U.S. TREASURY DEPARTMENT
OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 10 A.M. July 11, 2007
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TESTIMONY OF TREASURY ASSISTANT SECRETARY FOR TAX POLICY ERIC SOLOMON BEFORE THE SENATE FINANCE COMMITTEE ON THE TAXATION OF CARRIED INTEREST

Washington D.C. --Mr. Chairman, Senator Grassley, and distinguished Members of the Finance Committee:

Thank you for the opportunity to testify regarding the federal income tax treatment of carried interests. Carried interests have received increased public attention recently. However, they are not a new phenomenon. They have been used successfully for many decades by small and large partnerships, across many industries, to pool the capital of investors with the ideas and skills of other entrepreneurs in joint profit-making enterprises.

My testimony will discuss the current taxation of carried interests, the use of carried interests by both small and large partnerships in industries as diverse as real estate and natural resources, and the similarity of the current tax treatment for carried interests and other analogous areas. I will discuss alternatives that have been suggested for the taxation of carried interests. While it is important to review our tax laws and policies, we must fully assess the costs and benefits of changes that may have adverse consequences on entrepreneurial activity.

The 2 and 20 for Private Equity and Hedge Funds

Hedge and private equity funds are typically structured as partnerships for federal tax purposes. Managers of these funds often receive an asset-based management fee paid annually of 2 percent of the fund's committed capital and an interest of 20 percent in the profits of the fund. The 20 percent profits interest is referred to as the "carried interest." For managers of private equity

funds and in certain cases for managers of hedge funds, the carried interest represents a substantial portion of their total return from the funds.

Upon receipt of the carried interest, the fund manager becomes a partner in the fund and pays tax in the same manner as other partners on his distributive share of the fund's taxable income. The character of the income included in the manager's distributive share is the same as the character of the income recognized by the fund. Thus, if the fund earns ordinary income or short-term or long-term capital gain, each partner's distributive share includes a portion of that income. For example, if the fund sells stock of a portfolio company that it has held for more than a year, the manager's share of the long-term capital gain is taxed at the 15-percent federal long-term capital gain rate. Fund managers receive a benefit from owning the carried interest only if the fund is successful. In this manner, the fund managers' interests are aligned with those of the capital investors.

Background

A. Business Structures

There are many ways for U.S. business activity to be organized for tax purposes, including as corporations, sole proprietorships, or partnerships. Each of these business models contributes to the competitiveness of the U.S. capital markets and economy.

A partnership is a flexible business arrangement among co-venturers. The partnership format gives the partners substantial choice in how they will share the economics of their joint undertaking. The partners decide what each will contribute in capital, ideas and skills and how they will share in profits and losses. This flexibility of the partnership structure enables entrepreneurs more easily to establish and grow their businesses.

For tax purposes, a partnership is broadly defined to include any two or more persons that join together in a business activity for the purpose of making a profit. An attractive feature of a partnership is that income is not taxed at the partnership level. Instead, income flows through to the partners and is taxed to them based on the income's underlying character (e.g., ordinary income or capital gain). In contrast to this pass-through treatment for partnerships, income earned by a corporation is subject to two layers of federal income tax -- once at the corporate level and again at the shareholder level when dividends are paid.

The partnership tax rules are intended to permit taxpayers to conduct joint business or investment activities through a flexible economic arrangement without incurring an entity level tax. The tax rules allow partnerships to make special allocations of income and loss among partners to accommodate the myriad economic arrangements seen in the market today. Consequently, the partnership structure is an attractive business model for business enterprises of all types and sizes.

In 2005, nearly 2.8 million businesses of all sizes and in a broad range of industries filed a partnership information return.[1] The number of partnership returns filed by industry was as follows:

- Real estate, rental, and leasing -1,295,948
- Services - 520,726
- Finance and insurance - 87,958
- Wholesale and retail trade - 189,976
- Construction - 182,153
- Agriculture, forestry, etc. - 127,605
- Manufacturing - 44,828
- Information - 37,438
- Mining - 28,205
- All other - 48,788

The U.S. economy by any measure is among the strongest and most resilient in the world, and the flexibility offered by partnerships plays an important role in that success.

B. Taxation of Compensation for Services

The Internal Revenue Code has historically taxed compensation differently from income generated from investment. Compensation is taxed at ordinary income rates and is subject to employment tax. Income or gain derived from the return on investment is taxed at a variety of rates, which are generally lower than the ordinary income rates and are designed to encourage entrepreneurship, investment, and risk taking. Lower tax rates have been an important factor in promoting long-term economic growth. The best examples of the difference in rates are the federal individual long-term capital gain rate of 15 percent, and the federal individual dividends rate of 15 percent, compared to the maximum federal individual ordinary income tax rate of 35 percent.

Compensation income is typically a fixed and determinable amount payable to either an employee or independent contractor. The employee receives a salary (wages) that is reported on Form W-2, while an independent contractor receives payments normally reportable on a Form 1099. The employee's or independent contractor's right to payment of compensation, other than certain incentive bonus payments or performance fees, is not subject to entrepreneurial or business risks.

Unlike employees and independent contractors, a partner has a stake in the business with rights and obligations that vary depending upon the terms of the partnership agreement. While compensation of employees and independent contractors is typically fixed and payable regardless of the success of the business, a partner's distributive share of partnership income is subject to the entrepreneurial risks of the partnership's business. The partners are rewarded only

[1] Although income, gain and losses flow through to the partners, the partnership is required to file an information tax return on Form 1065. Partnerships are also required to provide the partners with a declaration of their share of the partnership items on a Schedule K-1.

if the partnership succeeds. In some instances, however, a partner may have a right to receive from the partnership guaranteed payments for services. Guaranteed payments under section 707(c) of the Code are determined without regard to income of the partnership and are taxed as ordinary income. The key difference between a guaranteed payment to a partner and a partner's distributive share is that the guaranteed payment is not subject to business risks while the distributive share is subject to such risks.

Additionally, the partnership rules in section 707(a) provide that if a partner engages in a transaction with a partnership other than in his capacity as a partner, the transaction will be viewed as one between the partnership and a person who is not a partner. Generally, payments falling in this category are not contingent in amount and not subject to any appreciable risk of nonpayment. In that regard, payments under section 707(a) are similar to guaranteed payments under section 707(c), with the principal difference being that the section 707(a) payments are made to a member other than in his capacity as a partner, while guaranteed payments under section 707(c) are made to a partner in his capacity as a partner. In any event, section 707(a) payments and section 707(c) payments are not subject to business risk.

Taxation of Partnership Profits Interests (Carried Interests)

A. General Rules

A consistent principle in the development of the federal income taxation of compensatory transfers of partnership interests is that after the partnership interest is issued, the service provider is taxed as a partner in the same manner as a person making an investment of capital in the partnership. As a partner, the service provider reports his distributive share of the partnership's taxable income. The character of the taxable income as either ordinary income (or loss) or capital gain (or loss) is normally determined for all partners at the partnership level.

Under current guidance, whether a service provider is taxed on the receipt of a partnership interest depends on whether the interest is a capital interest or a profits interest. A capital interest provides the service provider with a share of the partnership's liquidation proceeds if, immediately after the interest was transferred, all of the partnership's assets were sold at their fair market value, all liabilities were paid in full, and the remaining amount was distributed to the partners. A profits interest, by contrast, does not provide the service provider with a share in the liquidation proceeds. Rather, a profits interest allows the service provider to share only in the partnership's future income or appreciation in the partnership's assets.

Current guidance provides that a service provider is taxed on the receipt of a capital interest, but generally is not taxed on the receipt of a profits interest. This treatment of a profits interest represents a reconciliation of the tension between the partnership tax rules and provisions related to the taxation of compensation. Section 83 of the Code requires a service provider to recognize compensation income when vested property is transferred in connection with the performance of services. The amount of income that is recognized is equal to the excess of the fair market value of the vested transferred property over the amount paid for the property, if any. However, under the partnership tax rules, which are designed to tax income only once, if a partner were taxed upon the transfer of a profits interest, he would be taxed twice on the same income. First, he

would be taxed at ordinary income tax rates on the value of the profits interest at the time of transfer, which is generally determined by reference to the anticipated future stream of partnership income. Second, he would be taxed again when the income is recognized by the partnership. Also, determining the fair market value of a profits interest is difficult because of the speculative nature of the interest.

The taxation of the receipt of a profits interest has been the subject of substantial litigation dating from *Diamond v. Commissioner* (7th Cir. 1974) to *Campbell v. Commissioner* (8th Cir. 1991). In the most recent case, *Campbell*, the Eighth Circuit Court of Appeals held that the profits interest transferred to the service provider had no fair market value because of its speculative and contingent nature.

Rather than continue to expend resources in asserting that the receipt of a profits interest is taxable and challenging the valuation of profits interests, the Treasury Department and IRS in 1993 adopted an administrative rule that the receipt of a profits interest by a service provider generally is not a taxable event. In 2005, the Treasury Department and IRS published proposed regulations that would continue in most instances the approach adopted in 1993. The proposed guidance departs from the current administrative rules in one significant respect by requiring that the partnership and its partners make an affirmative election to determine the fair market value of the partnership interest transferred to service providers by reference to its liquidation value. This election is intended to ensure that neither the partnership nor any partner will take a deduction in connection with the transfer of the interest that is different from the amount (if any) included in income by the service provider. This symmetry in the context of a profits interest means that, while the service provider reports no income in connection with the transfer of a profits interest, neither the partnership nor any partner may take a deduction.

> The following simple example illustrates the application of these tax rules:
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> Entrepreneur and Investor form a partnership to acquire a corner lot and build a clothing store. Investor has the money to back the venture and contributes $1,000,000 . Entrepreneur has the idea for the store, knowledge of the fashion and retail business, and managerial experience. In exchange for a 20 percent profits interest, Entrepreneur contributes his skills and know how. Entrepreneur and Investor are fortunate and through their combination of capital and efforts, the clothing store is successful. At the end of 5 years, the partnership sells the store for $1,600,000 reflecting an increase in the going concern value and goodwill of the business. Entrepreneur has $120,000 of capital gain and Investor has $480,000 of capital gain. (Some of the gain may be treated as ordinary income due to recapture of previously claimed depreciation deductions.)

Under current tax law, Entrepreneur does not have compensation income at the time of receipt of the 20 percent profits interest. He is treated as a partner from the date he receives the interest and is subject to tax at capital gains rates on his portion of the gain from the sale of the business. To the extent the partnership generates ordinary income from operations prior to the sale of the business, Entrepreneur is subject to tax at ordinary income tax rates on his distributive share of the operating income.

B. The Taxation of Carried Interests Parallels Taxation of Services in Analogous Areas

The development of the tax law regarding partnership interests transferred in connection with the performance of services generally has been consistent with the tax treatment of compensatory transfers in other areas. These areas include the taxation of services provided by a sole proprietor in his business, the taxation of a stock grant to a service provider, and the taxation of a service provider under various forms of sharing arrangements, such as for oil and gas exploration and development.

A sole proprietor who through his labor turns an idea into a valuable business generally will be taxed at capital gains rates when the business is sold. Our federal income tax system does not attempt to tax the gain from the sale of the business at ordinary income tax rates under the theory that the proprietor's labor enhanced the value of the business. Furthermore, the federal income tax law does not attempt to distinguish between the enhanced value of the business due to the proprietor's services and the enhanced value due to market conditions.

When a corporate employer makes a vested stock grant to an employee, the employee recognizes compensation income under section 83 of the Code in an amount equal to the fair market value of the shares, and the employer is entitled to a tax deduction in an equal amount. Thereafter, the employee is treated as holding the stock as an investor and is subject to tax at capital gains rates on any gain from the sale of the stock.[2] The employee may continue to be employed and his labor may contribute to the enhancement of the value of the shares, but he is still taxed at capital gains rates on the gain from the sale of the shares.

Stock options awarded to an employee are taxed somewhat differently than a stock award. Under section 83 of the Code and Regulation §1.83-7, the employee is not subject to tax upon the grant of a nonqualified stock option that has no readily ascertainable value. Instead, at the time of exercise of the nonqualified stock option, the employee recognizes compensation income on the spread between the fair market value on the date of exercise and the exercise price, and the employer is entitled to a tax deduction in an equal amount. Following exercise of the option and receipt of the shares, the employee is treated as an owner and is taxed in the same manner as an investor at capital gain rates on the gain from the sale of the shares. A special statutory rule applies for the taxation of incentive stock options (ISOs) under section 422 of the Code. In this case, the employee is not subject to tax at ordinary income rates when the ISO is exercised and is subject only to tax at long-term capital gain rates when the shares are sold, provided that the employee holds the shares for at least one year from the date of exercise or two years from the date of grant, whichever is longer.

Some have argued that the transfer of a carried interest is similar to the transfer of a stock option to an employee and should be taxed similarly. Both the stock option and profits interest provide

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[2] A stock grant is similar economically to a profits interest in certain circumstances. For example, assume an executive of a new corporation receives a grant of Class A shares, which by their terms provide the executive with an economic return only after payment to the capital investors in Class B preferred shares. In this case, the value of the Class A shares is speculative and contingent on performance of the business. Consequently, the Class A shares may have only nominal value. Under the rules for taxing a stock grant, the executive is subject to tax upon the receipt of the Class A shares, but the amount taken into income may be nominal.

the service provider with the right to receive a fixed interest -- 20 percent for example -- in the appreciation of the enterprise's equity over a stated amount. However, important differences between stock options and carried interests lead to different tax treatment.

Upon receipt of a stock option, the employee has no ownership rights until the option is exercised and he receives the underlying shares. The employee has no voting rights and no economic rights to dividend payments with respect to the stock until the option is exercised. Upon receipt of a carried interest, the service partner has an immediate ownership interest in the enterprise with all of the attendant rights and responsibilities. The service provider is taxable on his distributive share of partnership taxable income and has the rights and responsibilities with respect to ownership of the partnership interest provided in the applicable partnership agreement and state law.

Another analogy may be made to oil and gas contractual arrangements. It is common in connection with the development of oil and gas properties for the owner of a property to enter into a contractual sharing arrangement with a service provider in which the service provider provides exploration, development and completion services on the property. For example, the owner may assign an interest in the oil and gas property to the service provider in exchange for the service provider's agreement to drill and complete a well on the property. The tax law dating back to the early 20th Century has been that the service provider is not taxed upon receipt of the property interest, but rather that the service provider is taxed only on the production from or sale of the property. As such, except for recapture of intangible drilling costs, depletion and accelerated depreciation, gain from the sale of the oil and gas property is treated as section 1231 gain taxable at long-term capital gains rates.

In all of the situations described above, services have unquestionably contributed to an increase in the value of the business or assets. Nevertheless, following the service provider's receipt of an ownership interest in the enterprise, if capital assets (or assets described in section 1231 of the Code) are sold, the gain is taxed at capital gain rates. The common theme in all these instances is that a person who contributes skill and knowledge to the success of the enterprise and receives an ownership interest that is subject to entrepreneurial risk will succeed only if the enterprise succeeds. The service provider in each instance has acquired an ownership interest in the enterprise betting that his upside will provide an ample economic reward. The incentives provided by this structure contribute to innovation and risk-taking.

Alternatives to the Current Taxation of Carried Interests

Several alternatives to the current system of taxing carried interests have been suggested. This section briefly summarizes the alternatives and some of the potential issues.

A. Value the Carried Interest as of the Date of Transfer and Tax the Service Partner on That Value

This alternative requires that a value be determined for the carried interest at the time of receipt by the service partner and that the service partner include the amount in income as ordinary

income. The partnership (and thus the partners) would be entitled to a deduction equal to the income recognized by the service partner subject, however, to existing limitations on deductions.

Concerns and complexities raised by this alternative include:

- The service partner would be taxed twice on the same income. First, the service partner would be taxed at ordinary income rates on the fair market value of the profits interest, which is generally the present value of the future stream of income. Thus, he would pay that tax at the beginning of the business venture, whether or not it succeeds. Next, the service provider would be taxed on his share of the income generated by the partnership, which flows through to the partners.

- As discussed above, this approach requires the valuation of speculative partnership interests. Requiring a valuation of such partnership interests, including private equity and hedge fund interests, would lead to litigation between the service partner and the IRS. In the past, the IRS has attempted to enforce a fair market value valuation on transfers of profits interests, which led to protracted litigation.

- This proposal would add substantial uncertainty to the taxation of carried interests for partnerships, small and large, in many industries. This rule is likely to affect the economic deal between the service partners and the investors.

B. Tax the Service Partner's Distributive Share of Income From the Carried Interest as Ordinary Income

This alternative requires treating the service partner's distributive share of taxable income from the carried interest as ordinary income taxed at ordinary income tax rates.

Concerns and complexities raised by this alternative include:

- The proposal reverses longstanding tax rules that determine the character of a partner's distributive share of partnership income by reference to the character of the partnership's income. These rules have operated successfully for many decades.

- Unlike the simple example of the Entrepreneur and Investor earlier in this testimony, in many instances, the service partner will make an investment of contributed capital or undistributed profits in the partnership or may be responsible for a portion of the partnership's debts. Under this alternative, the tax rules would have to provide for an allocation of the partnership's taxable income between the carried interest and invested capital and distinguish between the enhancement of value due to services and the enhancement of value due to market conditions.

- This would add significant complexity to the tax law and increased administrative difficulties for the IRS.

- The proposal leads to tax results that are at odds with other analogous instances, such as sole proprietorships.

- This proposal would add substantial uncertainty to the taxation of carried interests for partnerships, small and large, in many industries. This rule is likely to affect the economic deal between the service partner and the investors.

C. Impose Annual Income Realization on the Service Partner

This alternative retains present-law treatment of the transfer of a carried interest, with the result that the service partner recognizes no income upon receipt of the carried interest and is immediately treated as a partner. Unlike current law, however, this alternative would require that the service partner recognize ordinary income each year in an amount intended to approximate the cost of the service partner's use of the investors' capital. For example, if the investors contributed a total of $1,000,000 to the partnership and the service partner had a 20-percent carried interest, the service partner would be treated as having the use of 20 percent of the investors' capital of $1,000,000, or $200,000, and would recognize annually ordinary income at a predetermined cost of capital rate.

Concerns and complexities raised by this alternative include:

- It is unclear what the cost of capital rate should be for the service partner and whether different rates would be necessary based upon each particular partnership.

- It is unclear how best to determine the amount of investor capital available for use by the service partner.

- This proposal would affect all types of partnerships, small and large, in many industries and would add substantial complexity to the tax law. This rule is also likely to affect the economic deal between the service partner and investors.

Concerns Regarding Changes in the Taxation of Carried Interests

The current tax treatment of carried interests provides certainty for taxpayers in planning their transactions and, at the same time, is administrable for the IRS. The current taxation of carried interests also encourages the pooling of capital, ideas and skills in a manner that promotes entrepreneurship and risk-taking.

Partnerships of every size and every industry have established and operated their businesses in reliance on the existing tax rules. While it is important to review our tax laws and policies, we must be cautious about making significant changes to partnership tax rules that have worked successfully to promote and support entrepreneurship for many decades.

Thank you for the opportunity to testify before the Committee today. I would be pleased to answer any of your questions.

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