Tax Equality: Eliminating the Low Effective Marginal Tax Rates for Private Equity Professionals

Shrilaxmi S. Satyanarayana
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SHRILAXMI S. SATYANARAYANA†

INTRODUCTION

The issue of income classification—ordinary income versus capital gains income—has received considerable media scrutiny in the past eighteen months with respect to private equity funds, as large private equity firms have gone public, and information about their management structures and compensation practices have been subject to disclosure. Private equity funds are partnerships that invest in companies and/or entire business

† J.D. Candidate, December 2008, St. John's University School of Law; M.B.A., 1998, William E. Simon Graduate School of Business Administration, University of Rochester; A.B., 1995, Barnard College. The author would like to thank Professors Jacob L. Todres and Robert A. Ruescher for their insight and guidance. In addition, the author would like to thank Allan A. Wiesel and the other editors and staff of the St. John's Law Review; and Anne MacEwen, Audrey Schwarz and Vijay Satyanarayana for their comments on earlier drafts. The author would especially like to thank her family for their unwavering support and encouragement, particularly Uma and B.R. Satyanarayana, and Vishwas and Akash Prabhakar.

While the issue affects fund management firms generally, this Note focuses on private equity funds specifically, given the increased scrutiny they have faced in light of several high profile initial public offerings on the public stock exchanges. Indeed, given that hedge funds, another category of fund management firms, actively trade their underlying assets in order to exploit market opportunities, it is unlikely that they are affected by the current debate: The short holding periods of the underlying assets disqualify their treatment as long-term capital assets, and they are subject, therefore, to ordinary income treatment. See JOHN RUTLEDGE, ANALYSIS OF THE IMPACT OF INCREASING CARRIED INTEREST TAX RATES ON THE U.S. ECONOMY 11 (2007); see also Victor Fleischer, Two and Twenty: Taxing Partnership Profits in Private Equity Funds, 83 N.Y.U. L. REV. 1, 15 (2008).

units, manage them, and then sell them off at a profit. The investments in the companies and/or business units generally qualify as capital assets. Private equity firms typically retain ownership of their equity stakes for several years. Given that the minimum holding period for the sale of a capital asset to qualify for long-term capital gains treatment is one year, the profit received on disposal of these private equity investments therefore takes the form of a long-term capital gain and is subject to lower tax rates than the sales of capital assets that are held for one year or less.

The general partners of the private equity fund make the investment decisions regarding the companies in which the fund is invested, while the limited partners provide investment capital. For their investment decisions, the general partners are compensated in two ways: First, they receive two percent of the assets under management annually as a management fee, on

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3 See Fred F. Murray, Uncertainties Increase for Taxation of Private Equity Investments, DAILY TAX REP. (BNA), June 27, 2007, at 1.

4 A capital asset is defined as "property held by the taxpayer, (whether or not connected with his trade or business)," but excludes certain items such as inventory, property used in trade or business qualifying for depreciation, real property used in trade or business, copyright, literary, musical or artistic composition, or similar property created by or created for the taxpayer, accounts receivable acquired in the ordinary course of business, and other assets. I.R.C. § 1221(a) (West 2008). Although arguably the ownership stakes acquired by the private equity firms could be viewed as property that is used in "trade or business," they are neither real property nor depreciable, and hence they qualify as capital assets. See 4 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 47.3 (2003).


6 See BITTKER & LOKKEN, supra note 4, ¶ 49.1 ("Gain or loss on a sale or exchange of a capital asset is long-term capital gain or loss only if the property was held for more than one year; it is short-term capital gain if the property was held for one year or less.").

7 See Senate Hearings II, supra note 5, at 1 (statement of Bruce Rosenblum, Chairman of the Board, The Private Equity Council). General partners also invest some capital in the partnership, but their primary contribution is in the form of investment and management expertise to the funds. See id. at 2 (noting that general partners contribute "3–10% of the partnership's overall investment capital"); see also Senate Hearings II, supra note 5, at 2 (statement of William D. Stanfill, Founding Partner, Trailhead Ventures, L.P.), available at http://finance.senate.gov/hearings/testimony/2007test/073107testws.pdf (noting that the general partners in his fund "invest at least 1% of the fund's capital").
which they are taxed at ordinary income tax rates, and second, they receive 20 percent of the fund's profits, the "carried interest," for which they are often taxed at the lower capital gains rate. The capital gains rate on the 20 percent profit share is permissible under current Internal Revenue Code ("I.R.C.") rules because the partnership itself receives the profits in the form of capital gains, and through pass-through principles, it retains that character when it flows through to the individual partners. Given that private equity professionals receive significant remuneration via the carried interest, and are taxed at the lower capital gains rate, Congress, in contemplation of legislation subjecting carried interests to the higher ordinary income marginal tax rate, held hearings during the late summer and early fall of 2007 to understand the economics of these arrangements and to understand the arguments both in favor of and against the current tax treatment.

Private equity professionals assert that their investments are "integral to capital formation and liquidity in this country" and contend that imposing a higher marginal tax rate would result in the "sky...fall[ing] and...private

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8 This is known as a profits interest in tax parlance because the interest is in the partnership's profits, not its capital. See Rev. Proc. 93-27, 1993-2 C.B. 343 (defining 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 then the proceeds were distributed in a complete liquidation of the partnership" and a profits interest as "a partnership interest other than a capital interest"). Throughout this Note the terms profits interest and carried interest will be used interchangeably.

9 See I.R.C. § 702(b) (2000 & Supp. III 2003). This section states:
The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (7) of subsection (a) [describing the forms of income inclusions] shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

Id.

10 See Johnston, supra note 2 ("Questions in Congress about possibly raising taxes on such compensation were prompted in part by publicity about the rich rewards for people who run these firms. Stephen A. Schwarzman, the co-founder of the Blackstone Group, made nearly $400 million last year, for example.").

11 The Senate Finance Committee held hearings on July 11 and July 31, 2007, and the House Ways and Means Committee held a hearing on September 6, 2007 on "Fair and Equitable Tax Policy for America's Working Families," in which the tax treatment of investment fund managers was considered.

12 Senate Hearings II, supra note 5, at 1 (statement of Bruce Rosenblum, Chairman of the Board, The Private Equity Council).
equity... shrivel[ing] up and d[ying]." According to these professionals, the imposition of higher marginal tax rates would result in fewer deals getting funded in the United States, hampering the United States’ economy. In addition, they contend that the current tax treatment is appropriate for encouraging risk taking with respect to funding companies that have difficulty raising capital from traditional sources.

In contrast, proponents of change to the current tax structure maintain that increasing the marginal tax rate is necessary to ensure equality and fairness. Individuals in other high paying professions, such as executives and lawyers, are subject to taxation at the ordinary income tax rate, whereas private equity managers are taxed at the long-term capital gains rate, because their income is structured in the form of carried interests. In addition, they claim that warnings of a precipitous drop in private equity funding as a result of proposed tax code changes are spurious, given that private equity managers do not bear risk to the same extent as do entrepreneurs, and that

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13 Id. at 7.
14 See id.; see also Steve Forbes, Private Equity, Public Benefits, WALL ST. J., July 25, 2007, at A14 (“Raising taxes on private equity doesn’t just harm fund managers or investors—it also harms the companies that need private equity investments to bring their innovations to market, which, in turn, makes our entire economy less competitive.”).

[The Venture Capital] fund structure encourages the pooling of labor and capital by allowing the partners to divide the profits from the enterprise—whether created by the VCs’ labor or the combination of the VC and [Limited Partners’] capital—in whatever manner they determine best rewards the long-term, entrepreneurial risk taken by each partner. . . .

. . . [I]t is appropriate to reward investors of sweat equity with the same long-term capital gain tax benefits that investors of financial equity receive.

Id.

17 Id.
many investments tend to be made in a relatively narrow geographic area to facilitate monitoring.\textsuperscript{19}

This Note will evaluate the arguments by both challengers and proponents to tax reform with respect to carried interests and propose two methods to bring about change in the tax treatment. This Note will conclude that a change in the tax code is needed to maintain equality and fairness, given that the carried interest is more appropriately considered as compensation. In addition, in light of advances in financial valuation techniques, the existing tax treatment is inappropriate and section 83 of the Internal Revenue Code, which addresses the taxation of property received as compensation, should be applicable to the receipt of carried interests.

Part I of this Note will recount the chronology of the existing tax treatment, laying out the partnership and section 83 landscapes, including a discussion of \textit{Diamond v. Commissioner}\textsuperscript{20} and \textit{Campbell v. Commissioner},\textsuperscript{21} and the resulting Treasury regulations.\textsuperscript{22} Part II will evaluate arguments opposing and supporting any changes to the current scheme of allowing carried interests to be treated as capital gains. Finally, Part III will conclude that subjecting carried interests to inclusion in ordinary income under section 83 of the I.R.C. is a reasonable approach to equalizing income tax treatment of compensation, particularly in light of advances in financial valuation techniques, before which the valuation of profits interests was more difficult. In the alternative, this Note will assert that cutting off the source of the capital gains treatment, namely by denying the pass-through treatment for carried interests in partnerships, is also a viable alternative.

\textbf{I. SETTING THE SCENE—PARTNERSHIP AND ORDINARY INCOME TAX PRINCIPLES}

This Part outlines the primary sections of the I.R.C. that affect the carried interests of private equity partnerships. Part
I.A defines partnership capital and profits interests and discusses the relevant partnership taxation provisions, including the pass-through treatment of partnership income. Part I.B discusses section 83 of the I.R.C. (which addresses restricted stock awards), its legislative history, demonstrating similarities to the current debate on private equity carried interests, and the rationale for excluding partnership profits interests from its treatment. This foundation is important, as Part III asserts that section 83 provides an adequate framework for taxing the partnership profits interests as ordinary income. Finally, Part I.C sets forth the current treatment of partnership carried interests, which is a combination of the two areas—the relevant partnership provisions and section 83—along with the two seminal cases, Diamond and Campbell, and the ensuing Treasury regulations that have resulted in the current favorable tax treatment for carried interests. An understanding of the existing tax treatment is necessary to appreciate the contemporary debate over whether to maintain the status quo that is discussed in Part II.

A. Partnership Taxation Scheme

In order to understand the current treatment of partnership profits interests, it is first necessary to distinguish between the two types of partnership interests—the capital interest and the profits interest. A capital interest is "an interest that would give the holder a share of the proceeds if the partnership's assets were sold . . . and then the proceeds were distributed in a complete liquidation of the partnership. This determination generally is made at the time of receipt of the partnership interest."23 Thus, an individual receives a partnership capital interest if he is entitled to receive a share of the existing value of the partnership's assets.24 Since the value of the capital interest is based on the existing value of the partnership's assets, the value of that interest may be valued without much difficulty, with reference to those underlying assets.

The profits interest, in contrast, is defined as "a partnership interest other than a capital interest."\textsuperscript{25} The profits interest is not valued based on the value of the partnership's existing assets since the partner receiving such an interest does not receive a share of the partnership's existing assets, but rather receives payment based on future income; the value of that future income is uncertain at the time the profits interest is granted.\textsuperscript{26} Due to the speculative nature of the profits interest and the limitations on its valuation, profits interests have not been taxed on receipt traditionally.\textsuperscript{27}

The current favorable taxation treatment of profits interests is a function of the partnership taxation scheme that treats the partnership as a pass-through entity whereby the partnership's income flows through to the individual partners and is taxed to the individuals and not to the entity.\textsuperscript{28} Critical to the preferential treatment of the carried interest is the general partnership taxation principle that in allocating the income and expense amounts to each individual partner, the items retain the character that they bear at the partnership level.\textsuperscript{29} Thus, to the extent the partnership realizes a long-term capital gain through the disposition of a capital asset, that gain retains the capital gains characterization when it passes through to the individual partners to be taxed.

Generally, neither the partnership nor a partner recognizes a gain or loss on property contributions exchanged for a partnership interest, and therefore, no tax is assessed.\textsuperscript{30}


\textsuperscript{26} See id. ("[C]ourts have . . . found that typically the profits interest received has speculative or no determinable value at the time of receipt.").

\textsuperscript{27} See, e.g., Campbell v. Comm'r, 943 F.2d 815, 823 (8th Cir. 1991) ("More troubling . . . is [the] argument that the profits interests . . . received had only speculative, if any, value. We fully agree with this contention . . . .").

\textsuperscript{28} See I.R.C. § 701 (2000) ("A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities."); see also McKee, Nelson & Whitmire, supra note 24, ¶ 1.01[1].

\textsuperscript{29} See I.R.C. § 702(b).

\textsuperscript{30} See id. § 721(a). According to I.R.C. section 721(b), I.R.C. section 721(a) does not apply to transfers of property to partnerships that would be treated as investment companies within the meaning of I.R.C. section 351, were the partnerships to be incorporated. See id. § 721(b); see also McKee, Nelson & Whitmire, supra note 24, ¶ 4.01[1][a] (noting also that nonrecognition applies
However, an individual receiving a partnership capital interest in exchange for services rendered or to be rendered is taxable under sections 61 and 83 of the I.R.C.\textsuperscript{31} Treasury Regulation section 1.721-1(b)(1) is explicit that "to the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services," section 721, relating to nonrecognition of gains or losses, is inapplicable.\textsuperscript{32} Furthermore, the fair market value of the capital interest received as compensation by a partner is included in gross income.\textsuperscript{33} The valuation is as of the time the transfer was made for past services, or at the time services have been rendered in the case where transfer of the property is conditional on completion of the recipient's future services.\textsuperscript{34} The timing of realization, however, is dependent on "all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of [the] interest."\textsuperscript{35}

On the other hand, the tax treatment of a profits interest received as compensation for services performed is more complex. This is due in part to the fact that the value of that interest is not based on the value of the partnership's existing assets, as previously mentioned. Part C discusses the issues with respect to carried interests after reviewing the section 83 landscape in more detail.

\textsuperscript{31} See McKee, Nelson & Whitmire, supra note 24, ¶¶ 5.01, 5.02[1]; see also id. ¶ 4.01[1][a] (noting that nonrecognition under I.R.C. sections "721 through 723 [is] applicable only if 'property' is contributed to the partnership. A major consequence of this limitation is that transactions in which partnership interests are issued in exchange for services are not eligible for nonrecognition treatment under section 721"). Sections 722 and 723 concern the partners' basis in and adjustments to basis in property contributions to the partnership. See Campbell, 943 F.2d at 820 ("When a service partner receives an interest in partnership capital, the cases clearly hold that a taxable event has occurred. The receipt of the capital interest must be included in the service partner's income.").


\textsuperscript{33} Id.

\textsuperscript{34} Id.

\textsuperscript{35} Id.
B. Internal Revenue Code Section 83—Property Received in Exchange for Services

When a taxpayer is compensated with property for having provided services, he is taxed at ordinary income tax rates on the amount by which the fair market value exceeds any payments he may have made for the property himself. According to section 83, that value is recognized in the taxpayer's income in the first taxable year in which he enjoys ownership rights in the property—when the property is transferable or is not subject to a substantial risk of forfeiture, as applicable. Thus, a person who receives compensation in the form of non-statutory restricted stock or other property is taxed on it at ordinary income tax levels in the year that it is no longer forfeitable or in the year in which restrictions on its transferability lapse.

Congress enacted section 83 during the 1960s in response to the widespread use of restricted stock options to reduce tax liability after a debate that mirrors today's carried interest dialogue. Back then, as today, Congress was concerned that certain already well-remunerated individuals were able to structure their compensation in a tax-advantageous manner to avoid paying their appropriate tax liability. Congress determined that maintaining fairness in the tax scheme was critical and enacted a change to the tax law to provide for the recognition of income where property is received in exchange for services. While section 83 was enacted in response to the problem uncovered regarding restricted stock plans, it has wider applicability than to just those plans, and as this Note argues later, it can be used to tax the partnership carried interests. But, to see how closely the issues surrounding carried interests and restricted stock plans parallel each other, it is useful to review the history of section 83.

37 Id.
38 Non-statutory restricted stock does not meet the requirements established in I.R.C. section 421, which provides for non-recognition of income by the taxpayer on the exercise of qualifying stock options. See id. § 421(a)(1).
41 H.R. REP. NO. 91-413, at 1645.
Congress enacted section 83 of the I.R.C. in 1969 to remedy inequities in the tax scheme relating to restricted stock plans.\(^4\) Under prevailing regulations at the time, executives receiving non-statutory restricted stock were not subject to immediate recognition of income on receipt of stock options containing restrictions that appeared to have no independent business justification; the options were being used as a means of providing tax-deferred compensation to the recipients.\(^4\) By structuring stock grants with time restrictions, companies were able to compensate certain employees in a manner that allowed tax to be deferred until that restriction lapsed. The individuals would then be taxed at a lower rate because recognition would be deferred until the individual had retired from employment and would therefore be in a lower tax bracket. In addition, to the extent tax was owed on the increase in value between the time of stock transfer and the time of the lapse of the restriction, it would be treated as a capital gain.\(^4\) Congress sought to remove this loophole in enacting section 83 by disregarding the time restriction for tax purposes and requiring recognition of income—the excess of the fair market value of the stock over any consideration paid by the employee—on receipt of the stock either if the interest in that property were transferable or if it were not subject to a substantial risk of forfeiture.\(^5\) The exceptions for income recognition for property subject to restrictions on transferability and substantial risk of forfeiture acknowledged limitations imposed by law and by legitimate business needs.\(^6\)

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42 See id. at 1645, 1733–35.
43 See Bureau of National Affairs, Tax Management Portfolios, 83.9 [hereinafter BNA]. (Edwin S. Cohen of the Treasury Department testified before the House Ways and Means Committee, “[W]e recommend that restrictions barring sale for a specified number of years not be given any effect for tax purposes. On the other hand, restrictions under shareholders’ agreements which do not expire by lapse of time, and thus are prompted by bona fide business rather than tax considerations would be taken into effect.” (emphasis added)).
44 See H.R. REP. NO. 91-413, at 1734; see also BNA, supra note 43 at 83.9, Technical Explanation of Treasury Tax Reform Proposals.
45 See H.R. REP. NO. 91-413, at 1735.
46 See BNA, supra note 43, at 83.9. (Edwin S. Cohen of the Treasury Department testified before the House Ways and Means Committee, “[R]estrictions under shareholders’ agreements which do not expire by lapse of time, and thus are prompted by bona fide business rather than tax considerations would be taken into effect. Also, restrictions imposed by law would be taken into account.”); see also S.
In enacting this change, Congress rejected arguments claiming that such a change would discourage companies from giving employees a stake in the business, stating that it had already provided for such goals through the use of qualified stock options. The motivating factor for the restricted stock plans was compensation rather than providing employees with an ownership stake in the business. Even though the measure would not result in significant revenue gains to the fisc, Congress noted the need for fairness in the tax scheme: "If taxpayers are generally to pay their taxes on a voluntary basis they must feel that these taxes are fair."

Section 83 contained the following exceptions to its applicability: (1) a transaction to which section 421 relating to stock options applied; (2) pension and profit sharing plans; (3) the transfer of an option without a readily ascertainable fair market value; or (4) the transfer of property pursuant to the exercise of an option with a readily ascertainable fair market value at the

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47 See H.R. REP. NO. 91-413, at 1735.
48 See id. at 1734-35 (noting that the I.R.C. provisions for statutory stock options included specific requirements that were "designed to decrease the compensatory nature of stock options and to place more emphases on stock options as a means of giving employees a stake in the operation of their business").
49 See BNA, supra note 43, at 83.13 (noting that an argument against enacting the proposed change was that "[l]ittle revenue appears to be involved; hence there is no real benefit accruing from making a change").
50 See H.R. REP. NO. 91-413, at 1645. In pushing for the inclusion of restricted stock in gross income, Edwin S. Cohen, Assistant Secretary of the Treasury for Tax Policy, testified before the Senate that "[o]ur self-assessment tax system depends upon equitable rules under which each persons [sic] pays a fair share of his income tax. Permitting certain forms of compensation arrangements to be taxed at capital gains rates while others are taxed as ordinary income creates serious inequities in the individual income tax." BNA, supra note 43, at 83.20.
51 Difficulties in valuation are arguably less of an issue today than they were in 1969, with advances in financial modeling. For example in 1973, Nobel Laureate Robert Merton published a comment on options valuation using the Black-Scholes option pricing model in the Journal of Finance. See Robert C. Merton, The Relationship Between Put and Call Option Prices: Comment, 28 J. FIN. 183, 183-84 (1973). The Black-Scholes model is widely used in financial valuation.
date of grant.\textsuperscript{52} While the third exception excludes options having speculative values from immediate taxation on receipt, no exceptions were made explicitly with respect to partnership interests received in exchange for services performed to that partnership. However, due to valuation concerns, section 83 has not been applied to profits interests received in exchange for services performed to a partnership.\textsuperscript{53}

Although Congress sought to end the tax gamesmanship through the restricted stock loophole, it did not eliminate it completely. The Senate added a provision allowing employees to elect to recognize income on receipt of nontransferable property even if it were subject to a substantial risk of forfeiture, thus permitting capital gains treatment for any subsequent gains realized on the disposition of that property.\textsuperscript{54} If the property were later forfeited, however, no deduction would be allowed for the value forfeited on which tax previously had been paid, \textsuperscript{55} although the amount paid for the property, "as distinguished from the amount included in income as a result of the election," may be deducted as a loss on forfeiture.\textsuperscript{56} Thus, Congress allowed employees receiving restricted stock to elect to prepay their income taxes and thereby obtain capital gains treatment on subsequent sales of the restricted stock, but at the same time eliminated the ability to subsequently recapture the taxes paid if the stock value actually declined. The fact that Congress specifically did not permit tax recapture in such a scenario is important, for it should also apply in the carried interest context.\textsuperscript{57} Since this provision would prevent recipients of


\textsuperscript{53} See supra Part I.A and infra Part I.C; see also McKee, Nelson & Whitmire, supra note 24, ¶ 5.01 (noting that "by administrative fiat, the receipt of partnership profits interest for future services to the issuing partnership or past services rendered to, or for the benefit of, the issuing partnership generally is not treated as a taxable event" absent certain conditions); Fleischer, supra note 1, at 10 (stating that "valuation and other considerations prevent the tax law from treating this receipt [of the profits interest] as a taxable event").


\textsuperscript{55} See I.R.C. § 83(b); see also S. REP. NO. 91-552, at 2154.

\textsuperscript{56} 3 Bittker & Lokken, supra note 4, ¶ 60.4.3 n.59 (2005); see also Treas. Reg. § 1-83.2(a) (1978) (indicating that losses in excess of the amount paid for the property over the amount received on forfeiture would be treated as a realized loss).

\textsuperscript{57} See infra Part II.B.
restricted stock from recapturing tax paid on income not actually received—arguably a larger population than carried interest recipients—there is no compelling reason for preventing its application to partners receiving carried interests.

C. **Blending Internal Revenue Code Section 83 and Partnership Taxation—Diamond, Campbell, and the Aftermath**

It would appear that section 83 should apply to profits interests since they are property received in exchange for the provision of services; however, "by administrative fiat [it] is not treated as a taxable event, unless either (a) the profits interest relates to a 'substantially certain and predictable stream of income from partnership assets' or (b) within two years of receipt, the partner disposes of the profits interest."\(^{58}\) This administrative position has evolved as a consequence of judicial decisions,\(^{59}\) the two major ones being *Diamond v. Commissioner*\(^{60}\) and *Campbell v. Commissioner*,\(^{61}\) in which both the valuation and speculative nature of profits interests have proved troublesome.

Although the *Diamond* case pre-dates the enactment of section 83,\(^{62}\) the Seventh Circuit affirmed the Tax Court's decision in favor of the Internal Revenue Service.\(^{63}\) The court held that the profits interest in the partnership was includible in the partner's gross income where the taxpayer sold the partnership interest soon after receipt, but the court generally questioned the practicality of treating the profits interest as compensation, given the difficulties in determining fair market value where the interest was not disposed of so quickly.\(^{64}\) In *Diamond*, the taxpayer obtained a 60 percent profits interest in a partnership in exchange for arranging the financing to acquire an office building.\(^{65}\) The partnership was entered into on

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\(^{60}\) 492 F.2d 286 (7th Cir. 1974).

\(^{61}\) 943 F.2d 815 (8th Cir. 1991).

\(^{62}\) Although the case was decided in 1974, the tax year at issue was 1962. *Diamond*, 492 F.2d at 286–87.

\(^{63}\) See *id.* at 291.

\(^{64}\) *Id.*

\(^{65}\) *Id.* at 286.
December 15, 1961, and on February 18, 1962, the office building was purchased. On March 8, 1962, the taxpayer sold his partnership interest to a third party for $40,000. The taxpayer reported the proceeds of the sale as a short-term capital gain, against which he offset unrelated short-term capital losses, resulting in no tax consequences; however, the Tax Court ruled that the taxpayer's acquisition of the profits interest constituted compensation for services, worth $40,000, and was includible as ordinary income. In so concluding, the Tax Court, and the Seventh Circuit in upholding the decision, went against the "substantial consensus of commentators."

In the nearly two decades that have elapsed between Diamond and Campbell, the issue was not litigated frequently. The IRS "made no overt move to embrace or reject Diamond. Instead, it tried to avoid the issue by controlling efforts of field agents to raise it." During that intervening period, Congress enacted section 83 of the Internal Revenue Code. As a result, when Campbell was litigated, the Tax Court considered the relevance of section 83 to the issue, and found the section to apply. In Campbell, the taxpayer received limited partnership profits interests in three partnerships "in exchange for services he had rendered in the formation and syndication of [those] partnership[s]." Unlike in Diamond, however, the taxpayer did
not dispose of these interests immediately, which was a critical distinction.\textsuperscript{75} While the Tax Court held that the limited partnership profits interest constituted income to the taxpayer and hence was includible in his gross income, the Eighth Circuit reversed.\textsuperscript{76} In so doing, the Eighth Circuit noted the critical distinction that while the taxpayer in \textit{Diamond} "did not intend to function as or remain a partner," this was not the case in \textit{Campbell}, for the taxpayer's partnership interests "were not transferable and were not likely to provide immediate returns.\textsuperscript{77} This distinction contributed to the overall assessment that the value of the partnership interest was too speculative and hence ought not to have been included in gross income.\textsuperscript{78}

Although the Internal Revenue Service succeeded in persuading courts that section 83 applies to profits interests in partnerships,\textsuperscript{79} in 1993, the Treasury Department promulgated Revenue Procedure 93-27, under which the receipt of a profits interest in exchange for services rendered would not be considered a taxable event to either the partner or the partnership, subject to certain exceptions.\textsuperscript{80} These exceptions—"the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities"); the partner disposes of the partnership interest within two years of receipt; or the profits

\textsuperscript{75} See id.
\textsuperscript{76} Campbell v. Comm'r, 943 F.2d 815, 823 (8th Cir. 1991).
\textsuperscript{77} Id. at 822–23.
\textsuperscript{78} Id. at 823. While this rationale may appear to support the position that the taxpayer's intent is more relevant to valuation than the length of the holding period, it is doubtful that the Eighth Circuit intended to provide a standard that could be easily manipulable by a person simply asserting that she intended to hold onto the property for a longer time period. Some objective factor, beyond the taxpayer's control would also likely be required. For example, in the area of financial reporting, companies holding debt securities to maturity must have the "positive intent and ability" to actually hold the securities in order to qualify for favorable accounting treatment. A company that sells held-to-maturity securities for reasons other than certain enumerated objective factors would need to reclassify the entire held-to-maturity portfolio to the less favorable available-for-sale designation. See FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 115: ACCOUNTING FOR CERTAIN INVESTMENTS IN DEBT AND EQUITY SECURITIES 4 (1993), available at http://www.fasb.org/pdf/fas115.pdf.
\textsuperscript{79} See MCKEE, NELSON & WHITMIRE, supra note 24, ¶ 5.02[7]. See generally Howard E. Abrams, Taxation of Carried Interests, 116 TAX NOTES 183 (2007).
interest is a limited interest in a "publicly traded partnership"—indicate that the valuation of the profits interest is not speculative and therefore, deny the nonrecognition treatment if any applies to the interest in question.\textsuperscript{81}

In 2001, the Treasury Department issued Revenue Procedure 2001-43 to clarify the treatment specified in Revenue Procedure 93-27.\textsuperscript{82} The 2001 Revenue Procedure specified that the nonrecognition treatment would apply with respect to a profits interest received for services rendered, as of the grant date, where: (1) "[t]he partnership and the service provider treat the service provider as the owner of the [profits] interest from the date of its grant and the service provider" accounts for it appropriately for the entire period during which she holds the interest; (2) neither the partnership nor any of the partners "deducts any amount...for the fair market value of the interest," on grant of the interest, or at the time it becomes substantially vested; and (3) the exceptions specified in Revenue Procedure 93-27 do not apply.\textsuperscript{83} In other words, Revenue Procedure 2001-43 clarifies that "the determination under Revenue Procedure 93-27, as to whether a partnership interest is a profits interest, is made at the time the interest is granted even if the interest is substantially nonvested at that time, provided that certain requirements are met."\textsuperscript{84} For profits interests meeting the requirements of both Revenue Procedure 93-27 and Revenue Procedure 2001-43, neither the grant of the profits interest nor the event that causes that interest to become substantially vested will be treated as a taxable event for the partner or the partnership.\textsuperscript{85}

More recently, the Treasury Department issued Proposed Revenue Procedure 2005-43, which is designed to ensure that neither a partnership nor its partners may take a deduction with respect to a profits interest transferred to a service partner, for which under the prevailing revenue procedures tax is not owed.\textsuperscript{86} The proposed revenue procedure does so "by requiring...the

\textsuperscript{83} See id.
\textsuperscript{84} MCKEE, NELSON & WHITMIRE, supra note 24, ¶ 5.04[2].
\textsuperscript{85} See id.
\textsuperscript{86} See Senate Hearings I, supra note 15, at 5 (statement of Eric Solomon, Treasury Assistant Secretary for Tax Policy).
partnership and its partners [to] make an affirmative election to determine the fair market value of the partnership interest transferred to service providers by reference to its liquidation value. The significance of the proposed revenue procedure lies in the fact that it makes section 83 applicable to profits interests. In effect, the proposed revenue procedure allows service providers receiving the profits interest to make a section 83(b) election, when the liquidation value of the partnership is zero, allowing the continued capital gains treatment for such interests.

II. THE DEBATE OVER CARRIED INTERESTS' TAXATION—ARGUMENTS AGAINST AND IN FAVOR OF CHANGE

As previously stated, the favorable tax treatment of partnership carried interests has garnered considerable attention in the past eighteen months, as large private equity funds have gone public. While the topic has been debated among tax professionals since the Diamond case was decided, it has not received such attention by the wider public until now. On one side of the debate are those within the affected structures who contend that the favorable tax treatment is critical to encourage individuals to take risks in developing and running businesses that are not guaranteed to succeed. On the other side of the debate are those who argue that the exploitation of legitimate partnership taxation principles is fundamentally unfair as already highly-compensated individuals gain an unimagined boost through tax rates that are twenty percentage points below the ordinary income level. This Part considers those arguments in more detail, first addressing arguments opposing reform before turning to arguments in favor of it.

87 Id.

88 See McKee, Nelson & Whitmire, supra note 24, ¶ 5.02[8] (noting that the new approach "while consistent with the general § 83 scheme, stands in marked contrast to the administrative practice under Revenue Procedure 93-27, as supplemented by Revenue Procedure 2001-43, pursuant to which the receipt of a partnership profits interest was treated as a nontaxable event without further action on the part of the recipient of that interest or the partnership").

89 See Sheppard, supra note 2; see also Fleischer, supra note 1, at 12 (noting that even with the proposed regulations, the status quo would be reaffirmed).

90 See supra note 1.

91 See Abrams, supra note 79.
A. Preserving Economic Efficiency by Maintaining the Status Quo—Arguments Against Change

The proponents of the current tax scheme for carried interests, namely those within the industry, argue that maintaining the status quo is imperative for nurturing innovation and preserving the United States’ economic leadership. They contend that without the favorable tax treatment, service partners would not have an incentive to take an active management role to ensure the success of their portfolio companies and so would become little more than passive investors. Such a “scenario would be potentially devastating to the entrepreneurial community that actively seeks venture capital for the... expertise... they receive alongside the financial investment.”

In addition, supporters of the existing tax treatment cite their own fairness rationale: Given that the capital gains treatment is available to every American, “fundamental fairness requires that the tax code not single out certain investors for less favorable treatment because they are, for example, private equity partners, or because they are successful.” However, this argument overlooks the fact that “the capital gain preference... is being used to reduce taxes not on investment, but on the labor income of some of the most highly paid citizens in the nation,” which is surely not available to “every American.”

A related argument that has been raised is that the structure of these partnerships is not designed with tax avoidance in mind. Rather, it is a means of aligning the general partners’ interests with those of the limited partners. Indeed, general partners are subject to “clawback” agreements whereby general partners must return distributions “to the extent of any subsequent losses in other investments of the fund.” Even were

92 See Senate Hearings I, supra note 15, at 12 (statement of Kate D. Mitchell, Managing Director, Scale Venture Partners).
93 See id.
94 Senate Hearings II, supra note 5, at 6 (statement of Bruce Rosenblum, Chairman of the Board, The Private Equity Council).
95 Senate Hearings II, supra note 5, at 4 (statement of Joseph Bankman, Ralph M. Parsons Professor of Law and Business, Stanford Law School).
96 Senate Hearings II, supra note 5, at 3 (statement of Bruce Rosenblum, Chairman of the Board, The Private Equity Council).
the carried interests considered analogous to bonuses that are paid out when employees and/or firms meet certain targets, and on which ordinary compensation taxation applies, the latter is generally based on annual performance, whereas the general partners' carried interest is based on multi-year performance. In addition, while the payment of an incentive bonus reduces the value of the business, the payment of the carried interest means that "the business was sold and a third party has paid [the general partner], leaving the assets and value inside the business." Arguably, however, as long as the employee receiving the bonus payments remains with the employer and continues to meet performance targets, thus continuing to earn the incentive payments, the employee continues to add value to the employer's bottom line and, as such, is the employer's asset. After all, the incentive payments are granted in recognition of that employee's accretive value to the employer's net income and/or asset base. In contrast, the general partner who was so instrumental in increasing the value of the portfolio company is not involved in that company to the same extent, if at all, once the company has been sold.

Another argument in favor of maintaining the status quo is that raising the taxation on carried interest would result in detrimental gamesmanship that would cost the United States' economy.\textsuperscript{99} Private equity individuals would likely expend resources unproductively to develop strategies to minimize their income tax burdens, rather than productively managing their portfolio companies. In some cases, this could involve shifting operations offshore to jurisdictions having lower relative tax

\textsuperscript{97} See Senate Hearings I, supra note 15, at 11 (statement of Kate D. Mitchell, Managing Director, Scale Venture Partners).

\textsuperscript{98} Id.

\textsuperscript{99} See Senate Hearings II, supra note 5, at 7 (statement of Bruce Rosenblum, Chairman of the Board, The Private Equity Council) ("[T]o suggest that a 130% tax increase will have no effect on behavior is quite optimistic. . . . It is a mistake to assume that nothing will change if Congress profoundly alters the basic business model on which our industry has been organized and operated with great success."); Fleischer, supra note 1, at 49 (observing that "[c]hanging the treatment of a profits interest in a partnership would create new pressures on the system"); see also Senate Hearings I, supra note 15, at 13–14 (statement of Kate D. Mitchell, Managing Director, Scale Venture Partners) (asserting that a change to a less favorable tax regime would accelerate the relocation of venture capital firms from the United States to overseas markets that have more favorable tax structures).
burdens compared to the United States. While some firms may shift their operations overseas, not all will be in a position to do so. And, to the extent they are funding United States–based businesses, such a move would be impractical since they would be less able to actively monitor their investments.  

Finally, in addition to the economic arguments already discussed, opponents of change argue that given the speculative nature of the carried interests, it is not practical to include them in gross income due to difficulties in valuing them. While this traditional argument may have been valid during an earlier era, improvements in financial modeling have resulted in better, albeit not necessarily perfect, gauges of value. As a result, carried interests may be valued, and indeed, several estimates of valuation have been derived. For example, in its registration statements with the Securities and Exchange Commission, Blackstone provided a value for its carried interests. In addition, Professor Michael S. Knoll has applied traditional options valuation methodology to determine a value for private equity carried interests. Similarly, Andrew Metrick and Ayako Yasuda have surveyed existing compensation structures for venture capital and buyout firms—two segments of the private

100 Cf. Senate Hearings II, supra note 5, at 3 (statement of William D. Stanfill, Founding Partner, Trailhead Ventures, L.P.) ("My firm is too small to play in the international field—the learning curve is too steep and the expenses are too high. And if you are doing seed investing, we've always found sufficient deals in our own backyard.").

101 See supra Part I.C.

102 For example, the securitization market developed beginning in the 1970s as a way of creating liquidity in the mortgage market. Securitization involves valuations of underlying collateral in order to structure bonds that can be sold to third-party investors. See supra note 51 (discussing the publication of the Black-Scholes options pricing methodology).

103 See The Blackstone Group L.P., Amendment No. 9 to Form S-1, (Form S-1/A), at 122 (June 21, 2007) (estimating the general partner carried interest allocations at $594.5 million, for the year ended December 31, 2006); see also Sheppard, supra note 2 ("Even the most speculative partnership profits interest has an option value; somebody would pay something for it. . . . There is a value that is not only good enough for government work, but also is good enough for financial accounting, as the recent Blackstone public offering documents demonstrate."); Michael S. Knoll, The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of Taxing Profit Interests as Ordinary Income 9 (Inst. for Law & Econ., Univ. of Pa. Law Sch., Research Paper No. 07-20, 2007), available at http://ssrn.com/abstract=1007774 (explaining that the "carried interest is effectively a call option" and utilizing standard options pricing theory to derive a value).

104 See Knoll, supra note 103, at 10-11.
equity universe, the former specializing in new companies, and the latter focusing on relatively more mature companies—and have applied options valuation methodology and regression analysis to estimate the average present value for private equity carried interests based on the private equity fund's assets invested.\textsuperscript{105} Thus, including carried interests in gross income, through section 83, is a more reasonable option than it was at the time \textit{Campbell} was decided. Indeed, the Treasury has explicitly stated that there is no "substantial basis for distinguishing among partnership interests for purposes of section 83," despite the litigation history culminating in \textit{Campbell}.

\textbf{B. Leveling the Playing Field—Arguments in Favor of Change}

For the tax system to be viable, taxpayers need to believe that it is fair.\textsuperscript{107} In the private equity context, fund managers are able to "defer the tax on income derived from their human capital...[and] convert the character of that income from ordinary income into [tax-preferential] long-term capital gain[s]."\textsuperscript{108} Individuals toiling outside the partnership structures and not in receipt of carried interests do not similarly benefit from either the deferral or, more significantly, the lower effective tax rate, regardless of their compensation level.\textsuperscript{109} In essence, these fund managers have managed to convert the "income


\textsuperscript{108} Fleischer, \textit{supra} note 1, at 3.

\textsuperscript{109} See, e.g., \textit{Senate Hearings II, supra} note 5, at 2–3 (statement of William D. Stanfill, Founding Partner, Trailhead Ventures, L.P.) ("All workers add value—to a greater or lesser extent... But the tax rate on [private equity] carried interest[s] is less than the tax on [other workers'] such as landscapers and teachers—earnings."); \textit{Senate Hearings II, supra} note 5, at 1 (testimony of Joseph Bankman, Ralph M. Parsons Professor of Law and Business, Stanford Law School) (implying that "our best and brightest young people" are more likely to become venture capitalists and the like in order to benefit from the lower tax rates); \textit{Senate Hearings I, supra} note 15, at 1 (opening statement of Sen. Max Baucus, Chairman, S. Comm. on Finance) ("[P]rofessional athletes, Silicon Valley executives, and lawyers on contingency fees will also often take home a great deal of income...[that is] based on performance. But they tend to pay taxes at the ordinary income rate.").
derived from their human capital" into long-term capital gains.\(^\text{110}\) While high compensation levels appear to attract people to the private equity industry, it is not obvious that the preferential tax treatment is an added lure.\(^\text{111}\)

This transformation in the character of income is all the more unfair given that the fund managers themselves have relatively small sums of money at risk in the partnerships.\(^\text{112}\) General partners are taking risks with other people's money rather than with their own, and therefore, are less analogous to entrepreneurs.\(^\text{113}\) In addition, although industry representatives equate their role to that of entrepreneurs, with respect to the idea of "sweat equity" this is not accurate.\(^\text{114}\)

[While entrepreneurs] may work for years with little or no pay, betting [their] entire economic future[s] on the success of [their] idea[s], invention[s] or efforts[,] [f]und managers perform intermediation and advisory services [for which t]hey receive generous management fees and benefit from the performance of a portfolio of companies, the success of each of which is dependent on the inspiration and efforts of the entrepreneur.\(^\text{115}\)

Thus, by exploiting legitimate partnership tax provisions, general partners of these private equity funds have managed to convert their human capital into tax deferred long-term capital

\(^{110}\) Fleischer, supra note 1, at 3.

\(^{111}\) See id. at 5 (observing that "[w]hile the high pay of fund managers is well known, the tax gamesmanship is not"); see also Louise Story, Bye, Bye B-School, N.Y. TIMES, Sept. 16, 2007, § 3, at 1. ("As more Americans have become abundantly wealthy, young people are recalculating old assumptions about success.... Many college graduates who are bright enough to be top computer scientists or medical researchers are becoming traders instead, and they measure their status in dollars instead of titles.").

\(^{112}\) See Fleischer, supra note 1, at 8 (noting that the general partner's contribution to the fund ranges from 1 to 5 percent of the fund's total capital). But see Senate Hearings II, supra note 5, at 2 (statement of Bruce Rosenblum, Chairman of the Board, The Private Equity Council) (stating that general partners contribute between 3 to 10 percent of the fund's overall capital). Nonetheless, even if general partners contribute 10 percent of the fund's overall capital, third parties, who are the limited partners, contribute 90 percent of the funding.

\(^{113}\) See Senate Hearings II, supra note 5, at 3 (testimony of William D. Stanfill, Founding Partner, Trailhead Ventures, L.P.) ("To the extent [fund managers] take risk[s], [they] take it with other people's money.").


\(^{115}\) Senate Hearings II, supra note 5, at 3 (testimony of Joseph Bankman, Ralph M. Parsons Prof. of Law and Business, Stanford Law School).
gains, and thus avoid paying their fair share of tax, violating fundamental fairness.

Perhaps one response to the fundamental fairness argument is that the private equity professionals are merely taking advantage of tax preferences expressed by Congress that are no different from advantages granted to other segments of society, such as members of the clergy and members of the armed services.\(^1\) While the obvious answer to this response is that such tax preferences expressed by Congress were the result of express congressional action, rather than the effect of administrative sympathy, a review of the legislative history governing section 702(b) of the I.R.C. proves the fallacy. In 1938, Congress specifically enacted the predecessor to section 702(b) to prevent individual partners from applying capital losses to offset ordinary income and avoid any tax liability.\(^1\) Thus, far from being a tax preference for partners, the income characterization rules of section 702(b) are meant to prevent partners from enjoying tax benefits that are denied to other taxpayers.

While private equity firms unquestionably serve an important role in the economy, the exploitation of partnership pass-through principles undermines the fairness of the tax system, thus requiring a change to the status quo. Part III of this Note discusses two alternative proposals.

\(^{116}\) See I.R.C. § 107 (2000 & Supp. II 2002) (exempting certain housing allowances and the value of housing provided as part of a clergy member’s compensation from inclusion in gross income); I.R.C. § 112 (2000) (exempting from gross income compensation received for active service members for months during which they served in a combat zone, or were hospitalized due to wounds, disease or injury incurred while serving in a combat zone, subject to certain limitations).

\(^{117}\) See J.S. SEIDMAN, SEIDMAN’S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938–1961, at 90 (1938). Prior to the enactment of the Revenue Act of 1934, partners were able to use their allocable shares of the partnership capital net losses to offset not merely net gains from their individual capital transactions but their ordinary incomes as well. The grave abuses and widespread avoidance of income taxes resulting from this fact was the principal reason for [subsequent changes that aimed to curtail this abuse].

Id. (quoting the HOUSE WAYS AND MEANS SUBCOMMITTEE REPORT, 75th Cong. (Jan. 14, 1938)). In the 1938 legislation, the House recommended that in the case of a partnership, net short-term capital gains, net short-term capital losses, net long-term capital gains and net long-term capital losses be segregated from the ordinary net income, and carried into the computation of the individual partner’s income as thus segregated.

Id.
III. RESTORING A MEASURE OF EQUALITY—TWO REFORM ALTERNATIVES

This section considers two primary proposals for reforming the carried interest taxation scheme: (1) explicitly bringing partnership profits interests within the fold of section 83; or in the alternative (2) cutting off the pass-through treatment of income when the profits interest is being used to compensate service partners.

A. Subjecting Profits Interest to Internal Revenue Code Section 83

Under section 83, the excess fair market value of property received in exchange for services performed over the amount paid for the property, if any, is to be included in gross income in the first taxable year in which the rights of the recipient are transferable or are not subject to a substantial risk of forfeiture.\(^{118}\) Taxpayers are permitted to make an election to subject the property received to immediate taxation in the year of transfer, even if the property is restricted, and thus preserve the capital gains treatment for any subsequent appreciation in that property.\(^{119}\) However, to the extent that the property on which the election is made is subsequently forfeited, the taxpayer is not permitted to take a deduction with respect to the taxes that were paid on the forfeited property.\(^{120}\) Nevertheless, the taxpayer is permitted to treat the excess of any amount paid for the property over any amount realized on the forfeiture as a realized loss, characterized as either ordinary or capital based on the characterization of the underlying asset that was forfeited.\(^{121}\)

With respect to the private equity and venture capital funds, general partners’ carried interests are subject to “clawback” provisions, pursuant to which should the limited partners fail to receive a return of their invested capital along with a hurdle rate, the general partners forfeit as much of their entitlement to the profits interest as is necessary to make the limited partners


\(^{119}\) See id. § 83(b).

\(^{120}\) See id.

whole. The hurdle rate is the minimum return required by the limited partners in order to make an investment. As such, the clawback provision can be viewed as a "substantial risk of forfeiture" under section 83, since it is a continuing restriction over the life of the fund, and the general partner must continue to service the portfolio companies successfully throughout the life of the fund. As a result, in these cases, the issuance of a profits interest would not subject the general partner to taxation; rather, taxation is deferred until the general partner actually realizes that interest, and since inclusion would be required under section 83, the general partner would be taxed on that interest as compensation, rather than as capital gains.

While it has been argued that such treatment is inappropriate, given that the general partner's remuneration is really a combination of compensation and capital gains, section 83 provides an opportunity for this split treatment via the section 83(b) election. Under the section 83(b) election, as previously stated, the taxpayer would have the option of paying tax on the carried interest in the year of issuance without giving effect to the restrictions. For example, suppose that a service partner is granted a profits interest with an expected value of $100, and for which he has not made cash payments. There is an equal chance that when the underlying company is sold, the service partner receives either $50 or $150. Since realization is subject to significant effort to be expended by the service partner, the property can be deemed to be subject to a substantial risk of forfeiture and therefore, under section 83(a), would not be included in the service partner's gross income. However, the service partner could make a section 83(b) election, and in the year of the profits interest grant, it would include $100 in gross income. At a future date, when the property is sold, if the amount realized were $150, the service partner would report $50 in capital gains income—the difference between the $100 already taxed as ordinary income and the $150 actually realized. Were


123 See Treas. Reg. § 1.83-3(c)(1) (2005) (explaining that a substantial risk of forfeiture arises "where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person").

124 See Abrams, supra note 79.
the amount realized only $50, although the service partner would realize a capital loss of $50, that loss could not be used to offset capital gains income.\textsuperscript{125}

A difficulty with this proposal is that given that the individual funds last for several years, valuations would require several assumptions and as such, are vulnerable to manipulation. Indeed, as has been argued, many funds do not pay out carried interest shares at all.\textsuperscript{126} As noted earlier, however, valuation techniques have improved over time, and financial modeling has also become more sophisticated, allowing for more reasonable valuations. Furthermore, even allowing for some degree of undervaluation, at least some portion of the carried interest would be subject to taxation at ordinary interest rates, which is better than the current situation. Therefore, a section 83(b) election would have the advantage of providing general partners with some capital gains treatment for their carried interests, while at the same time restoring fairness to the tax system by ensuring that a certain portion is taxed as ordinary compensation for those who choose to make the election. While the Treasury's 2005 proposed regulation, discussed above, provides for a safe harbor election in which electing partnerships set the profits interest at its liquidation value—that is, zero—such a provision is not necessary, given improved valuation techniques.\textsuperscript{127}

\textsuperscript{125} An underlying assumption in the example is that the service partner did not have to pay anything for the profits interest. However, were he to have been required to have paid the partnership some value on top of the services he provides to the partnership, that cost basis could be deducted as a capital loss. \textit{See} Treas. Reg. § 1.83-2(a).

\textsuperscript{126} \textit{See Senate Hearings II, supra} note 5, at 6 (testimony of Bruce Rosenblum, Chairman of the Board, The Private Equity Council).

\textsuperscript{127} It is interesting to note that during the "dot com" bubble in the late 1990s, many technology company employees received incentive stock option compensation for which they were eligible to make I.R.C. section 83(b) elections. As the market valuations for many of these companies were rising during this time, many individuals chose not to make such an election. Unfortunately, by the time the restrictions had lapsed, the bubble had deflated and many of these people were subject to tax on property that was worth far less than the associated tax. While the section 83(b) election would not have eliminated the situation, it would have mitigated it. \textit{See generally} Robert L. Sommers, \textit{ISOs Meet the AMT: Employees Ambushed by the Tax Code}, 91 \textit{TAX NOTES} 2055 (2001). In fact, for certain individuals, a section 83(b) election was not an option at all. \textit{Id.} Thus, eliminating the 2005 safe harbor provision removes the insulation from "compensation risk," or
Granting private equity professionals the ability to make a section 83(b) election would enable them to maintain some measure of capital gains treatment for a portion of their efforts, while still subjecting them to taxation at ordinary income levels. However, as the example above demonstrates, to the extent that some of the income on which tax was subjected via the section 83(b) election is forfeited, these individuals incur sizeable cash outlays for tax payments on election and real economic costs due to the non-realization of that estimated income. As such, the ability to elect for immediate recognition of income via section 83(b) should remain an option and not be a mandatory requirement. Such a proposal is consistent with the discretion currently granted to persons receiving other forms of property in exchange for their services. Indeed, since private equity professionals would be provided with the same discretion granted to other taxpayers, a measure of fairness would be restored to the tax system.

B. Cutting Off Pass-Through Treatment When Interests Are Used as Compensation

An alternative to requiring carried interests to be subject to section 83 is to eliminate the pass-through treatment of section 702 in the limited instance where profits interests are being used to at least partly compensate service partners. While critics would argue that such a targeted provision unfairly singles out a particular industry or group, such an approach is not without precedent. Congress has, for example, targeted investment companies in denying the nonrecognition treatment of gains or losses where “property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and

the risk that compensation will be less than foreseen, that individuals other than service partners bear.

128 This approach has been proposed by Professor Mark Gergen, who advocates amending I.R.C. section 702 to require that the distributions be treated as ordinary income, “regardless of the character of the underlying assets sold by the partnership.” Fleischer, supra note 1, at 51.

129 See supra Part II.A (discussing fairness principles); see also Rutledge, supra note 1, at 3 (“By calling for punitive tax treatment of certain sectors, and industries, those who would raise tax rates risk undermining America’s preeminent position in the world as a leader in invention, innovation, entrepreneurial activities, and growth.” (emphasis added)).
immediately after the exchange such person or persons are in control... of the corporation.\textsuperscript{130} In enacting this exception in 1966, Congress sought to prevent the simulation of untaxed mutual funds that were created using the tax-free transfer mechanism of section 351(a).\textsuperscript{131}

Similarly, and in a directly related area, the Senate is recently contemplated legislation that would bar partnerships, primarily in the finance fields, from taking advantage of the exemption for publicly-traded partnerships with passive income under section 7704(c), and not being subject to income tax on becoming public entities.\textsuperscript{132} Under the bill that was considered by the Senate, the exception would not apply to partnerships that directly or indirectly derive income from investment adviser services or related asset management services.\textsuperscript{133} The bill was proposed in the wake of several high profile initial public offerings by large private equity firms.\textsuperscript{134} The existence of the bill demonstrates that Congress is not averse to targeting specific industries when it determines they are unfairly taking advantage of the tax code.

In being denied pass-through treatment under section 702, service partners would not be able to qualify for capital gains treatment and would be required to treat the profits interest as compensation. The grant of a profits interest would be treated as contingent compensation, whereby the partner would have no income on receipt of the carried interest, but would be taxed at ordinary income rates on all the profits allocated to him.\textsuperscript{135} By taxing the profits when allocated as opposed to taxing the carried interest on receipt, the concern that the service provider may undervalue the carried interest is mitigated.\textsuperscript{136}

This approach has the advantage of being simple, and would more closely align the carried interest treatment with that of

\textsuperscript{130} See I.R.C. § 351(a); see also I.R.C. § 351(e) (stating the exception to the general nonrecognition rule provided in I.R.C. section 351(a)).

\textsuperscript{131} See 4 BITTKER & LOKKEN, supra note 4, ¶ 91.2.2.

\textsuperscript{132} See I.R.C. § 7704(c)(2).

\textsuperscript{133} See S. 1624, 110th Cong. (2007); see also H.R. 2785, 110th Cong. (2007).


\textsuperscript{136} See id. at 102.
nonqualified stock options.\textsuperscript{137} At-the-money nonqualified stock options are the corporate equivalent of a partnership profits interest.\textsuperscript{138} However, a difficulty does arise in terms of appropriately distinguishing the extent to which the returns to a partner who contributes both capital and labor are attributable to the labor component.\textsuperscript{139} In addition, it is perhaps unrealistic to expect that general partners would continue to structure their compensation in such a manner without altering the structures to again achieve some type of favorable return.\textsuperscript{140} However, "a half a loaf is better than none—a portion of the manager's return will be taxed as compensation."\textsuperscript{141}

CONCLUSION

The current favorable tax treatment violates the fundamental notion of fairness in the tax system. Given that many individuals in the private equity industry are highly compensated, it offends notions of fair play to discover that their compensation is taxed well below the ordinary compensation rates. This Note has sought to highlight two alternative taxation systems that would restore fairness in the system by restoring the compensation treatment of carried interest given that these profits interests are more appropriately viewed as ordinary income rather than capital gains.

\textsuperscript{137} See Fleischer, supra note 1, at 51.
\textsuperscript{138} See id. at 4.
\textsuperscript{139} See Gergen, supra note 135, at 107–08. For example, in a two-person partnership, if each partner contributes capital and labor to the same extent, the income received would be treated as a return on capital, because they would each receive a 50 percent share in the income of the partnership. See id. at 107. However, this is less of an issue in the private equity context where the partners do not contribute capital and labor in equal shares. In this situation, any income received in excess of the proportional capital contribution would be treated by the partner as a return on labor or compensation.
\textsuperscript{140} See Fleischer, supra note 1, at 51.