some find objectionable, is a difficult exercise in line-drawing. In many respects, the exercise is not very different than the determinations needed to determine the appropriate transfer pricing or arrangements between related parties under Section 482 of the

Code: it must be determined what portion, if any, of the return on equity received by the service provider is attributable to compensation for services and what portion is attributable to the service provider's portion of the increased goodwill and going concern value of the underlying business. To date, the exercise has apparently been deemed futile, as can be seen by the failure of the Treasury department to issue regulations under Section 707(a)(2)(A) as it relates to services more than 30 years after Congressional authorization to do so; nor are we aware that anyone attempts to make any such allocation.

Presumably, the critics of the current tax treatment of carried interest would argue that so much of the return is attributable to compensation for services that it subsumes any portion of the return that might be attributable to the increase in the value of any particular business that the fund itself is conducting. That approach would appear clearly to tax too much as ordinary income. Another theoretical approach would be to evaluate and determine, perhaps using Section 482 principles, the portion of a particular equity return, which is actually compensation for services. Attempting to make this actual determination would be quite difficult in most situations, and would require an intensive, fact-specific inquiry into each particular taxpayer and each particular fund. Administratively, such an approach might be practically impossible for both taxpayers and the Internal Revenue Service.

Nevertheless, there are alternative approaches which are more practical. These approaches offer some reasonable guidance for drawing the appropriate lines and offer guidelines for distinguishing when capital gain treatment is appropriate for the service provider with respect to his or her equity in the enterprise.

One possible method of distinguishing between those situations in which it is widely considered acceptable to treat equity compensation (inventors, entrepreneurs, employee-owned active businesses) as capital gain, and those where the provision of "sweat equity" is considered inappropriate by some (private equity, venture capital, buyout and similar funds), is to differentiate between those situations where the capital gain to be realized by the service provider is attributable in significant part to an increase in the "goodwill" of the venture. Generally, "goodwill" refers to an intangible asset that reflects an expectation of earnings greater than a fair return on capital invested in the business or other means of production or any other positive attribute a firm acquires in the progress of its business.[15] It is usually said to depend on an expectation of continued patronage.[16] Under Section 197, the term means the value of a trade or business that is attributable to the expectation of continued customer patronage, whether due to the name or reputation of the trade or business, or to any similar factor.

Goodwill would generally be found only in an entity which itself conducts some active trade or business which could reasonably expect continued patronage by its customers, whether

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[15] *See* Rev. Rul. 59-60, 1959-1 CB 237.

[16] *See, e.g.*, Boe v. Commissioner, 307 F.2d 339 (9th Cir. 1962).

other businesses or consumers. However, some critics might argue that a partnership which merely invests in various debt and equity securities would not typically have value attributable to the continued patronage of the customers of the partnership. In particular, such critics might claim that long term continued patronage would be very difficult to expect in a private equity or venture capital fund with a relatively short life span of only five to ten years.

Another method of dividing between those favored types of "sweat equity" recipients and the class of disfavored recipients would be to look at two key factors which appear to be essential in determining when returns to labor may be eligible for capital gain treatment. The first is how entrepreneurial is the activity: the greater the amount of active business as opposed to passive investment activity, the more likely the treatment should be capital. Second, the more that labor and capital are combined into a single return, the more likely it should be treated as capital. For example, many self-created assets (including, significantly, patents) are entitled to capital gain treatment upon disposition. An inventor who puts in many hours of labor receives capital gain treatment when the invention is sold. A proprietor who raises capital to start a business and uses his or her expertise and labor to build the business receives capital gain treatment when he or she sells the business.

A third method is to examine the total amount of ordinary income and capital gain received by a service provider. As in the corporate context, when the service provider receives compensation income commensurate with the value of the services rendered, gain on the disposition of the service provider's equity interests in the enterprise is appropriately taxed as capital gain. In the case of a business conducted through an entity taxed as a partnership, this compensation for services can be earned in two ways. First, the person can receive direct compensation, either through guaranteed payments for services or otherwise as salary.[17] Second, the partner can receive compensation through an allocation of the ordinary income earned by the partnership, as is the case of service entities such as accounting firms, law firms and traditional investment managers.

Under any of these approaches or a combination of them, it is clear that a sale of a Neuberger Berman partner's equity in the firm should be taxed as capital gain. First, the increase in the value of the equity is attributable to the entrepreneurial efforts of the partners. During the Lehman bankruptcy, it was unclear whether Neuberger Berman and the investment management business would survive, or whether the professionals would scatter to other firms and let the business dissipate. Instead, the senior managers and others banded together to resurrect the firm and lead it to its current success. Second, Neuberger Berman is engaged in the active business of providing professional investment advice to a wide range of clients. The advice is rendered with respect to the client's assets—unlike private equity or other similar funds, Neuberger Berman does not hold an equity interest in the underlying investments themselves. Moreover, more than 95% of the income earned by Neuberger Berman is taxed as fees for services rendered, at

[17] A person may, for example, be a partner of a parent partnership, yet an employee of a subsidiary partnership that is a regarded entity.

ordinary income tax rates. Third, each Neuberger Berman employee receives directly, as salary, a market rate compensation for his or her services and this compensation is taxed as ordinary income.

Recent Proposals on Carried Interest

There have been several proposals in the last few years in Congress to change the tax treatment of certain types of partnership interests, as part of an attempt to change the tax treatment of carried interest. One of the main proposals is generally attributed to Representative Sander Levin, and has been submitted multiple times in somewhat differing versions over the past several Congresses. A more recent significant proposal is one attributed to Representative David L. Camp, former Chairman of the Ways and Means Committee. We discuss these proposals in turn below.

Summary of the Levin Proposal

The most recent proposal by Representative Levin addresses carried interest by recharacterizing capital gain earned by certain specified "investment partnerships" and allocated to certain specified "investment services partnership interests" as ordinary income. The Levin proposal also recharacterizes any gain from the disposition of any "investment services partnership interests" as ordinary income.

A partnership would be subject to the recharacterization rules if substantially all of the assets of the partnership are "specified assets" and if more than half of the capital of the partnership is attributable to "qualified capital interests" which, in the hands of the holders of such interests, are not held in connection with a trade or business. "Specified assets" includes any "security" as defined in Section 475(c)(2) (which includes any stock of a corporation), interests in partnerships, and certain other property. Generally speaking, the proposal is intended to address partnerships that principally engage in the business of acquiring, holding and then selling stock in corporations, equity interests in various entities, or other financial assets, and where more than half of the partnership's capital is attributed to passive investors.

An interest in an investment partnership is an "investment services partnership interest," and therefore subject to the recharacterization rules, if (subject to special rules and exceptions) it is acquired or held by any person in connection with the conduct of certain trades or businesses (generally, advising with respect to the investing or selling of, managing of, or arranging financing with respect to "specified assets," or related or similar services). Thus, in order for a person to be treated as holding an "investment services partnership interest," the person must hold the interest in connection with the provision of enumerated services to an "investment partnership" with respect to the assets actually held by the partnership.

Under the Levin proposal, once a partnership interest is classified as an "investment services partnership interest" in an "investment partnership," all capital gain allocated to such interest, and all gain recognized on the sale of such interest, is recharacterized as ordinary

income (with some exceptions). The key exception is that any portion of the investment services partnership interest attributable to a "qualified capital interest"—generally, the portion of any interest which is attributable to actual invested capital by a partner (or income that has already been recognized by such partner) and which receives entitlements to allocations and distributions in proportion to other holders of interests attributable to invested capital—is not recharacterized. Thus, fundamentally, the Levin proposal treats *all* of the income associated with an "investment services partnership interest" as attributable to compensation (and thus subject to ordinary income treatment), except to the extent directly attributable to direct cash contributions or income actually recognized on the interest.

Summary of the Camp Proposal

The proposal by Representative Camp has two significant components. The first component is the identification of a class of partnership interests that would be subject to special income classification rules—in effect, the proposal identifies certain interests as being similar to carried interests and thus subject to recharacterization. The second component is the method by which certain capital gain income allocated to a holder of such an identified interest, or recognized upon sale, exchange or disposition of such an interest, is recharacterized as ordinary income.

The Camp proposal's recharacterization rules would apply to an "applicable partnership interest." An "applicable partnership interest" is any interest in a partnership which, directly or indirectly, is transferred to (or is held by) the taxpayer in connection with the performance of services by the taxpayer, or any other person, in an "applicable trade or business." An applicable trade or business is a trade or business that consists, in whole or in part, of the following activities: (1) raising or returning capital; (2) investing in (or disposing of) trades or businesses (or identifying trades or businesses for such investing or disposition); and (3) developing such trades or business.

Once a partnership interest is classified as an "applicable partnership interest," a somewhat complex calculation would be applied to determine whether certain allocations of capital gain with respect to, or recognized capital gain on the sale, exchange or disposition of, the interest are recharacterized as ordinary income. This proposal can be analogized to a related-party loan, although loan terminology or characterization is not actually used in the text of the proposed legislation or official explanations of the Camp proposal.

Very generally, the effect of the proposal is to set a minimum baseline of ordinary income that a holder of an "applicable partnership interest" will need to recognize as a result of his or her interest in the partnership equal to: (i) an annual rate equal to applicable federal rate plus 10% multiplied by (ii) the portion of the partnership's capital that will "fund" the carried interest in excess of the holder's actual capital contributions, decreased by (iii) ordinary income to the extent realized by the holder. This value is calculated from year to year through the life of the fund, and unused recharacterization amounts carry forward to future years. In effect, the holder of a carried interest can be thought of as borrowing capital from the capital investors, and

must record a deemed interest charge (equal to the applicable federal rate plus 10%), which must be paid when capital gains are allocated or recognized.

Although the technical rules are complicated, as a general matter, if a manager of a fund has a 20% carried interest and has made no capital contributions, 20% of the fund's capital contributions would be treated as "funding" the manager's return. The annual rate applicable to that capital would be the amount of capital gain that is subject to recharacterization as ordinary income. The stated intent of the proposal is to approximate the portion of the manager's earnings that the proposal's drafters view as compensation for managing the fund's capital. It is unclear, however, whether any management fee income earned by the manager might reduce the amount of capital gain subject to ordinary income recharacterization.

Analysis of the Proposals

The Camp proposal properly recognizes the difficulties of altering the tax treatment of some partnership interests, and does take a relatively sophisticated approach to determining the amount of recharacterization of capital gain into ordinary income. The Camp proposal does, for instance, recognize that a partnership interest falling under the "carried interest" classification has both a capital and compensation component, and attempts to create a rough rule of thumb as to how to calculate the size of the appropriate compensation component. The Levin proposal merely identifies a target and then recharacterizes the entire amount of gain from the target as ordinary. In this regard, the Levin proposal makes no attempt to discern what income is appropriately attributable to services.

Both proposals have several shortcomings, in particular with respect to investment manager or investment advisor businesses (such as Neuberger Berman's). First, the definitions of "investment services partnership interest" (in the Levin proposal) and "applicable partnership interest" (in the Camp proposal) are too vague and broad.

It is unclear whether partnership interests in all businesses which provide investment advice or management would be subject to these definitions. While active investment advisor or investment manager businesses consist of raising funds from investors and identifying and overseeing investments and related activities, it is uncertain whether or not such activities would be covered, as the traditional advisor or manager does not have an equity interest in the investments acquired with those funds. Particularly with respect to the Camp proposal, this latter element—having an equity interest in the entities in which the investment is made—should be important. Furthermore, the proposals are not clear whether the investments in, and management of, any partnership's own operating subsidiaries would constitute "trades or businesses" that would potentially cause the partnership interests to be covered by the proposals. Under a broad reading of these provisions, a pure holding company that happens to be a tax partnership (in other words, a partnership whose main activity is managing subsidiary entities, which conduct active trades or businesses) might be classified as issuing "investment services partnership interests" or "applicable partnership interests" to its officers and employees as compensation,

even though such a partnership would be no different than a holding company that happened to be a corporation.

Second, investment advisors and investment managers will generally own some interests in traditional private equity or venture capital funds that they manage. It is not clear from the proposals what threshold portion of the partnership's total assets or gross income must be involved in a relevant trade or business in order to cause the investment advisor itself to be treated as caught by the proposals.

Third, the proposals' calculation of the amount of income to be recharacterized as ordinary might be inappropriate in many cases. With respect to the Levin proposal, the characterization of *all* of the income from a specified partnership interest (other than the "qualified capital interest" portion of such interest) as being effectively compensation is greatly overinclusive. Even a partner who invests no capital into a partnership, and who receives a partnership interest solely due to services, is receiving *some* income attributable to goodwill, going concern value, or other intangible capital assets upon the later sale or liquidation of the partnership or its underlying business activities.

With respect to the Camp proposal the 10%-plus-applicable-federal-rate recharacterization rate might in some cases be too low, if under a fair arm's length pricing for a particular partnership and for a particular service provider the amount that would ordinarily be charged for services would be even higher. On the other hand, the Camp proposal's ambiguity as to whether any credit is provided for management fees or other service income actually received has the risk of causing too much capital gain to be recharacterized. In those circumstances where the managers are receiving a substantial amount of compensation income (which every party is appropriately recognizing as compensation income), it might be inequitable to cause any portion of a capital gain allocation to be recharacterized as ordinary income.

An Alternative Approach to the Taxation of Carried Interest

As is apparent from the above discussion on the Levin and Camp proposals, there are at least two key problems facing any proposal to changing the tax treatment of carried interest: (1) determining which partnership interests should be subject to the new tax treatment, and (2) how to appropriately and equitably calculate the portion of any allocation or gain on the sale of such an interest that is compensation (and thus, should be characterized as ordinary income, regardless of the character of any underlying allocations or gain). One possible approach to this question is to consider refreshing an older, outdated rule that also attempted to divide up income properly allocable to capital and properly allocable to services—although the older rule did so in a much different context. In particular, old Section 1348 and the regulations promulgated thereunder attempted to address this question of dividing up allocated income in the context of a maximum tax on earned income. As discussed further below, this approach could be adopted for use for carried interest.

This approach is consistent with the approach in the Camp proposal of attempting to fix a formula for approximating the amount of income attributable to services performed. It differs from the Camp approach in that the focus is on the total amount of income recognized, taking into account both the ordinary income and capital gain allocated to the service provider partner over the life of the partnership. Thus, for those partnerships that generally provide ordinary compensation income to partners commensurate with their services, this approach should not cause any recharacterization of gain recognized on the sale of their equity interests.

Background to Section 1348 and Applicable Regulations

Section 1348 was enacted in order to provide a maximum tax rate for certain high-income earners who generally earned their income through services (such as attorneys, accountants and doctors). The stated concern was that high rates of taxation on earned income generally increased the incentives to engage in tax shelter activity, as well as creating disincentives to engage in additional personal effort to generate more income. As such, Congress felt a maximum rate of tax was warranted—but only on income generally earned through services, rather than investment income.

Section 1348 imposed a 50 percent maximum rate on a taxpayer's "earned taxable income." "Earned taxable income" was calculated based on "earned income," which was defined by cross-references to Section 401(c)(2)(C) and Section 911(b). Generally, "earned income" included wages, fees for compensation, prizes, gains from the sale or licensing of property where an individual's personal efforts created such property, and the like, and excluded dividends, other distributions, capital gains and the like (in other words, investment income).

By separately creating a maximum tax on certain income while leaving the maximum tax rate unbounded on other income, the regulations under Section 1348 had to address the situation where an individual engaged in a trade or business in which both personal services and capital were material income-producing factors. The solution that the final regulations adopted was to allow for a reasonable allowance of the income generated by the business as compensation for personal services rendered by the individual, but a cap of 30 percent of the share of the net profits of such trade or business was placed on the allocation. Thus, taxpayers were allowed to treat some of the income they earned in an unincorporated business as tax preferred (which, in Section 1348, was "earned taxable income"), subject to a cap—this approach balanced the need for fairness to the taxpayer while ensuring that an excess amount of income would not be recharacterized.

Application of Section 1348 Principles to Carried Interest

The precedent set forth by Section 1348 provides a helpful framework for an alternative approach to handling the tax treatment of carried interest. First, the concept of capital and services both being material income-producing factors could be imported as a criterion for determining whether any given partnership interest should be subject to any new, special carried interest rules. Second, the notion of reasonable allowances for services or capital (with a

specified maximum percentage of the profits treated as tax-favored income) could be used to calculate the appropriate portion of any capital gain allocated to, or recognized on the sale of, any partnership interest classified as carried interest that should be recharacterized as ordinary income. These two points are elaborated on below.

First, any carried interest proposal could adopt a rule that the only partnership interests covered by any new rule are those interests in partnerships in which capital is a material income-producing factor and in which services are performed by direct or indirect holders of interests in the partnership. For these purposes, capital would be considered a material income-producing factor only if the return on that capital consisted of material amounts of investment income (such as capital gains, dividends or interest). An interest holder would be considered to perform services to the partnership if there are any allocations of income or gain made to the interest holder that are not proportionate to its capital contributions. This test appropriately excludes several categories of partnerships from the definition of carried interest—such as partnerships in which capital is not material (such a law firms, or investment advisory or asset management firms).[18]

With such a definition of carried interest, any proposal could apply the principles of Section 1348 and the final regulations promulgated thereunder to calculate the appropriate amount of income recharacterized as ordinary income in the case of capital gains allocated to, or recognized from the sale of, such interests. The main concern motivating the various carried interest proposals is the prevention of the conversion of income that is appropriately considered compensation into income treated as capital gain. Similarly, Section 1348 was concerned about the appropriate characterization of income between "earned taxable income" and other income (which was, generally speaking, investment income). As such, the rules under Section 1348 could be adapted, with some adjustments, to apply to carried interests.

One possible approach for a recharacterization rule would be as follows: First, for each holder of a specified partnership interest, calculate how much total income the holder of the partnership interest earns through its participation in the underlying businesses of the partnership, both through allocations of income attributable to the specified partnership interest, gain from the sale of such an interest, and compensation income directly earned—such as through separately-stated fees, guaranteed payments under Section 707 or salary paid to the holder of the interest. Second, there needs to be determined a reasonable allowance for a return on capital or the goodwill of the business with respect to the interest. This amount could vary over time, for example, starting at one fixed percentage of the total income from the interest and increasing up to a maximum percentage after a period of years. The actual percentage maximum merits careful discussion, but should reflect that over a long period of time, a more substantial portion of the increase in value of an enterprise may be attributable to goodwill of a shared

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[18] These tests could be applied on a consolidated basis for controlled groups of pass-through entities. Moreover, these tests should be measured over a period of several years. In general, if the overwhelming portion (more than 85% for example) of income recognized by the partnership is ordinary, the partnership should be excluded from operation of this recharacterization rule.

deployment of capital. (For purposes of the remainder of this discussion and the examples, we have used an 80% maximum after 10 years.) Finally, to the extent that the percentage of the total income earned with respect to the specified business reported as capital gain, aggregated over all tax years in which the holder held the interest, is greater than the aggregate reasonable allowance for a return on capital or goodwill over this time period, this excess gain is recharacterized as ordinary income.

It is worth noting that this approach could also be useful in other similar situations where there is a conflict between the accretion of value in a business which is subject to capital gains treatment and compensation for services. For instance, closely-held subchapter S corporations have long been identified as a vehicle for conversion of compensation income into dividends and capital gains through the use of artificially low employee-owner compensation. Similarly, closely-held C corporations can be used by wealthy individuals to defer income recognition indefinitely and to convert compensation income into capital gains by declining to take a salary for the management of the corporation. Congress could consider adopting rules similar to the above approach to apply to these fact patterns.

This approach is closely tailored to the particular policy concerns raised by those critical of the current tax treatment of carried interest: namely, the concern that carried interests in investment partnerships are converting income that should be compensation into capital gain. The methodology set forth above appropriately focuses on the right question: how much income earned by the holder of a carried interest should be deemed compensation for services, and how much income has the holder of such carried interest already reported as ordinary income. Finally, the methodology set forth above minimizes the risk that taxpayers could take aggressive positions with respect to the reasonable allowance for returns on capital or goodwill by placing an overall cap on the percentage of income that could be allocated to this category.

Examples

a. <u>Example one</u>

Assume an individual X owns carried interest issued by partnership P on day 1 of Year 1. Under the terms of the carried interest, X is entitled to certain allocations of income, gain, loss and deduction from P. X also receives a salary of $5 a year for services performed with respect to P's business. X did not invest any capital in P.

P's only assets are shares of stock in portfolio corporations. At the end of Year 2, P sells certain of its portfolio corporations and recognizes capital gain, of which $100 is allocated to X. Assume that the applicable percentage return on capital and goodwill is 10%.

In Year 1, X earned and reported $5 of ordinary income with respect to X's salary. In Year 2 X earned $105—$5 from salary, and $100 from capital gain allocated from the carried interest. Because the applicable percentage return is 10%,— the portion of X's total return of

$110 that may be considered attributable to goodwill or shared capital is $11, $89 of the capital gain is recharacterized as ordinary income.

b. Example two

Assume an individual X owns carried interest issued by partnership P on day 1 of Year 1. Under the terms of the carried interest, X is entitled to certain allocations of income, gain, loss and deduction from P. X also receives a salary of $75 a year for services performed with respect to P's business. X did not invest any capital in P.

In Year 10, X sells the carried interest and recognizes a gain of $1500. In Years 1 through 10, X earned and reported an aggregate amount of $750 of ordinary income with respect to X's salary. In Year 10, X earned an additional $1500 of capital gain from the sale of the carried interest. Assume the maximum rate is 80% of total income that may be treated as capital gain. In this case, X's total income is $2250 from salary and capital gain from the sale of the carried interest. Using the 80% maximum, X is entitled to treat up to $1800 as capital gain. Therefore, the entire amount of gain on the sale of carried interest would be treated as capital gain and no portion would be recharacterized.

Conclusion

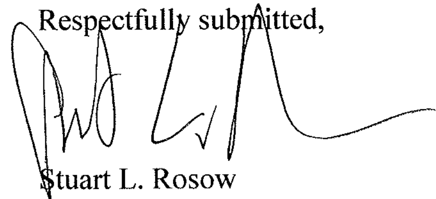
The critics of the current tax treatment of carried interest have raised multiple objections to what many view as the tax-advantaged nature of partnership allocations and sales, at least in the context where the capital gain allocated (or recognized on sale) represents, in such critics' view, compensation for services. We acknowledge the concern of such critics, although as we discuss above, the current tax treatment is a long-established aspect of basic U.S. federal income tax principles and of the operation of Subchapter K. We also note that there are exceedingly difficult line-drawing issues that arise when attempting to identify those partnership interests where such concerns are more central versus other partnership interests where the tax treatment of capital gain allocations and capital gain recognition on sale are undeniably appropriate.

Neuberger Berman and we support the tax reform endeavors to create a simple, fair tax system that promotes growth, innovation and employment. Efforts to reform the tax treatment of carried interest should focus on those situations in which compensation income masquerades as capital gain. Such reform should not discourage development of active business enterprises through the combination of sweat equity and capital, but should continue to reward those who contribute to such development by continuing to tax the realization of that enterprise value as capital gain.

The proposal set forth in this statement attempts to draw the line at the most appropriate place and create a manageable system to recharacterize allocations and gain as ordinary income. This is consistent with attempts made in the Camp proposal, and seeks to balance the competing tax policy objectives.

Neuberger Berman and we are pleased to have this opportunity to submit this statement and are happy to discuss this matter and other tax reform issues with members of the working group and the staff.

Respectfully submitted,



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