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Capital Gains, Ordinary Income and Shades of Gray

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WHAT is carried interest? And why does it get the tax treatment it does?

These arcane questions are usually reserved for the green-eyeshade crowd. And for good reason: they can be so bewildering that they seem to be taken from an I.Q. test written just for accountants. But because they concern a few very high-income individuals, including the presidential candidate Mitt Romney, for whom I am an adviser, they have been getting broader attention lately. So let's examine the issue.

Throughout almost the entire history of the United States income tax, the tax rate on capital gains has been lower than that on ordinary income. Today, the top rate is 15 percent for capital gains and 35 percent for ordinary income. There are good reasons for this — including, for example, the fact that capital gains are not indexed for inflation. But put that aside. If we are going to tax capital gains at a lower rate, one question necessarily arises: What is a capital gain, and how can we distinguish it from ordinary income?

The answer seems simple. If you have a job, the money you are paid for your work is ordinary income. If you buy an asset at one time and sell it later for a higher price, the profit you made from holding it is a capital gain.

But is it really that easy? Consider five examples, and see if you can identify what is ordinary income and what is a capital gain:

• Abe buys a vacation home for his family for $800,000. Some years later, when his children have grown and left home, he sells it for $1 million. He makes $200,000.

• Bob is a real estate investor. After scouring the market for the best investment opportunities, he buys a house for $800,000 that he believes is undervalued. A few years later, he sells it at $1 million, for a profit of $200,000.

• Carl is a real estate investor and a carpenter. He buys a dilapidated house for $800,000. After spending his weekends fixing it up, he sells it a couple of years later for $1 million. Once again, the profit is $200,000.

• Dan is a real estate investor and a carpenter, but he is short of capital. He approaches his friend, Ms. Moneybags, and they become partners. Together, they buy a dilapidated house for $800,000 and sell it later for $1 million. She puts up the money, and he spends his weekends fixing up the house. They divide the $200,000 profit equally.

• Earl is a carpenter. Ms. Moneybags buys a dilapidated house for $800,000 and hires Earl to fix it up. After paying Earl $100,000 for his services, Ms. Moneybags sells the home for $1 million, for a profit of $100,000.

How much capital gains and ordinary income do we attribute to Abe, Bob, Carl, Dan and Earl? (To keep things simple, assume that Ms. Moneybags is untaxed. Think of her as running a pension fund or university endowment.)

Let's take the easy cases first. It seems clear that Abe has a capital gain. His profit of $200,000 comes from simply holding an asset over time. And it seems equally clear that Earl's $100,000 is ordinary income. He is being paid for providing his services.

But between these cases, the situation gets murky. Bob and Carl are being rewarded in part for the time they spend, but the tax law treats both as having earned entirely capital gains. The tax code does not count the time that Bob spent looking for investments as employment and his gain as taxable labor compensation, even though some of it arguably is. Nor does it try to tax Carl's sweat equity as labor compensation.

This brings us to Dan and his partnership with Ms. Moneybags. The tax law treats this partnership as exactly equivalent to Carl's situation. In this case, however, the $200,000 capital gain is divided into halves: some of it goes to Ms. Moneybags, who provided the cash, and some goes to Dan, who provided the sweat equity. Once again, nothing is treated as ordinary income.

In some ways, this treatment makes sense. After all, Dan is doing half of what Carl did, so why should he have to pay a higher tax rate than Carl did on that half of his income? On the other hand, it seems that Dan is getting off easy. Dan does not seem very different from Earl, because both are getting $100,000 for fixing up the house.

If these examples leave your head spinning, you are not alone. Economists and tax lawyers who study these issues are unsure about the best way to handle these situations in practice.

Here is where carried interest enters the picture. Carried interest from a private equity partnership is like the income that Dan earns from his real estate partnership. In this case, however, Dan is not a carpenter but a specialist in business turnarounds. The partnership does not buy dilapidated houses to fix up and sell; it buys troubled businesses to fix up and sell. And just as Dan the carpenter can treat his share of the partnership income as a capital gain, Dan the business specialist can do the same.

Critics of current law think it is unfair that these private equity partners are taxed at capital gains rates, whereas other high-income individuals like doctors and lawyers pay the much higher tax rates for ordinary income. It is a reasonable point, and some reform may well be appropriate. But as the tax situations of Abe through Earl illustrate, it is not obvious what the best approach would be. Not all problems have easy answers.