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ARTICLES

TWO AND TWENTY: TAXING PARTNERSHIP PROFITS IN PRIVATE EQUITY FUNDS

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Private equity fund managers take a share of the profits of the partnership as the equity portion of their compensation. The tax rules for compensating general partners create a planning opportunity for managers who receive the industry standard “two and twenty” (a two percent management fee and twenty percent profits interest). By taking a portion of their pay in the form of partnership profits, fund managers defer income derived from their labor efforts and convert it from ordinary income into long-term capital gain. This quirk in the tax law allows some of the richest workers in the country to pay tax on their labor income at a low rate. Changes in the investment world—the growth of private equity funds, the adoption of portable alpha strategies by institutional investors, and aggressive tax planning—suggest that reconsideration of the partnership profits puzzle is overdue.

While there is ample room for disagreement about the scope and mechanics of the reform alternatives, this Article establishes that the status quo is an untenable position as a matter of tax policy. Among the various alternatives, perhaps the best starting point is a baseline rule that would treat carried interest distributions as ordinary income. Alternatively, Congress could adopt a more complex “Cost-of-Capital Method” that would convert a portion of carried interest into ordinary income on an annual basis, or Congress could allow fund managers to elect into

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either the ordinary income or “Cost-of-Capital Method.” While this Article suggests that treating distributions as ordinary income may be the best, most flexible approach, any of these alternatives would be superior to the status quo. These alternatives would tax carried interest distributions to fund managers in a manner that more closely matches how our tax system treats other forms of compensation, thereby improving economic efficiency and discouraging wasteful regulatory gamesmanship. These changes would also reconcile private equity compensation with our progressive tax system and widely held principles of distributive justice.

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It’s like Moses brought down a third tablet from the Mount—and it said “2 and 20.”

—Christopher Ailman, Chief Investment Officer, California State Teachers’ Retirement System¹

INTRODUCTION

Private equity fund managers take a share of partnership profits as the equity portion of their compensation. The industry standard package is “two and twenty.” The “two” refers to an annual management fee of two percent of the capital that investors have committed to the fund. The “twenty” refers to a twenty percent share of the future profits of the fund; this profits interest is also known as the “promote,” “carry,” or “carried interest.” The profits interest is what gives fund managers upside potential: If the fund does well, the managers share in the treasure. If the fund does badly, however, the manager can walk away. Any proceeds remaining at liquidation would be distributed to the original investors, who hold the capital interests in the partnership.²

The tax rules treat partnership profits interests more favorably than other forms of compensation. By getting paid in part with carry instead of cash, fund managers defer the tax on income derived from their human capital.³ Often, they are also able to convert the character of that income from ordinary income into long-term capital gain,

¹ Neil Weinberg & Nathan Vardi, *Private Inequity*, FORBES, Mar. 13, 2006, at 88, 92 (quoting Christopher Ailman).

² For detailed discussions of the financial structure of venture capital funds, see generally Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1070–76 (2003), and William A. Sahlman, *The Structure and Governance of Venture Capital Organizations*, 27 J. FIN. ECON. 473 (1990). For a description of private equity funds, see generally Ulf Axelson et al., *Why Are Buyouts Levered: The Financial Structure of Private Equity Funds* (Nat’l Bureau of Econ. Research, Working Paper No. 12826, 2007), available at <http://www.nber.org/papers/w12826>.

³ See I.R.S. Notice 2005-43, 2005-1 C.B. 1221 (providing liquidation value safe harbor for purposes of I.R.C. § 83 (West 2007) and, thus, helping to ensure that profits interest is not taxed at time of issuance).

which is taxed at a lower rate.⁴ This conversion of labor income into capital gain is contrary to the general approach of the Internal Revenue Code⁵ and diverges from the treatment of other compensatory instruments. Partnership profits interests are treated more favorably than other economically similar methods of compensation, such as partnership capital interests, restricted stock, or at-the-money non-qualified stock options (the corporate equivalent of a partnership profits interest)⁶. The tax treatment of carry is roughly equivalent to that of Incentive Stock Options (ISOs).⁷ Congress has limited ISO treatment to relatively modest amounts; the tax subsidy for partnership profits interests is not similarly limited.⁸ A partnership profits interest is the single most tax-efficient form of compensation available without limitation to highly paid executives.

This Article explains why the status quo is untenable as a matter of tax policy. One significant concern is economic distortion. There is a loss of efficiency when investors and managers alter their contracts to provide compensation in this tax-advantaged form: Investors swallow an increase in agency costs in order to allow fund managers to

⁴ See I.R.C. § 702(b) (West 2007) (providing general rule that character of income included in partner's distributive share is determined as if item of income were realized at partnership level).

⁵ See *infra* notes 98–107 and accompanying text (comparing tax treatment of carried interest to that of corporate executive compensation).

⁶ See *infra* note 103 (explaining economic equivalence of partnership profits interest and corporate nonqualified stock options).

⁷ In both cases, the executive receives the benefit of deferral and conversion into capital gain. In the case of Incentive Stock Options (ISOs), the employer loses the benefit of any deduction for compensation. In the case of carried interest, the limited partners (LPs)—the partners not involved with management and who are the equivalent of the employer in this context—may be somewhat better off than the corporate employer: Although the deduction is deferred, the LPs can achieve the same result as a deduction for compensation by allocating income directly to the general partner (GP)—the manager of the fund. This is equivalent to the LPs taking that amount into taxable income and then paying it over to the GP as an incentive fee and taking a deduction for that payment. In the case of LPs who are taxable individuals, carried interest may often be preferable to an incentive fee because of limitations on the LPs' ability to take deductions. See, e.g., I.R.C. § 67(a) (West 2007) (setting two percent floor for miscellaneous itemized deductions). In the case of private equity funds, the “employers” are mostly tax-exempt limited partners, making the loss of the benefit of a current deduction less relevant.

⁸ Congress has limited ISO treatment to options on \$100,000 worth of underlying stock, measured on the grant date, per employee per year. I.R.C. § 422(d) (West 2007). The capital interests underlying the profits interests of fund managers, by comparison, generally range from \$100 million to several billion dollars. See, e.g., Henny Sender, *Carlyle Looks Beyond Credit Turmoil To Raise Real-Estate, Buyout Funds*, WALL ST. J., Sept. 8, 2007, at B3 (discussing Carlyle's new \$3 billion real estate fund and \$7 billion buyout fund); Andrew Metrick & Ayako Yasuda, *The Economics of Private Equity Funds 6–7*, (Sept. 9, 2007) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=996334 (noting median buyout fund size of \$600 million). For an explanation of why an option and carried interest are economically equivalent, see *infra* note 103.

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pay lower taxes, which in turn allows investors to pay less compensation.⁹ Current law also unnecessarily favors private investment funds, which are organized as partnerships, over investment banks and other financial intermediaries organized as corporations.¹⁰ This tax advantage for partnerships distorts the decision as to how to organize new business entities.

Distributive justice, of course, is also a concern. This quirk in the partnership tax rules allows some of the richest workers in the country to pay tax on their labor income at a low effective rate. While the high pay of fund managers is well known, the tax gamesmanship is not. Changes in the investment world—the growth of private equity funds, the adoption of portable alpha strategies by institutional investors, the increased capital gains preference, and more sophisticated tax planning—suggest that reconsideration of the partnership profits puzzle is overdue.¹¹ Ironically, while the public and the media have focused on the “excessive” pay of public company CEOs, the evidence suggests that they are missing out on the real story. In 2004, almost nine times as many Wall Street managers earned over \$100 million than did public company CEOs; many of these top earners on Wall Street are fund managers.¹² And fund managers pay tax on much of that income at a fifteen percent rate,¹³ while the much-maligned¹⁴ public company CEOs pay tax at a thirty-five percent rate on most of their income.¹⁵

At the same time, populist outrage won't necessarily lead us to the right result. The best tax policy design depends on an intricate

⁹ I have previously considered how the tax law may distort contract design and the behavior of fund managers. See Victor Fleischer, *The Missing Preferred Return*, 31 J. CORP. L. 77, 108–16 (2005) (identifying use of hurdle rates rather than true preferred returns and absence of preferred return in venture capital context as potential tax-related distortions).

¹⁰ Private investment funds organize as partnerships or limited liability companies (LLCs), rather than C corporations, in order to avoid paying an entity-level tax that would eat into investors' returns. See *Private Equity Funds*, Tax Mgmt. Portfolios, Tax Mgmt. Inc. (BNA) No. 735, at A-13 (2004) (“Virtually every U.S. private equity fund, with the exception of certain parallel entities, is structured as a pass-through entity for tax purposes.”).

¹¹ See *infra* Part II.

¹² Steven N. Kaplan & Joshua D. Rauh, *Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?* 3 (Ctr. for Research in Sec. Prices, Working Paper No. 615, 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=931280.

¹³ See I.R.C. § 1(h)(1)(C) (West 2007) (setting fifteen percent tax rate on most long-term capital gains).

¹⁴ See, e.g., Eduardo Porter, *More than Ever, It Pays To Be the Top Executive*, N.Y. TIMES, May 25, 2007, at A1 (describing widening gap between CEO pay and pay of other executives and average workers).

¹⁵ See I.R.C. § 1(a)–(d), (i) (West 2007) (setting thirty-five percent as top rate on ordinary income).

and subtle set of considerations, including the extent to which one wishes to subsidize entrepreneurial risk taking, whether one believes the partnership tax rules are a sensible way to provide such a subsidy, one's tolerance for complex rules, and one's willingness to tolerate the deadweight loss associated with tax planning. Furthermore, increasing the tax rate on private equity firms will encourage them, on the margins, to hire employees overseas rather than in the United States. That said, if transaction costs require the performance of many of these services in the United States, this may not be much of a concern.

This Article thus offers a menu of reform alternatives, and it illuminates what might make some alternatives more attractive than others. The right answer depends on the relative weight that policy-makers choose to place on these various considerations. While I do not take a strong position on which reform alternative is best, I do conclude that a rule treating all carried interest distributions as ordinary income is probably the most appealing policy option.

This Article makes three principal contributions to the tax policy literature. First, it makes a practical contribution to the doctrinal literature by reexamining the partnership profits puzzle in the context of modern private equity finance. The tax policy implications of current law are quite different—and the case for law reform is stronger—than one might think from reading the partnership tax rules in isolation, without considering the institutional context in which they matter the most.¹⁶

Second, the Article introduces a novel “Cost-of-Capital Method” to measure and tax the value of carried interest and similar compensatory arrangements. This approach treats the general partner (GP), the manager of the fund, as if it has received an interest-free loan from the limited partners (LPs)—the investors—and taxes the GP annually on the forgiven interest as if it were ordinary income. The method approximates the tax treatment of other economically similar arrangements and curbs the opportunities to defer tax on compensation to fund managers. It also disaggregates the timing and character issues in a useful way.¹⁷

¹⁶ Cf. Chris William Sanchirico, *The Tax Advantage to Paying Private Equity Fund Managers with Profit Shares: What Is It? Why Is It Bad?* 75 U. CHI. L. REV. (forthcoming 2008) (manuscript at 24), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=996665 (observing how context matters by noting that “[w]ere all partners taxed in the same way, compensatory profits interests would reduce the fund manager/general partner’s tax bill only nominally”). For an explanation of the circumstances under which the treatment of carried interest does and does not provide a tax benefit, see *infra* notes 44–46 and accompanying text.

¹⁷ See *infra* Part V.D (describing Cost-of-Capital Method).

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Third, the Article builds on this Cost-of-Capital Method to offer a new, elective approach to taxing carried interest—what I term the “Talent-Revealing Election.” This alternative would offer GPs an explicit election between (1) deferring income until gains are realized by the partnership, at which point the GP’s distributive share would be taxed as ordinary income, and (2) following the Cost-of-Capital Method, which imposes a smaller tax on the GP annually at ordinary income rates but allows capital gains treatment on further appreciation in the fund.¹⁸ A similar alternative—an implicit election—would provide a baseline rule treating all gains distributed to the GP as ordinary income but would allow the GP, if it so chooses, to restructure the arrangement into an actual formal loan from the LPs. Existing Code sections would treat the forgiven interest on the loan as ordinary income, producing the same result as the Cost-of-Capital Method.¹⁹ In either case, the elective approach provides an added benefit. GPs who are confident in their ability to produce high returns will opt for the Cost-of-Capital Method, trading in the benefit of deferral in exchange for long-term capital gains treatment on the back end. GPs who are less confident may prefer deferral on the front end and ordinary income on the back end and may tend to use the baseline rule, taxing gains distributed to the GP at ordinary rates. This Talent-Revealing Election may thus provide useful information about the GPs to investors choosing among funds.²⁰

The Article is organized as follows. Following this Introduction, Part I sets the stage with an overview of how private equity funds are taxed. Part II explains why addressing the long-standing partnership profits puzzle has taken on new importance. Part III analyzes deferral issues, while Part IV analyzes conversion issues. Part V, building on this analysis, offers a menu of reform alternatives. I conclude that a baseline rule treating carried interest distributions as ordinary income is probably the best alternative.

¹⁸ See *infra* Part V.E (describing Talent-Revealing Election).

¹⁹ See I.R.C. § 7872 (West 2007) (including forgone interest in borrower’s income); *id.* § 163(d) (limiting interest deduction where borrowed money is used to make investments and, thus, preserving taxation of forgone interest); *infra* note 216 and accompanying text (describing implicit election).

²⁰ See *infra* Parts V.E–F. (further explaining Talent-Revealing Election and demonstrating that GP’s choice, in part, depends on fund’s expected rate of return).

I

OVERVIEW OF TWO AND TWENTY

A. *Organization of Private Investment Funds*

In order to keep the length of this Article manageable, I offer only a brief description of the organization of private investment funds before turning to the tax treatment of fund manager compensation.²¹ Funds are organized as limited partnerships or limited liability companies (LLCs) under state law. Investors become limited partners (LPs) in the partnerships and commit capital to the fund. A general partner (GP) manages the partnership in exchange for an annual management fee, usually two percent of the fund's committed capital.²² The GP also receives a share of any profits; this profit-sharing right is often called the "promote," "carry," or "carried interest." The GP typically receives twenty percent of the profits. The carried interest helps align the incentives of the GP with the goals of the LPs: Because the GP can earn significant compensation if the fund performs well, the fund managers are driven to work harder and earn profits for the partnership as a whole. The GP also contributes some of its own capital to the fund so that it has some "skin in the game." This amount ranges from one to five percent of the total amount in the fund. This structure of private investment funds is illustrated in Figure 1.

After formation, the GP deploys the capital in the fund by investing in portfolio companies.²³ In the case of venture capital funds, the portfolio companies are start-ups. In the case of private equity funds, the fund might buy out underperforming public companies, divisions of public companies, or privately held businesses. After some period of time, the fund sells its interest in the portfolio company to a strategic or financial buyer, or it takes the company public

²¹ For sources providing detailed descriptions of how private investment funds are organized, see *supra* note 2. For more on how tax considerations affect the compensation arrangements between fund managers and investors, see Fleischer, *supra* note 9, at 113–16, which explains how managers in venture capital funds are compensated and asserts that form of compensation can, in part, be explained by tax considerations. That article also includes a brief description of the structure of investment partnerships that is similar to the one in this Section. *Id.* at 82–83.

²² The GP traditionally has a small number of professionals as members. In recent years some larger GPs have chosen to go public, issuing units in the partnership to investors. See, e.g., Victor Fleischer, *Taxing Blackstone*, 61 TAX L. REV. (forthcoming 2008) (manuscript at 9–13), available at <http://ssrn.com/abstract=1012472> (describing structure of Blackstone Group's initial public offering).

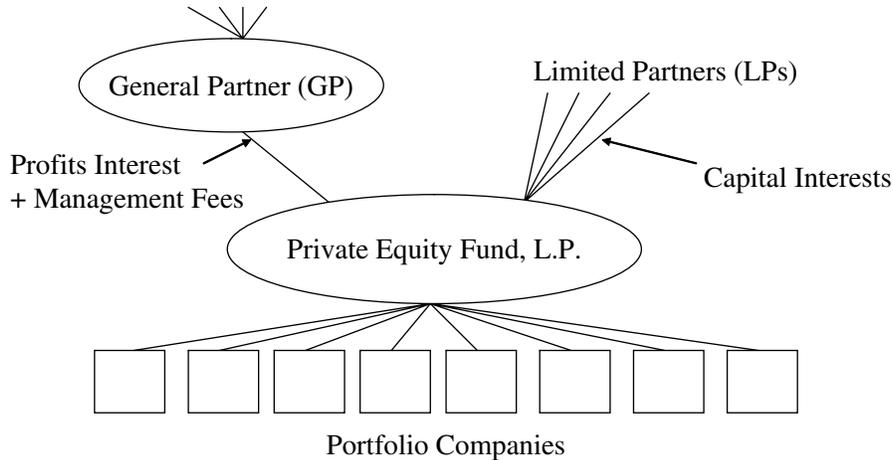
²³ As part of the private equity fund's portfolio of investments, the companies acquired by private equity funds are commonly known as "portfolio companies."

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FIGURE 1
Investment Professionals (members of the GP)



and sells its securities in a secondary offering.²⁴ The proceeds are then distributed to the partners, and when all of the partnership's investments have been sold, the fund itself liquidates.

The carried interest creates a powerful financial incentive for the GP. Often, the GP is itself a partnership or LLC with a small number of professionals as members. The GP receives a management fee that covers administrative overhead, diligence, and operating costs and pays the managers' salaries. The management fee is fixed and does not depend on the performance of the fund. The carried interest, on the other hand, is based on performance. Because private equity funds are leanly staffed, a carried interest worth millions of dollars may be split among just a handful of individuals.²⁵ The next Section provides an overview of the tax treatment of this compensation.

B. Tax Treatment of Two and Twenty

The tax treatment of a fund manager's compensation depends on the form in which it is received.²⁶ The management fee is treated as

²⁴ The average holding period varies depending on market conditions. See *A Boom in Bust-Ups*, *ECONOMIST*, Sept. 29, 2007, at 92, 92 ("Carlyle's boss, David Rubenstein, told a recent private-equity conference that the average holding period is likely to rise to four to six years, far above today's levels.").

²⁵ See generally Paul Gompers & Josh Lerner, *An Analysis of Compensation in the U.S. Venture Capital Partnership*, 51 *J. FIN. ECON.* 3 (1999) (discussing trends in compensation). Subsequent updates are reflected in JOSH LERNER ET AL., *VENTURE CAPITAL & PRIVATE EQUITY: A CASEBOOK* 69–75 (3d ed. 2005).

²⁶ The discussion in this Section of the tax treatment of carried interest is similar to that in a previous article of mine. See Fleischer, *supra* note 9, at 108–13.

ordinary income to the GP, included in income as it is received on an annual or quarterly basis.²⁷ As I discuss later, however, many fund managers take advantage of planning techniques that convert these tax-disadvantaged management fees into tax-advantaged carry.²⁸

The treatment of carried interest is more complicated. When a GP receives a profits interest in a partnership upon the formation of a fund, that receipt is not treated as a taxable event.²⁹ This treatment seems counterintuitive. The GP receives something of value at the moment the partnership agreement is signed. But the difficulty of valuation and other considerations prevent the tax law from treating this receipt as a taxable event. This creates a conceptual tension. On the one hand, a carried interest is a valuable piece of property that often turns out to be worth millions and even hundreds of millions of dollars. On the other hand, fair market value is difficult to pin down at the time of grant because the partnership interest is typically non-transferable, highly speculative, and dependent on the efforts of the partners themselves (and thus would have a lower value in the hands of an arm's-length buyer).³⁰ How should we treat this aspect of the transaction for tax purposes?

In the context of corporate equity compensation, § 83 gives executives a choice: They may make a § 83(b) election and recognize income immediately on the current value of the property, or they can wait and see.³¹ If they make the election, any further gain or loss is capital gain or loss. If they wait and see, however, the character of the income is ordinary. From a revenue standpoint, the stakes of this choice are fairly low: The deferral of income, which lowers the executives' tax bills, is roughly offset by the deferral of the corporate deduction for compensation paid.

The treatment of partnership equity is different from corporate equity, and it is not entirely consistent with these § 83 principles. The tax law tackles the problem of partnership equity by dividing partnership interests into two categories: capital interests and profits inter-

²⁷ See I.R.C. § 61(a)(1) (West 2007) (including fees in gross income).

²⁸ See *infra* Part II.B.4.

²⁹ See *supra* note 3.

³⁰ See, e.g., *Carried Interest, Part II: Hearing Before the S. Comm. on Finance*, 110th Cong. 5 (2007) (statement of Eric Solomon, Treasury Assistant Secretary for Tax Policy), available at <http://www.senate.gov/~finance/hearings/testimony/2007test/071107testes.pdf> (pointing to valuation problems as motivating Rev. Proc. 93-27, 1993-2 C.B. 343, in 1993, which provided that receipt of partnership interest is not taxable event where, among other things, partnership's income stream is not certain and predictable).

³¹ I.R.C. § 83 (West 2007). Note that executives only have this option to defer taxation of the property received as compensation if the property is "not transferable" or is "subject to substantial risk of forfeiture." Otherwise, the property is automatically taxed upon receipt. *Id.* § 83(a).

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ests.³² A profits interest is an interest that gives the partner certain rights in the partnership, but that has no current liquidation value. A capital interest gives the partner certain rights in the partnership and has a positive current liquidation value.³³ When a partner receives a capital interest in a partnership in exchange for services, the partner has immediate taxable income on the value of the interest.³⁴ Determining the proper treatment of a profits interest is more difficult, however. It lacks any liquidation value, making its value difficult to determine. This categorization is analytically convenient, but it is also deceptive, since the categorization is somewhat inaccurate from an economic standpoint and creates planning opportunities that are widely exploited.

The following two subsections further detail the treatment of carried interest with regard to two key factors: the timing of taxes imposed and the character of the income received.

1. *Timing*

The timing of taxes imposed on a profits interest in a partnership has been fairly consistent historically. Namely, the profits interest is generally not subject to tax upon receipt of the interest, with tax deferred until profits are distributed. There was a period of uncertainty following the 1971 case of *Diamond v. Commissioner*,³⁵ where the Tax Court, as later affirmed by the Seventh Circuit, held that the receipt of a profits interest “with determinable market value” was taxable income.³⁶ However, a profits interest in a partnership rarely has a determinable market value, and the receipt of a profits interest was generally treated as a nontaxable event. The IRS later provided a safe harbor for most partnership profits interests in Revenue Procedure 93-27.³⁷

³² See Rev. Proc. 93-27, 1993-2 C.B. 343, 343 (defining capital and profits interests).

³³ See *id.* (distinguishing profits interest from capital interest in terms of proceeds received upon liquidation). Initially, a profits interest has no liquidation value since, if all assets were liquidated, all the proceeds would be distributed to the holders of the capital interests of the partnership.

³⁴ Treas. Reg. § 1.721-1(b)(1) (1996) (providing that capital interest earned in exchange for services is immediately includible in taxable income).

³⁵ 56 T.C. 530 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974).

³⁶ 492 F.2d at 290–91 (summarizing and affirming Tax Court’s position).

³⁷ Rev. Proc. 93-27, 1993-2 C.B. 343. The Revenue Procedure spelled out the limits of this safe harbor. To qualify, the profits interest must not relate “to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease,” and must not be disposed of within two years of receipt. *Id.* at 344. Furthermore, the partnership must not be publicly traded. *Id.*; see Rev. Proc. 2001-43, 2001-2 C.B. 191 (providing that profits interest that is not substantially vested triggers taxable event when restrictions lapse and that recipients need not file

The Treasury Department has released proposed regulations³⁸ and an accompanying notice³⁹ that would reaffirm the status quo. The proposed regulations and notice, like Revenue Procedure 93-27, require that, in order for the receipt of a profits interest to be treated as a nontaxable event, the partnership's income stream cannot be substantially certain and predictable, the partnership cannot be publicly traded, and the interest cannot be disposed of within two years of receipt.⁴⁰ The typical carried interest finds ample shelter in the proposed rules. The interest has no current liquidation value; if the fund were liquidated immediately, all of the drawn-down capital would be returned to the LPs. And while the carried interest has value, it is not related to a "substantially certain and predictable stream of income from partnership assets."⁴¹ On the contrary, the amount of carry is uncertain and unpredictable.⁴²

The receipt of a partnership profits interest, therefore, is not a taxable event under current law. The timing advantage of carried interest continues to create a tax advantage for the GP as the partnership operates. The partnership holds securities in its portfolio companies; these securities are often illiquid and difficult to value. The GP then enjoys the benefit (or detriment) of the realization doctrine, which allows taxpayers to defer gain or loss until investments are actually sold or until some other realization event occurs. Deferral produces this benefit (or detriment) because of the time value of money: Taxes paid or saved now are worth more than taxes paid or saved later. One might think that the timing effect of the realization doctrine would even out; taxable losses are deferred, just as gains are. The realization doctrine in fact works to the benefit of GPs, however, because the GP receives a substantial share of the economic gains but only a small share of the fund's losses (the one to five percent "skin in

protective § 83(b) elections). Revenue Procedure 93-27 defines a capital interest as an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and the proceeds were then distributed in a complete liquidation of the partnership. Rev. Proc. 93-27, 1993-2 C.B. 343, 343. A profits interest is defined as a partnership interest other than a capital interest. *Id.* The determination as to whether an interest is a capital interest is made at the time of receipt of the partnership interest. *Id.*

³⁸ Prop. Treas. Reg. § 1.83-3(l), 70 Fed. Reg. 29675, 29680-81 (May 24, 2005).

³⁹ I.R.S. Notice 2005-43, 2005-1 C.B. 1221.

⁴⁰ See Prop. Treas. Reg. § 1.83-3(l), 70 Fed. Reg. at 29,680-81 (proposing safe harbor that would allow GP to treat fair market value of profits interest as equal to liquidation value for purposes of § 83(b) election, thus shielding it from immediate taxation); I.R.S. Notice 2005-43, 2005-1 C.B. 1221, 1224 (outlining eligibility requirements for safe harbor).

⁴¹ I.R.S. Notice 2005-43, 2005-1 C.B. 1221, 1224.

⁴² See Laura E. Cunningham, *Taxing Partnership Interests Exchanged for Services*, 47 TAX L. REV. 247, 269 (1991) (discussing valuation difficulties in light of uncertainty of future profits).

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the game”). In sum, the tax law provides a timing benefit for GPs by allowing deferral on their compensation so long as the compensation is structured as a profits interest and not a capital interest in the partnership.⁴³

The impact of these timing rules on the other partners varies from fund to fund. Where the LPs are taxable investors, the timing rule on GP compensation works to the LPs’ detriment and may not generate any net tax benefit for the partnership. Treating the receipt of a profits interest by the GP as a nonevent for tax purposes is good for the GP but bad for taxable LPs, as the partnership cannot take a deduction for the value of the compensation awarded to the GP at the time of grant. This, in turn, means that the LPs lose the benefit of that current deduction. If the GP and the LPs have the same marginal tax rates, then the tax benefit to the GP is offset perfectly by the tax detriment to the LPs. This effect is often denoted “substitute taxation,” as a tax on one set of entities (here, the LPs) substitutes for a tax on another entity (here, the GP).⁴⁴

However, if the LPs are tax exempt, then the timing rules generate a tax benefit for the partnership and the government loses revenue. Here, substitute taxation fails, since the LPs are not subject to tax. As discussed in more detail below, many LPs in private equity firms are tax exempt, such as pension funds and university endowments.⁴⁵ It is therefore rational for many funds to exploit the gap

⁴³ The net result is also more advantageous than parallel rules for executive compensation with corporate stock. As two commentators have explained, the valuation rules for corporate stock are more stringent:

The treatment of [a GP]’s receipt of a profits interest under Rev. Proc. 93-27 is significantly better than the treatment of an employee’s receipt of corporate stock. While the economics of a profits interest can be approximated in the corporate context by giving investors preferred stock for most of their invested capital and selling investors and the employee “cheap” common stock, the employee will recognize [ordinary income] under Code Sec. 83 equal to the excess of common stock’s [fair market value] (not liquidation value) over the amount paid for such stock. In addition, if the common stock layer is too thin, there may be a risk that value could be reallocated from the preferred stock to the common stock, creating additional [ordinary income] for the employee.

William R. Welke & Olga A. Loy, *Compensating the Service Partner with Partnership Equity: Code § 83 and Other Issues*, 79 TAXES 94, 105 (2001); see also *infra* Part II.C (comparing tax treatment of corporate equity to that of carried interest).

⁴⁴ In theory, and often in practice, “substitute taxation” leaves the government, the GP, and the LPs in the same position as if the GP had been taxed directly. The government would receive the same amount of revenue. Furthermore, knowing that the LPs would be paying tax in place of the GP, the GP and the LPs—provided transaction costs are low and parties are rational—would negotiate the compensation contract so that the GP receives the same amount of after-tax compensation as if the GP had been taxed directly.

⁴⁵ See *infra* note 69 and accompanying text (describing investment trend among major tax-exempt investors).

between the economics of carried interest and its treatment for tax purposes.⁴⁶

2. *Character*

By treating the carried interest as investment income rather than service income, the tax law allows the character of realized gains to be treated as a capital gain rather than ordinary income—a benefit, since long-term capital gains are taxed at a fifteen percent rate,⁴⁷ while ordinary income is taxed at a top rate of thirty-five percent.⁴⁸ Compensation for services normally gives rise to ordinary income. But in the partnership context, payments to the fund manager are not necessarily characterized as compensation; the manager is not merely an employee but rather a partner in the partnership. Section 83 provides the general rule that property received in connection with the performance of services is income.⁴⁹ Section 707 addresses payments from a partnership to a partner.⁵⁰ So long as the payment is made to the partner in its capacity as a partner (and not as an employee) and is determined by reference to the income of the partnership (i.e., is not guaranteed), then the payment will be respected as a payout of a dis-

⁴⁶ Imagine a fund has paid \$100 to its GP this year and, for tax purposes, could either choose to recognize the compensation as being paid now or next year. For the purposes of illustration, assume that there is a very high annual return to capital of 100%. This means that \$1 of taxes either paid or saved next year would be worth only \$0.50 today. Assuming a marginal tax rate of thirty-five percent on both the GP's compensation and the earnings of the LPs, the GP—either this year or next year—would pay \$35 of income taxes on this compensation, and the LPs would take a \$100 ordinary deduction in whichever year the GP recognizes the income, saving the LPs \$35 in taxes. Between the LPs and the GP, no taxes are paid, on net, as a result of compensating the GP, and there is no net tax benefit from deferring recognition of the income. If the LPs are tax-exempt, however, the value of that tax deduction is zero, leaving a net tax liability of \$35 between the two parties. This means that, by waiting a year, the net tax liability could be reduced to \$17.50 in today's dollars. Thus, with tax exempt LPs, there is incentive to defer recognition.

⁴⁷ I.R.C. § 1(h)(1)(C) (West 2007).

⁴⁸ *Id.* § 1(a), (i).

⁴⁹ *Id.* § 83(a). If one assumes that a partnership profits interest is property, then a simple reading of § 83 suggests that the GP should be taxed immediately on the fair market value of the carried interest. It is far from clear, however, that Congress intended this reading when it enacted § 83. Compare TAX SECTION, N.Y. STATE BAR ASS'N, REPORT ON THE PROPOSED REGULATIONS AND REVENUE PROCEDURE RELATING TO PARTNERSHIP EQUITY TRANSFERRED IN CONNECTION WITH THE PERFORMANCE OF SERVICES 10–11 (2005) [hereinafter NYSBA REPORT] (“The legislative history of Section 83 . . . does not contain any specific indication that Congress intended to change the long-standing tax treatment of compensatory partnership interests.”), with Cunningham, *supra* note 42, at 263 (noting that Senate Finance Committee had, when explaining effects of newly enacted § 707(a)(2), suggested that partnership interest received in exchange for services may give rise to taxable income upon receipt of that interest under § 83).

⁵⁰ I.R.C. § 707(a), (c) (West 2007).

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tributable share of partnership income rather than salary.⁵¹ In other words, if a GP receives a cash salary and an at-the-money or out-of-the-money equity “kicker,”⁵² the kicker is treated as investment income, not labor income, and is taxed at a lower rate than labor income.

The tax code, therefore, treats the initial receipt of the carry as a nonevent, and it treats later distributions of cash or securities under the terms of the carried interest as it would any other distributable share of income from a partnership. Because partnerships are pass-through entities,⁵³ the character of the income determined at the entity level is preserved as it is received by the partnership and distributed to the partners.⁵⁴ With the notable exception of hedge funds that actively trade securities, most private investment funds generate income by selling the securities of portfolio companies, which normally gives rise to long-term capital gain.⁵⁵

In sum, a profits interest in a partnership is treated more like a financial investment than payment for services rendered. Partnership profits are treated as a return on investment capital, not a return on human capital. In Parts III and IV, I explore why that is the case. Before turning to the justifications for deferral and conversion, however, it is worth highlighting why this issue is worthy of attention.

⁵¹ See *id.* § 707(c) (treating guaranteed payments, made in exchange for services, “as made to one who is not a member of the partnership”). Arguably, the initial receipt of the carried interest is better characterized as *itself* a guaranteed payment (as it is made before the partnership shows any profit or loss). Professor Cunningham asserts that a profits interest should, like a capital interest, be treated as a form of guaranteed payment:

Because the value of a partnership *interest* received by a service partner, whether capital or profits, invariably is dependent upon the anticipated income of the partnership, the mere fact that the right to reversion of the capital has been stripped from the interest does not convert the property interest represented by the profits interest into a distributive share of partnership income.

Cunningham, *supra* note 42, at 267.

⁵² An at-the-money or out-of-the-money equity kicker offers the GP an option to buy into the investment fund at a price equal to the initial fair market value (at-the-money) or above the initial fair market value (out-of-the-money) of the fund’s investments. If the investments gain value over time and exceed the strike price (the price at which the option can be exercised), the GP would exercise the option and benefit from this gain in value. This is economically equivalent to carried interest, through which the GP shares more directly in the fund’s appreciation.

⁵³ A pass-through entity does not face income taxes at the entity level. Instead, income taxes are imposed at the individual, ownership level with profits and losses “passed through” to the owners for tax purposes.

⁵⁴ See I.R.C. § 702(b) (West 2007) (providing that character of distributive share is determined at partnership level).

⁵⁵ See *id.* §§ 1221–22 (defining capital asset for purposes of determining capital gains and losses and setting one-year holding period requirement to qualify as “long-term” capital gain).

II

WHY IT MATTERS NOW

The scholarly literature on the tax treatment of a profits interest in a partnership is extensive.⁵⁶ The debate sometimes has the air of an academic parlor game. Despite a couple of hiccups in the doctrine—the *Diamond*⁵⁷ and *Campbell*⁵⁸ cases familiar to partnership tax jocks—it is well-settled law that the grant of a profits interest in a partnership does not immediately give rise to taxable income.⁵⁹ The Treasury Department's proposed regulations would further solidify this longstanding rule. Why reopen the debate? I argue that that the increased use of partnership profits as a method of executive compensation in the context of private investment funds suggests the need for

⁵⁶ See generally Sheldon I. Banoff, *Conversions of Services into Property Interests: Choice of Form of Business*, 61 TAXES 844, 844 (1983) (assessing tax consequences of receipt of property interest in exchange for services); Martin B. Cowan, *Receipt of an Interest in Partnership Profits in Consideration for Services: The Diamond Case*, 27 TAX L. REV. 161 (1972) (discussing potential effect of *Diamond* decision); Cunningham, *supra* note 42 (arguing that proper dividing line is between future services and past services, not capital interests and profits interests); Barksdale Hortenstine & Thomas W. Ford, Jr., *Receipt of a Partnership Interest for Services: A Controversy that Will Not Die*, 65 TAXES 880 (1987) (arguing for compromise approach to taxing receipt of partnership profits interest that would only exclude from initial taxation that value attributable to GP's "extraordinary services"); Leo L. Schmolka, Commentary, *Taxing Partnership Interests Exchanged for Services: Let Diamond/Campbell Quietly Die*, 47 TAX L. REV. 287 (1991) (arguing that pivotal question regarding taxing partnership profits interest is whether services are performed in one's capacity as partner).

⁵⁷ *Diamond v. Comm'r*, 56 T.C. 530 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974). For a brief description of *Diamond*, see *supra* text accompanying notes 35–36.

⁵⁸ *Campbell v. Comm'r*, 59 T.C.M. (CCH) 236 (1990), *rev'd*, 943 F.2d 815 (8th Cir. 1991). In *Campbell*, the Tax Court echoed its decision in *Diamond*, holding a profits interest to be taxable upon receipt. *Id.* at 248–49. While the Eighth Circuit reversed the Tax Court, it did so largely based on the difficulty of valuing the profits interest at issue in the case, *Campbell*, 943 F.2d at 823, and its decision did not fully resolve the uncertainty that the Tax Court's affirmation of *Campbell* had generated, Schmolka, *supra* note 56, at 287.

⁵⁹ Subchapter K, Internal Revenue Code of 1954, Pub. L. No. 83-591, Subchapter K, 68A Stat. 3, which governs the taxation of partnerships, was enacted in 1954. Even before then, under common law rules, a profits interest was treated at least as favorably as it is under the current law. See NYSBA REPORT, *supra* note 49, at 9 ("Prior to the enactment of Subchapter K in 1954, when the taxation of partnerships was largely based on common law principles[,] . . . it would have been considered obvious that the receipt of a compensatory partnership profits interest was not currently taxable."). The *Diamond* and *Campbell* cases stirred some uncertainty among the tax bar, but there was never serious doubt that the grant of a profits interest with uncertain value in exchange for future services was not a taxable event. The IRS distanced itself from its position in the *Diamond* case in a General Counsel Memorandum. See I.R.S. Gen. Couns. Mem. 36,346 (July 23, 1975) (disavowing *Diamond* "to the extent that it holds that the receipt of an interest in future partnership profits as compensation for services results in taxable income"). This uncertainty was later resolved in I.R.S. Revenue Procedure 93-27, 1993-2 C.B. 343. See *supra* note 37 (discussing this revenue procedure).

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reform. The investment world has changed since the days when mortgage broker Sol Diamond sold his partnership interest for \$40,000.⁶⁰

The key development has been the growth and professionalization of the private equity industry. The private equity revolution has shaped the source of investment capital,⁶¹ spurred an increase in demand for the services of intermediaries,⁶² and allowed portable alpha strategies to develop.⁶³ These institutional changes have put increasing pressure on the partnership tax rules, which were designed with small businesses in mind.⁶⁴ Gamesmanship has increased in the formation of private equity funds,⁶⁵ while Congress, in the wake of the Enron scandal, restricted tax benefits for executive compensation in the corporate arena.⁶⁶ The gap between the treatment of corporate equity and partnership equity is increasing and, if not addressed, will encourage even more capital to shift from the public markets into private equity.⁶⁷

A. *Changing Sources of Capital*

The first factor that warrants reconsideration of the partnership profits puzzle is the change in private equity's source of investment capital. In the 1950s and 1960s, the private equity industry was populated mostly by individuals. The industry had a maverick culture. It attracted risk-seeking investment cowboys. Today, by contrast, even the most stolid institutional investors include alternative assets like venture capital funds, private equity funds, and hedge funds in their

⁶⁰ See *Diamond*, 56 T.C. at 539 (“On March 8, 1962, petitioner assigned his 60-percent interest in the trust to Kargman in exchange for Kargman’s check for \$40,000.”).

⁶¹ See *infra* Part II.A.

⁶² See *infra* Part II.B.1.

⁶³ See *infra* Part II.B.2.

⁶⁴ See Curtis J. Berger, *W(h)ither Partnership Taxation?*, 47 TAX L. REV. 105, 110 (1991) (“Partnerships of that era [in which Subchapter K was enacted] were rather simple ventures: the neighborhood hardware store or lumber yard, the law firm or brokerage house, the band of theatrical angels or the oil and gas syndicate.”).

⁶⁵ See, e.g., STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS 181–241 (Comm. Print 2003) (discussing gamesmanship issues related to subchapter K in Enron scandal).

⁶⁶ See American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 885, 118 Stat. 1418, 1634–41 (codified as amended at I.R.C. § 409A (West 2007)) (addressing deferred compensation).

⁶⁷ The shift into private equity includes, in this sense, investment in publicly traded private equity firms like Blackstone, Fortress, Apollo, and Oaktree. See Fleischer, *supra* note 22, at 5–6 (listing private equity firms that have gone public using the Blackstone structure and thus continue to enjoy the tax benefits of carried interest).

portfolios.⁶⁸ Many of the most powerful investors, such as major public pension funds and university endowments, invest large shares of their portfolios in alternative assets.⁶⁹

This shift in the source of investment capital creates tax-planning opportunities. Large institutional investors are long-term investors, who have an appetite for investments like private equity that offer an illiquidity premium.⁷⁰ The lengthy time horizon of these investments increases the value of deferring compensation for tax purposes. More importantly, many of these institutional investors are tax-exempt, and substitute taxation is not available as a backstop to prevent exploitation of gaps in the tax base created by the realization doctrine.⁷¹

B. *The Growing Use of Carried Interest*

The second reason that the partnership profits puzzle should be reconsidered is the rapid growth of the private equity industry and the

⁶⁸ See DAVID F. SWENSEN, PIONEERING PORTFOLIO MANAGEMENT: AN UNCONVENTIONAL APPROACH TO INSTITUTIONAL INVESTMENT 128–31 (2000) (describing how certain major universities have aggressively pursued investments in alternative asset classes).

⁶⁹ See *id.* at 129 tbl.5.5 (showing asset allocations of four major university endowments). The shift began with modern portfolio theory and accelerated with the Department of Labor’s “prudent man” ruling in 1979, which allowed institutional investors to include high-risk, high-return investments as part of a diversified portfolio. See 29 C.F.R. § 2550.404a-1 (2007) (stating that fiduciary of employee benefit plan, to act prudently, must make investments “reasonably designed . . . to further the purposes of the plan”); 44 Fed. Reg. 37,221, 37,222 (June 26, 1979) (explaining, in preamble to regulation, that “the relative riskiness of a specific investment . . . does not render such investment . . . either *per se* prudent or *per se* imprudent”).

⁷⁰ The illiquidity premium compensates investors for not being able to readily convert the investment into cash. All else being equal, investors prefer liquid investments, since this gives the investor greater flexibility as to the timing of disinvestment.

⁷¹ See *supra* notes 44–46 and accompanying text (describing substitute taxation and explaining why substitute taxation of carried interest is defeated if LPs are tax-exempt entities). In the corporate context, substitute taxation is essential to bringing the tax treatment of deferred compensation close to that of nondeferred compensation. Consider the typical corporate executive who receives nonqualified stock options. Those stock options have economic value when they are received, yet the executive can defer recognition until the options vest. This deferral is valuable to the executive, but it is costly to the employer, who must defer the corresponding deduction. Thus, corporate equity compensation is not enormously tax-advantaged in the usual case, but it can be if the corporation shorts its own stock to hedge the future obligation or if the executive’s marginal tax rate is higher than the corporation’s marginal tax rate. See Merton H. Miller & Myron S. Scholes, *Executive Compensation, Taxes, and Incentives*, in FINANCIAL ECONOMICS: ESSAYS IN HONOR OF PAUL COOTNER 179, 185–99 (William F. Sharpe & Cathryn M. Cootner eds., 1982) (discussing tax consequences of deferred compensation); David I. Walker, *Is Equity Compensation Tax Advantaged?*, 84 B.U. L. REV. 695, 727–40 (2004) (addressing net tax effects of deferral on employer and employee); see also Ethan Yale & Gregg D. Polsky, *Reforming the Taxation of Deferred Compensation*, 85 N.C. L. REV. 571, 592–99 (2007) (reviewing major reform proposals related to taxation of deferred compensation).

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concomitant increase in the use of carried interest.⁷² This Section describes four factors contributing to the carried interest boom.

1. *Increased Use of Intermediaries*

The first factor contributing to the growth of carried interest is the increased use of intermediaries. As the industry has professionalized, the demand for private equity has increased. Smaller institutions, family offices,⁷³ and high net-worth individuals now seek access to the industry. Funds-of-funds⁷⁴ and consultants have stepped in to provide these services.⁷⁵ In addition to providing increased access to funds, these intermediaries screen funds to find the best opportunities and monitor the behavior of GPs in the underlying funds. In exchange, they often receive a share of the profits—a carried interest of their own.⁷⁶ Each year, more and more financial intermediaries take advantage of the tax treatment of “two and twenty.”⁷⁷

2. *Portable Alpha*

The second factor contributing to the growth of carried interest is the pursuit of a new investment strategy, called a “portable alpha”

⁷² See PETER R. ORSZAG, CONG. BUDGET OFFICE, TAXATION OF CARRIED INTEREST: STATEMENT BEFORE THE COMMITTEE ON WAYS AND MEANS 4 & fig.1 (2007), available at http://www.cbo.gov/ftpdocs/85xx/doc8599/09-06-CarriedInterest_Testimony.pdf (“In 2006, private equity firms raised more than \$240 billion in capital, up from less than \$25 billion a year in the early 1990s . . .”).

⁷³ A “family office” is a trust or private company that manages the assets of a wealthy family.

⁷⁴ “Funds-of-funds” are funds that invest in a portfolio of other investment funds.

⁷⁵ See LERNER ET AL., *supra* note 25, at 76–87 (discussing evolution of private equity fund intermediaries such as funds-of-funds and pension fund consultants, known as “gatekeepers”).

⁷⁶ Private investment funds (including most funds-of-funds) are engineered to be exempt from the Investment Company Act of 1940. See Investment Company Act of 1940, 15 U.S.C. § 80a-3(c)(1), (7) (2000) (exempting issuers with securities owned by not more than one hundred persons plus any number of “qualified purchasers”). As a result, the fund managers may be compensated by receiving a share of the profits from the fund. In contrast, mutual fund managers may not receive a share of the profits, but rather may be paid a percentage of the assets of the fund (like the management fee in a private equity fund). See Investment Advisers Act of 1940, 15 U.S.C. § 80b-5(a) (2000) (prohibiting compensation to certain types of investment advisers from certain clients “on the basis of a share of capital gains upon or capital appreciation of the funds” but allowing compensation based on size of fund). As capital shifts away from mutual funds into private investment funds, more compensation takes the form of tax-advantaged carry, and less takes the form of tax-disadvantaged management fees.

⁷⁷ See STAFF OF J. COMM. ON TAXATION, 110TH CONG., PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS 35 fig.1 (Comm. Print 2007) [hereinafter J. COMM., CARRIED INTEREST] (charting rise of aggregate private equity fund commitments).

strategy, by institutional investors.⁷⁸ Tax scholars have generally discussed the partnership profits puzzle in the abstract, or in the context of small businesses and real estate partnerships.⁷⁹ But today the issue arises perhaps most often, and certainly with greatest consequence, for private investment funds.⁸⁰ Thanks to recent growth in the industry, private equity funds now manage more than one trillion dollars of investment capital.⁸¹ Because of economies of scale, one might expect to see a small increase in absolute compensation but a decrease in proportion to the size of the fund. Instead, “two and twenty” has remained the industry standard.⁸² Something is fueling demand for the services that private equity fund managers provide.

The growing adoption of portable alpha strategies among institutional investors helps explain the increased demand for the services of private investment fund managers.⁸³ Portable alpha is an investment strategy that emphasizes seeking excess, risk-adjusted returns (“alpha”), using derivatives and other financial instruments to manage the risk of the investment. Investors desire risk-adjusted returns that exceed the general market rate of return, but they may not want to

⁷⁸ See generally *Alpha Betting*, *ECONOMIST*, Sept. 16, 2006, at 83 (discussing demand for alpha strategies).

⁷⁹ See, e.g., Cunningham, *supra* note 42, at 257–61 (using grocery store as example of partnership profits in context of small business); Schmolka, *supra* note 56, at 294–302 (responding to Cunningham, *supra*, with same grocery store example).

⁸⁰ Cf. NYSBA REPORT, *supra* note 49, at 15–16 (using example of private equity buyout fund—and not small business—to illustrate concept of compensatory profits interest in partnership).

⁸¹ ORSZAG, *supra* note 72, at 4. Between hedge funds, private equity funds, and venture capital funds, the amount of investment capital flowing through the “two and twenty” structure easily exceeds \$2 trillion globally. See J. COMM., CARRIED INTEREST, *supra* note 77, at 32, 34 (reporting that, worldwide, hedge funds control \$1.46 trillion and private equity controls \$1 trillion); ORSZAG, *supra* note 72, at 4 (“[P]rivate equity funds and hedge funds together have more than \$2 trillion under management.”). Discussing the problem of carried interest in the context of anachronistic cases such as *Diamond* and *Campbell* is like drafting stock dividend rules to accommodate Myrtle Macomber. See *Eisner v. Macomber*, 252 U.S. 189, 219 (1920) (holding that stock dividend is not income within meaning of Sixteenth Amendment). Human stories about family-run businesses and old judicial opinions may make the problem more accessible for students and scholars, but they can also distort public policy considerations.

⁸² In larger funds one does tend to observe a lower management fee. See Gompers & Lerner, *supra* note 25, at 22–23, 23 tbl.5 (“We find that larger and older venture [capital] organizations are associated with significantly lower fees . . .”).

⁸³ One might ask why, if demand is increasing, supply does not follow. It does, of course—there are more fund managers than there used to be—but because it takes some time to develop a reputation, there is a lag. See Douglas Cumming & Jeffrey MacIntosh, *Boom, Bust, and Litigation in Venture Capital Finance*, 40 WILLAMETTE L. REV. 867, 877–81 (2004) (discussing “inelasticity in the supply of [venture capital] managers in the short run”).

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increase or decrease their sensitivity to overall market volatility (“beta”).

Prior to the adoption of portable alpha, modern portfolio theory focused on diversification as the dominant method for managing risk. In its simplest form, modern portfolio theory cautions investors to maintain a diversified mix of stocks, bonds, and cash in order to balance the volatility of their portfolios with the desire to maximize returns. Under this theory, only a small amount of assets would be placed in risky alternative asset classes like real estate, venture capital, buyout funds, and hedge funds.

Portable alpha proponents advocate a method for managing risk that allows investors greater investment in alternative asset classes. Traditional modern portfolio theory leads investors to acquire what, in the end, amounts to an expensive index fund. A portable alpha strategy, by contrast, recognizes that an investor can invest fairly freely in volatile assets; sensitivity to overall market volatility can be managed using derivatives rather than through the broad diversification of the portfolio. According to this theory, when alpha opportunities arise, they should be exploited fully; the remainder of the portfolio can be cheaply adjusted, using derivatives, to achieve the overall desired level of exposure to beta.⁸⁴ As more investors adopt portable alpha strategies, managers of alternative assets who employ the “two and twenty” structure—venture capitalists, buyout fund managers, and hedge fund managers—share in the gains.

3. *Design of the Preferred Return*

The third factor contributing to the growth of carried interest is the design of the preferred return. Many investment funds exploit the tax treatment of a profits interest in a partnership by not indexing the measurement of profits to an interest rate or other reflection of the cost of capital.⁸⁵ This phenomenon, which I call the “missing preferred return,” allows fund managers to maximize the present value of

⁸⁴ The ability to adjust beta through the use of derivatives is what makes the alpha “portable.” Alpha requires two inputs: the talent of the managers who create it, and the capital of investors to implement the strategy. The two parties share the expected returns; investors are rationally willing to share large amounts of the abnormal returns with the fund managers who create them. See generally Edward Kung & Larry Pohlman, *Portable Alpha: Philosophy, Process, and Performance*, J. PORTFOLIO MGMT., Spring 2004, at 78 (explaining portable alpha).

⁸⁵ See Fleischer, *supra* note 9, at 113–14 (discussing impact of tax on design of carried interest).

the carried interest and accept lower management fees than they otherwise would, thereby maximizing the tax advantage.⁸⁶

A true preferred return would limit the GP's profit-sharing right to amounts that exceed a target rate of return that reflects the investor's cost of capital. Economically, a carried interest subject to a true preferred return would function like a cost-of-capital indexed stock option, which is thought to properly align incentives for corporate executives. A true preferred return gives the GP a financial incentive to invest only in companies that will generate a return in excess of the stated interest rate.

Rather than a true preferred return, however, most funds use a hurdle rate. Until a fund clears a hurdle of, for example, an eight percent return, any profits are allocated to the LPs and not to the GP. Once the hurdle is cleared, however, profits are then allocated disproportionately to the GP until the GP's compensation catches up to the point where it would have been had the GP received twenty percent of the profits from the first dollar.⁸⁷ This kink in the payout structure distorts the GP's decisions about how to exit investments once they have been made, thus increasing agency costs. But the tax code encourages this structure notwithstanding the increase in agency costs. Using a hurdle rate rather than a true preferred return maximizes the value of the carried interest, allowing GPs to reduce tax-disadvantaged management fees in favor of tax-advantaged carry.

Moral hazard concerns prevent private equity funds from doing away with the preferred return entirely.⁸⁸ Still, by using a hurdle rate—also known as a disappearing preferred return—rather than a true preferred return, profits interests are larger than they would otherwise be, raising the stakes on the tax question.⁸⁹

⁸⁶ See *id.* at 114 (noting tax efficiency of keeping management fees low and maximizing present value of carried interest).

⁸⁷ See *id.* at 84–85 (explaining hurdle rates and distinguishing them from true preferred return).

⁸⁸ A hurdle rate protects against moral hazard by ensuring that the GP does not invest in low-risk, low-return investments that would not clear the hurdle rate. In the venture capital context, where the portfolio companies are limited to technology start-ups, this moral hazard risk is not present, and funds forgo using a preferred return. Instead, venture capital managers simply receive carry starting with the first dollar of profit. See *id.* at 114–16 (comparing incentives of venture capitalists to managers in other types of investment funds and explaining how differences in incentives are reflected in how profits interests are structured).

⁸⁹ Whether the design of the preferred return is explained by tax motivations is a question I take up elsewhere. *Id.* at 108–16. Regardless of whether the design is itself tax-motivated, there is no question that GPs are maximizing the amount of compensation they receive in carried interest. Nor is there any question that (with the exception of certain hedge funds) distributions typically give rise to long-term capital gain. Thus, even if one thinks that tax somehow has no influence on the design of preferred returns, the tax conse-

4. Conversion of Management Fees into Capital Gain

The fourth factor contributing to the growth of carried interest is the aggressive conversion of management fees (which give rise to ordinary income) into additional carried interest.⁹⁰ This planning strategy defers income and may ultimately convert labor income into capital gain. Some GPs opt to reduce the management fee in exchange for a larger allocation of fund profits. The choice may be made during formation of the fund and be triggered upon certain conditions; in other cases, the GP may reserve the right to periodically waive the management fee in exchange for an enhanced allocation of fund profits during the next fiscal year of the fund.⁹¹

There is a tradeoff between tax risk and entrepreneurial risk. So long as there is some economic risk that the GP may not receive sufficient allocations of future profit to make up for the forgone management fee, most practitioners believe that the constructive receipt doctrine⁹² will not apply, and that future distributions will be respected as distributions out of partnership profits.⁹³

quences raise considerations of distributional equity. A large amount of profits allocated to GPs represents the time value of money, received in exchange for services, and yet it is treated as a risky investment return and afforded capital gains treatment.

⁹⁰ See Ryan J. Donmoyer, *Fund Managers' Taxes May Rise as Senate Targets Fees Strategy*, BLOOMBERG.COM, June 19, 2007, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aydxW3YnhjK4#> (describing recent congressional scrutiny of private equity managers' conversion of their management fees into additional carried interest); cf. J. COMM., CARRIED INTEREST, *supra* note 77, at 50 (“[T]axpayers may seek to convert management fees, which are generally subject to tax as ordinary income, to an arrangement that achieves deferral of income recognition, or conversion to capital gain treatment, or both.”).

⁹¹ See JACK S. LEVIN, *STRUCTURING VENTURE CAPITAL, PRIVATE EQUITY, AND ENTREPRENEURIAL TRANSACTIONS* ¶ 1004, at 10-15 (2007 ed.) (describing how choice to convert management fees into carried interest can be made up front at formation of fund or, if right is reserved, at later election); see also Wilson Sonsini Goodrich & Rosati, *Converting Management Fees into Carried Interest: Tax Benefits vs. Economic Risks* (Sept. 2001) (unpublished presentation, on file with the *New York University Law Review*) (explaining that, to waive management fee and avoid immediate inclusion in taxable income, “GP must waive the right to receive [management fee] prior to the time it becomes payable”).

⁹² The constructive receipt doctrine deems income to be taxable if a person has an unrestricted right to receive it, even if the person does not exercise that right. See BORIS I. BITTKER, MARTIN J. McMAHON, JR. & LAWRENCE A. ZELENAK, *FEDERAL INCOME TAXATION OF INDIVIDUALS* ¶ 39.02[3] (3d ed. 2002) (“[C]onstructive receipt means that ‘a taxpayer may not deliberately turn his back upon income and thus select the year for which he will report it.’” (quoting *Hamilton Nat’l Bank of Chattanooga v. Comm’r*, 29 B.T.A. 63, 67 (1933))).

⁹³ See LEVIN, *supra* note 91, ¶ 1004, at 10-15 (concluding that, as long as there is “meaningful economic risk” that GP would not regain forgone management fee in additional carried interest, conversion would be respected for tax purposes). See generally Wilson Sonsini Goodrich & Rosati, *supra* note 91 (explaining how “[b]y adding

The entrepreneurial risk may be smaller than it appears at first glance, depending on the underlying portfolio of the fund. If the management fee is waived in favor of an increased profit share in the following year, and the GP knows that an investment that is likely to generate sufficient profits will be realized, then the constructive receipt doctrine should arguably apply. To my knowledge, however, there is no published authority providing guidance as to how much economic risk justifies deferral in this context.⁹⁴

Lastly, GPs also take advantage of the current tax rules by converting management fees into priority allocations of carry that replace *capital* interests.⁹⁵ Recall that GPs are expected to have some “skin in the game” in the form of their own capital contributed to the fund. This gives GPs some downside risk and partially counterbalances the risk-seeking incentive that the carried interest provides. Rather than contribute after-tax dollars to buy a capital interest, GPs can, instead, convert management fees, on a pretax basis, into investment capital. In this technique, known as a “cashless capital contribution,” GPs forgo a portion of the management fee that otherwise would be due, instead taking a priority allocation of carried interest. This arrangement slightly increases agency costs (as it reduces the downside risk in the initial years of the fund), but the tax savings more than offset the increase in agency costs.⁹⁶

C. *Economic Efficiency and the Distortion of Investment Behavior*

Lastly, carried interest warrants renewed attention because the treatment of a profits interest in a partnership represents a striking departure from the broader design of executive compensation tax policy. Economically similar transactions are taxed differently, and the tax advantage bestowed on carried interest distorts investment behavior. Investors structure deals to take advantage of the different tax treatment. Generally speaking, this sort of tax planning is thought to decrease social welfare by creating deadweight loss—that is, the loss created by inefficient allocation of resources. Specifically, the tax-advantaged nature of partnership profits interests may encourage more investments to take place through private investment funds,

entrepreneurial risk to the Management Fee,” GP can successfully convert fee into carried interest for tax purposes).

⁹⁴ Cf. I.R.S. Notice 2005-1, 2005-1 C.B. 274, 279 (discussing nonapplication of § 409A restrictions on deferred compensation to profits interest in partnership).

⁹⁵ See Wilson Sonsini Goodrich & Rosati, *supra* note 91, at 33–35 (explaining how reduction in management fees can be used to offset GP’s expected capital contribution).

⁹⁶ These tax savings can effectively be shared with the LPs by reducing management fees slightly.

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which are taxed as partnerships, rather than through publicly traded entities, which are generally taxed as corporations.⁹⁷

Section 83 is the cornerstone of tax policy regarding executive compensation.⁹⁸ Broadly speaking, § 83 requires that property received in exchange for services be treated as ordinary income.⁹⁹ When an executive performs services in exchange for an unfunded, unsecured promise to pay, or when she receives property that is difficult to value because of vesting requirements, compensation may be deferred.¹⁰⁰ When compensation is received, however, the full amount must be treated as ordinary income. The treatment of partnership profits interests departs from this basic framework.

The clearest way to understand the point is to compare the treatment of a partnership profits interest to that of a nonqualified stock option (NQSO).¹⁰¹ When an executive exercises an option and sells the stock, she recognizes ordinary income to the extent that the market price of the stock exceeds the strike price.¹⁰² By contrast, a fund manager's distributions are typically taxed at capital gains rates. A profits interest, in other words, is treated unlike its economic sibling, an NQSO,¹⁰³ but is instead treated in the executive's hands like

⁹⁷ As I discuss in more detail later, there may be offsetting positive social externalities that may justify the disparate treatment of partnership equity. See *infra* notes 191–94 and accompanying text. As an initial matter, however, it is useful to describe the disparity before exploring whether the distortions that follow might nonetheless be justified on other policy grounds.

⁹⁸ See BITTKER, McMAHON & ZELENAK, *supra* note 92, at ¶ 40.03[1] (“[Section] 83 provides that a taxpayer who performs services in return for property realizes income and that the amount realized is the fair market value of the property or, if the transfer takes the form of a bargain purchase, the excess of its value over the amount paid.”). For a discussion of § 83 in the context of start-up companies, see Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Start-ups*, 57 TAX L. REV. 137, 168–69 (2003).

⁹⁹ See I.R.C. § 83(a) (West 2007) (treating property received in connection with performance of services as income).

¹⁰⁰ See *id.* (not requiring inclusion in income if property received in exchange for services is “subject to a substantial risk of forfeiture”); Treas. Reg. 1.83-3(e) (as amended in 2005) (excluding “an unfunded and unsecured promise to pay money or property in the future” from taxation under § 83); see also Rev. Rul. 60-31, 1960-1 C.B. 174, 178 (requiring inclusion of deferred compensation only in year in “which the taxpayer actually receives” money or property).

¹⁰¹ A nonqualified stock option (NQSO) is a stock option given to employees that does not meet the requirements of I.R.C. § 422 to qualify as an incentive stock option (ISO). See *infra* note 104. When recognized by the recipient of the NQSO, income from an NQSO is taxed at ordinary rates. Assuming there is no readily ascertainable fair market value, the recipient of the NQSO need not include the value of the option in her income upon receipt of the option. I.R.C. § 83(e)(3) (West 2007). Instead, when the option is later exercised or sold, the employee pays tax at ordinary income rates on the spread between the market price and the strike price of the option. Treas. Reg. § 1.83-7(a) (2007).

¹⁰² See Treas. Reg. § 1.83-7(a) (2007) (outlining tax treatment of NQSOs).

¹⁰³ A profits interest is economically equivalent to an NQSO. Imagine an executive with an at-the-money option to buy twenty percent of the company's stock. The stock

an incentive stock option (ISO) (i.e., deferral on receipt; capital gains when recognized).¹⁰⁴ ISOs are subject to a \$100,000 per year limitation,¹⁰⁵ reflecting a congressional intent to limit the subsidy. Carried interests, by contrast, are not subject to any limitation.

The disparity between the treatment of corporate and partnership equity has grown recently. Section 409A, enacted in response to deferred compensation abuses associated with the Enron scandals, has forced more honest valuations of grants of common stock.¹⁰⁶ Internal Revenue Service guidance for § 409A, however, exempts the grant of a profits interest in a partnership from similar scrutiny.¹⁰⁷

D. Summary

Together, the factors described in this Part suggest that the tax treatment of carried interest should be reevaluated. In recent years, there has been an important but largely overlooked shift in executive compensation strategy in the financial services industry. The most talented financial minds among us—those whose status is measured by whether they are “airplane rich”¹⁰⁸—are increasingly leaving investment banks and other corporate employers to start or join private investment funds organized as partnerships.¹⁰⁹ The partnership profits puzzle has greater significance than ever before, and while this

currently has a market capitalization of \$100x and is trading at \$100 per share. The stock appreciates in value to \$150. The executive can exercise the option, harvesting twenty percent of the gains—\$10x, or \$50 per share on twenty percent of the company stock. But if the stock declines in value, the executive can walk away. Similarly, imagine a fund manager with a twenty percent profits interest. Imagine that the fund, originally worth \$100x, appreciates to \$150x. The fund manager receives twenty percent of the profits, or \$10x. As with the corporate executive, if the fund declines in value, the fund manager can walk away, financially unscathed.

¹⁰⁴ An ISO is a stock option given to employees that qualifies for treatment under § 422. To qualify, an option must meet certain requirements. For instance, the exercise price of the stock option must be no less than the fair market value of the stock at the time the option is granted, I.R.C. § 422(b)(4) (West 2007), and a person’s ISOs that are first exercisable in a given year cannot exceed \$100,000 worth of stock. *Id.* § 422(d). An ISO is taxed upon sale of the stock purchased with the ISO and at capital gains rates. *See id.* § 421(a)(1) (providing that there is no recognition of gain upon exercise of option, which defers tax until sale of underlying stock).

¹⁰⁵ The limit provides that the value of stock purchasable by a person’s ISOs first exercisable in a given year cannot exceed \$100,000. § 422(d).

¹⁰⁶ *See* I.R.C. § 409A(a)(1)(B) (West 2007) (imposing surtax on certain nonqualified deferred compensation); Vanessa A. Scott, *Fallacies of Presumption: Unpacking the Impact of the Section 409A Proposed Regulations on Stock Appreciation Rights Issued by Privately-held Companies*, 59 *TAX LAW*, 867, 873–76 (2006) (discussing legislative history of § 409A).

¹⁰⁷ I.R.S. Notice 2005-1, 2005-1 C.B. 274, 279.

¹⁰⁸ You are “airplane rich” if you own your own private jet.

¹⁰⁹ *See, e.g.*, Jack Welch & Suzy Welch, *The New Brain Drain*, *BUSINESSWEEK*, Apr. 23, 2007, at 122 (“[T]here is definitely a worrisome trend emerging as a growing number of talented senior executives leave publicly traded business for privately held concerns.”).

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fact is well known within the private equity industry, it has received little attention from academics or policymakers.¹¹⁰

III

DEFERRAL

The concept that a fund manager can receive a profits interest in a partnership without facing immediate tax on the grant may not sit well with one's intuitive sense of fair play. These profits interests have enormous economic value. *Tax Notes* columnist Lee Sheppard characterizes the Treasury's proposed regulations as a "[m]assive [g]iveaway."¹¹¹

But the question is more complicated than it might seem at first glance. Historically, there has been broad agreement among tax scholars that deferral is appropriate for a profits interest received in exchange for future services.¹¹² The underlying principles in support of deferral are: (1) a philosophical resistance to taxing endowment and/or taxing unrealized human capital,¹¹³ (2) a desire to encourage the pooling of labor and capital,¹¹⁴ (3) a long-standing policy, in certain contexts, of only taxing the imputed income invested in self-created assets once the assets are sold,¹¹⁵ and (4) measurement/valuation concerns.¹¹⁶

This Part argues that these principles do not justify the current tax treatment of carried interest. The objections to taxing endowment are easily dealt with by considering accrual taxation alternatives.¹¹⁷ Encouraging the partnership form as a convenient method of pooling together labor and capital is somewhat more appealing as a justifica-

¹¹⁰ Although this issue generally received little attention in the past, it attracted attention on Capitol Hill and in the media while this Article was circulating in draft form. See Editorial, *Taxing Private Equity*, N.Y. TIMES, Apr. 2, 2007, at A22 (citing this Article as "[a]dding grist to lawmakers' skepticism," notably that of "Senator Max Baucus, the Democratic chairman of the Finance Committee, and Senator Charles Grassley, the committee's top Republican"); *infra* notes 219–21 and accompanying text (describing reform proposal being considered by Congress).

¹¹¹ Lee A. Sheppard, *Massive Giveaway in Partnership Compensatory Options Regs*, 107 TAX NOTES 1487, 1487 (2005).

¹¹² See, e.g., Cunningham, *supra* note 42, at 276 ("Taxation of any partnership interest issued in exchange for *future* services, however, violates the spirit and purpose of subchapter K."); Schmolka, *supra* note 56, at 300–01 (arguing that whether person has already "fully rendered all services that are required of him" by partnership should be important factor in determining whether person should be treated as employee, rather than partner but, unlike Professor Cunningham, not deeming this "the sole litmus test").

¹¹³ See *infra* Part III.A.

¹¹⁴ See *infra* Part III.B.

¹¹⁵ See *infra* Part III.C.

¹¹⁶ See *infra* Part III.D.

¹¹⁷ See *infra* Part III.A.2.

tion for current law, but the normative underpinning for such a subsidy is unclear. Nor is it self-evident that such a subsidy, if desirable, should be extended to large investment partnerships.¹¹⁸ Furthermore, the tax system's failure, in certain contexts, to tax the imputed income associated with self-created assets is driven not by conceptual objections to doing so, but instead by administrability concerns that do not arise in the context of carried interest.¹¹⁹ Finally, while measurement concerns are certainly valid, I offer a novel method for dealing with such concerns in Section D below.¹²⁰

A. Endowment

1. The Reluctance To Engage in Endowment Taxation

The deferral of income associated with the receipt of a profits interest can be justified by the same objections that scholars have toward taxing endowment. Endowment taxation calls for taxing people based on their ability or talent. A pure endowment tax base would tax both realized and unrealized human capital.¹²¹ The current system, in contrast, generally taxes only realized human capital.

One key attraction of using endowment as a tax base is an equity-based argument. It would compensate those with less ability. In redistributing resources, it may be desirable to insure people against outcomes over which they have no control and for which they cannot insure themselves; endowment taxation serves as a method of insuring against the brute luck associated with variance in innate ability.¹²²

A second attraction of using endowment as a tax base is efficiency-based. By taxing ability rather than earned income, we would eliminate the incentive problem created by the fact that utility derived from nonmarket activities is untaxed in a traditional income tax. Endowment taxation reduces or eliminates the tax system's favorable treatment of activity that produces nonpecuniary returns versus activity that generates financial returns. The bias distorts decision-making and results in deadweight loss.¹²³ Endowment taxation would,

¹¹⁸ See *infra* Part III.B.

¹¹⁹ See *infra* Part III.C.

¹²⁰ See *infra* Part III.D.

¹²¹ See Lawrence Zelenak, Essay, *Taxing Endowment*, 55 DUKE L.J. 1145, 1146 (2006) (describing one definition of endowment tax as tax on present value of initial endowment of financial wealth plus earning power).

¹²² See *id.* at 1154–55 (describing endowment tax as way of insuring against “brute luck”).

¹²³ Take, for instance, the labor/leisure tradeoff. Even as income from labor, in the form of monetary compensation, is taxed, income from leisure, in the form of the utility derived from leisure activities, goes untaxed. This difference in treatment leads to a distortion of decisionmaking, with people substituting leisure for labor (on the margin) due to the dif-

for example, eliminate the tax advantage of the currently untaxed psychological, status, and identity benefits of being a law professor—such as the intellectual stimulation of the job, the joy of teaching, academic freedom, and lifetime job security. On the margins, an endowment tax scheme would encourage workers to labor in the sector in which market compensation is highest, which in turn allocates labor resources more efficiently, reducing deadweight loss.

Using endowment as a tax base can give rise to a so-called “talent-slavery” objection.¹²⁴ In a pure endowment tax system, a talented lawyer graduating from a top law school would be taxed on her anticipated future profits at a Wall Street law firm. She would have to pay this tax even if she quits law firm practice to become a law professor or to work for a charitable organization—after all, the tax is based on one’s ability to earn income, not one’s actual earned income.

Few tax scholars, if any, support a pure system of taxing endowment.¹²⁵ There are powerful liberal egalitarian objections to taxing endowment, mostly rooted in the “talent-slavery” objection. Equality is important, but so too is the autonomy of the most talented among us.¹²⁶ Human beings were not created simply to create wealth or even simply to maximize personal or social utility; the government should play only a limited role in dictating the paths people choose to follow.

ference in tax treatment. Such distortion generates deadweight loss due to the inefficient allocation of resources.

¹²⁴ See Zelenak, *supra* note 121, at 1156–62 (discussing nature of “talent-slavery” objection, responses to objection, and methods of designing endowment tax to avoid “talent-slavery”).

¹²⁵ See David Hasen, *Liberalism and Ability Taxation*, 85 TEX. L. REV. 1057, 1075–1106 (2007) (arguing that endowment taxation is incompatible with liberal political theory); Daniel Shaviro, *Endowment and Inequality*, in TAX JUSTICE: THE ONGOING DEBATE 123, 125, 136, 144 (Joseph J. Thorndike & Dennis J. Ventry Jr. eds., 2002) (concluding that endowment taxation deserves greater prominence as orienting idea but acknowledging that we may not want to adopt literal direct tax on endowment); Zelenak, *supra* note 121, at 1172–81 (discussing desirability of “slouching toward endowment taxation” by taking steps in direction of endowment taxation without adopting “full-fledged” endowment tax); Linda Sugin, *Why Endowment Taxation Is Unjust, passim* (Fordham Legal Studies Research, Paper No. 959710, 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=959710 (“[E]ndowment taxation fails to fulfill the equality norm that motivates liberal egalitarian thinkers.”). But see Kirk J. Stark, *Enslaving the Beachcomber: Some Thoughts on the Liberty Objections to Endowment Taxation*, 18 CAN. J.L. & JURISPRUDENCE 47, 58–65 (2005) (rejecting “talent-slavery” objections).

¹²⁶ See, e.g., LIAM MURPHY & THOMAS NAGEL, *THE MYTH OF OWNERSHIP: TAXES AND JUSTICE* 123 (2002) (describing endowment taxation’s limitation on autonomy as “extreme”); JOHN RAWLS, *JUSTICE AS FAIRNESS: A RESTATEMENT* § 48.2 (Erin Kelly ed., 2001) (concluding that taxing to equalize endowments “would violate our basic liberties”); Hasen, *supra* note 125, at 1081–82 (“The very point of the social contract is to preserve, and perhaps to further, autonomy . . .”).

These liberal egalitarian objections to endowment taxation help explain why we do not tax a profits interest in a partnership received in exchange for future services. In the partnership-profits tax literature, which predates the recent revival of academic interest in endowment taxation, the concern is articulated as an objection to taxing unrealized human capital. Professor Rudnick characterizes this principle—of taxing human capital only as income is realized—as one of the four fundamental premises of partnership tax.¹²⁷ “Human capital,” she notes, “is not generally taxed on its expectancy value.”¹²⁸ It is unfair to tax someone today on what she has the ability to do tomorrow; taxing human capital on its expected value commodifies human capital by treating it like investment capital. Endowment taxation may provide a more accurate assessment of the value of human capital (and thus, arguably, a sounder tax base), but carries a high perceived cost.

Similarly, Professor Gergen has argued that taxing unrealized human capital is inconsistent with our system of income taxation: “No one thinks, for example, that a person making partner in a law firm should pay tax at that time on the discounted present value of her future earnings.”¹²⁹ Professor Gergen acknowledges that the profits interest puzzle can be more complicated than the simple analogy to a law firm associate making partner, and he identifies weaknesses in the usual arguments about taxing human capital.¹³⁰ In the end, however, he concludes that equity holds up the bottommost turtle:¹³¹ “Perhaps we cross over a line where valuation or other problems are sufficiently

¹²⁷ Rebecca S. Rudnick, *Enforcing the Fundamental Premises of Partnership Taxation*, 22 HOFSTRA L. REV. 229, 232–33 (1993) (“[One] major premise[] of Subchapter K [is] that . . . human capital providers are not taxed on the receipt of interests in profits if they are of merely speculative value . . .”).

¹²⁸ *Id.* at 350.

¹²⁹ Mark P. Gergen, *Pooling or Exchange: The Taxation of Joint Ventures Between Labor and Capital*, 44 TAX L. REV. 519, 544 (1989).

¹³⁰ See *id.* at 545–50 (cataloguing objections to endowment taxation, including problems of valuation, illiquidity, double taxation, human dignity, and consistency with rest of tax regime, and noting possible responses to these criticisms).

¹³¹ *Id.* at 550. When it comes to the bottommost turtle, Stephen Hawking tells an anecdote about an encounter between a scientist and a little old lady:

A well-known scientist (some say it was Bertrand Russell) once gave a public lecture on astronomy. He described how the earth orbits around the sun and how the sun, in turn, orbits around the center of a vast collection of stars called our galaxy. At the end of the lecture, a little old lady at the back of the room got up and said: “What you have told us is rubbish. The world is really a flat plate supported on the back of a giant tortoise.” The scientist gave a superior smile before replying, “What is the tortoise standing on?” “You’re very clever, young man, very clever,” said the old lady. “But it’s turtles all the way down!”

STEPHEN HAWKING, *A BRIEF HISTORY OF TIME 1* (10th anniversary ed. 1998).

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difficult that wealth in the form of human capital cannot be taxed in most cases, and so, for the sake of equity, we choose to tax it in no cases.”¹³²

Professor Gergen’s objections to taxing unrealized human capital are more pragmatic than normative. Emphasizing the importance of consistency, he would draw a bright line between the receipt of cash in exchange for future services (which he would treat as a taxable event) and the receipt of any other form of property including a profits interest (which he would not treat as taxable).¹³³ Professor Gergen’s approach, while elegant and practical, creates its own inconsistencies, namely by treating economic equivalents differently. In a later Article, Professor Gergen refined his view to allow deferral, while taxing all distributions to the GP as ordinary income.¹³⁴ I discuss his refined views in more detail below.¹³⁵

2. *The Accrual Income Tax Alternative*

The parade of horrors associated with taxing endowment should not be used to justify a blanket rule that does not tax unrealized human capital. Accrual-based income taxation may serve as an attractive middle ground between endowment taxation and transaction-based income taxation. Even if we do not want to tax human capital on its expectancy value, we may want to approximate the current value of returns on human capital as they accrue, rather than waiting until those returns are actually realized in the form of cash.

Under our current system, compensation may be deferred if the employer offers only an unfunded, unsecured promise to pay money in the future.¹³⁶ An accrual-based system, on the other hand, would tax the performance of services as they are performed and compensation earned, even if payment has not yet been received. Suppose a wealthy investor agrees to pay a financial advisor an incentive fee of ten percent of the overall appreciation in the investor’s portfolio of publicly traded stocks and bonds at the end of ten years, with the gains measured and the fee paid only at the end of ten years. In the first year, the portfolio appreciates from \$10 million to \$15 million. Under an accrual-based system, the financial advisor would have

¹³² Gergen, *supra* note 129, at 550.

¹³³ *Id.* (“Whatever the reason, the reality is that we do not tax human capital, and, unless we want to radically change the tax [system], consistency requires that we not tax rights short of cash given in anticipation of future services.”).

¹³⁴ Mark P. Gergen, *Reforming Subchapter K: Compensating Service Partners*, 48 *TAX L. REV.* 69, 69, 103–11 (1992) (proposing elimination of special allocations, with effect that “[a] partnership may pay a service partner income from capital only as salary”).

¹³⁵ *See infra* Part V.B.

¹³⁶ *See supra* note 100 and accompanying text.

\$500,000 of income in that first year, even though the cash has not yet been received and the gains may be temporary. (If the portfolio later loses money, the financial advisor would recognize a taxable loss as those losses are accrued.) The service provider may have to pay tax on income earned before she receives the money with which to pay the tax; as such, an accrual-based tax may not make sense administratively when taxpayers have significant liquidity concerns or would have trouble accessing credit markets.

But it is important to see that accrual-based taxation overcomes one of the key conceptual objections to endowment taxation: Because accrual income taxation taxes partners or employees only so long as they remain in their chosen profession, it avoids the “talent-slavery” objections to endowment taxation. Elite lawyers could still work for the Southern Center for Human Rights if they so chose. A Harvard MBA would not be forced to toil away at a private equity fund in order to pay off a tax imposed on her ability to perform the work. But once she chooses the path of riches, there is nothing normatively objectionable about taxing the returns from her human capital on an annual basis rather than on a transactional basis (i.e., whenever the partnership liquidates investments). One might object to the added complexity of accrual-based taxation of partnership profits, of course, but it suffices at this stage of the argument to note that the “talent-slavery” objection is a red herring.

B. Pooling of Labor and Capital

It is often said that the appeal of the partnership form is its convenience as a method of pooling together labor and capital.¹³⁷ The corporate form can be rigid, for example, by demanding one class of stock (if organized as an S corporation)¹³⁸ or extracting an entity-level tax on profits (if organized as a C corporation).¹³⁹ In the executive compensation context, tax law generally treats the corporation as a separate entity in transactions with individuals, even if those individuals also happen to be shareholders. Thus, when an executive contributes human capital to the enterprise and receives an ownership interest in the company, the transaction is treated as a taxable exchange, not a pooling event that goes unrecognized for tax pur-

¹³⁷ Cf. Berger, *supra* note 64, at 131–34 (describing advantage of partnerships over S corporations in classic “money and brains” partnership); Schmolka, *supra* note 56, at 288, 302–12 (emphasizing special status in tax law applicable to partners versus employees).

¹³⁸ I.R.C. § 1361(b)(1)(D) (West 2007).

¹³⁹ *Id.* §§ 11, 1363(a) (imposing tax on C corporations and exempting S corporations from entity-level tax).

get into and get out of a partnership without incurring tax. But it is not as simple as a sole proprietorship.¹⁴⁷

But this policy goal of facilitating pooling lacks a solid normative justification. Pooling of labor and capital takes place in all entity forms, from a sole proprietorship to a publicly traded corporation and everything in between, like mutual funds, real estate investment trusts, and insurance companies. It is not self-evident why we should advantage partnerships over other entity classifications. If we accept as a given that we treat sole proprietors one way and corporate executives another, the determination of how to treat partners turns, among other things, on whether the activities conducted by partners more closely resemble the activities of sole proprietors on the one hand or corporate executives on the other. Taxing similar activities alike reduces deadweight loss by discouraging restructuring out of the optimal business form in order to reduce taxes.¹⁴⁸

The normative underpinnings of treating partners more like sole proprietors than executives have gone largely unexamined. Professor Laura Cunningham, for example, has argued that a partnership profits interest granted in exchange for future services should not be treated as a realization event, notwithstanding the arbitrary distinction between a capital interest and a profits interest.¹⁴⁹ While resting her

¹⁴⁷ With a sole proprietorship, the owner can immediately invest her own money (or borrowed money) into the business and enjoy any tax benefits, such as depreciation of the business's assets, that may follow.

¹⁴⁸ It is worth emphasizing that arbitrary line-drawing between pooling transactions (treated as nonrecognition events) and exchange transactions (treated as recognition events) already takes place under current law. The current rules treat the receipt of a profits interest as a pooling event, since this is not recognized as a taxable event, but they treat receipt of a capital interest as an exchange subject to immediate taxation (like the receipt of other forms of property, like stock or cash, received in exchange for services). See *supra* notes 33–46 and accompanying text (describing tax treatment of profits interest and capital interest received in exchange for services). Professor Laura Cunningham's 1991 *Tax Law Review* article challenged the logic of distinguishing between a capital interest and a profits interest in a partnership: "[T]here is no economic distinction between capital and profits interests which would justify taxing them differently." Cunningham, *supra* note 42, at 248. Because the value of a profits interest, like the value of a capital interest, depends on the value and expected return of the partnership's underlying assets, she concluded that the distinction is without a difference. *Id.* at 256. Treating a profits interest as speculative simply because it has no current liquidation value, see *supra* note 33 (discussing liquidation value), does not bring one closer to economic reality.

¹⁴⁹ For Professor Cunningham, the only relevant question is whether the partnership interest is received for services performed in the past or expected to be performed in the future. Property received for services already performed ought to be taxed currently, according to Professor Cunningham, regardless of whether the property is styled as a profits interest or a capital interest. Cunningham, *supra* note 42, at 260. If property is received in exchange for future services, however, current taxation would violate realization principles, see *id.* ("[W]here all or substantially all of the services . . . are completed at the time [the recipient partner] receives his interest in the partnership, . . . the realization

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position in part on a policy of not taxing unrealized human capital,¹⁵⁰ she adds, “subchapter K[, which governs taxation of partnerships,] arguably was intended to encourage just this type of pooling of labor and capital by staying current tax consequences until the partnership itself realizes gross income.”¹⁵¹

However, embedded in Professor Cunningham’s and others’ arguments for subsidizing pooling through the partnership form is the assumption that subchapter K “was intended to encourage just this type of pooling of labor and capital.”¹⁵² It depends what type of pooling “just this type” refers to. At the time that the partnership tax rules were enacted, partnerships were generally “simple ventures.”¹⁵³ But Professor Cunningham and others do not address the workings of these rules in the context of large private equity investment firms that compete with global investment banks. Today, perhaps two or three trillion dollars in investment capital is flowing through private investment partnerships worldwide,¹⁵⁴ with the United States income derived from managing that capital largely deferred until realization. It is not clear that Congress would make the same choice if asked to consider it on these terms. To inform that choice, the next Section explores another argument in favor of deferral, namely that GPs should be treated like sole proprietors when it comes to taxing the income associated with self-created assets.

C. Taxing the Self-Created Asset

When partnership tax scholars argue in favor of pooling, what they have in mind is treating two or more partners like a sole proprietor. If you can mix your own labor and capital together without triggering a taxable event, why shouldn’t partners be able to do the same? A key argument for deferral of tax on carried interest thus arises from the tax treatment of self-created assets in sole proprietorships.

event with respect to the services is complete.”), and Professor Cunningham argues that a wait-and-see approach is proper. *Id.* Professor Cunningham would therefore limit immediate taxation to cases in which the service partner completed all or substantially all of the services to be rendered at the time it receives its interest in the partnership. *Id.*

¹⁵⁰ See *id.* (“Where the profits interest is granted in anticipation of services to be rendered in the future, . . . taxation of the interest on receipt would violate . . . the policy against taxing human capital. This would be inconsistent with the basic purpose and structure of subchapter K.”).

¹⁵¹ *Id.*

¹⁵² *Id.* at 259.

¹⁵³ Berger, *supra* note 64, at 110. The change in size and complexity of partnerships leads Professor Berger to call for reform of the partnership tax rules that would limit pass-through treatment to “small business.” *Id.* at 161–67.

¹⁵⁴ See J. COMM., CARRIED INTEREST, *supra* note 77, at 32, 34 (stating that, worldwide, hedge funds control \$1.46 trillion and private equity controls \$1 trillion).

In a sole proprietorship, one is not taxed on an unrealized increase in wealth attributable to one's own labor. Put differently, unrealized imputed income in the form of self-created assets is generally exempt from taxation.¹⁵⁵ If you build a gazebo in your backyard, you are not taxed when the last nail is struck. You are only taxed, if at all, when you sell the house. If you rent a kiosk at the mall and stock it with appreciated works of art, you are not taxed when you open for business. You are only taxed as you realize profits from selling the paintings.

Should this tax treatment be extended from the individual to the partnership context? The normative case is weak. Performing services for oneself creates an actual increase in wealth. If the wealth were created in the context of market transactions—performing services for another person in exchange for cash, then buying an asset with the cash—a tax would be imposed. We decline to tax the self-created asset in the context of an individual, despite the fact that she has income, chiefly because of administrability concerns: Measuring the increase in wealth by adding value to a self-created asset is difficult and doing so might be intrusive to individual autonomy. As a result, we wait to tax the individual's imputed income until there is an observable market transaction. The gazebo you built in your backyard might be worth a lot of money, but we don't consider it an increase in your wealth until you sell the gazebo to your next-door neighbor. Until that market transaction takes place, valuation would be highly subjective and sensitive to gamesmanship. Furthermore, liquidity poses a problem; if a tax is assessed before the increase in wealth is realized, you might not have the cash to pay the tax. These administrability concerns, not conceptual objections, drive the deferral of tax on the imputed income from self-created assets.

Suppose now that we analogize the carried interest to a self-created asset. Does it follow that unrealized income derived from carried interest should be deferred? Not necessarily. The administrability concerns used to justify deferral in the context of a self-created asset are no longer present. As I discuss below, measurement concerns can be handled by using the Cost-of-Capital Method as a

¹⁵⁵ See Gergen, *supra* note 134, at 79 (“Some defend the statutory line [allowing deferral on a GP's receipt of a profits interest] on the ground that it preserves for partners a privilege they enjoy as individuals. This is the privilege not to be taxed on wealth in the form of self-created assets.”). Even in the sole-proprietorship context, this tax treatment of self-created assets has not gone uncriticized. See generally Noël B. Cunningham & Deborah H. Schenk, *How To Tax the House that Jack Built*, 43 TAX L. REV. 447 (1988) (arguing for taxing imputed income on accrual basis so as to “not unintentionally create biases in favor of (or against) any particular type of economic behavior or group of taxpayers”).

proxy for income. Nor is liquidity a concern; the annual management fees earned by private equity funds would provide more than enough cash to pay the tax on an annual basis. Analogizing the carried interest to a self-created asset, then, fails to provide a robust defense of deferral.

Other commentators have justified deferral in efficiency terms by articulating a desire to be neutral between a service provider's decision to act as a sole proprietor or to provide services within a partnership. Taxing a GP currently would appear to "distort the choice between being a partner versus a sole proprietor engaging in a borrowing transaction."¹⁵⁶ In efficiency terms, the key question is which is a closer substitute for carried interest: (1) acting as a sole propri-

¹⁵⁶ Rudnick, *supra* note 127, at 354. Professor Rudnick, following this train of thought, argues for deferral. She acknowledges that the analogy is imperfect; some projects are too risky to be funded entirely with debt. *Id.* at 355. But she argues that giving partners deferral makes sense even in the context of risky ventures where the taxpayer relies on others' financial capital. Pointing to founder stock (coupled with a § 83(b) election) as the classic example, Rudnick argues that "the tax law has generally allowed service providers to share equity returns with others and to receive capital gain returns." *Id.* at 355 & n.528. When the founders of a company receive stock, they typically pay little or no tax on the front end, contribute labor to the enterprise, and pay tax only when their investment in the company is ultimately sold.

A subtle yet important detail, however, distinguishes the taxation of a partnership profits interest from stock. When valuing stock for purposes of a § 83(b) election, the relevant regulations do not necessarily allow one to rely on liquidation value alone. *See* Treas. Reg. § 1.83-2(a) (1978) (imposing tax on "fair market value" of property received for which there is § 83(b) election without providing safe harbor, as exists for profits interest in partnership, that equates fair market value to liquidation value); *see also* Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874, 899-901 (2003) (describing use of liquidation value of common stock paid to managers of start-ups as "aggressive[]"); *id.* at 907-09 (noting how organizing start-up as partnership and paying managers profits interest offer same tax benefit with less risk of IRS challenge as aggressive valuation of common stock). In the context of high-tech start-ups, for example, one rule of thumb among Silicon Valley practitioners is that even in the case of common stock with no liquidation value, the common stock should be valued at one-tenth of the value of the preferred stock to reflect the option value (the amount that someone would pay to buy an option with the same economic characteristics) of the common stock. *Id.* at 900-01 n.86 (describing rule of thumb and noting that some practitioners have adopted more aggressive ratios). This approximation is generally thought to undervalue the common stock paid to managers, *id.* at 899-901, and these valuations have been receiving increased scrutiny as a result of § 409A, which requires more honest valuation procedures in measuring the value of deferred compensation. I.R.C. § 409A (West 2007); *see also* I.R.S. Notice 2005-1, 2005-1 C.B. 274, 278-79 (discussing valuation requirements under § 409A for equity-based compensation). Even at a low valuation, however, current practice with respect to stock results in *some* immediate recognition of income, while partnership profits interests, under current law and the proposed regulations, may be valued at their liquidation value, which is generally zero. *See supra* notes 37-42 and accompanying text (describing liquidation value safe harbor for profits interest). In other words, there is an inconsistency between the treatment of partnership and corporate equity on which Professor Rudnick does not focus.

etor and engaging in a borrowing transaction, or (2) forming a corporation and issuing equity to raise money. If the former is indeed the closer substitute, then we should consider extending deferral to carried interest; if the latter, then we should treat carried interest more like corporate equity grants.

Corporate equity appears to be the closer substitute. There are practical hurdles that make it unlikely that managers will forgo the current “two and twenty” structure in favor of debt-financed sole proprietorships. For example, the risky nature of private equity investing makes it difficult for managers to issue debt at the fund level. The “J-curve” returns of private equity funds do not lend themselves to making timely interest payments, and contingent “debt” issued on similar terms to the equity now received by LPs would be recharacterized as equity. If anything, then, the current tax treatment of carried interest as if it were a debt-financed sole proprietorship would seem to exacerbate rather than ease the economic distortion of the tax code, since the law treats carried interest more favorably than its closer substitute, corporate equity.¹⁵⁷

To be sure, it is difficult to predict whether and how some fund managers might choose to restructure their affairs in response to a change in the tax law. But the more concrete concerns relate to the proper measurement of unrealized income.¹⁵⁸ I address these concerns next.

D. Measurement Concerns and the Cost-of-Capital Method

The strongest argument for deferral is the difficulty of measuring a partner’s income on an accrual basis. This argument is especially strong in the context of venture capital and private equity funds, where the underlying investments are illiquid. A mark-to-market system could not function,¹⁵⁹ as there is no market for portfolio com-

¹⁵⁷ See *supra* Part II.C (comparing tax treatment of carried interest to that of corporate equity).

¹⁵⁸ See Cunningham, *supra* note 42, at 269 (“Because the value of a profits interest depends entirely on the future success or failure of the partnership business, the valuation problems posed may make taxing the interest on receipt administratively infeasible”); Gergen, *supra* note 129, at 550 (“Perhaps we cross over a line where valuation or other problems are sufficiently difficult that wealth in the form of human capital cannot be taxed in most cases, and so, for the sake of equity, we choose to tax it in no cases.”); Rudnick, *supra* note 127, at 350–51 (noting that, to impose current tax, “the profits interest [would be] valued on a highly speculative approach”); Schmolka, *supra* note 56, at 307–08 (“Resort to a proxy is necessary for valuation.”).

¹⁵⁹ A mark-to-market system would assign a value to the fund each year based on current market value and tax any gain or allow deduction of a loss even though the gain or loss would not have been realized.

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panies from which we could reliably estimate a value, and a mark-to-model system would be subject to significant manipulation.¹⁶⁰

1. *Cost-of-Capital Method*

But perhaps the valuation problem is not as intractable as it seems. While neither a mark-to-market nor mark-to-model system is desirable, we could use another proxy, which I call the “Cost-of-Capital Method.” Under this method, the GP would recognize income, on an annual basis, of an interest rate times its share of the profits times the amount of capital under management. The GP’s use of the LPs’ capital is like a compensatory loan; but for the services provided by the GP, the LPs would charge a market rate of interest on the loan. This method would equate the compensation for services paid to the GP with the forgiven interest on the loan. I derive this Cost-of-Capital Method from Professor Schmolka’s analogy between a profits interest and a nonrecourse loan.¹⁶¹

¹⁶⁰ Where assets are not regularly traded, models can be used to estimate the value of the asset if such a market existed. This is known as a “mark-to-model” system. Given the illiquidity of private equity assets and the uncertainty of their value, a mark-to-model tax system would invite needless gamesmanship and encourage funds to keep two sets of books, one for their investors (projecting high returns) and one for the taxing authorities (projecting low returns).

¹⁶¹ Schmolka, *supra* note 56, at 302–08. Schmolka explains that even if one insists on recognizing the economic value of a profits interest, one need not tax the profits interest upon receipt. Rather, he suggests, the proper economic analogy is to § 7872, I.R.C. § 7872 (West 2007), which governs compensation-related and other below-market interest rate loans. Schmolka, *supra* note 56, at 302–08. Professor Schmolka’s central premise is that a naked profits interest shifts the use of capital for a period to the GP. “Economically, that temporary [capital] shift is the equivalent of an interest-free, compensatory demand loan.” *Id.* at 302. Section 7872 would force GPs to recognize ordinary income for the forgone interest payments on the deemed loan; if the deemed loan had an indefinite maturity, then the rules would demand this interest payment on an annual basis so long as the “loan” remained outstanding.

Despite making this analogy between carried interest and a below-market interest rate loan, Professor Schmolka does not recognize a need for reforming the treatment of carried interest. According to Professor Schmolka, subchapter K, which governs partnerships, already comes close to the tax result produced by a below-market interest rate loan. *Id.* at 308. Professor Schmolka explains that subchapter K does so by looking to actual partnership income (the income produced by the constructive loan) rather than by using a market interest rate for lack of a better proxy. *Id.* “So long as [the GP’s] services are rendered as a partner,” and not as an employee, Professor Schmolka concludes that “nothing beyond subchapter K is needed.” *Id.* at 307–08.

Professor Schmolka’s argument holds up, however, only if the partnership is one that has current income from business operations, like a law firm or a restaurant. The income of the partnership is not a good proxy for the ordinary income of a GP if, as is the case in venture capital and private equity funds, the realization doctrine defers the partnership’s recognition of income for several years. (The partnership’s timing of income is determined at the entity level, when it liquidates portfolio companies. Even with an increase in wealth, there is no income to allocate to the partners until investments are liquidated.)

The standard argument is to analogize a twenty percent profits interest in a partnership to an at-the-money call option on twenty percent of the fund.¹⁶² But a profits interest is also economically equivalent to a nonrecourse, zero stated interest rate demand loan of twenty percent of the capital under management, where the GP invests the loan proceeds in the fund.¹⁶³ The GP effectively borrows twenty percent of the contributed capital from the LPs but is not asked to pay interest on the loan. Under the principles of § 7872, as the imputed interest is forgiven each year, that amount should be treated as ordinary income. The principles of § 7872 provide a convenient proxy for the GP's unrealized income.

To illustrate, imagine a \$100 million fund that appreciates to \$150 million over three years. The GP would receive \$10 million, or twenty percent of the \$50 million in profits. Now, imagine that instead of a twenty percent profits interest, the LPs made the GP a \$20 million loan. The loan would be made nonrecourse on the condition that the loan proceeds are invested in the fund. The fund would appreciate to \$150 million, making the GP's share worth \$30 million. The GP would then pay back the \$20 million, leaving it with \$10 million, the same as if it had received the profits interest in the first place. The twist is that the GP never pays any interest on the loan. Under § 7872, the GP would have to recognize annually, as ordinary income, the amount of the loan times the short-term applicable federal rate of interest.¹⁶⁴ By

¹⁶² An at-the-money option on twenty percent of the fund would allow the GP to purchase twenty percent of the fund's assets at a price equal to the initial fair market value (at-the-money) of the fund. Thus, this option would entitle the GP to twenty percent of the company's positive returns (the returns on the twenty percent of the assets which the GP has the option to buy). This is equivalent to giving the GP a twenty percent profits interest.

¹⁶³ A nonrecourse loan is one where the creditor's recovery, in case of default, is limited to the collateral that secures the loan. The profits interest is equivalent to a nonrecourse loan since the GP does not face any loss if the fund drops in value. More specifically, a twenty percent profits interest is economically equivalent to a nonrecourse loan from the LPs to the GP that is secured by the twenty percent of the fund which is purchased by the GP using the proceeds from the loan.

¹⁶⁴ See I.R.C. § 7872(a) (treating forgone interest of below-market demand loans as transfer from lender to borrower); *id.* § 7872(f)(2)(B) (setting interest rate for calculating forgone interest on demand loans as equal to short-term applicable federal rate). The treatment described here assumes that the loan from the LPs to the GP is a demand loan—payable at any time at the demand of the lender. Alternatively, one could view the arrangement as a term loan with original issue discount, in which case the GP/borrower would recognize imputed income under § 7872(b). See *id.* § 7872(b)(1) (including value of below-market interest rate loan in borrower's income). It is unclear which analogy—term loan or demand loan—is closer to the carried interest arrangement. While the partnership agreement usually provides for termination after ten years, partnerships often distribute cash and other assets to the limited partners after just a few years, and the life of the partnership may often be extended with consent of the limited partners. Irrespective of

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structuring the transaction as a profits interest and not a loan, the GP would escape the tax consequences of § 7872.¹⁶⁵

It may be helpful to back up a step. The deferral problem is caused by the realization doctrine, which reflects the fact that we cannot reasonably estimate the value of the partnership's assets on an annual basis. The key challenge is disaggregating the relative value of the returns on human capital, which we would presumably like to tax currently as the services are performed, from the returns on investment capital, which we would like to tax only when the income is realized. We cannot measure the returns on human capital directly; under current law, if the compensation is paid in the form of a profits interest, we estimate the return on human capital portion at zero and treat the entire amount, if and when it is received, as a return on investment capital.¹⁶⁶

I argue here that there is another proxy available. It is an imperfect proxy and is likely to undervalue the true amount of the increase in value of partnership assets that reflects a return on human capital, but it is undoubtedly more economically accurate than current law, which estimates this amount at zero. We can separate the return to capital and labor by calculating the size of the implicit loan from investors to the GP in order to reasonably estimate the value of the contribution of labor based on the opportunity cost to investors.

2. *The Cost-of-Capital Method and the "Imputed Income Subsidy"*

To better illustrate how exactly the Cost-of-Capital Method works, this Section highlights how this approach would reduce, if not eliminate, what I call the "imputed income subsidy." This subsidy results from being able to invest labor in one's own business using pretax (as opposed to after-tax) dollars—which is what GPs, currently, are allowed to do. The Cost-of-Capital Method would effectively prevent GPs from investing their labor income in the investment fund without first paying a tax bill. It is informative to

whether carried interest is considered to be equivalent to a demand or term loan, the tax results are similar. In either case, the Code would tax the value of receiving a below-market interest rate loan.

¹⁶⁵ An additional question arises under the Cost-of-Capital Method concerning whether the GP should receive a deduction for the deemed interest payments or a basis adjustment in its capital interest. As a cost of making the investment, the GP's deemed interest payment should be accounted for one way or another. In my view, the GP should receive an upward basis adjustment to the extent it recognizes ordinary income, which would reduce its capital gain (or even produce a capital loss) on the back end. Alternatively, the GP could receive a deduction for investment interest, subject to the limitations of I.R.C. § 163(d) (West 2007).

¹⁶⁶ See *supra* Part I.B.2 (describing how tax system treats carried interest as capital income).

compare this to an alternative reform, what I call the “Ordinary-Income Method,” which would not eliminate this subsidy. The Ordinary-Income Method would treat all distributions of carried interest as ordinary income. But even while increasing the tax rate to thirty-five percent from current law, the Ordinary-Income Method would continue to allow deferral. In other words, just like in the current system, the Ordinary-Income Method would defer tax on the imputed income from investing labor in one’s own business.

To illustrate the imputed income subsidy, compare the difference between the Cost-of-Capital Method and Ordinary-Income Method. Assume a fund manager raises \$100 million and takes a twenty percent profits interest, and further assume that the fund appreciates by six percent a year, and assume that the same rate applies to impute interest income under the Cost-of-Capital Method. At the end of seven years, the fund liquidates. First, consider the tax consequences under the Cost-of-Capital Method. The fund manager would be treated as receiving a \$20 million loan from the limited partners, and would be treated as if it reinvested the proceeds in the fund, receiving a twenty percent capital interest in the fund. Each year, the fund manager would pay \$420,000 in income tax on the forgiven interest from the imputed loan ($\$100 \text{ million} \times 20\% \text{ carry} \times 6\% \text{ interest rate} \times 35\% \text{ ordinary income rate}$), and it would effectively be deemed to reinvest that amount in the fund, receiving a basis increase by that same amount. At the end of year seven, the fund manager’s capital interest would be worth just over \$30 million, and after repaying the \$20 million loan to the limited partners and paying capital gains tax on the difference between the amount realized and its adjusted basis, the fund manager would receive about \$9.5 million after tax. The present value of all of its cash flows is about \$3.5 million, assuming a discount rate of eight percent. By contrast, under the Ordinary-Income Method, the fund manager would pay no income tax currently, but rather would defer all its income to the end of the fund, at which point it would receive about \$6.5 million after-tax income (again assuming a 35% ordinary income rate). The present value of this amount is about \$3.8 million, again using a discount rate of eight percent. The Ordinary-Income Method proves more advantageous for the fund manager under these assumptions, demonstrating the “imputed income subsidy” that deferral provides, which survives even under the higher tax rate of the Ordinary-Income Method.¹⁶⁷

¹⁶⁷ The difference would be even more striking if the back-end gains under the Cost-of-Capital Method were taxed at ordinary rates rather than at capital gains rates. Conversely, if the capital gains rate is assumed to be zero, the two methods are equivalent in this case, much like the tax equivalence, under certain conditions, of a Roth IRA and regular IRA.

In sum, in circumstances where a partnership's income is deferred by reason of the realization doctrine, current law allows deferral of returns on human capital.¹⁶⁸ A Cost-of-Capital Method might prove to be a better measurement of labor-related income than current law, thus ensuring that the taxpayer's choice of form is driven by economic considerations rather than tax considerations. The cost of such an approach would be added complexity; current law works well in most contexts outside of investment partnerships.

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I now shift focus from the timing of income from a partnership profits interest to the character of that income once recognized. Most tax scholars agree that we ought to tax labor income progressively so that the average tax rate rises with income.¹⁶⁹ Despite this, a flat, lower rate on capital income can be justified because of lock-in effects and other considerations, and a rich debate surrounds the capital gains preference.¹⁷⁰ But generally speaking, our tax system tries to tax

Simply taxing the total investment return at thirty-five percent, in other words, does not eliminate the advantage of investing with pretax dollars. As Professor Halperin showed in his 1986 *Yale Law Journal* article, a special surtax equal to the fund manager's marginal tax rate is needed to equalize the tax treatment between the person who invests with after-tax cash and the fund manager who can invest using pretax dollars. Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 *YALE L.J.* 506, 539–50 (1986). The surtax would be designed to tax the employee on the interest earned on compensation that has been deferred. See Yale & Polsky, *supra* note 71, at 599–620 (discussing methods of implementing special surtax).

For a more complete comparison of the Cost-of-Capital Method and Ordinary-Income Method under different assumptions, see *infra* Part V.F.

¹⁶⁸ One caveat to this analysis should be noted. As Professor Sanchirico explains in some detail, the tax benefits of the status quo treatment of a profits interest in a private equity fund are tax-advantaged only in the event that the LPs have a lower tax rate than the GP. Sanchirico, *supra* note 16, at 32–33. Otherwise, every dollar of tax liability avoided by the GP would be offset, from a revenue perspective, by an extra dollar of tax liability paid by LPs. See *supra* notes 41–44 and accompanying text (describing substitute taxation and explaining how, in theory, substitute taxation could leave government, GP, and LPs in same position as if GP had been taxed directly). But the majority of LPs are tax-exempt, and it seems unlikely that this institutional detail will change in the near future. See J. COMM., CARRIED INTEREST, *supra* note 77, at 37 (stating that of investors in venture capital funds, forty-two percent are pension funds and twenty-one percent are endowments and foundations).

¹⁶⁹ See, e.g., Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 *CAL. L. REV.* 1905, 1966–67 (1987) (“Although the optimal tax literature does not answer the question of what the exact rate structure should be, it strongly suggests that if a goal of the tax system is to maximize individual welfare, the rate structure should be progressive.”).

¹⁷⁰ See generally Noël B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 *TAX L. REV.* 319 (1993) (reviewing and evaluating arguments for capital gains preference).

labor income progressively.¹⁷¹ One largely overlooked anomaly in the system is the treatment of sweat equity. Sweat equity, as I define it here, is the ability to convert labor income into an investment in one's own business.¹⁷²

Sweat equity is more lightly taxed than other forms of labor income. The entrepreneurial-risk subsidy that results can be justified by administrative concerns and, perhaps, by the widely shared view that entrepreneurship generates positive social externalities. As I discussed in the previous Part, however, the subsidy for entrepreneurship does not stem solely from the capital gains preference.¹⁷³ Rather, it also comes from the choice we make to defer tax on the imputed income that accompanies working for oneself—the ability to invest with pretax dollars and not pay tax until one's investment is sold. Doing away with the capital gains preference for sweat equity, therefore, would not extinguish the entrepreneurial risk subsidy.

A. *Below-Market Salary and Conversion*

Imagine a grocer who could earn \$50,000 per year managing the produce section of a branch of Whole Foods, a natural and organic foods retailer. Instead, he borrows money, uses the money to open a local organic grocery, and pays himself a modest salary of \$20,000 per year. Ultimately, he pays off the debt and sells the store to a financial buyer three years later for a large gain. Under endowment tax principles,¹⁷⁴ the grocer should be taxed at ordinary income rates on \$50,000 per year, followed by a recontribution into the business of the \$30,000 difference between a market rate of salary and his actual salary (the human capital now converted into investment capital). Any additional gain or loss would be properly treated as capital gain or loss. But because we resist the concept of endowment taxation (and the second-guessing of one's choice of employment),¹⁷⁵ we have no easy way of seriously questioning whether the amount of salary the grocer pays to himself is an improper base for taxing his labor. His invest-

¹⁷¹ See I.R.C. § 1(a), (i) (West 2007) (providing rate structure for individuals on ordinary income).

¹⁷² There are four departures from a pure endowment tax base that create potential tax benefits for sweat equity: (1) the ability to choose to work for oneself at a lower salary than one might be able to make in the market (the self-investment with pretax dollars); (2) deferral on the receipt of the equity interest (i.e., the nontaxation of unrealized human capital); (3) deferral as the value of the sweat equity appreciates; and (4) on exit, the opportunity to be taxed at capital gains rates on the labor income which has been converted into a self-created capital asset.

¹⁷³ See *supra* Part III.D.

¹⁷⁴ See *supra* note 121 and accompanying text (defining endowment tax).

¹⁷⁵ See *supra* Part III.A.1 (describing reluctance to engage in endowment taxation).

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ment in his own business is treated as a true investment, and the character of that gain is respected as such.

One is tempted to think that even if we believe the current salary is too low, the difference is inconsequential. If the grocery store generates current operating income, the income will either pass through to the grocer¹⁷⁶ (if the business is organized as a sole proprietorship,¹⁷⁷ partnership,¹⁷⁸ or S corporation¹⁷⁹) or will be taxed at the entity level (if organized as a C corporation¹⁸⁰). Even if the grocery store's appreciation in value is deferred—say, if it derives from the increase in value of the underlying land on which the store sits—the grocer will not necessarily benefit. While his current income is artificially low, so too is his basis in the grocery store. When the store is sold, the income will be captured by the greater difference between the amount realized and the grocer's adjusted basis. Assuming constant tax rates, the deferral would appear to be irrelevant from a tax policy standpoint.

The model just described breaks down in two ways, however, revealing the subsidy for entrepreneurship. The first way in which the model breaks down, as discussed in Section III.D.2, is through the failure to tax the imputed income that comes from investing in a self-created asset. In more familiar terms, the GP has the ability to invest in its own business using pretax dollars. The failure to reach this imputed income provides a significant entrepreneurial-risk subsidy.

The second way the model breaks down is in its assumption of constant tax rates. When the grocery store is sold, the gain or loss may be treated as long-term capital gain.¹⁸¹ Thus, if the grocer is working for himself, so long as he is willing to put up with the entrepreneurial risk of taking a below-market salary and investing in the business, the tax code provides an additional subsidy in the form of conversion from ordinary income to capital gain. Professors Gilson

¹⁷⁶ The income “passes through” since it is not taxed to the entity but, instead, is taxed to the owners. This is in contrast to entity-level taxation where income is taxed at the entity level but is not immediately taxed at the owner level.

¹⁷⁷ See Treas. Reg. § 301.7701-3(a)–(b) (1996) (providing that, unless owner elects otherwise, entity with single owner is “disregarded as an entity separate from its owner” for tax purposes).

¹⁷⁸ See I.R.C. § 701 (West 2007) (exempting partnerships from entity-level tax and imposing tax on partners in their individual capacities).

¹⁷⁹ See *id.* § 1366 (passing through income earned by S corporation to its shareholders on pro-rata basis).

¹⁸⁰ See *id.* § 11 (imposing tax on C corporations).

¹⁸¹ I am assuming, for the sake of simplicity, that the increase in value comes from gain that would be capital in nature, such as an increase in the value of the underlying land, rather than gain that would be ordinary, such as gains attributable to unrealized receivables or inventory. See *id.* § 1221 (defining capital asset).

and Schizer have noted how, in an analogous situation, the tax law subsidizes the founders of venture capital-backed start-ups in the same way, allowing them to place low tax valuations on their common stock.¹⁸²

B. *Compensating General Partners*

Let us focus more closely now on the conversion element of the equation. We could eliminate conversion via the Ordinary-Income Method, which treats sweat equity as labor income: It would tax *all* income that arises from the labor of GPs as ordinary income. This approach, which has already been briefly described in this Article, would treat the grant of a profits interest in a partnership as an open transaction;¹⁸³ as income is received, it retains its character as ordinary income.¹⁸⁴ As this Article has previously explained, the Ordinary-Income Method would not eliminate the entrepreneurial-risk subsidy altogether.¹⁸⁵ Nonetheless, taxing carried interest as ordinary income would bring fund managers in line with other service providers. Professor Gergen, in a 1992 *Tax Law Review* article, outlines the necessary reforms and justifies this approach.¹⁸⁶

The Ordinary-Income Method, as detailed by Professor Gergen, is relatively simple. It does not change the status quo with respect to realization. A grant of a profits interest in a partnership, by itself, would not give rise to taxable income. When compensatory allocations are made, however, they would be treated as salary paid by the

¹⁸² Gilson & Schizer, *supra* note 156, at 898–901; *see also* Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 1015–20 (2006) (discussing impact of tax rules on corporate governance of start-ups). Section 409A has complicated matters somewhat, as aggressive valuations could be questioned by the government and subjected to an excise tax. Unlike other scholars, however, I would characterize the problem as not simply one of valuation, but rather a problem that is inextricably tied to the fact that the portfolio company's value depends on the efforts of the entrepreneur. Even if one had a crystal ball about market conditions, regulatory risk, and all other exogenous factors that could affect the price of the stock, the valuation would be imperfect unless one could also assess the talent, ability, and preferences of the entrepreneur.

¹⁸³ In an “open transaction,” the stream of income from a transaction is taxed as it is received. This is in contrast to a “closed transaction” in which the stream of income is valued upon the date it is promised and taxed then.

¹⁸⁴ *See* Henry Ordower, *Taxing Service Partners To Achieve Horizontal Equity*, 46 TAX LAW. 19, 41 (1992) (“Partners receiving capital or profits interests in a partnership in exchange for services realize ordinary income upon receipt of those interests.”).

¹⁸⁵ *See supra* Part III.D.2 (describing how Ordinary-Income Method would not eliminate “imputed income subsidy”).

¹⁸⁶ Gergen, *supra* note 134, at 103–11.

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partnership. The allocation would be income to the recipient and the partnership would deduct or capitalize the expense.¹⁸⁷

Professor Gergen argues that the decision not to initially tax the exchange of a profits interest for services “arguably compels” taxing later allocations of profits to the GP as compensation. Otherwise, he argues, partners enjoy “extraordinary privileges” not available to service providers in other contexts.¹⁸⁸ If the GP’s income is not being treated as compensation, the GP does not pay social security tax. It never pays tax at ordinary rates if the allocations represent capital gain, or if it sells its profits interest to a third party or sells it back to the partnership. If it receives in-kind compensation, it may pay no tax at all.

Professor Gergen acknowledges that the measurement of income is imperfect, but he argues it is the best that we can do.¹⁸⁹ “These changes measure the income of service partners and other partners,” he explains, “as well as it can be measured given the current rules on deferred compensation and capitalization outside of subchapter K.”¹⁹⁰ Importantly, the proposal would not discourage innovative compensation arrangements. By making the tax consequences follow the economics more closely, however, the proposal would reduce distortions between the use of corporate equity and partnership equity.

V

REFORM ALTERNATIVES

An entrepreneurial-risk subsidy of some sort arguably makes sense as a matter of tax policy. The economics literature suggests that there are positive externalities associated with entrepreneurship. The case for an entrepreneurial-risk subsidy is more complicated than one might think, however.¹⁹¹ Companies that grow and succeed generate positive spillovers that benefit others in the economy. But for every successful company, there are also failures, which may impose social

¹⁸⁷ *Id.* at 103.

¹⁸⁸ *Id.* at 94.

¹⁸⁹ *See id.* at 100–02 (recognizing that, “[i]n theory, [the GP] ought to recognize income equal to the value of the interest when he receives it,” but questioning administrability of such system).

¹⁹⁰ *Id.* at 69.

¹⁹¹ *See, e.g.,* Douglas Holtz-Eakin, *Should Small Businesses Be Tax-Favored?*, 48 NAT’L TAX J. 387, 387 (1995) (“[I]t is difficult to construct a case in favor of systematically favoring small businesses.”); Donald Bruce & Tami Gurley-Calvez, *Federal Tax Policy and Small Business* 7–8 (Hudson Inst., Research Paper No. 06-02, 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=904641 (“[T]he current literature does not provide sufficient evidence in favor of using the tax code to target subsidies toward small businesses.”).

costs. Many small businesses, for that matter, do not create new jobs, but merely displace old ones. A progressive tax system, by its very nature, provides some insurance against risk by compressing the distribution of after-tax incomes.¹⁹² And, as this Article has noted, the income tax embeds a valuable subsidy in its structure by failing to tax the unrealized human capital invested in one's own business.¹⁹³ As a practical matter, then, some tax subsidy for entrepreneurship will continue in any regime short of an endowment tax. The case for a tax subsidy that goes *beyond* this built-in advantage for sweat equity is certainly plausible, but it has yet to be made. Furthermore, it is difficult to transport the entrepreneurship arguments beyond venture capital and into the broader world of private equity partnerships, which traditionally tend to invest in slow-growth companies.¹⁹⁴

Making the normative case for or against such a subsidy and answering these political questions is beyond the scope of this Article. The best tax design for the taxation of partnership profits depends not only on one's preference for an entrepreneurship subsidy, but also on a number of other tricky assumptions, including:

- one's views about distributive justice;
- the role of the tax system in redistributing income;
- whether we take the entity-level tax of publicly traded corporations as a given;
- whether we take the tax-exempt status of pension funds and endowments as a given;
- whether we take the capital gain preference as a given, and at what rates, and with what holding period;
- whether we take the realization doctrine as a given;
- what we predict the incidence of the tax subsidy to be (i.e., how much of the tax benefit to fund managers is passed on to other

¹⁹² Cf. Evsey D. Domar & Richard A. Musgrave, *Proportional Income Taxation and Risk-Taking*, 58 Q.J. ECON. 388 (1944) (discussing ability of proportional income tax system to cushion losses). A progressive tax system does impose a penalty on entrepreneurship by disfavoring those with volatile incomes. See William M. Gentry & R. Glenn Hubbard, *Tax Policy and Entrepreneurial Entry*, 90 AM. ECON. REV. 283, 287 (2000) ("While most tax research focuses on the effects of marginal tax rates on behavior, our analysis indicates that the convexity of the tax system also affects behavior."). Still, this effect all but disappears for those with high (even if volatile) incomes, such as hedge fund managers, that, even in their worst years, are subject to the top marginal rate on the vast majority of their income.

¹⁹³ See *supra* Part III.D.2.

¹⁹⁴ See George W. Fenn et al., *The Economics of the Private Equity Market* 21 (Bd. of Governors of the Fed. Reserve Sys., Staff Paper No. 168, 1995), available at <http://www.federalreserve.gov/pubs/staffstudies/1990-99/ss168.pdf> ("Companies that have undergone public buyouts typically have moderate or even slow growth rates, stable cash flows, and management that was misusing the discretionary cash flows for negative present value acquisitions or other activities.").

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parties, such as the founders, employees, and customers of the portfolio companies they fund); and

- the efficiency and dynamic revenue effects of the increased incentive, on the margins, for fund managers to relocate overseas.

Given the number of variables and the uncertain economic effects of various changes, there is ample room for disagreement about the scope and mechanics of reform alternatives. Nonetheless, as this Part concludes, the status quo is an untenable position as a matter of tax policy. This Part further finds that, among the various alternatives, the best starting point may be a baseline rule that would treat carried interest distributions as ordinary income, while allowing partnerships to engage in tax planning so as to achieve the same tax result as under the Cost-of-Capital Method.

I discuss five alternatives below: (1) the status quo, which allows both deferral and conversion; (2) the Ordinary-Income Method, which allows deferral but no conversion; (3) the Forced-Valuation Method; (4) the Cost-of-Capital Method, which eliminates deferral but allows some conversion; and (5) the Talent-Revealing Election, which allows both deferral and conversion, but only under certain circumstances.

A. *The Status Quo*

Under current law, a profits interest is not taxable upon receipt, and income may be deferred until realization at the partnership level and converted into capital gain. The status quo has the benefit of being predictable and well understood by practitioners.

Some social welfare effects of the status quo are unclear. Current law provides a sizable, categorical subsidy for the private equity industry. This tax subsidy probably lowers the cost of capital for venture capital-backed start-ups, which might be good economic policy; the status quo also benefits private equity more broadly, as well as certain hedge funds, but it disadvantages innovation ventures at publicly held corporations. If the social policy goal is to encourage innovation, more targeted incentive structures ought to be considered.

The status quo has one clear benefit: The gamesmanship that we see is a known quantity. Changing the treatment of a profits interest in a partnership would create new pressures on the system. For example, funds might replace profits interests with options to acquire a capital interest, which is economically equivalent. The taxation of compensatory partnership options is not entirely settled law, and any of the reform options discussed below would probably have to be

extended to reach compensatory partnership options as well. Similarly, new funds will have an increased incentive to locate overseas. To the extent that transaction costs require the performance of services in the United States, however, this concern may be overstated. Funds that target U.S. portfolio companies rarely perform those services from abroad; income derived from work performed in the United States would still be taxed as U.S.-source income. Moreover, other jurisdictions that are considered attractive locales for private equity, like the United Kingdom, are also considering eliminating the preferential tax rate on carried interest distributions.¹⁹⁵

The drawbacks of the status quo, however, are crystal clear. Current law encourages regulatory gamesmanship and leads to wasteful tax planning. It distorts the design of the contract between GPs and their investors, increasing agency costs. Moreover, the tax advantage of carried interest creates an anomaly in the tax system—creating both equity-based and efficiency-based concerns. Because of the quirk of the industry they work in, private equity fund managers pay tax at a lower rate than corporate executives. And this tax disparity in turn encourages more people to become fund managers, while there is no reason to believe that such activity needs a subsidy.

And while this Article has focused on the doctrinal and efficiency-based reasons to consider reform, we should not brush off the broader concerns of distributive justice that give this issue political appeal. After all, the tax treatment of carried interest is what allows fund managers to pay tax at a low rate. This quirk of the tax law circumvents our system of progressive taxation and, in so doing, it undermines public confidence in the tax system. While it would be troubling to look *only* at public reaction in shaping public policy—such is the domain of pundits, not academics—in this case public reaction dovetails with the widely held academic view that progressive taxation is sound public policy.¹⁹⁶ Taxing the labor income of fund managers at a low rate is a severe departure from widely accepted tax norms, and it ought to be addressed.

¹⁹⁵ See, e.g., *Carried Away*, *ECONOMIST*, June 7, 2007, at 13 (describing push in United Kingdom to raise tax rates on carried interest).

¹⁹⁶ To be sure, not everyone (myself included) is wedded to a progressive *income* tax, as opposed to a consumption-based tax. Academic proponents of consumption taxes, however, are also careful to build in methods to preserve progressivity. See, e.g., Mitchell L. Engler, *Progressive Consumption Taxes*, 57 *HASTINGS L.J.* 55, 56 (2005) (discussing methods of taxing consumption without sacrificing individual progressivity).

B. *The Gergen/Ordinary-Income Method*

I derive the simplest reform approach, the Ordinary-Income Method, from Professor Gergen's 1992 *Tax Law Review* article.¹⁹⁷ The receipt of a profits interest in a partnership would be treated as an open transaction. When distributions are ultimately made to the GP, however, the distributions would be treated as ordinary income, regardless of the character of the underlying assets sold by the partnership.¹⁹⁸ As compared to the current system, this would increase the tax rate on the distribution of most carried interest to private equity GPs from fifteen percent¹⁹⁹ to thirty-five percent.²⁰⁰

The benefit of this approach is its relative simplicity. One could implement a rule that any property received in exchange for services is, once realized, treated as ordinary income. This approach has the benefit of treating partnership equity in the same way that we treat its closest corporate cousin, a nonqualified stock option.²⁰¹

The Ordinary-Income Method would not eliminate the subsidy associated with the ability to invest with pretax dollars. This aspect of Gergen's approach is consistent with the broader entrepreneurial risk subsidy of the tax code, embedded in many aspects of the tax treatment of sweat equity. If consistency with corporate equity is important, then Gergen's approach is a sensible compromise.

A potential drawback of the Ordinary-Income Method is the availability of planning options. For example, a GP could secure a nonrecourse loan for twenty percent of the capital of the fund and use the proceeds to buy a capital interest in the fund. Forgone interest on the imputed loan would be taxed pursuant to § 7872,²⁰² but some conversion could still be achieved. This puts more pressure on the rules relating to the tax treatment of compensatory loans; if the applicable interest rate is too low, the GP might be undertaxed. Still, the challenge of precisely separating returns on human capital from returns on investment capital suggests that rough justice might be an acceptable result. In other words, the availability of planning options may not be undesirable. Indeed, as I discuss below in Section E, an elective

¹⁹⁷ See Gergen, *supra* note 134, at 103–11 (detailing Gergen's proposal).

¹⁹⁸ See *id.* (proposing to treat compensatory allocations of profit as salary).

¹⁹⁹ See I.R.C. § 1(h)(1)(C) (West 2007) (setting fifteen percent tax rate on most long-term capital gains).

²⁰⁰ See *id.* § 1(a), (i) (setting top rate of thirty-five percent on ordinary income).

²⁰¹ See *supra* notes 101, 103 (explaining economic equivalence of profits interest and nonqualified stock option).

²⁰² See I.R.C. § 7872 (West 2007) (addressing below-market interest rate compensatory loans).

approach would be consistent with the tax code's general approach to executive compensation.

C. *The Forced-Valuation Method*

Another alternative would be to revisit the holding of *Diamond*, which established that the receipt of a partnership interest gives rise to immediately taxable income only if the partnership interest has a determinable market value.²⁰³ By forcing valuation and inclusion wherever the value of the profit interest can be estimated, this approach would reduce deferral but allow some conversion into capital gain.

The method would force the round peg of partnership equity into the square hole of § 83,²⁰⁴ and this would have little likelihood of success. In the corporate context, if an entrepreneur joining a new start-up receives common stock and a venture capital fund holds preferred stock, the receipt of the common stock still gives rise to taxable income. The stock may not be valued simply by taking the liquidation value of the stock, which is typically zero. Rather, the valuation must also account for the option value of the common stock. The problem, of course, is that, given the speculative nature of the enterprise, an appraisal necessarily resorts to arbitrary rules of thumb, is easily gamed, and will tend to understate the option value of the interest.²⁰⁵ Moreover, § 409A forces appraisers to take the question more seriously than before, driving up administrative costs, but generating little in the way of revenue.²⁰⁶ There is little reason to believe that forcing valuation of partnership profits interests in this fashion would lead to a more salutary result.

D. *The Cost-of-Capital Method*

A Cost-of-Capital Method would, like the Forced-Valuation Method, reduce deferral but allow some conversion into capital gain. Counterintuitively, it would often provide a greater entrepreneurial-risk subsidy than the Ordinary-Income Method,²⁰⁷ and it provides precious few planning or gamesmanship opportunities.

²⁰³ *Diamond v. Comm'r*, 56 T.C. 530, 546–47 (1971), *aff'd*, 492 F.2d 286, 290–91 (7th Cir. 1974).

²⁰⁴ It is the habit of most tax professionals to depict partnerships as ovals or circles and corporations as squares or rectangles. For a description of § 83, see *supra* text accompanying notes 31–34.

²⁰⁵ See *supra* note 156 (discussing tax treatment of common stock in corporate start-ups).

²⁰⁶ See Scott, *supra* note 106, at 885–86 (discussing “onerous, costly, and risky valuation rules” for certain equity interests under § 409A).

²⁰⁷ See *infra* Table 1.

Under a Cost-of-Capital Method for taxing a profits interest in a partnership, fund managers would be allocated an annual cost-of-capital charge as ordinary income. The allocation would be equal to a market rate of interest times the percentage profits interest times the amount of capital under management. The GP's use of the LPs' capital is like a compensatory loan; but for the services provided by the GP, the LPs would charge a market rate of interest on the loan.²⁰⁸ The true market interest rate would be rather high, given the nonrecourse nature of the "loan" and the level of risk involved. Because the actual cost-of-capital is difficult to know, however, I propose following § 7872's approach and deeming a normal rate of interest to have been forgiven.²⁰⁹

This approach results in a modified form of accrual taxation. The GP would be taxed currently on the value of the use of the LPs' capital. To the extent the fund appreciates, however, those gains would not be recognized until the income is realized by the partnership. The character of any gains would be preserved as capital gains.²¹⁰

²⁰⁸ Arguably, the applicable federal rate of interest, which is set by the Treasury Department based on interest paid on federal debt, *see* I.R.C. § 1274(d) (West 2007) (setting method for determining applicable federal rate), would be far too low an interest rate given the riskiness of the "loan" from the LPs to the GP, *see* J. COMM., CARRIED INTEREST, *supra* note 77, at 51 ("Because the fund investments are frequently risky enough that very high rates of return are contemplated, the use of a Treasury debt rate, generally considered to be a 'risk-free' rate, may not be appropriate."). But we should not dismiss "rough justice" as a plausible goal here in light of the administrative complexity. Congress could simply choose a higher interest rate (such as the risk-free rate plus several hundred basis points, which would still fall below the true cost of capital), or it could give the Treasury the legislative authority to determine an appropriate interest rate.

²⁰⁹ *See* I.R.C. § 7872(f)(2) (West 2007) (employing applicable federal rate, which is set based on interest rates on federal debt, for calculating forgone interest on below-market loans). The Cost-of-Capital Method could be extended to other contexts, such as to estimate the option value of common stock. Detailed consideration of such an application is beyond the scope of this Article.

²¹⁰ Consider the following example. Suppose LPs contribute \$95 million to a private equity fund, and the GP contributes \$5 million. The GP also receives a two percent annual management fee and twenty percent carried interest. Assume for the sake of simplicity that all the capital is contributed at once and is invested in portfolio companies. In year one, the GP would take \$2 million in management fees. Because the management fees are not contingent, they would be taxed under § 707(c) as if the GP were an employee, just as they are now. I.R.C. § 707(c) (West 2007). The GP would be taxed on \$2 million as ordinary income, and the partners would allocate the deduction according to the terms of the partnership agreement. Next, we account for the cost of capital. Assume a market interest rate of eight percent. Under the Cost-of-Capital Method, the GP would pay a cost-of-capital surtax in the amount of \$532,000 (eight percent cost of capital times twenty percent profits interest times \$95 million (the non-GP source of capital) times a thirty five percent tax rate). This amount would be ordinary income to the GP. The LPs would be allocated a \$532,000 deduction according to their percentage interests as reflected in their capital accounts (or would capitalize the expense, as appropriate). Because most LPs are tax-exempt, there is still a net revenue gain to the Treasury. The GP would receive an upward

The chief benefit of the Cost-of-Capital Method is that it would be difficult to plan around this rule without altering the underlying economic arrangement between the GP and the LPs. Compared to current law, it would represent a move towards neutrality of tax form that would reduce both agency costs and the deadweight loss associated with tax planning. This approach reduces the incentive to unduly favor partnership profits interests over other economically equivalent forms of compensation, and it thus reduces economic distortions in contract design and minimizes planning opportunities. It is, however, rather complex. It might be difficult for taxpayers and the IRS to administer.

E. Talent-Revealing Election

The last approach is a “Talent-Revealing Election,” which would change the default rule to the Ordinary-Income Method but allow partnerships to elect into the Cost-of-Capital Method. Similar to a § 83(b) election for restricted stock, the election would be attractive to managers who expect to achieve high investment returns and unattractive to managers who are not so sure. It would accelerate current income but would allow conversion of any additional income into capital gain. By allowing managers to choose between deferral and conversion, the election might serve as a useful screening device, revealing information to investors as to the managers’ expectations of the rate of return.

The election is consistent with our tax system’s usual method of handling executive compensation valuation problems. We offer executives a choice. Generally, if property is not vested, the executive may elect to be taxed currently, and the fair value (less any amount paid) becomes taxable as ordinary income.²¹¹ Any further appreciation is then eligible for the capital gains preference. The valuation is performed as if the property was not subject to vesting requirements or other restrictions.²¹² If no election is made, the full amount is taxable as ordinary income if and when the property vests.²¹³

I recognize that the analogy to restricted stock is a little off; the closest economic analogy is to a nonqualified stock option,²¹⁴ and,

basis adjustment, each year, reflecting the cost-of-capital charge. Any realized gains or losses from the fund’s operations would be allocated as usual.

²¹¹ See I.R.C. § 83(b) (West 2007) (providing election).

²¹² *Id.* § 83(b)(1)(A).

²¹³ See *id.* § 83(a) (requiring, absent § 83(b) election, that property be included in income once there is no longer “substantial risk of forfeiture”).

²¹⁴ See notes 101–05 and accompanying text (describing nonqualified stock option and its economic similarity to carried interest).

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under § 83(e)(3), one cannot make a § 83(b) election with respect to an option with no readily ascertainable fair market value.²¹⁵ Here, however, the Cost-of-Capital Method is used to approximate the compensatory value of the use of someone else's capital, and it thus serves as an appropriate amount for inclusion under a § 83-style election. Section 83 reflects a policy of having a default rule that property (and gains from property) received in exchange for services is ordinary income unless the property recipient elects out of deferral to get the reward of conversion if things go well.

The Ordinary-Income Method, then, could become our default rule. Compensatory allocations would be ordinary income in the usual case. Partners could then elect *in* to the Cost-of-Capital Method, which would accelerate income but offer the promise of capital gains on appreciation.

A similar approach is to take the Ordinary-Income Method as a baseline rule, but then allow fund managers to constructively elect a Cost-of-Capital Method by restructuring the carried interest as an actual formal loan. If the interest on the loan is below the market rate of interest, or is forgiven, § 7872 would apply,²¹⁶ taxing the general partner currently on the economic use of the LPs' capital. Alternatively, the LPs might allow the GP to pay interest on the loan and increase the management fees to compensate, in which case the increased management fees would be taxed as ordinary income.

F. Examples

To illustrate the differences among the various approaches, I assume the following: that a fund manager receives a twenty percent profits interest in a \$100 million fund; that the fund sets an eight percent hurdle rate; and that the fund appreciates at an annual rate of ten percent per year for seven years, at which point the fund realizes and distributes its gains. I further assume a discount rate of eight percent in calculating those figures given in net present value. (In the table that follows, I also calculate the after-tax return assuming annual returns of five, fifteen, and twenty percent.)

Example 1 (Status Quo). The fund manager pays no tax on receipt of the profits interest, and pays tax at the long-term capital gains rate when receiving the distribution in year seven. The fund is worth \$195 million at the end of year seven; the carry is worth \$19 million, and the GP's after-tax return is \$16.1 million. The present

²¹⁵ I.R.C. § 83(e)(3) (West 2007).

²¹⁶ See *id.* § 7872 (including forgone interest on below-market rate interest loan in borrower's income).

value of this amount, using an eight percent discount rate, is *\$9.4 million*.

Example 2 (Ordinary-Income Method). All the facts remain the same as in Example 1, but the fund manager now pays income tax at ordinary income rates of thirty five percent, leaving her with after-tax investment proceeds of \$12.3 million. The present value of this amount is *\$7.2 million*.

Example 3 (Nonrecourse Loan). Now assume that, rather than taking a profits interest in the fund, the fund manager is loaned \$20 million from the LPs on a nonrecourse basis, uses that money to purchase a twenty percent capital interest in the partnership, and that interest on the loan is forgiven as it accrues. Further assume an interest rate of six percent under § 7872. Assuming the form of the transaction is respected, the fund manager recognizes \$1.2 million of ordinary income each year (paying tax at a thirty-five percent rate), receives additional basis of \$1.2 million each year, and pays tax on the back-end gains at fifteen percent. The present value of her after-tax return is about *\$8.0 million*.

Example 4 (Cost-of-Capital Method). By assumption, the cost of capital method would produce the same results as a nonrecourse loan. The present value of her after-tax return would be about *\$8.0 million*.

TABLE 1

Summary of Examples		Present Value of After-tax Returns (In Millions)				
		Fund's Assumed Annual Return				
Fact Pattern	Tax Law Option	5% (Hurdle Rate)	5% (No Hurdle Rate)	10%	15%	20%
(1) 20% Carry	Status Quo	0	\$4.04	\$9.41	\$16.47	\$25.62
(2) 20% Carry	Ordinary-Income Method	0	\$3.09	\$7.20	\$12.59	\$19.59
(3) Nonrecourse Loan	Status Quo	(\$1.45)	\$2.59	\$7.96	\$15.01	\$24.17
(4) 20% Carry	Cost-of-Capital Method	(\$1.45)	\$2.59	\$7.96	\$15.01	\$24.17

The results show that from the GP's point of view, the appeal of the Cost-of-Capital/Loan Method versus the Ordinary-Income Method depends on the GP's assumptions about the future returns of the fund. If the GP expects high returns, the Cost-of-Capital Method is most appealing for the GP, as more gains are taxed at the lower capital gains rate. If the GP expects low returns, or returns below the hurdle rate, then the Ordinary-Income Method is most appealing, as it

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avoids early (or even “phantom”) recognition of income. As this Article has discussed, this is why an election between these methods may tend to reveal the GP’s self-assessed talent.

G. Policy Recommendations

1. Ordinary-Income Method as the Baseline Rule

Perhaps the most attractive approach to reform is the Ordinary-Income Method. The main appeal of this approach is its simplicity as a baseline rule. Carried interest allocations would be deferred until gains are realized at the partnership level and would be treated as ordinary income.

From a policy standpoint, the biggest apparent drawback of the Ordinary-Income Method is the potential concern that taxpayers might plan around the rule. Fund managers could easily restructure the carried interest as a nonrecourse loan from the LPs with the GP investing the loan proceeds into the fund. This arrangement is economically equivalent to a profits interest.

But, as it turns out, the tax implications of this planning option may be perfectly acceptable from a policy standpoint, even though the result may be somewhat more favorable to taxpayers than treating all the income as ordinary income.²¹⁷ Specifically, with some simple planning, taxpayers could achieve the same tax results as the Cost-of-Capital Method.

Consider the likely response of fund managers to the legislative change. Fund managers who anticipate achieving large amounts of capital gains will seek to restructure the formal arrangement with LPs to improve the tax treatment without upsetting the economics of the deal. To preserve the economics of a twenty percent carried interest, LPs could make a nonrecourse loan to the GPs for twenty percent of the capital of the fund, which the GP would then invest directly into the fund. Because the legislative change would reach only compensatory allocations (i.e., allocations disproportionate to the amount of capital a partner has invested into the fund), GPs would then achieve capital gains treatment on allocations of partnership capital gains, just like any other investor.

But there is nothing offensive about this arrangement. It is equivalent to the Cost-of-Capital Method, but is imposed by voluntary private ordering into existing tax rules rather than by new legislative fiat. The key is looking at the interest on the loan from the LPs to the GP. If the loan bears interest at a market rate, then the LPs are likely

²¹⁷ I am indebted to Professor Bankman for this insight.

to gross up the management fee to allow the GP to pay the interest. The additional amount of management fees would be treated as ordinary income under current law. Alternatively, the LPs could offer a zero interest or below-market rate interest loan. In that case, § 7872 would kick in and would impute income as if a market rate of interest had been forgiven. In either case, the GP will recognize ordinary income on the cost of capital carried by the LPs, which is precisely the amount of income that reflects compensatory returns on human capital rather than returns on investment capital. Additional gains deserve the same capital gains preference that we attach to investment capital, and would receive that treatment. The net result is equivalent to the Cost-of-Capital Method, but with less administrative complexity. (To be more precise, it is equivalent to the Talent-Revealing Election, as the decision to restructure the profits interest as a loan is entirely voluntary.)

The baseline rule, then, is relatively simple: Allocations of income that are disproportionate to the amount of capital a partner has invested in a fund will be treated as ordinary income. Fund managers who anticipate large capital gains will restructure the carried interest as a nonrecourse loan and will recognize an appropriate mix of ordinary income and capital gain as a result.

2. “Rifleshot” Approach to Reform

Any of these reform options have unwelcome consequences for certain interests. Naturally, Congress may anticipate some opposition from industries that use partnerships, such as the real estate industry, the oil and gas industry, the timber industry, and the small business community in general. Congress may want to consider a “rifleshot” anti-abuse approach, carefully targeting any reform to reach only large, private investment funds. By limiting its application to large investment partnerships,²¹⁸ lawmakers could balance concerns of efficiency, fairness, and progressivity with concerns about administrative convenience and political viability.

²¹⁸ Depending on how narrow policymakers intend the approach to be, the rules could apply only to partnerships where capital is a “material income-producing factor,” *cf.* I.R.C. § 704(e)(1) (West 2007) (defining partnership interest in certain family partnerships in these terms), or even just to “investment partnerships” defined as investment companies for purposes of section 3 of Investment Company Act of 1940, 15 U.S.C. § 80a-3 (2000), but for application of the exemptions in section 3(c)(1) or section 3(c)(7) of the Act, *id.* § 80a-3(c)(1)(A), (c)(7). This is similar to the definition in I.R.C. § 743(e)(6)(B) (West 2007) which defines investment partnerships for purposes of basis adjustments based on these sections of Investment Company Act of 1940.

CONCLUSION

After this Article began circulating in draft form, the taxation of private equity fund managers became a hotly contested issue in Washington. A variety of approaches to taxing carried interest have been suggested, and one bill was introduced in the House.²¹⁹ That bill—introduced by Representative Sander Levin of Michigan—would treat carried interest distributions as ordinary income (similar to the Ordinary-Income Method proposed by Professor Gergen) and would apply to a wide variety of “investment management services” partnerships, including funds managed by real estate firms as well as private equity and venture capital firms.²²⁰ The bill eventually passed in the House as a way to pay for temporary relief from the Alternative Minimum Tax (AMT),²²¹ but the legislation failed to gather enough steam to make it out of the Senate Finance Committee, which chose to pass AMT relief without a revenue offset. The House ultimately agreed to drop the issue.²²² The issue is likely to come up again as part of a debate over tax reform in 2009.²²³

The status quo treatment of a profits interest in a partnership is no longer a tenable position to take as a matter of sound tax policy. This Article’s most novel contribution, a Cost-of-Capital Method to valuing partnership profits interests, might be difficult to administer if adopted legislatively. But the analysis also shows that if the Ordinary-Income Method is adopted, allowing fund managers to achieve the same results as the Cost-of-Capital Method through a nonrecourse loan may, in fact, be a favorable outcome.

²¹⁹ H.R. 2834, 110th Cong. (2007).

²²⁰ *Id.*

²²¹ H.R. 3996, 110th Cong. § 611 (as passed by House of Representatives, Nov. 9, 2007).

²²² See David M. Herszenhorn, *Congress Averts Higher Tax Bill for Middle Class*, N.Y. TIMES, Dec. 20, 2007, at A1 (“House Democrats angrily approved the bill after giving in to demands . . . that the tax cut not be offset by raising other taxes.”).

²²³ See Capital Commerce, <http://www.usnews.com/blogs/capital-commerce/2007/10/26/rangel-tax-bill-could-reverse-reaganomics.html> (Oct. 26, 2007, 13:34 EST) (“As investment firm Goldman Sachs put it in a note to clients today: ‘This bill is very unlikely to become law before the 2008 election, but is important because it signals the possible direction of tax reform efforts in 2009 if Democrats control both the White House and Congress.’”).