FIGURE 5

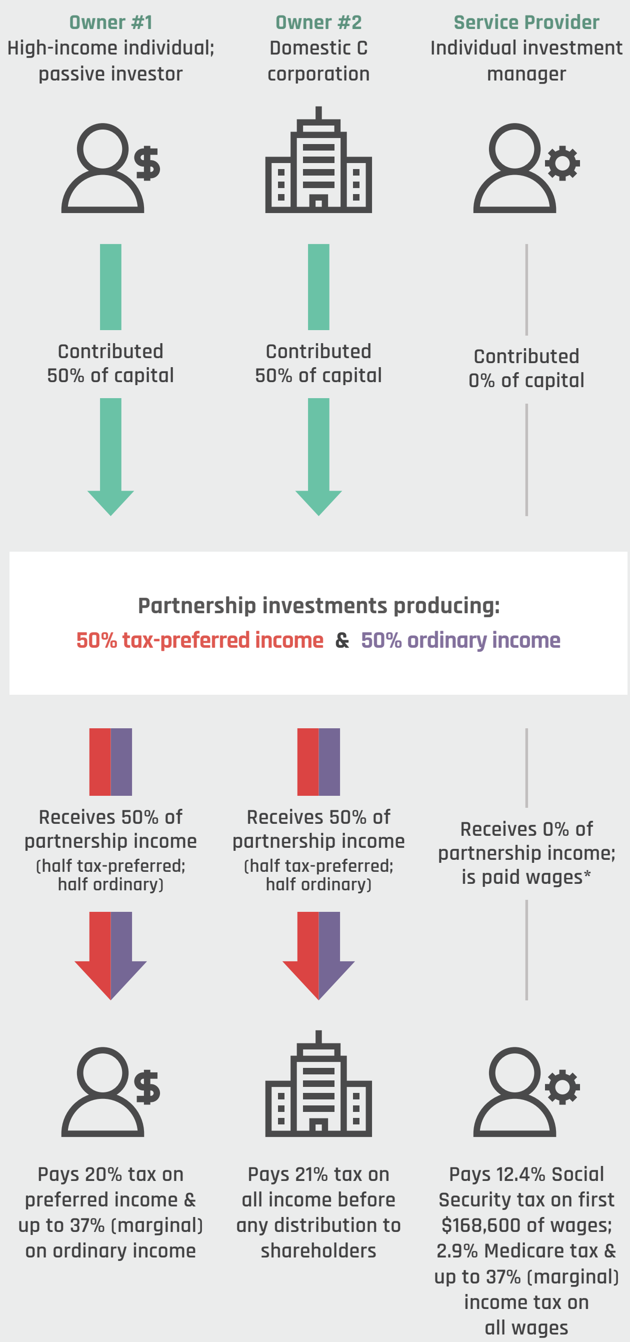
Lax U.S. partnership tax rules allow ownership structures that maximize tax avoidance

Simplified examples of investment fund structures, based on 2024 tax rates

The first example, inflexible allocations of income, is a counterfactual in which taxable income flows are determined entirely by partners' capital contributions.

- Capital contributions
- Tax-preferred income
- Ordinary income

SCENARIO 1 — INFLEXIBLE ALLOCATIONS

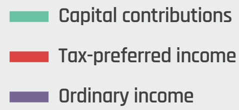


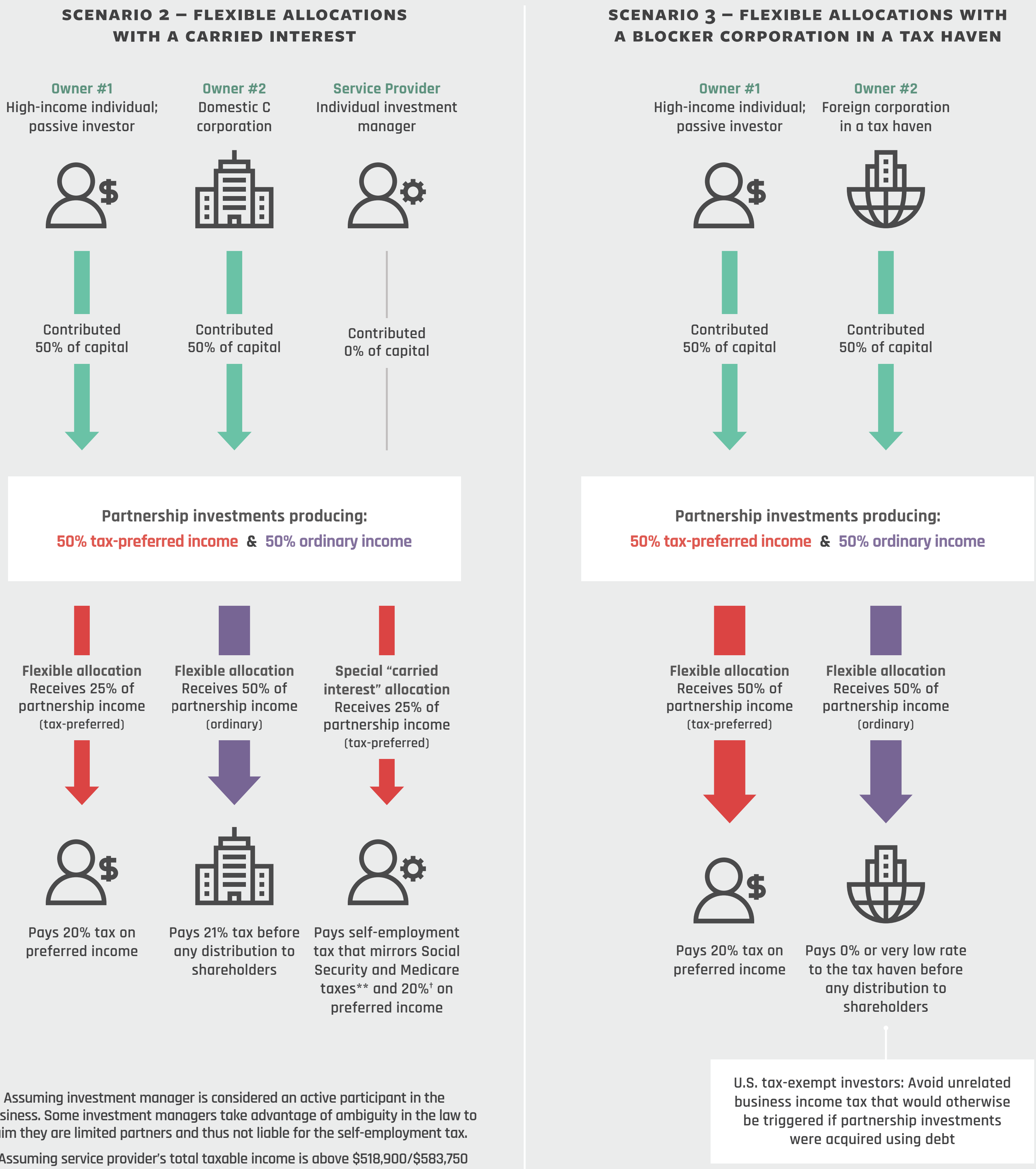
* In the partnership context, wages are called "guaranteed payments" if the service provider is a partner, rather than an employee or an independent contractor. In any of these cases, the partnership can deduct the payment as a business expense.

Note: Tax-preferred investment income includes long-term capital gains and qualified dividends, while ordinary investment income includes short-term capital gains and interest. For simplicity, the net investment income tax and additional Medicare tax are ignored in these examples, as are the potential income flows to and tax treatment of the shareholders of the domestic corporation. Technically, flexible tax allocations have to substantially reflect the economic reality of the enterprise and cannot be designed purely for tax avoidance, but that has proven to be a difficult standard for the IRS to define and enforce.

Source: Author's visualization, informed by Michael Love, "Where in the World Does Partnership Income Go? Evidence of a Growing Use of Tax Havens." Working Paper (2021), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3985535.

The second examples, flexible allocations with carried interest and with a blocker corporation, depict how U.S. partnerships are actually able to allocate taxable income: as determined by their partnership agreement, in compliance with (highly flexible) partnership tax allocation rules.





** Assuming investment manager is considered an active participant in the business. Some investment managers take advantage of ambiguity in the law to claim they are limited partners and thus not liable for the self-employment tax.

† Assuming service provider's total taxable income is above \$518,900/\$583,750 (single/married)