

The Tax Advantage to Paying Private Equity Fund Managers with Profit Shares: What Is It? Why Is It Bad?

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INTRODUCTION

The prototypical “private equity” fund pools the capital of sophisticated investors, purchases ailing companies, restructures the companies, and then resells them—at a profit, if all goes well.¹ In fact, all has gone extraordinarily well for some funds. Accordingly, the earnings of those who market and manage such funds are not only among the largest in the nation,² but are so historically outsized as to inspire talk of a new Gilded Age.³

Yet, as the fortunes of private equity fund managers have grown, so too has the intensity of the scrutiny they have attracted from the press,⁴ Congress,⁵ and the academy.⁶ Calls for reform ring out from

¹ See generally Department of the Treasury, *A Report to Congress in Accordance with § 356(c) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA Patriot Act)* (“Treasury Report”) 26–29 (Dec 31, 2002), online at <http://www.fincen.gov/356report.pdf> (visited June 8, 2008) (describing the key elements and parties involved in private equity funds); SEC Staff Report, *Implications of the Growth of Hedge Funds* (“SEC Report”) 7–8 (Sept 29, 2003), online at <http://www.sec.gov/news/studies/hedgelfunds0903.pdf> (visited June 8, 2008) (describing the setup, operation, and dissolution of private equity funds); Andrew Metrick and Ayako Yasuda, *The Economics of Private Equity Funds* 5–14 (Swedish Institute for Financial Research Conference on the Economics of the Private Equity Market, Sept 2007), online at <http://ssrn.com/abstract=996334> (visited June 8, 2008) (describing the economics of private equity and venture capital funds with frequent reference to and analysis of a novel database); Henry Ordower, *Demystifying Hedge Funds: A Design Primer*, 7 UC Davis Bus L J 323, 329 (2007) (describing the law governing various investment funds including regulated investment companies, private equity funds, venture capital funds, hedge funds, and real estate investment trusts). See also Emily Thornton, *What’s Bigger than Cisco, Coke, or McDonald’s? Steve Feinberg’s Cerberus, a Vast Hedge Fund That’s Snapping up Companies—Lots of Them*, Bus Wk 100, 100–10 (Oct 3, 2005) (profiling a prominent private equity fund manager).

² Stephen Taub, *The Top 25 Moneymakers: The New Tycoons*, Alpha Magazine (Apr 24, 2007), online at <http://www.alphamagazine.com/Article.aspx?ArticleID=1328498> (subscription only) (visited June 8, 2008) (profiling the twenty-five highest earning private equity and hedge fund managers).

³ Jenny Anderson and Julie Creswell, *Make Less than \$240 Million? You’re Off Top Hedge Fund List*, NY Times A1 (Apr 24, 2007) (“With the modern gilded age in full swing, hedge fund managers and their private equity counterparts are comfortably seated atop one of the most astounding piles of wealth in American history.”).

⁴ A LexisNexis search of major newspapers reveals hundreds of articles and editorials published over the last year on the issue of carried interest alone. Several of the most informative of these are cited in this Article. See notes 1–3, 7, 18, 21, and 199. Editorials by major newspapers include: Editorial, *Taxing Private Equity*, NY Times A22 (Apr 2, 2007) (“Today’s preferential rate for capital gains is excessive Tackling the too-easy tax terms for private equity is a good way for Congress to begin addressing that bigger issue.”); Editorial, *Assault on the Investor Class*, Wall St J A14 (May 7, 2007) (“There’s no good rationale for [taxing carried interest as ordinary income] beyond the fact that Congress wants money and private equity funds have lots of it.”); Editorial, *The Wrong Loophole; Senators Looking to Restore Tax Cuts Should Keep Their Hands Off Private Equity Funds’ Capital Gains*, LA Times A14 (May 15, 2007) (“This time lawmakers are barking up the wrong loophole.”).

⁵ In the Senate, the Finance Committee held a well attended three-part hearing over the summer of 2007 on the tax treatment of the earnings of private equity fund managers. Carried

several sources concerning various aspects of the way in which these funds do business. One of the chief pressure points—and the one that

Interest Part I, Hearings before the Senate Committee on Finance (“Carried Interest Part I Hearings”), 110th Cong, 1st Sess (July 11, 2007), online at <http://www.senate.gov/~finance/sitepages/hearing071107.htm> (visited June 8, 2008); Carried Interest Part II, Hearings before the Senate Committee on Finance (“Carried Interest Part II Hearings”), 110th Cong, 1st Sess (July 31, 2007), online at <http://www.senate.gov/~finance/sitepages/hearing073107.htm> (visited June 8, 2008); Carried Interest Part III: Pension Issues, Hearings before the Senate Committee on Finance (“Carried Interest Part III Hearings”), 110th Cong, 1st Sess (Sept 6, 2007), online at <http://www.senate.gov/~finance/sitepages/hearing090607.htm> (visited June 8, 2008). Senators Baucus and Grassley, the Chair and ranking minority member, respectively, of the Finance Committee have cosponsored, along with others, a bill to impose corporate level tax on publicly traded private equity partnerships. S 1624, 110th Cong, 1st Sess (June 14, 2007), in 153 Cong Rec S 7733-01 (June 14, 2007).

In September 2007, the House Ways and Means Committee held a hearing to consider, among other things, a measure that will link alternative minimum tax relief for the middle class to increased taxes on private equity fund managers. Fair and Equitable Tax Policy for America’s Working Families, Hearings before the House Committee on Ways and Means (“Fair and Equitable Tax Hearings”), 110th Congress, 1st Sess (Sept 6, 2007), online at <http://waysandmeans.house.gov/hearings.asp?formmode=detail&hearing=584> (visited June 8, 2008). Another hearing is scheduled, which “will focus on a comprehensive examination of Federal income tax fairness, with particular attention to investment fund manager compensation and the effects of the alternative minimum tax on tax rates.” House Committee on Ways and Means, Advisory, *Chairman Rangel Announces Hearing on Fair and Equitable Tax Policy for America’s Working Families*, August 30, 2007, online at <http://waysandmeans.house.gov/hearings.asp?formmode=view&id=6420> (visited June 8, 2008). See also Ryan J. Donmoyer and Peter Cook, *Rangel to Push Buyout-Firm Tax Increase in September*, Bloomberg News (Aug 3, 2007) (quoting the Ways and Means Committee Chairman, Representative Charles Rangel, as saying this legislation is “top priority”). Representative Levin and thirteen other Democratic representatives, including Representative Rangel, have introduced a bill to treat income from a partnership interest acquired partly in return for “investment management services” as ordinary income. See HR 2834, 110th Cong, 1st Sess (June 22, 2007).

⁶ Ordower, 7 UC Davis Bus L J at 323 (cited in note 1); Daniel Shaviro, *Tax Break for Managers of Private Investment Funds*, Start Making Sense (May 15, 2007), online at <http://danschaviro.blogspot.com/2007/05/tax-break-for-managers-of-private.html> (visited June 8, 2008); Daniel Shaviro, *Hedge Fund Managers Again*, Start Making Sense (June 18, 2007), online at <http://danschaviro.blogspot.com/2007/06/hedge-fund-managers-again.html> (visited June 8, 2008); Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Firms*, 83 NYU L Rev (forthcoming 2008).

Since the first draft of this paper was circulated and posted in June 2007 (see note †), several other tax scholars have expressed their views in papers, reports, and testimony. A partial list of academic papers includes: Howard E. Abrams, *Taxation of Carried Interests*, 116 Tax Notes 183, 183–88 (2007); David A. Weisbach, *Professor Says the Taxation of Carried Interest Legislation Is Misguided*, 116 Tax Notes 505, 505–11 (2007); Noël B. Cunningham and Mitchell L. Engler, *The Carried Interest Controversy: Let’s Not Get Carried Away*, 61 Tax L Rev (forthcoming 2008); David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 Va L Rev (forthcoming 2008). A partial list of congressional testimony includes: Carried Interest Part I Hearings (cited in note 5) (testimony of Marc P. Gergen, Foundren Foundation Centennial Chair for Faculty Excellence, The University of Texas School of Law); Carried Interest Part II Hearings (cited in note 5) (testimony of Joseph Bankman, Ralph M. Parsons Professor of Law and Business, Stanford Law School); Carried Interest Part III Hearings (cited in note 5) (testimony of Professor Alan J. Auerbach, Robert D. Burch Professor of Law and Economics, University of California, Berkeley).

seems to be of greatest concern to private equity firms themselves⁷—is the income tax treatment of fund manager compensation.

Fund managers are generally paid in two ways. First, they receive a “management fee” that is typically equal to 2 percent of the total amount invested in the fund. Second, and in addition, they receive on the order of 20 percent of whatever investment profits they are able to generate for the fund.⁸ This second means of payment, referred to as a fund managers’ “profits interest” or “carried interest,” is the subject of the current controversy.

Commentators argue that the income from such profits interests is essentially labor income and is unjustifiably tax advantaged compared to the way in which labor income is normally taxed. Most emphasize two tax advantages: “conversion” and “deferral.”⁹ “Conversion” refers to the fact that, for reasons explained below,¹⁰ fund managers’ income from such profits interests is often taxed at long-term capital gains rates (generally 15 percent) rather than the substantially higher ordinary income rates (maximally 35 percent) that typically apply to labor income. “Deferral” refers to the fact that fund managers are not taxed on the receipt of their profits interests until they realize income therefrom, which may not occur until several years after they provide the services that earn them such interests. The significance of these tax advantages has perhaps been most potently illustrated by comparing fund managers to their secretaries. While the secretary pays tax on his middling labor income as he earns it and at a rate of up to 35 percent, the fund manager pays tax on her astronomical labor income only several years hence and at a rate of only 15 percent.

But is it really this simple? The recent academic literature on private equity has provided an invaluable service by bringing the topic of service-compensatory profits interests to the forefront of tax scholarly discourse.¹¹ Yet, having raised the issue, the existing literature hardly

⁷ Jenny Anderson and Andrew Ross Sorkin, *Congress Weighs End to Tax Break for Hedge Funds*, NY Times A1 (June 21, 2007) (“At this moment, the single most important issue for us,” said Doug Lowenstein, president of the Private Equity Council, “is ensuring that the current—and we believe correct—treatment of carried interest as capital gains is retained.”).

⁸ See Fleischer, 83 NYU L Rev (forthcoming 2008) (cited in note 6) (describing the compensation of private equity fund managers); Metrick and Yasuda, *Economics of Private Equity Funds* at 8–14 (cited in note 1) (same); Ordower, 7 UC Davis Bus L J at 346–48 (cited in note 1) (same).

⁹ Some commentators argue that there is yet a third and even more significant tax benefit, related to the general tax benefit for imputed income. Apparently, the assertion is that some portion of fund managers’ service compensation is never taxed in any form. See Fleischer, 83 NYU L Rev (forthcoming 2008) (cited in note 6); Ordower, 7 UC Davis Bus L J at 358–61 (cited in note 1). This Article addresses (and finds no basis for) this third putative advantage in Part III.B.

¹⁰ See notes 54–55.

¹¹ Much of the credit belongs to Professor Fleischer. See generally Fleischer, 83 NYU L Rev (forthcoming 2008) (cited in note 6); Ordower, 7 UC Davis Bus L J at 323 (cited in note 1).

resolves it. On the contrary, even the most fundamental aspects of the issue remain obscure. Answers to questions as basic as what the tax advantage really *is*, what other advantages in the Code¹² it is analogous to, and why it might be objectionable are often only dimly drawn—or, even worse, are confidently marked out, but incorrectly so. This is a particularly woeful state of affairs for a policy issue whose combination of salience and complexity lends to the academy an uncommonly urgent and important role.

Against this backdrop, the present Article has two objectives. First, it seeks to provide a much needed clarification of the precise nature of the tax advantage for service-compensatory profits interests. Second, it critically appraises several of the key normative assertions that underlie calls for reform.

With regard to the first task, the Article's main point is that the tax advantage accorded to private equity profits interests is most fundamentally a form of "joint tax arbitrage." That is, the advantage operates by exploiting differences in the tax rates faced by fund managers and their investors. Without such rate differences, the tax advantage is largely nonexistent.

In particular, the tax advantage for profits interests is not merely a matter of conversion and deferral for the fund manager. While it is true that taking service compensation in the form of a profits interest converts and defers income for the fund manager, *it generally has an equal and opposite effect on investors*. As Part I explains in detail, because a direct salary paid to the fund manager would likely be deductible¹³ by the partnership, the investor ends up with *more* current ordinary income and *less* future long-term capital gains—in precisely

An earlier literature, sparked by Tax Court adjudication on the taxation of partnership profits interests, also appears to have had a positive impact on public discourse and policy in this area. This literature also remains quite relevant. Contributions to this literature include Laura E. Cunningham, *Taxing Partnership Interests Exchanged for Services*, 47 *Tax L Rev* 247 (1991); Leo L. Schmolka, *Taxing Partnership Interests Exchanged for Services: Let Diamond/Campbell Quietly Die*, 47 *Tax L Rev* 287 (1991); Mark P. Gergen, *Reforming Subchapter K: Compensating Service Partners*, 48 *Tax L Rev* 69 (1992); Henry Ordower, *Taxing Service Partners to Achieve Horizontal Equity*, 46 *Tax Law* 19 (1992). Also of importance is the somewhat earlier contribution, Mark P. Gergen, *Pooling or Exchange: The Taxation of Joint Ventures between Labor and Capital*, 44 *Tax L Rev* 519 (1989). See also Joseph Bankman, *The Structure of Silicon Valley Start-ups*, 41 *UCLA L Rev* 1737 (1994); Ronald J. Gilson and David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 *Harv L Rev* 874, 890–91 n 57, 908 n 113 (2003).

¹² IRC § 1 et seq (2007).

¹³ This discussion assumes that were the manager compensated in a manner that triggered current income, the fund partnership would not be required to capitalize the cost. As discussed in Part II.A, this assumption can be justified by reference to existing law. Also discussed in Parts II.B and II.C, respectively, is the possibility that the limited partner's deduction would be limited (for example, because it is treated as a "miscellaneous itemized deduction") as well as the possibility that it would be suspended (for example, as a passive loss). Furthermore, Part II.D points out that the effect on the partners' joint employment/self-employment tax base is not zero-sum.

the same amount as is converted and deferred for the fund manager. This means that were the fund manager and the investors taxed at precisely the same rates, the investors' tax bill would increase by the same amount as the fund manager's tax bill decreased.

Compensating the fund manager with a profits interest is, thus, certainly of no tax benefit to the same-taxed investor. It is also of no tax benefit to the parties jointly, as the tax consequences across manager and investors are zero-sum. Indeed, given the absence of a joint tax benefit, profits interest compensation is also of no real benefit to the fund manager herself. Because a same-taxed investor pays more in taxes to precisely the same extent that the fund manager pays less, writing a compensatory profits interest into the fund agreement is tantamount to including a term that requires investors to send a check to the Treasury for part of the fund manager's tax bill. An investor would only agree to such a term if the fund manager in effect counted the check as part of the fund manager's compensation, lowering her explicit fees accordingly. Yet, by lowering her explicit fees, the fund manager is still in effect paying the tax herself.¹⁴

When, on the other hand, the fund manager and the investors do *not* face the same tax rates, service-compensatory profits interests can benefit all parties. The clearest and maximally tax-reducing case is where the investors are tax exempt—which, in fact, many private equity investors are.¹⁵ A tax-exempt investor's tax bill is zero no matter when or how she receives any income.¹⁶ *A fortiori*, the investor's tax

¹⁴ This paragraph is an explication of the justification for what is often referred to as the "joint tax perspective." A similar principle has often been applied to other tax issues, though it is oddly neglected in the treatment of private equity profits interests. For examples of where the joint tax perspective has been applied, see Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 Yale L J 506, 519–24 (1986); Gilson and Schizer, 116 Harv L Rev at 890–91 n 57, 908 n 113 (cited in note 11); Michael S. Knoll, *The Tax Efficiency of Stock-based Compensation*, 103 Tax Notes 203, 208 (2004) ("Whether a compensation mechanism is tax-efficient should be determined from a joint contracting perspective rather than the employer's or employee's perspective alone."); Michael S. Knoll, *The Section 83(b) Election for Restricted Stock: A Joint Tax Perspective*, 59 SMU L Rev 721 (2006).

¹⁵ Treasury Report at 28 n 95 (cited in note 1) (stating that approximately 20 percent of assets invested in private equity funds come from "endowment organizations" and approximately 30 percent come from pension funds). See also Private Equity Council, Press Release, *Raising Taxes on Private Equity Investments Could Hurt U.S. Companies and Competitiveness, PEC Tells Congress* (July 31, 2007), online at <http://www.privateequitycouncil.org/press-releases/2007/07/31/raising-taxes-on-private-equity-investments-could-hurt-us-companies-and-competitiveness-pec-tells-congress> (visited June 8, 2008) ("Private equity investment firms between 1991 and 2006 returned more than \$430 billion in profits to their investors, nearly half of which are public and private pension funds, university endowments and charitable foundations, [PEC Board Chairman Bruce Rosenblum] said.").

¹⁶ This discussion assumes that the income does not generate unrelated business income tax. See IRC § 511 et seq. This tax is generally not imposed upon income from an organization's non-trade or business investment activities, unless the income from such activities is "debt-

bill does not seesaw up when the fund manager's tax bill is lowered by adopting service-compensatory profits interests. The result is a lower tax bill for the parties in aggregate, a benefit shared by all parties via adjustments in fees and terms.

In effect, then, service-compensatory profits interests allow the fund manager to swap current ordinary income for future long-term capital gains with her tax-exempt investors. The fund manager "gives" current ordinary income to the investor. The investor "gives back" the same amount of future long-term capital gains. The essence of the arbitrage is that the more lightly taxed form of income (deferred long-term capital gains) is shifted to the more highly taxed party (the fund manager).

There are several reasons why it is imperative to reorient the debate over private equity compensation to view the tax advantage to profits interests as a form of joint tax arbitrage.

First and foremost, to understand that the tax advantage to profits interest is a joint tax arbitrage is to understand why the heretofore most successful and frequently invoked¹⁷ argument made in favor of

financed." See IRC §§ 512(b) (excepting non-trade or business investment income from the definition of "unrelated business taxable income"), 514 (including "debt-financed" income in the definition of "unrelated business taxable income"). If necessary, the tax-exempt organization can use an offshore "blocker" corporation in a no- or low-tax jurisdiction to avoid either or both: (a) the pass-through of trade or business characterization; (b) pass-through attribution of debt-financing. With regard to the former, see note 101. With regard to the latter, see IRS Private Letter Ruling No 199952086 at 4-5 (1999).

¹⁷ Numerous references to this argument populate the transcripts of the recent three-part Senate Finance Committee hearings on carried interest. Carried Interest Part I Hearings (cited in note 5); Carried Interest Part II Hearings (cited in note 5); Carried Interest Part III Hearings (cited in note 5); Carried Interest Part II Hearings (cited in note 5) (testimony of Joseph Bankman, Ralph M. Parsons Professor of Law and Business, Stanford Law School) (stating, in reference to the argument supporting current tax treatment that "the low tax rate on fund managers is consistent with the treatment accorded to inventors and entrepreneurs," that "[e]veryone who testified in favor of capital gain treatment of carry at the July 11 hearing [Carried Interest Part I] compared fund managers to entrepreneurs").

In scholarly circles, the analogy to the supposed tax benefit for sweat equity is equally pervasive. See Weisbach, 116 *Tax Notes* at 507 (cited in note 6) ("[E]ntrepreneurs such as founders of companies get capital gains when they sell their shares even if the gains are attributable to labor income. . . . [T]his approach is built deeply into the structure of current law."), 509 ("The tax law makes a fundamental distinction between an employee performing services and an entrepreneur creating or increasing the value of its business. There is little question that a sponsor of a private equity fund is more like an entrepreneur than an employee."); Carried Interest Part II Hearings (cited in note 5) (written testimony of Joseph Bankman, Ralph M. Parsons Professor of Law and Business, Stanford Law School) (accepting the existence of a tax subsidy for entrepreneurs, but suggesting that only small partnerships and not large private equity fund managers are sufficiently analogous to entrepreneurs to merit the same subsidy); Carried Interest Part III Hearings (cited in note 5) (written testimony of Professor Alan J. Auerbach, Robert D. Burch Professor of Law and Economics, University of California, Berkeley) (similar).

See also generally Fleischer, 83 *NYU L Rev* (forthcoming 2008) (cited in note 6) (affirming the existence of the deferral and conversion benefits conventionally associated with the term "sweat equity," but generally using that term to describe a different type of supposed subsidy, discussed in the present Article below and in Part III.B).

the current tax treatment of profits interest is largely groundless. This is the argument that the tax treatment of profits interests is analogous to the tax treatment of “sweat equity.” Business owners—usually painted specifically as entrepreneurs by those who deploy this argument—are thought to convert and defer labor income when they devote skill and effort (“sweat”) to building a business, and are compensated for this labor contribution only later upon sale of the business for a profit—a profit often taxed at long-term capital gains rates. Proponents of the current tax treatment for profits interests argue that the tax benefit for profits interests is just the same as this, and rightly so.

But the two are not the same. How could they be? The tax advantage to profits interest is a joint tax arbitrage between fund managers and differently taxed investors. The sweat equity story is (apparently) a single actor tax play. The sweat equity tax advantage, if it exists, must therefore operate by some other kind of tax logic.

In fact, the sweat equity tax advantage is highly problematic on its own terms. Given the deductibility of many investment-oriented labor costs, the sweat equity tax advantage is, in fact, far less significant than it has been made out to be. In the canonical sweat equity scenario, for example, the unsalaried business owner labors to build going concern value on which she is taxed at capital gains rates when she eventually sells the business. It appears then that labor income is being taxed at capital gains rates. But this conclusion fails to take into account the fact that, had the business owner paid someone else for the same labor, that labor cost would most likely have been deductible. Relative to the second party employment context, therefore, the unsalaried working owner avoids having current salary income, but also forgoes an offsetting salary expense deduction.

In general, the tax consequences to the owner of sweating for equity rather than for salary align with the tax consequences to the fund partners of paying the fund manager with a profits interest when the manager and the investors face the same tax rates. In either case, when the explicit compensation alternative would generate not just income, but also a deduction, there is no real tax advantage.

The joint tax arbitrage view also has significant implications for the debate regarding the economic impact of reform. Those who oppose reform claim that removing the tax advantage would greatly discourage financial investment and hinder growth. Those who favor reform argue that the current subsidy has an enormous distortionary impact on the economy. Professor Alan Blinder, a well known economist who favors reform, closes his *New York Times* editorial with an economics lesson: “Just remember one simple principle: if we tax Ac-

tivity A at 15 percent and Activity B at 38 percent, a free-market economy will give us more A and less B.”¹⁸ But the real tax play from profits interests is not, in fact, as simple as this. Put another way, the pleasingly simple description, “taxing Activity A at 15 percent and Activity B at 38 percent,” is only accurate if “Activity A” is given an awkwardly complex definition, which Blinder does not provide. “Activity A,” in particular, would have to stand not for labor services provided by private equity fund managers, as Blinder seems to intend, but for labor services provided by private equity fund managers *who manage investments for differently taxed investors such as tax-exempt entities*. The tax benefit for profits interest is narrower than Blinder’s statement makes it seem, and the implications for keeping or removing the tax benefit are probably also narrower than both sides recognize. Were profits interest taxed as ordinary income, we would likely see less partnering of private equity firms and tax exempts like pensions and university endowments. In fact, as explained below, private equity investment by some wealthy individual investors might even increase.

Lastly, internalizing the fact that the tax advantage of profits interests is a form of joint tax arbitrage, and that this arbitrage is best accomplished when the fund manager joins with tax-exempt investors, has significant implications for judging the “incidence” of the tax benefit—that is to say, judging from an economic equality standpoint, who really gains or loses from the favorable tax treatment. In particular, the important role of tax exempts, such as university endowments and pension funds, complicates the tax incidence picture. It is reasonable to suppose that such entities share, at least to some extent, in the tax advantage that they have an integral role in generating. Conversely, were this advantage removed, it stands to reason that such entities would bear some of the impact.¹⁹ It is even reported that some of the contracts between the state of Washington and the private equity firms that manage almost 20 percent of the state’s pension assets obli-

¹⁸ Alan S. Blinder, *The Under-taxed Kings of Private Equity*, NY Times BU4 (July 29, 2007). Professor Blinder uses the figure 38 percent because he is including the effect of employment taxes. See Part II.D.

¹⁹ Carried Interest Part III Hearings (cited in note 5) (written testimony of Russell Read, Chief Investment Officer, California Public Employees’ Retirement System) (emphasizing the negotiated and variable terms of private equity partnership agreements, and predicting that tax reform would indirectly affect private equity investors like pensions); Carried Interest Part III Hearings (cited in note 5) (written testimony of Professor Alan J. Auerbach, Robert D. Burch Professor of Law and Economics, University of California, Berkeley) (“[T]he ultimate burden of this tax increase may be borne at least partially by others in the economy, notably by the investors in the affected funds, including pension funds and, ultimately, by these funds’ beneficiaries.”).

gate the state to pay the private equity firms' tax bill directly.²⁰ This is certainly not to say that allowing this kind of joint tax arbitrage is the best way to help pensioners and universities, but the important role of tax exempts is an undeniable part of the tax advantage to profits interests and so an undeniable part of the incidence analysis of the tax benefit. This ought to at least be a factor in judging whether the profits interest issue is severe enough to warrant the public and political attention that it is now receiving.

This is the main thrust of the first portion of the Article, which seeks to clarify the true tax advantage of profits interests, and these are the reasons why revising our understanding of that tax advantage is so important for the current discourse. The second objective of the Article is to critically evaluate several of the most prominent normative arguments for and against the tax benefit.

The first main contribution of the Article in this respect is to point out the myopia of the chief normative argument in favor of reform: the argument embodied in the comparison mentioned earlier of fund managers and their secretaries.²¹ The Article questions why we are not also comparing fund managers to their wealthy heir investors. It may be true that, when partnered with tax-exempt investors, fund managers pay tax on their endowments of skill and drive at lower rates than many other labor suppliers in the economy, not to mention in their own offices. But many investors pay essentially no tax at all on their endowments of inherited wealth. As the estate tax continues to fade into oblivion, this is becoming true in a more and more comprehen-

²⁰ Alicia Mundy, *Private-equity Tax Measure Could Cut into State Pensions*, Seattle Times B1 (July 31, 2007) (“[S]ome of the state’s contracts with private-equity funds require the state to pay the fund managers’ tax bills, said State Treasurer Michael Murphy.”).

²¹ Jenny Anderson, *Scrutiny on Tax Rates That Fund Managers Pay*, NY Times C3 (June 13, 2007) (quoting former Treasury Secretary Robert Rubin at a recent Brookings Institution event: “It seems to me what is happening is people are performing a service, managing peoples’ money in a private equity form, and fees for that service would ordinarily be thought of as ordinary income.”); House Ways and Means Committee, Press Release, *Levin, Democrats Introduce Legislation to End Carried Interest Tax Advantage: Bill Seeks Fairness in Tax Code* (June 22, 2007), online at <http://waysandmeans.house.gov/News.asp?FormMode=print&ID=532> (visited June 8, 2008), quoting bill sponsor Representative Sandy Levin:

Investment fund employees should not pay a lower rate of tax on their compensation for services than other Americans. These investment managers are being paid to provide a service to their limited partners and fairness requires they be taxed at the rates applicable to service income just as any other American worker.

See also Fleischer, 83 NYU L Rev (forthcoming 2008) (cited in note 6) (“Distributive justice is also a concern for those who believe in a progressive or flat rate income tax system. 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.”). But see id at 39 (“The best tax design for the taxation of partnership profits depends . . . on [among other things] . . . whether we take the capital gain preference as a given.”).

sive and explicit sense.²² One has to ask whether it is appropriate for policymakers to be so deeply concerned with variations in how different kinds of labor income are taxed, and yet so seemingly unconcerned with the growing discrepancy in the taxation of human and financial endowments.

Secondly, the Article analyzes a second source of normative discomfort with the taxation of private equity profits interests: the enormity of some fund managers' earnings.²³ Most importantly, the Article suggests that if the *pretax* earnings of private equity fund managers are oversized, this is very likely not a tax issue. If, for instance, managers' fees are not being sufficiently bid down by market forces, the solution may lie in antitrust enforcement or in a fundamental reexamination of the laws that exempt these funds and their sophisticated investors from various regulations regarding disclosure and fee structure.

The Article concludes that when everything is added up—the fact that the tax play is not a matter of wholesale conversion and deferral but a particularized form of joint tax arbitrage, the integral role in this arbitrage of tax exemptions like pensions and universities, the arguably greater urgency of addressing the taxation of inherited “income,” and the strong possibility that the real problems with private equity investing lie outside the scope of Title 26 in other regulatory spheres—the tax treatment of profits interests comes to seem like something of a red herring. And while it is true that one should not “let the best be the enemy of the good,”²⁴ it is also true that political attention is a scarce and precious resource and that there are many “goods” to choose from, and many degrees of goodness. In the case of private equity, other good reforms may be a wiser investment.

The rest of the Article is organized as follows. Part I examines how service-compensatory profits interests generally affect the timing, character, and overall magnitude of partners' incomes in the private equity sector. In the process, Part I sets out the terms of an extended example that is carried throughout the Article. Part II considers whether and to what extent the base case analysis in Part I is affected by capitalization requirements and the limitation or suspension of deductions. Part II also discusses the impact of profits interests on the partners' employment/self-employment tax base. Part III analyzes the implications for tax liability and tax policy of the findings in Parts I and II regarding tax base. Part IV explains why the analogy to “sweat

²² See note 195 for a discussion of the estate tax and the income taxation of gifts and bequests.

²³ See, for example, Fleischer, 83 NYU L Rev (forthcoming 2008) (cited in note 6).

²⁴ Carried Interest Part II Hearings (cited in note 5) (testimony of Joseph Bankman, Ralph M. Parsons Professor of Law and Business, Stanford Law School).

equity” is generally inapt. Part V takes up several salient normative issues connected with private equity profits interests.

I. THE EFFECT OF SERVICE-COMPENSATORY PROFITS INTERESTS ON THE TIMING, CHARACTER, AND MAGNITUDE OF PARTNERS’ INCOMES

This Part examines how compensatory profits interests generally affect the timing, character, and overall magnitude of partners’ adjusted gross incomes. The next Part examines some potential qualifications to the base case presented in this Part. Part III examines the implications of these tax base effects for the partners’ joint and individual tax liabilities. The main expository device in this Part is an extended example. But before delving into the details of that example, a few general remarks are in order.

A. General Comments and Intuition

Private equity funds are typically organized as limited partnerships with the fund manager as general partner²⁵ and the fund investors as limited partners. The chief source of tax law in this area is thus Subchapter K, which concerns the taxation of partnerships.

The analysis in this Part imagines a hypothetical fund partnership and centers on the comparison of two “compensatory plans” for the fund manager/general partner. As noted, fund managers/general partners are generally paid a management fee, equal to 2 percent of assets, and a profits interest, or “carry,” equal to 20 percent of fund profits. The comparison of plans that we shall focus on is designed to highlight the tax issues surrounding the tax treatment of that portion of actual fund manager compensation that is paid in the form of a profits interest. Each compensatory plan is thus a stripped down version of actual compensation arrangements, which typically involve not just profits interests, but also management fees.

Under the first compensatory plan, the “cash salary reinvestment plan,” the fund manager is paid a cash salary, which she reinvests in the fund, earning a return on that investment just like the other fund participants (who may have contributed their own earnings from different occupations). One can think of this compensatory plan either as the explicit remittance of salary, or as a constructive payment that is taxed as salary income.

²⁵ The general partner of the fund is itself typically a partnership, namely the “private equity firm.” Nevertheless, we shall treat the general partner as an individual. Ignoring the additional layer of partnership structure does not affect our analysis, because, for our purposes, the missing partnership would be a purely pass-through entity.

The second compensatory plan, the “imputed salary plan,” corresponds to the current tax treatment of profits interests. Under this plan, the fund manager receives no salary, either explicitly or constructively. Rather, she is paid for her services out of the profits of the fund. Here salary is merely “imputed.”

Importantly, in the analysis to follow, the fund manager supplies the same amount of labor and expertise to the partnership enterprise under either compensatory plan. And (because the salary is reinvested under the first plan) the fund manager invests the value of this labor and expertise in precisely the same way, in precisely the same amount. As is crucial in locating the tax advantage of one plan over another,²⁶ the two plans are economically equivalent.

The question is whether the plans are *tax* equivalent and, if not, precisely how they differ. In contrast to existing accounts, the present Article sets out to answer this question by considering the full array of tax mechanics set in motion by each compensatory plan, including the relevant adjustments to the partners’ bases in their interest in the fund partnership. The Article also considers the tax consequences for all fund partners, including not just the fund manager/general partner, but also the investors/limited partners. Considering all the partners is important not only in its own right, but also because, as discussed in the Introduction, fund managers are unlikely to truly enjoy a nominal tax advantage if they have to compensate their partners for a corresponding tax *disadvantage*.

The Article’s core finding regarding the nature of the tax advantage of service-compensatory profits interests is as follows: shifting to the imputed salary plan from the cash salary reinvestment plan effects, in the general case, a “swap” of sorts among the partners. In this swap, the fund manager/general partner “gives” early ordinary income to her partners. Her partners “give back” to her later long-term capital gains, in an amount equal to the early ordinary income that they receive from her. The swap thus occurs “diagonally” along the two dimensions of timing and tax character: early ordinary income is exchanged for later capital gains.

How, in general terms, does this diagonal swap operate? For purposes of gaining intuition it suffices to equate the partnership with the set of investor/limited partners, ignoring the possible allocation of partnership-level tax flows to the fund manager/general partner.

Consider, first, the “transfer” of current ordinary income from the fund manager/general partner to the investors/limited partners. How does switching from the cash salary reinvestment plan to the imputed

²⁶ See, for example, Knoll, 103 Tax Notes at 208–09 (cited in note 14).

salary plan produce this first directional flow of the swap? In the general case, less salary income for the manager/general partner means less of a current salary expense deduction, and so more current ordinary income, for the investors/limited partners.

This conclusion is subject to several potential qualifications: the possibility that the limited partners will be compelled to capitalize the current cost of the manager/general partner's salary under the cash salary reinvestment plan; the possibility that the limited partners' current deduction under the cash salary reinvestment plan will be suspended until future years (for example, due to a lack of offsetting passive income); and the possibility that the limited partners' current deduction will be permanently limited (for example, due to various limits on itemized deductions). The next Part discusses these potential qualifications, and argues that they are less important than might be imagined.

Consider next the second directional flow of the swap, the investors/limited partners' "counter transfer" of future long-term capital gains to the manager/general partner. The fund manager/general partner reaps greater future long-term capital gains because, in contrast to the case where she reinvests her salary, she takes no basis in her partnership interest under the imputed salary plan. A lower basis means larger capital gains upon disposition of that interest. The investors/limited partners have, correspondingly, a larger basis in their partnership interest—and so lower capital gains income—because they take no deduction for the fund manager's salary and, according to partnership tax rules, such a deduction would have triggered a corresponding reduction in their basis (similar to the reduction in basis for depreciation deductions).

To explain this diagonal swap with greater precision and completeness, we now turn to an extended example.

B. Base Case Example²⁷

1. The underlying business enterprise.

The fixed economic core of our base case example will be the following imagined business opportunity. A stagnant company can presently be purchased for \$1 million. With time and the addition of an-

²⁷ A formulaic web appendix, which is available online at http://www.cstone.net/~csanchir/Sanchirico_Private_Equity_Web_Appendix_082307.pdf (visited June 8, 2008), generalizes several features of the base case example, including the amount of the contributions, the amount of salary, the allocative shares of the salary expense deduction, and the form in which capital gains income from the profits interest is realized (whether by pass-through or liquidation).

other \$1 million worth²⁸ of expertise and effort, the company can be “turned around.”²⁹ It can then be sold for \$6 million. For the moment, we will imagine that this opportunity is a riskless proposition.³⁰

Viewed in skeletal form, then, the business opportunity is a simple input-output recipe. The inputs are \$1 million of “capital” and \$1 million of “labor,” both supplied in “year one.” The output is \$6 million in cash in “year two.”

Two individuals consider forming a partnership to engage in this activity. A “limited partner” stands ready to supply the \$1 million of capital. A “general partner” stands ready to supply the \$1 million of labor. In return for his respective contribution in year one, each partner will take a share of the \$6 million in proceeds from the sale of the company in year two.

For simplicity, we will assume that these sale proceeds are distributed to the partners in the context of terminating the partnership and liquidating its assets. Liquidation of the fund partnership is apparently a common means of realizing capital gains income from private equity profits interests.³¹ But the same results obtain if, in year two, the fund partnership has long-term capital gains income that passes to the general partner via her profits interest.³²

On the other hand, partnership level *ordinary income* that passes through to the general partner via her profits interest would be taxed as ordinary income to the general partner. Because the focus of controversy is that portion of profits interest income taxed at capital gains rates, we will assume that there is no such ordinary income at the partnership level.

²⁸ The analysis is not qualitatively affected by regarding a larger or smaller portion of the fund manager’s ultimate \$3 million return as salary.

²⁹ Some commentators are critical of what private equity funds do to companies once they obtain control. We will put this potentially important issue to one side in order to focus specifically on the tax treatment of profits interests.

³⁰ We adopt this simplifying assumption even though the tax treatment of profits interests turns in part on difficulties of valuation and on the extent to which the interest is vested. For a discussion of the tax law, see notes 54–55. The policy significance of the riskiness of profits interests is considered below in Part V.D.

³¹ SEC Report at 7–8 (cited in note 1) (“Private equity funds are long-term investments, provide for liquidation at the end of the term specified in the fund’s governing documents, and offer little, if any, opportunity for investors to redeem their investments. A private equity fund, however, may distribute cash to its investors when it sells its portfolio investment, or it may distribute the securities of a portfolio company . . . to its investors.”); Treasury Report at 28 & n 96 (cited in note 1) (noting that the average lifespan of a private equity fund is ten to twelve years, determined by agreement in the partnership papers).

³² See the formulaic web appendix to this Article, online at http://www.cstone.net/~csanchir/Sanchirico_Private_Equity_Web_Appendix_082307.pdf (visited June 8, 2008) (cited in note 27).

Alternatively, the reader can consider the analysis to be restricted to that portion of income from the general partner's profits interest that ends up being taxed at long-term capital gains rates.

2. Two economically equivalent compensation plans.

As noted, we consider two plans for compensating the general partner for her labor input. Under the first plan, the "cash salary reinvestment plan," the general partner is paid \$1 million of cash salary in year one, and then contributes this amount to the partnership in that same year in return for an interest in the "profits" of the partnership in year two. The particular structure and rate of the general partner's profits interest are immaterial for the present analysis.³³ What matters is that, as we shall see, the general partner will realize \$3 million from this interest in year two, and that this \$3 million realization (less adjusted basis) will be taxed as long-term capital gain.

Under the second plan, "the imputed salary plan," the general partner receives no cash salary in either year. Instead, she is granted the profits interest just described without having to contribute cash.

Before attempting to judge the relative tax advantage of the imputed salary plan, it is important that we confirm that we are comparing apples to apples.³⁴ That is, to be able to conclude that any difference in after-tax proceeds across the two plans is due to tax treatment, and not underlying economics, we need to be sure that the two plans are economically equivalent. To this end, note that pretax flows are the same for each partner under either plan. In both cases, the general partner expends the same labor services in year one³⁵ and acquires the same amount of cash in return in year two. And in both cases, the limited partner contributes the same amount of *cash* in year one and receives the same amount of cash in return in year two.

Tax issues aside, then, the only difference between the two plans is that, in the cash salary reinvestment case, a portion of the value of the property received by the general partner in return for her provision of services is momentarily removed from the enterprise in year one, in the form of cash, before being reinserted into the enterprise in that same year in the form of a cash contribution by the general partner.

The need to compare apples to apples is what justifies comparing the imputed salary plan — which conforms roughly to actual practice —

³³ For a helpful discussion of how profits interests are structured, see Ordover, 7 UC Davis Bus L J at 345–52 (cited in note 1).

³⁴ The key examples in Fleischer, 83 NYU L Rev (forthcoming 2008) (cited in note 6), do not appear to satisfy this requirement.

³⁵ Or so we shall stipulate, ignoring the question of whether there is any difference across the two plans in the performance incentives they offer to general partners.

to the cash salary reinvestment plan—which is rather artificial. In particular, it is crucial for the proper comparison of tax treatments that the explicit salary payment and the imputed salary amount be invested in the same way. If, for example, the explicit salary payment were invested at a lower return—say, in a bank account—some portion of the disadvantage for the general partner from taking salary would come from this lower return rather than from any difference in tax treatment.

3. Partners' adjusted gross incomes under the two compensatory plans.

In this Part, we map out how the partnership enterprise contributes to the adjusted gross income (for tax purposes) of each partner under each compensatory plan. We track the timing, character, and aggregate amount of each such contribution. We do this for the base case, wherein any salary paid to the fund manager would be deductible by the partners in the current year. (Part II discusses the possibility that this outlay would have to be capitalized as well as the possibility that the deduction for this outlay would be limited or suspended.)

Note that the *partnership* as such is not subject to income tax.³⁶ Its taxable income is merely computed,³⁷ and items of partnership income, gain, loss, deduction, or credit are then allocated to the individual partners,³⁸ for inclusion in their individual tax returns.³⁹

We start with the general partner, first considering her treatment under the cash salary reinvestment plan and then her treatment under the imputed salary plan. Next, we consider the taxation of the limited partner under each plan.

a) General partner.

i) Cash salary reinvestment plan. Under the cash salary reinvestment plan, the general partner has \$1 million of salary income in

³⁶ IRC § 701 (“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.”).

³⁷ IRC § 703(a) (“The taxable income of a partnership shall be computed in the same manner as in the case of an individual except [for several modifications].”).

³⁸ Such allocations are generally made according to the partnership agreement. IRC § 704(a). However, not all such allocations will be respected for tax purposes. See IRC § 704(b). A complex set of regulations determines whether a given allocation will be sustained. See Treas Reg § 1.704-1(b) (2007).

³⁹ Some additional simplifying assumptions: First, we will assume that both partners and the partnership have the same taxable years. Otherwise, see IRC § 706(a). Second, we will assume that both partners and the partnership are cash method taxpayers. Removing these assumptions would complicate the analysis, but would not affect the basic findings.

year one.⁴⁰ This salary payment generates a salary expense deduction of \$1 million for the partnership.⁴¹ Some portion of this partnership deduction may be allocated to the general partner.⁴² Let us assume—for purposes of illustration only—that the general partner is allocated \$100,000 of the salary expense deduction. This \$100,000 is referred to as the general partner’s “distributive share”⁴³ of the partnership’s deduction. The general partner deducts this \$100,000 against her \$1 million salary income.⁴⁴ (Specifically, she deducts it “above the line”⁴⁵ and against her ordinary income.) On net, therefore, the general partner has an additional \$900,000 of ordinary income, in year one, by virtue of the partnership enterprise.

The general partner contributes her \$1 million salary to the partnership under the cash salary reinvestment plan. (Recall that we are putting aside the question of how the general partner finances the tax she owes in year one until we consider deferral.) This \$1 million contribution gives her a basis in her partnership interest of \$1 million.⁴⁷ This basis is then adjusted downward for her distributive share of the partnership’s year one salary expense deduction.⁴⁸ Therefore, going into year two, the general partner’s adjusted basis in her partnership interest is \$900,000.

⁴⁰ IRC § 61(a)(1) (including “[c]ompensation for services” in gross income).

⁴¹ IRC §§ 703(a) (stating that “[t]he taxable income of a partnership shall be computed in the same manner as in the case of an individual,” but for certain modifications), 162(a)(1) (allowing a deduction for “reasonable allowance for salaries or other compensation for personal services actually rendered”).

⁴² See note 38. The proper allocation may be difficult to determine, but the magnitude of this allocation affects only the magnitude of the “swap,” not its nature or existence. See Part I.B.3.d.

Note also that under § 704(d), “[a] partner’s distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner’s interest in the partnership *at the end of the partnership year in which such loss occurred.*” IRC § 704(d) (emphasis added). As we shall see, the general partner’s adjusted basis at the end of this first taxable year will account for her contribution of cash salary.

⁴³ IRC § 704 (defining the partner’s distributive share). Contrast a partner’s “distributive share” of an item of partnership income, loss, deduction, and so forth, with a “distribution” to the partner of partnership property, as governed by IRC §§ 731–37.

⁴⁴ IRC § 162(a)(1) (allowing as a deduction “a reasonable allowance for salaries or other compensation for personal services actually rendered”).

⁴⁵ That is, she deducts it from her gross income in determining adjusted gross income, as opposed to deducting it from adjusted gross income in determining taxable income. IRC § 62(a)(1) (stating that this deduction is above the line). What is important for our purposes is that a dollar of allocated salary expense has an impact on adjusted gross income that is equal and opposite to a dollar of salary received. See Part II.B for additional discussion regarding the potential above-the-line nature of this deduction.

⁴⁶ IRC §§ 1221(a) (defining capital assets), 1222 (defining capital gains and losses).

⁴⁷ IRC § 722 (defining the basis of a contributing partner’s interest). A partner’s basis in her interest in the partnership is sometimes called her “outside” basis.

⁴⁸ IRC § 705(a)(2)(A) (directing that a partner’s basis be decreased by partnership losses).

Note that the general partner's adjusted basis in her partnership interest under the cash salary reinvestment plan equals her ordinary income in year one. This is true no matter how much salary she is paid and no matter how much of the partnership's corresponding salary expense deduction she is allocated. Because she contributes her salary payment under the plan, her initial basis equals her salary income. Both her basis and her ordinary income are then reduced by however much of the partnership's salary expense deduction she is allocated.

In year two, the general partner recognizes income upon the liquidating distribution of the partnership's assets.⁴⁹ Her interest in the partnership is treated as a "capital asset."⁵⁰ Her "amount realized" is \$3 million.⁵¹ From this, she subtracts her \$900,000 adjusted basis in her partnership interest.⁵² She thus has \$2.1 million of long-term⁵³ capital gain in year two.

In sum, under the cash salary plan, the general partner has \$900,000 of year one ordinary income and \$2.1 million of year two long-term capital gain. The total increment to her adjusted gross income—aggregated over the timing and character of income—is \$3 million.

ii) Imputed salary plan. Under the imputed salary plan, the general partner has no service-compensation income in year one—under either current law⁵⁴ or proposed regulations.⁵⁵ Correspondingly,

⁴⁹ IRC § 731 (governing the extent of recognition of gain or loss on the distribution of assets).

⁵⁰ IRC §§ 731 (prescribing that gain or loss from a liquidating distribution be treated as gain or loss from the sale or exchange of a partnership interest), 741 (stating that gain or loss from the sale or exchange of a partnership interest should be "considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in § 751 (relating to unrealized receivables and inventory items)"). We are assuming that IRC § 751 does not apply.

⁵¹ IRC § 1001(b) ("The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.").

⁵² IRC § 1001(a) (prescribing the computation of gain or loss).

⁵³ We are assuming that holding period requirements are met. IRC § 1222(1)–(4). Note that "year two" may be more than one year after "year one."

⁵⁴ Revenue Procedure 93-27 specifies that, subject to certain exceptions, if a partner receives a profits interest in return for the provision of services to a partnership, the receipt of such an interest is not a taxable event for the partner or the partnership. See Rev Proc 93-27, 1993-2 Cum Bull 343. See also generally Rev Proc 2001-43, 2001-2 Cum Bull 191 (clarifying Rev Proc 93-27). This tax treatment is conditioned on the following two requirements, both of which would generally be met by profits interests—if not by the artificially simple example that we are considering.

First, in providing her labor contribution, the general partner must be regarded as acting "in a partner capacity." Rev Proc 93-27, 1993-2 Cum Bull 344; IRC § 707(a)(2)(A). Partners who provide "management services," such as the general partner in our example, are generally regarded as acting "in a partner capacity." Rev Rul 81-300, 1981-2 Cum Bull 144; *Pratt v Commissioner of Internal Revenue*, 64 Tax Ct 203 (1975) (finding that partners providing management services were acting in a partner capacity), affirmed in part, reversed in part, 550 F2d 1023 (5th Cir 1977). Compare Rev Rul 81-301, 1981-2 Cum Bull 144 (stating that a general partner was not acting "in partner capacity" when the services the general partner provided to the partnership

the partnership has no salary expense deduction,⁵⁶ and the general partner has no distributive share thereof. The general partner's year one ordinary income is thus \$900,000 lower under the imputed salary plan than under the cash salary reinvestment plan.

Because she makes no contribution of property to the partnership, the general partner takes a zero basis in her partnership interest.⁵⁷ In year two, then, all of the general partner's \$3 million realization is long-term capital gain.⁵⁸

Notice that the general partner's \$3 million capital gain in year two under the imputed salary plan is \$900,000 greater than her year two capital gain under the cash salary reinvestment plan. This \$900,000

were substantially the same as those the general partner provided to others as an independent contractor or agent).

Second, the service-compensatory payments must not be considered "guaranteed payments" under IRC § 707(c). "Guaranteed payments" include service-compensatory payments to a partner that are determined without regard to the "income of the partnership." The word "income" in § 707(c) means *net* income, which is to say profits. Id. Profits interests are determined *with* regard to the "income of the partnership," and so are generally *not* guaranteed payments even to the extent that they are service-compensatory. Compare id with Rev Rul 81-300, 1981-2 Cum Bull 144 (stating that "guaranteed payments" need not be fixed payments and holding that compensation based on *gross* income, as opposed to profits, may be a "guaranteed payment").

⁵⁵ Proposed regulations would apply IRC § 83 to the general partner's receipt of her profits interest. Proposed Treas Reg § 1.83-3(l) (2005). Such a profits interest—in practice, if not in our artificially simplified example—would generally be regarded as "substantially nonvested" under IRC § 83. Proposed Treas Reg § 1.83-3(b)-(d). See also IRC § 83. The general partner could elect under IRC § 83(b) to take the value of such partnership interest into current ordinary income as compensation for services. Importantly, in doing so, the general partner would be permitted to calculate the value of the profits interest according to the "liquidation" method. Proposed Treas Reg § 1.83-3(l). Under this method, the value of the profits interest would equal what that interest would garner for the general partner were the partnership liquidated immediately after she received her profits interest. Specifically, the profits interest would be valued at (or near) zero. See also *Campbell v Commissioner of Internal Revenue*, 943 F2d 815, 823 (8th Cir 1991) (finding that a taxpayer's profits interest lacked current value). Therefore, the general partner would have no salary income in year one.

Further, the general partner would take a zero basis in her partnership interest. Treas Reg § 1.704-1(b)(2)(iv)(l) (describing transfers of partnership interests). And IRC § 83 would then not apply to the realization of her partnership interest in year two.

See also Notice 2005-43, 2005-24 Int Rev Bull 1221 (describing a proposed revenue procedure rendering obsolete Rev Proc 93-27 and Rev Proc 2001-43); note 54 (describing Rev Proc 93-27).

The Treasury lists finalization of these proposed regulations in its "Priority Guidance Plan" for the year ending June 30, 2007. Department of the Treasury, *First Periodic Update of the 2006-2007 Priority Guidance Plan* 23 (March 12, 2007), online at <http://www.irs.gov/pub/irs-utl/2006-2007pgp.pdf> (visited June 8, 2008).

⁵⁶ This is the case under current law, as described in note 54. See also Rev Proc 93-27, 1993-2 Cum Bull 343 (stating that the receipt of a profits interest is a nontaxable event for the partnership also); Rev Proc 2001-43, 2001-2 Cum Bull 191 (clarifying Rev Proc 93-27). This is also true under proposed regulations, as described in note 55 and IRC § 83(h).

⁵⁷ IRC § 722 (defining the basis of a contributing partner's interest).

⁵⁸ IRC § 1001 (governing the determination of amount of and recognition of gain or loss). Again, we assume that holding period requirements are met. IRC § 1222(1)-(4). Recall that "year two" may be more than one year after "year one."

is her adjusted basis under the cash salary reinvestment plan, which, as we have noted, equals her year one ordinary income under that plan.

iii) Effect of adopting the imputed salary plan. Therefore, moving from the cash salary plan to the imputed salary plan converts, for the general partner, \$900,000 of year one ordinary income into \$900,000 of year two long-term capital gain.

In particular, shifting to the imputed salary plan reduces the general partner's adjusted basis—thus increasing her year two capital gain—by the same amount that it reduces her ordinary income in year one.

b) Limited partner.

i) Cash salary reinvestment plan. Under the cash salary reinvestment plan, the limited partner has a deduction against ordinary income in year one. (Part II discusses the possibility that this outlay must be capitalized as well as the possibility that the deduction for this outlay will be limited or suspended.) This deduction is equal to his distributive share of the partnership's salary expense deduction, which arises from the partnership's payment of \$1 million of salary to the general partner.⁵⁹

Since we have assumed that \$100,000 of the salary expense deduction is allocated to the general partner, it must be the case that the other \$900,000 is allocated to the limited partner.⁶⁰ Therefore, under the cash salary plan, the partnership enterprise reduces the limited partner's adjusted gross income in year one by \$900,000. In particular, the deduction is again "above the line"⁶¹ and against ordinary income.⁶²

The limited partner's basis in his partnership interest is initially set to equal his \$1 million cash contribution.⁶³ His basis is then reduced by his distributive share of the partnership's salary expense deduction.⁶⁴ Therefore, the limited partner's basis going into year two is \$100,000.

In year two, under the cash salary reinvestment plan, the limited partner realizes \$3 million from his partnership interest. After sub-

⁵⁹ IRC §§ 703(a) (directing that taxable income of a partnership be computed in the same manner as in the case of an individual, but for certain modifications), 162(a)(1) (allowing a deduction for a "reasonable allowance for salaries or other compensation for personal services actually rendered"), 704 (governing allocations of partnership items of deduction); Treas Reg § 1.704-1 (same).

⁶⁰ IRC § 704 (governing allocations of partnership items of deduction); Treas Reg § 1.704-1 (same). See, in particular, the definition of "economic effect" in Treas Reg § 1.704-1(b)(2).

⁶¹ IRC § 62(a)(1) (allowing above-the-line deduction for nonemployee trade or business expenses). See Part II.B. for additional discussion regarding the above-the-line nature of this deduction.

⁶² IRC §§ 1221(a) (defining capital assets), 1222 (defining capital gains and losses).

⁶³ IRC § 722 (governing the basis of a contributing partner's interest).

⁶⁴ IRC § 705(a)(2)(A) (prescribing that a partner's basis is decreased by his distributive share of partnership losses).

tracting his \$100,000 adjusted basis, he has \$2.9 million of long-term capital gain.⁶⁵

ii) Imputed salary plan. Under the imputed salary plan, the limited partner has no deduction in the first year.⁶⁶ Thus, his ordinary income in year one is \$900,000 higher than under the cash salary reinvestment plan.

The limited partner then enters year two with an unreduced basis of \$1 million from his cash contribution.⁶⁷

The limited partner's realization of \$3 million in year two thereby produces \$2 million of long-term capital gain,⁶⁸ which is \$900,000 less than his year two capital gain under the cash salary reinvestment plan.

iii) Effect of adopting the imputed salary plan. Therefore, moving from the cash salary plan to the imputed salary plan *increases* the limited partner's year one ordinary income (via eliminating a deduction from ordinary income) by \$900,000, while reducing the limited partner's year two capital gain by the same amount (via eliminating the corresponding basis reduction).

c) The "diagonal swap" of timing and character. Now consider the general partner and the limited partner together. For the general partner, moving to the imputed salary plan converts \$900,000 of year one ordinary income into \$900,000 of year two capital gain. For the limited partner, moving to the imputed salary plan converts \$900,000 of year two capital gain into \$900,000 of year one ordinary income.

Therefore, moving to the imputed salary plan effectively causes the two partners to swap adjusted gross income simultaneously across the two dimensions of time and character. The general partner "gives" the limited partner \$900,000 of year one ordinary income—that is, the general partner's year one ordinary income decreases by this amount and the limited partner's increases by this amount. In return, the limited partner "gives" the general partner \$900,000 of year two long-term capital gain—that is, the limited partner's year two long-term capital gain goes down by this amount and the general partner's goes up by this amount.

d) Generalization. This basic story is in many respects quite general. Let any amount of salary be paid to the general partner under

⁶⁵ IRC §§ 731 (treating gain or loss from liquidating distribution as gain or loss from the sale or exchange of partnership interest), 741 (considering gain or loss from sale or exchange of partnership interest "as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items)"), 1001 (governing the determination of the amount of and recognition of gain or loss). Again, we are assuming that IRC § 751 does not apply.

⁶⁶ See notes 54–56.

⁶⁷ See notes 63–65.

⁶⁸ See note 58.

the cash salary reinvestment plan. Let any amount of the corresponding salary expense be allocated to the general partner. Call the net of these two amounts the general partner's "net salary income" under the cash salary reinvestment plan. Moving to the imputed salary plan causes a diagonal timing/character swap in the amount of this net salary income. The general partner gives to the limited partner (or, more generally, the other partners jointly) an amount of year one ordinary income equal to what the general partner's net salary income would be under the cash salary reinvestment plan. The limited partner (more generally, the other partners) gives back the same amount in year two long-term capital gains to the general partner.

A formulaic appendix available on the internet further generalizes the existence of this diagonal swap.⁶⁹ Among other things, this appendix shows that the realization of partnership long-term capital gain at an intermediate stage, after partnership formation and prior to liquidation, does not change the basic story. Each partner's basis in her partnership interest would be adjusted upward by an amount equal to her distributive share of this realization.⁷⁰ The intermediate realization would thus merely shift some amount of each partner's long-term capital gain half a step backward in time from the liquidation period to the intermediate period.

II. POTENTIAL QUALIFICATIONS

Even though the story told in Part I is more general than the example used to tell it, the story is nevertheless subject to several qualifications. First, the effect of service-compensatory profits interests on the partners' employment/self-employment tax bases, as opposed to their income tax bases, is not similarly zero-sum. Second, even for the income tax, our diagonal swap story rests on several premises concerning the tax treatment of the salary paid to the fund manager under the cash salary reinvestment plan. The first premise is that the partnership would not be required to capitalize this outlay. The second premise is that the partners would not be prohibited from deducting their distributive shares of the partnership's salary expense deduction by any of the Code's various deduction limits, such as the limit on "miscellaneous itemized deductions."⁷¹ The third premise is that the

⁶⁹ Online at http://www.cstone.net/~csanchir/Sanchirico_Private_Equity_Web_Appendix_082307.pdf (visited June 8, 2008) (cited in note 27).

⁷⁰ IRC §§ 704 (governing allocation of partnership income, including capital gains), 705 (governing adjustments to a partner's basis in her partnership interest for her distributive share of partnership income).

⁷¹ IRC § 67 (defining "miscellaneous itemized deductions" and allowing them only to the extent that their aggregate exceeds 2 percent of adjusted gross income).

partners' year one deductions for their share of the salary expense would not be suspended (as opposed to permanently disallowed) for lack of offsetting income. This Part explains and evaluates these qualifications and premises, starting with those pertinent to the income tax.

A. Capitalization: Possibility and Effect⁷²

The general principle of capitalization is that outlays should be subtracted from gross income only as the returns they generate are added to gross income.⁷³ Sometimes—and perhaps under other names—this matching principle is considered to extend beyond timing, also to character. To wit, outlays should be subtracted from gross income in the form of ordinary income deductions only when the proceeds that such outlays generate are added to gross income as ordinary income. When, on the other hand, the proceeds are added to gross income in the form of capital gains, the corresponding outlays should be subtracted, as part of adjusted basis, in the process of calculating capital gain.⁷⁴

Yet the tax law quite often strays from these general matching principles—usually with the apology that they are impractical to implement.⁷⁵ The fund manager's salary is an exceptionally clear example of this.

⁷² I thank Michael Knoll for suggesting, with regard to the June 2007 draft of this Article, that the issue of whether capitalization would be required deserved greater attention.

⁷³ IRC § 263 (disallowing deductions for certain capital expenditures); *INDOPCO, Inc v Commissioner of Internal Revenue*, 503 US 79, 88–89 (1992) (“Although the mere presence of an incidental future benefit . . . may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important.”); *Encyclopaedia Britannica, Inc v Commissioner of Internal Revenue*, 685 F2d 212, 214 (7th Cir 1982) (“The object of sections 162 and 263 of the Code, read together, is to match up expenditures with the income they generate.”).

⁷⁴ This occurs when capitalized costs are either: (a) not recovered in the form of deductions from ordinary income or the like—such as for depreciation, amortization, or the cost of goods sold; or (b) are so recovered, but then are subject to “recapture” upon sale or disposition of the asset. See IRC §§ 167 (allowing deduction for depreciation of certain business or income-producing assets), 168 (determining the magnitude of the § 167 depreciation deduction for certain tangible property), 197 (allowing an amortization deduction for certain business or income-producing intangibles), 263A (requiring capitalization of inventory costs and the cost of producing real or tangible property used in a trade or business or income producing activity), 61(a)(2) (including “gross income derived from business” in the definition of gross income); Treas Reg 1.61-3(a) (allowing the subtraction of “cost of goods sold” from revenues in determining “gross income derived from business” under IRC § 61(a)(2)). See also IRC §§ 1245 (requiring ordinary income treatment of gains from disposition of certain depreciable property to the extent of depreciation deductions previously taken), 1250 (providing a similar, but more limited recapture rule for certain depreciable realty).

⁷⁵ See *Encyclopaedia Britannica*, 685 F2d at 217:

If one really takes seriously the concept of a capital expenditure as anything that yields income, actual or imputed, beyond the period (conventionally one year) in which the expenditure is made, the result will be to force the capitalization of virtually every business ex-

In our extended example, the private equity fund manager provides, in the main, two kinds of services to the partnership—and this is presumably not far from the typical case. First, she manages the acquisition of a stagnant business. Second, she oversees various measures to increase the value of this business in anticipation of reselling it.

Regulations issued under § 263⁷⁶ would allow the partnership to deduct amounts paid to the fund manager for each of these services.⁷⁷ With regard to the first service, it is true that the regulations require capitalization of amounts paid to facilitate the purchase of a trade or business.⁷⁸ However, the regulations specifically exempt from this requirement service-compensatory payments of the kind that would be made to the fund manager as salary under the cash salary reinvestment plan.⁷⁹

With regard to the fund manager's second service, building up business value, while the regulations under § 263 do require the capitalization of costs paid to create or enhance an intangible asset, this is generally only when that asset is "separate and distinct" from a trade or business.⁸⁰ Building business value by redrawing organizational

pense. It is a result courts naturally shy away from. It would require capitalizing every salesman's salary, since his selling activities create goodwill for the company and goodwill is an asset yielding income beyond the year in which the salary expense is incurred.

(citations omitted).

⁷⁶ Treas Reg §§ 1.263(a)-4, -5.

⁷⁷ Were the fund manager's services employed in creating *tangible* assets (an unlikely or at least exceptional scenario), then a set of rules different from those discussed in notes 78–80 would apply. See text accompanying note 84.

⁷⁸ Treas Reg § 1.263(a)-5(a) (requiring capitalization of amounts paid to facilitate, among other things: (a) the acquisition of the assets that constitute a trade or business; (b) the acquisition of, roughly speaking, majority ownership in a trade or business; or (c) a restructuring, recapitalization, or reorganization of the capital structure of a business entity); Treas Reg § 1.263(a)-4(b)(1)(iv) (requiring capitalization of amounts paid to facilitate, among other things: (a) the acquisition of, roughly speaking, *non*majority ownership in a business venture; or (b) the acquisition of intangible assets *not* in connection with the acquisition of the assets that constitute a trade or business). See Treas Reg § 1.263(a)-5(b)(2) for "ordering rules" regarding the application of Treas Reg §§ 1.263(a)-4, -5.

⁷⁹ Treas Reg § 1.263(a)-5(d) (adopting the "simplifying convention" that "employee compensation" does not constitute a payment made to facilitate the transactions listed in Treas Reg § 1.263(a)-5(a), as described in note 78); Treas Reg § 1.263(a)-5(d)(2)(ii) (defining "employee compensation" to include "guaranteed payments to a partner"); Treas Reg § 1.263(a)-4(e)(4), (e)(4)(ii)(B) (similar exception for capitalization requirements in Treas Reg § 1.263(a)-4(b)(1)(iv), described in note 78). The fund manager's salary under the cash salary reinvestment plan would most likely be considered a "guaranteed payment to a partner." IRC § 707(c). See note 54 for a discussion of such "guaranteed payments."

⁸⁰ Treas Reg § 1.263(a)-4(b)(1)(iii) (requiring capitalization of the cost of creating or enhancing a "separate and distinct intangible asset"); Treas Reg § 1.263(a)-4(b)(3)(i) (defining "separate and distinct intangible asset"), quoted in note 81.

Were an alternative "future benefits" test for capitalization applied, it would probably point toward capitalization of salary paid to enhance goodwill. This future benefits test was famously employed by the Supreme Court in *INDOPCO*, 503 US at 88 (requiring capitalization of investment banker fees connected with a merger because such fees produced benefits beyond the

charts, firing and hiring, renegotiating or terminating labor contracts, improving customer relations, or adopting new market strategies would most likely not be considered the creation or enhancement of an intangible asset separate and distinct from a trade or business.⁸¹

It should be noted that, however justifiable, the subsidiary conclusion that capitalization would not be required under the cash salary reinvestment plan is pivotal with regard to characterizing adoption of the imputed salary plan as a timing and character swap among the fund partners. If the partners *were* required to capitalize the fund manager's salary under the cash salary reinvestment plan, and this amount was not recovered until subtracted as basis in calculating capital gains⁸²—that is, if the salary outlay matched the return it generated in both timing and character—the tax advantage of the imputed salary plan relative to this altered baseline would indeed be pure conversion and deferral for the fund manager with no seesaw effect upon the limited partner.

Why is this? Moving from a “*capitalized* cash salary reinvestment plan” to the imputed salary plan would still convert ordinary income

current year),⁸⁷ (asserting that the creation of a separate and distinct asset is sufficient but not necessary for capitalization, and pointing to the existence of future benefits as another consideration).

However, in promulgating Treas Reg §§ 1.263(a)-4, -5 in the wake of *INDOPCO*, the Treasury and the IRS seem to have eschewed *INDOPCO*'s “future benefits test,” at least for the time being. See Treas Reg § 1.263(a)-4(b)(1)(iv) (requiring capitalization of an “amount paid to create or enhance a future benefit *identified in published guidance in the Federal Register or in the Internal Revenue Bulletin*”) (emphasis added); TD 9107, 2004-7 Int Rev Bull 447:

[Section 1.263(a)-4 provides] that an amount paid to acquire or create an intangible not otherwise required to be capitalized by the regulations is *not required to be capitalized on the ground that it produces significant future benefits for the taxpayer, unless the IRS publishes guidance requiring capitalization of the expenditure*. If the IRS publishes guidance requiring capitalization of an expenditure that produces future benefits for the taxpayer, such guidance will apply prospectively. While most commentators support this approach, some commentators expressed concerns that this approach, particularly the prospective nature of future guidance, will permit taxpayers to deduct expenditures that should properly be capitalized. The IRS and Treasury Department continue to believe that the capitalization principles in the regulations strike an appropriate balance between the capitalization provisions of the Code and the ability of taxpayers and IRS personnel to administer the law, and are a reasonable means of enforcing the requirements of section 263(a). (emphasis added).

The IRS appears to have published no guidance requiring capitalization on the ground that an outlay produces future benefits.

⁸¹ Treas Reg § 1.263(a)-4(b)(3)(i) (defining “separate and distinct intangible asset” as “a property interest of ascertainable and measurable value in money's worth that is subject to protection under applicable . . . law and the possession and control of which is intrinsically capable of being sold, transferred or pledged (ignoring any restrictions imposed on assignability) separate and apart from a trade or business”). With specific regard to renegotiating labor contracts, see Treas Reg § 1.263(a)-4(b)(3)(ii) (treating outlays to facilitate contract termination or renegotiation as not creating or enhancing a separate and distinct asset).

⁸² For the importance of this second condition, see note 84 and accompanying text.

into capital gains for the fund manager/general partner.⁸³ But capitalization in the baseline plan would alter the effect of the transition on the limited partner in two ways. First, the limited partner would now lose no deduction in the transition between plans and so would not experience a seesaw increase in his current ordinary income. Second, and correspondingly, the transition between plans would no longer save the limited partner from a deduction-triggered basis reduction in his partnership interest. Therefore, the transition would no longer cause him to experience a seesaw reduction in capital gains.

Thus, where moving from the *deductible* cash salary reinvestment plan to the imputed salary plan converts ordinary income into capital gains for the fund manager/general partner *and vice versa* for the investor/limited partner, moving from a *capitalized* cash salary reinvestment plan to the imputed salary plan converts ordinary income into capital gains for the fund manager/general partner and *has no effect on* the investor/limited partner.

Foreshadowing the analysis in the next Part, adopting the imputed salary plan would then be tax beneficial for the partnership even if the two partners faced precisely the same tax rates. The general partner's one-sided conversion would be beneficial (in its own right) so long as the general partner, taken alone, pays a lower rate on capital gains than on ordinary income. The general partner's one-sided deferral would be beneficial (in its own right) so long as the general partner's tax rate on year one ordinary income is positive, the partnership has positive financing costs, and the general partner's tax rate is not expected to increase markedly over time.

Even so, it should be kept in mind that all this describes the case in which the fund manager's salary is capitalized *and* not recovered until subtracted as basis in calculating capital gains. Many situations in which an outlay must be capitalized are also situations in which the outlay is eventually recovered as a deduction from ordinary income in the form of depreciation, amortization, or inventory costs.⁸⁴ To the extent that the

⁸³ In fact, a full \$1 million of adjusted gross income would be converted from year one ordinary income into year two capital gains. Under the cash salary reinvestment plan, the general partner would also presumably have to capitalize her distributive share qua partner of the salary that she was taking fully into income qua service provider. She would thus have \$1 million of ordinary income in year one under that plan. Compare this to the \$900,000 of *net* salary income (that is, net of the general partner's distributive share of the salary expense deduction) that is converted in moving from the (noncapitalized) cash salary reinvestment plan to the imputed salary plan, as described in Part I.B.

⁸⁴ For example, costs that must be capitalized under IRC § 263A, the so-called Unicap rules, will be recovered as "cost of goods sold" (if incurred to produce or acquire property that is inventory in the hands of the taxpayer) or as depreciation (if incurred to produce real or tangible property used in a trade or business, or an activity for the production of income, that is not inventory in the hands of the taxpayer). See IRC §§ 263A, 167-68 (allowing and determining

salary cost under the cash salary reinvestment plan, though initially capitalized, would eventually be recovered in the form of a deduction from ordinary income, the tax consequences of adopting the imputed salary plan are essentially the same as when capitalization is not required, but the allowed deduction is suspended, as described in Part II.C.

B. Permanent Deduction Limits: Possibility and Effect

The tax code contains various provisions prohibiting “itemized deductions”⁸⁵ once and for all (as opposed to merely suspending them, a consequence discussed in Part II.C).⁸⁶ For example, § 67 limits individuals’ aggregate “miscellaneous itemized deductions” to that portion exceeding two percent of adjusted gross income.⁸⁷ Section 68 phases out, over adjusted gross income, the aggregate of a broader list of otherwise allowable itemized deductions for individuals.⁸⁸ And the alternative minimum tax⁸⁹ disallows “miscellaneous itemized deductions” altogether.⁹⁰

magnitude of deduction for depreciation of certain business or income-producing assets). Furthermore, intangible assets are often amortizable. See IRC § 197 (allowing amortization of specific intangibles including acquired goodwill, intellectual property, work force in place, and government licenses); Treas Reg § 1.167(a)-3 (allowing amortization of intangibles known to have a limited useful life).

To be sure, recapture rules may apply. See IRC §§ 1245 (requiring ordinary income treatment of gains from disposition of certain depreciable property to the extent of depreciation deductions previously taken), 1250 (providing a similar, but more limited recapture rule for certain depreciable realty). But recapture will not prevent the recovery from ordinary income of costs paid for an asset to the extent that the value of the asset truly declines over time. For example, if the depreciation allowances (and the corresponding basis reductions) for an item of “§ 1245 property” keep pace with the actual decline in the asset’s fair market value, then there is no gain upon disposition and no recapture. See IRC § 1245(a) (determining amount of recapture).

⁸⁵ IRC § 63(d) defines the term “itemized deductions” as follows: any deduction, other than the deduction for personal exemptions under IRC § 151, that is not subtracted from gross income in calculating adjusted gross income under IRC § 62.

⁸⁶ Another limitation with similar effect, and subject to similar analysis, arises with respect to carrying nonbusiness losses to other taxable years. This limitation is discussed in note 94.

⁸⁷ IRC § 67.

⁸⁸ IRC § 68(a)–(b). This phase-out on adjusted gross income is itself phasing out *over time*. See IRC § 68(f)–(g). However, this phase-out over time (of the phase-out on adjusted gross income) “sunset” on December 31, 2010. See Economic Growth and Tax Relief Reconciliation Act of 2001 § 103, Pub L No 107-16, 115 Stat 38, 44 (adding § 68(f)–(g)), § 901, 115 Stat at 150 (general sunset provision for the Act applicable to the Act’s addition of § 68(f)–(g)). For tax year 2007, § 68 reduces certain otherwise allowable itemized deductions by no more than 53 1/3 percent. For tax year 2008, the reduction is no more than 26 2/3 percent. The reduction in allowable deductions imposed by § 68 is made after, and in addition to, the reduction imposed by § 67. See IRC § 68(d).

⁸⁹ IRC § 56(b)(1)(A)(i). Note that deductions so prohibited are not “carried forward” in the form of a “minimum tax credit” against future years’ regular tax liability under § 53. See IRC § 53(d)(1)(B)(ii)(I).

⁹⁰ These limitations would be imposed at the partner level only. Treas Reg 1.702-1(a)(8) (requiring certain items of partnership income and loss to be “separately stated,” including expenses for the production of income under § 212); Temp Treas Reg 1.67-2T(b) (instructing that the § 67 limit on miscellaneous itemized deductions be applied at the partner level and not at the

Would the partners' distributive shares of the partnership's salary expense deduction under the cash salary reinvestment plan be considered itemized deductions—or even worse, miscellaneous itemized deductions? The question is worth asking in part because the deduction allowed under § 212⁹¹ for expenses for the production of income is often categorized as a miscellaneous itemized deduction.⁹² Such expenses include those incurred in “managing investments.”⁹³

Nevertheless, it seems likely that the partners could avoid having their deductions treated as itemized deductions. In particular, if they so desired, the partners could structure their enterprise so that the deduction was treated as a (nonemployee) trade or business expense under § 162(a) for the partners.⁹⁴ It would thereby be deducted “above the line”—that is, from gross income in the process of calculating adjusted gross income.⁹⁵ The definition of “itemized deductions” excludes such above-the-line deductions.⁹⁶

partnership level); Treas Reg 1.58-2(b) (clarifying that partnerships per se are not subject to the alternative minimum tax). See also IRC § 68(d) (specifying that § 68's limits are applied after those imposed by § 67). A separate issue is the level at which deductions would be characterized for purposes of applying these limits at the partner level. This is discussed in the text to follow.

⁹¹ IRC § 212 (allowing a deduction for expenses paid or incurred for the production of income). Thanks to NYU Tax Symposium participants, and to Mitchell Engler in particular, for inspiring me to further investigate this issue and expand this discussion.

⁹² But not always. Section 212 expenses “attributable to property held for the production of rents or royalties” are subtracted from gross income in calculating adjusted gross income. IRC § 62(a)(4). They are, therefore, not itemized deductions. IRC § 63(d). Consequently, they are also not miscellaneous itemized deductions. See IRC § 67(b).

⁹³ *Higgins v Commissioner of Internal Revenue*, 312 US 212, 213–14 (1941) (denying an individual taxpayer a trade or business expense deduction under the precursor to § 162 for “salaries and expenses incident to looking after” his investments in stocks and bonds); *Commissioner of Internal Revenue v Groetzinger*, 480 US 23, 30 n 9 (1987) (stating that Congress added § 212 to permit a deduction (now limited) for expenses ruled nondeductible as trade or business expenses in *Higgins*).

⁹⁴ Also turning on trade or business characterization is another kind of deduction limit, the limit on carrying non-trade or business losses to other taxable years, as mentioned in note 86. If a taxpayer's allowable deductions exceed his gross income, his deductions are to this extent effectively disallowed in the current taxable year. IRC § 1 (providing tax schedules wherein zero is the lowest level of taxable liability). Unused deductions, however, may be applied to other taxable years in the form of net operating loss carrybacks or carryovers. IRC § 172(a). However, for noncorporate taxpayers, unused *non-trade or business* losses may only offset non-trade or business gross income in calculating the carryable net operating loss derived from any given year. IRC § 172(d)(4). This raises the possibility that non-trade or business losses will be permanently disallowed, rather than merely suspended. This scenario would not apply to the limited partner's deduction—even if the limited partner is a noncorporate taxpayer with an overall loss in the current year—if the losses were regarded as having been incurred in the conduct of a trade or business. The definition of “trade or business” is the same for purposes of applying § 172(d)(4) as it is for applying § 162(a), which is discussed in the text. *Malchin v Commissioner of Internal Revenue*, 42 Tax Ct Mem Dec (CCH) 847, 847 (1981).

⁹⁵ IRC § 62(a)(1).

⁹⁶ IRC § 63(d).

How might the partners' distributive share of the partnership's salary expense under the cash salary reinvestment plan be characterized as a trade or business expense? The argument has two steps.

First, characterization of the salary expense would occur at the partnership level, as if the partnership were an entity,⁹⁷ and this characterization would pass through to the partners.⁹⁸ The issue, therefore, is not whether either partner is engaged in a trade or business, but whether the fund partnership is so engaged.

Second, there is good reason to believe that the partnership's investments could be legally structured in such a way that the salary expense would be regarded as incurred in the conduct of a partnership trade or business, even for the limited partner. Whether an activity constitutes a trade or business "requires an examination of the facts in each case."⁹⁹ But a number of key factors point toward the feasibility of achieving trade or business characterization.

First, because trade or business characterization is at the partnership level and because the partnership has no existence apart from its efforts in attempting to revive one or more stagnant companies, it seems easier to satisfy the requirement for trade or business characterization that the "taxpayer . . . be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity . . . be for income or profit."¹⁰⁰

⁹⁷ IRC § 702(b); *Tallal v Commissioner of Internal Revenue*, 778 F2d 275, 276 (5th Cir 1985) ("When the taxpayer is a member of a partnership, we have interpreted § 702(b) to require that business purpose must be assessed at the partnership level. Accordingly, for the purpose of determining whether an expense is deductible under § 162(a), the partnership's motive controls, not an individual partner's motive for joining the partnership.") (citations omitted); *Barham v United States*, 301 F Supp 43, 44–47 (MD Ga 1969) ("[F]or the purpose of determining the nature of an item of income, deduction, gain, loss or credit (in the hands of a distributee partner, as well as in the hands of the partnership before distribution), the partnership is to be viewed as an entity and such items are to be viewed from the standpoint of the partnership . . . rather than from the standpoint of each individual member."), affirmed per curiam, 429 F2d 40, 41 (5th Cir 1970); *Brannen v Commissioner of Internal Revenue*, 78 Tax Ct 471, 505 (1982) ("Based on the holdings of the numerous cases above discussed, we conclude that the issue of whether an activity carried on by a partnership amounts to a trade or business must be determined at the partnership level."), affirmed, 722 F2d 695 (11th Cir 1984).

⁹⁸ IRC § 702(b); Treas Reg § 1.702-1(b) (noting that "[t]he character in the hands of a partner of any item of income, gain, loss, deduction, or credit . . . 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," and providing as an example the partnership-level determination of whether an asset is used in a trade or business for purposes of determining whether gain from the sale thereof is taxed at favorable rates by virtue of IRC § 1231).

It is important to distinguish the case in which an expense is, *at the partnership level*, a miscellaneous itemized deduction, such as might arise under § 212. That characterization would likewise flow through to the partners. See IRC § 67(c); Treas Reg § 1.67-2T(a).

⁹⁹ *Higgins*, 312 US at 217. See also *Groetzinger*, 480 US at 32, 36 (emphasizing the factual nature of the determination).

¹⁰⁰ *Groetzinger*, 480 US at 35.

Second, it also seems quite possible that if the partnership purchases a division or company and holds it directly—as opposed to holding shares in its corporate form—the trade or business of the division or company would be imputed to the partnership.¹⁰¹ Arguably, a private equity fund that purchases the assets of an automaker and operates it as such is in the trade or business of making automobiles.

Lastly, the line of cases holding that “expenses incident to caring for one’s own investments, even though that endeavor is full time, are not deductible as paid or incurred in carrying on a trade or business”¹⁰² seems easily distinguishable in the case of private equity partnerships.¹⁰³ It is true that the taxpayer in *Higgins v Commissioner of Internal Revenue*,¹⁰⁴ the leading case in this line, was denied a trade or business expense deduction for expenses incurred in managing his investments in stocks and bonds. But he “did not participate directly or indirectly in the management of the corporations in which he held stock or bonds.”¹⁰⁵ Rather, he “merely kept records and collected interest and dividends from his securities, through managerial attention for his investments.”¹⁰⁶ Notably, the taxpayer’s trade or business characteriza-

¹⁰¹ What if the underlying business is in corporate form? If the business is in corporate form and the private equity fund holds shares in such corporation, the trade or business of the corporation will *not* be imputed to the private equity fund. *Whipple v Commissioner of Internal Revenue*, 373 US 193, 202 (1963). This does not establish that the private equity partnership is not engaged in a trade or business. *Id.* at 203–05 (leaving open the possibility that a supra-majority shareholder may be engaged in trade or business related to her shareholdings but distinct from any imputation of the corporation’s trade or business.). However, it would seem to make trade or business characterization less likely.

Thus, holding investments in corporate form may help to *avoid* trade or business characterization when such characterization would generate unrelated business income tax for tax-exempt limited partners. See IRC § 511 et seq (imposing unrelated business income tax). Note in this regard that the participation of taxable and tax-exempt investors may be differently structured under separate partnership agreements. See note 163 regarding the existence of varying agreements across investors. Note also that blocking the pass-through of trade or business character might also be achieved by interposing a corporation between the tax-exempt entity and its participation in the private equity partnership, as opposed to interposing a corporation between the private equity partnership and its investment in the underlying business. See note 16 for a discussion of this latter form of “blocker” corporation.

¹⁰² *Groetzinger*, 480 US at 31, citing *Higgins*, 312 US 212, *City Bank Farmers Trust Co v Helvering*, 313 US 121 (1941), and *United States v Pyne*, 313 US 127 (1941).

¹⁰³ Compare Andrew Needham, 95 Tax Notes 1215, 1230 n 89 (2002) (citing *Higgins* to support the proposition that the fund partnership would not be regarded as engaged in a trade or business).

¹⁰⁴ 312 US 212 (1941).

¹⁰⁵ *Id.* at 214.

¹⁰⁶ *Id.* at 218. For a more recent case that is similarly distinguishable, see *Schmidt v Commissioner of Internal Revenue*, 46 Tax Ct Mem Dec (CCH) 1586, 1586 (1983) (denying a § 162 deduction for a partner’s distributive share of a partnership’s construction cost overruns based on the finding that the partnership was not engaged in a trade or business, and basing this finding on the taxpayers’ failure to produce sufficient evidence that the partnership took an active role in the construction project, or indeed “engaged in any activity, supervisory or otherwise”).

tion of similar expenses incurred in his “real estate activities . . . in renting buildings” was not contested, as the Court carefully notes.¹⁰⁷

It is one thing to manage one’s investments in businesses. It is another to manage the businesses in which one invests.¹⁰⁸ The hands-on nature of their investment model is arguably a defining feature of private equity partnerships.¹⁰⁹ These partnerships are not “investment clubs”¹¹⁰ formed for sharing stock tips or brokerage fees. The prototypical private equity partnership purchases a stagnant company with a plan to turn it around and with the intention to exercise the control necessary to implement its plan. That underlying economic reality seems capable of being reflected in the tax characterization of the fund manager’s salary payment (to the extent that the partners so desire).¹¹¹

Even so, trade or business characterization is, as noted, determined under a “facts and circumstances” test.¹¹² And it is certainly possible that for any given legal and/or economic structure other factors will predominate. Perhaps, for example, the fund is, by the terms of the partnership agreement, relatively short-lived, so that its activities are not considered regular and continuous.¹¹³ Or perhaps the fund is relatively diversified across a wide range of investments over which it exercises relatively little control, so that on the continuum between *Higgins* and the automaker, the fund falls close enough to *Higgins* to preclude trade or business characterization.

Thus, it is worth asking: what *would* happen to the timing, character, and magnitude of the partners’ adjusted gross incomes, if the deduction were regarded as a § 212 expense and thereby limited? For

¹⁰⁷ *Higgins*, 312 US at 213–14.

¹⁰⁸ A separate issue is whether, if such businesses are held in corporate form, the trade or business of the corporation will be imputed to the active controlling shareholder. As noted, *Whipple*, 374 US at 202, holds against imputation across the corporate boundary. But the same case leaves open the possibility that the controlling shareholder is engaged in a separate trade or business in his individual capacity. *Id.* at 203–05.

¹⁰⁹ Metrick and Yasuda, *The Economics of Private Equity Funds* at 7 (cited in note 1) (concluding, based on extensive survey data, that the “median [venture capital] fund expects to make 20 investments, which yields five investments per partner at that fund. . . . [E]ach investment typically requires significant work from a venture capitalist. . . . [Buyout funds] tend to make larger investments and require even more intense involvement on each one, with the median fund making only 12 investments, or 2.4 per partner”). See generally Thornton, *What’s Bigger than Cisco, Coke, or McDonald’s?*, *Bus Wk* at 100–10 (cited in note 1) (offering a rare journalistic account of how private equity firms operate).

¹¹⁰ Rev Rul 75-523, 1975-2 Cum Bull 257 (holding that ministerial expenses of a partnership formed to invest in securities are deductible under § 212 and not § 162).

¹¹¹ See the second paragraph of note 101 regarding tax-exempts, unrelated business income, and blocker corporations.

¹¹² See note 99.

¹¹³ See note 100.

simplicity let us suppose that the partners are entirely precluded from taking the deduction.¹¹⁴

Consider first year one. Moving from the cash salary reinvestment plan to the imputed salary plan now has no effect on the limited partner in year one because she now loses no deduction. The general partner, on the other hand, lowers her ordinary income by a full \$1 million in year one, rather than by \$900,000. Her reduction in ordinary income from avoiding current salary is no longer tempered by the loss of her distributive share of the salary expense deduction.

The partners' bases in their partnership interest going into year two are unaffected by the fact that their year one deduction was limited. This is trivially true under the imputed salary plan. But it is also true under the cash salary reinvestment plan. In particular, under the cash salary reinvestment plan, each partner still reduces her basis in her partnership interest by her distributive share of the salary expense deduction, even though neither was actually able to take this deduction.¹¹⁵ Therefore, under the cash salary reinvestment plan, the general partner still enters year two with a basis in her partnership interest of \$900,000 (\$1 million from her contribution less \$100,000 for her distributive share of the deduction). Similarly, the limited partner still enters year two with a basis in her partnership interest of \$100,000 (\$1 million from her contribution less \$900,000 for her distributive share of the deduction).

Since the partners' adjusted bases are unaffected by the deduction limits, so too are their capital gains in year two. In particular, under the cash salary reinvestment plan, the general partner still has \$2.1 million of capital gains and the limited partner still has \$2.9 million. Moving to the imputed salary plan still increases the general partner's year two capital gains by \$900,000 (by virtue of the forgone basis increase from the cash contribution net of the deduction share). Similarly, moving to the imputed salary plan still decreases the limited partner's year two capital gains by the same amount (by virtue of his avoiding a decrease in basis for her share of the year one deduction).

Thus, for the general partner, moving from the cash salary reinvestment plan to the imputed salary plan reduces her year one ordinary income by \$1 million and in return increases her year two capital gains by \$900,000. Notice that her total adjusted gross income is not now constant over the plans, but rather falls by \$100,000. For the limited partner, moving from the cash salary reinvestment plan to the

¹¹⁴ Note also that, as discussed in note 90, these limitations would be applied only at the partner level.

¹¹⁵ IRC § 705(a)(2)(A).

imputed salary plan has no effect on his year one ordinary income and reduces his year two capital gains by \$900,000. The limited partner's total adjusted gross income is also reduced (by \$900,000) as a result of the shift in plans.

Jointly, then, moving from the cash salary reinvestment plan to the imputed salary plan reduces the partners' total adjusted gross incomes by \$1 million. The change in year two capital gains across the two partners is still zero-sum: it is as if the limited partner gives the general partner \$900,000 of year two capital gains. The entire \$1 million reduction in joint adjusted gross income comes in the form of a reduction in year one ordinary income—in particular, the year one ordinary income of the general partner.¹¹⁶

Thus, when the salary expense deduction is limited, the imputed salary plan is joint tax advantaged relative to the cash salary reinvestment plan, even if the partners' marginal tax rates are precisely the same. This is because the imputed salary plan effectively avoids the deduction limit by excluding the salary altogether, rather than including it and then attempting to deduct it.

What does it mean, though, that the tax advantage of service-compensatory profits interests is a matter of avoiding the limits on deducting expenses for the production of income under § 212? In the first place, avoiding such limits seems quite different in form from the conventional conception of the tax advantage as one-sided conversion and deferral for the fund manager. Moreover, it is arguably quite different normatively. What the partners are avoiding under this conception of the tax advantage is not itself easy to justify as a policy matter. After all, why should expenses for the production of non-trade or business income be disfavored relative to expenses for the production of trade or business income? The income produced in either case is not (necessarily) differently taxed. Income from a portfolio of bonds is ordinary, as is income from sales of goods and services. Income from the sale of stock is capital gains, as is income from the sale of going concern value.

Congress originally enacted § 212 expressing similar sentiments. *Higgins*, decided in 1941 prior to enactment of § 212, disallowed a deduction for expenses incurred by the taxpayer in looking after his in-

¹¹⁶ If one ignores the effect on the general partner's distributive share of the deduction, one can also easily conceive of this effect in terms of rate differences across the partners. In particular, one views the limited partner's marginal tax rate on year one ordinary income to be zero. With respect to conversion, we will do just this in Part III.E.2. If one accounts for the general partner's distributive share of the deduction, however, reconceiving of the effect in terms of rate differences is possible but less convenient, as it would require introducing two rates on ordinary income: one for deduction and one for inclusion.

vestments in stocks and bonds. In the following year, Congress passed § 212 to rectify what it viewed as the inequitable result in that case.¹¹⁷ Importantly, the deduction limits that now apply to § 212 did not exist at the time.¹¹⁸ The Tax Court in *DiTunno v Commissioner of Internal Revenue*¹¹⁹ highlights this excerpt from the 1942 Congressional Record:

Trade or business has received such a narrow interpretation that many meritorious deductions are denied. The Supreme Court [in *Higgins*] held that expenses in connection with a taxpayer's investments in income-producing properties were not deductible, on the ground that making casual investments was not a trade or business. Since the income from such investments is clearly taxable it is inequitable to deny the deduction of expenses attributable to such investments.¹²⁰

Indeed, the Supreme Court itself, in *Commissioner of Internal Revenue v Groetzinger*,¹²¹ seems unimpressed with its earlier ruling in *Higgins*, calling the opinion "bare and brief" and "devoid of analysis."¹²²

C. Suspension: Possibility and Effect

Suppose that the partnership may deduct, rather than capitalize, the fund manager's salary. Suppose also that the partners' distributive shares of this deduction would not be permanently disallowed. But imagine now that the limited partner, lacking offsetting income in year one, can only take the deduction in year two. (We focus in this subpart on the limited partner, because as will become clear below, it is unlikely that the provisions that might suspend the limited partner's deduction would apply to the general partner.)

Under this scenario, adopting the imputed salary plan would still be zero-sum with regard to character. But it would no longer be zero-sum with regard to timing. Rather, adopting the imputed salary plan would effect an overall net delay in the partners' joint tax liability.

¹¹⁷ See *DiTunno v Commissioner of Internal Revenue*, 80 Tax Ct 362, 372 n 14 (1983) ("Congress was evidently surprised at the result in *Higgins*. . . . By enacting sec. 212, the Congress intended to restore meritorious deductions which *Higgins* denied.").

¹¹⁸ Section 67, limiting miscellaneous itemized deductions, was enacted in 1986. See An Act to Reform the Internal Revenue Laws of the United States, Pub L No 99-514, 100 Stat 2085 (1986). Section 68, imposing an overall limit on itemized deductions, was enacted in 1990. See An Act to Provide for Reconciliation Pursuant to Section 4 of the Concurrent Resolution on the Budget for Fiscal Year 1991, Pub L No 101-508, 104 Stat 1388 (1990). The alternative minimum tax was enacted in 1969. See An Act to Reform the Income Tax Laws, Pub L No 91-172, 83 Stat 487 (1969), codified at IRC § 55.

¹¹⁹ 80 Tax Ct 362 (1983).

¹²⁰ *Id.* at 372 n 14, quoting 88 Cong Rec 6376 (1942).

¹²¹ 480 US 23 (1987).

¹²² *Id.* at 29-30.

Under the cash salary reinvestment plan, even though the limited partner would not be able to deduct the general partner's net salary income in year one, he would still lower his basis in his partnership interest by this amount.¹²³ The limited partner would then carry the unused deduction forward to year two. At that time, he would take the deduction (and not additionally lower his basis). He would still have \$2 million of adjusted gross income over the two years. But now, instead of a year *one* deduction of \$900,000 and year two capital gains of \$2.9 million, he would have a year *two* deduction of \$900,000 and year two capital gains of \$2.9 million.

Under the imputed salary plan, on the other hand, suspension would not change the timing of the limited partner's adjusted gross income. Under the imputed salary plan, the limited partner would have no deduction in either year and also no offsetting basis reduction in either year. The limited partner's adjusted gross income would still consist solely of year two capital gains of \$2 million.

Therefore, were the limited partner's deduction under the cash salary reinvestment plan suspended, adopting the imputed salary plan would decrease his year two capital gains by \$900,000 and increase his year *two* (not now year *one*) ordinary income by the same amount. Adopting the imputed salary plan would now affect only the character, and not the timing, of the limited partner's adjusted gross income.

For the *general* partner, adopting the imputed salary plan would affect the timing and character of adjusted gross income in the manner described above. Suspension of the limited partner's deduction would have no impact. Adopting the imputed salary plan would still lower the general partner's year one ordinary income by \$900,000 and raise her year two capital gains by the same amount.

All told, then, adopting the imputed salary plan would produce for the partners a *joint* deferral of taxation. The partners' joint capital gains would remain the same—the general partner's increasing by \$900,000, the limited partner's decreasing by the same amount. But the general partner's year *one* ordinary income of \$900,000 would become the limited partner's year *two* ordinary income.

To foreshadow the analysis in the next Part, because the deferral benefits would be joint, and not offsetting, adopting the imputed salary plan would be tax beneficial even if the partners had precisely the same tax rates. The joint deferral would still be beneficial so long as the general partner's tax rate on year one ordinary income is positive, the partnership has positive financing costs, and tax rates are not expected to increase markedly over time.

¹²³ IRC § 705(a)(2)(A).

It is worth pausing to compare the impact of suspension to the impact of capitalization with and without ordinary income cost recovery.¹²⁴ With neither suspension nor capitalization, there is no joint effect of either kind: both deferral and conversion are zero-sum across the partners. Suspension adds joint deferral. Capitalization with ordinary income cost recovery, as for depreciation, is essentially the same as suspension. Capitalization without ordinary income cost recovery adds both joint deferral and joint conversion.

How important is the possibility that the limited partner's deduction will be suspended? There are three important points to emphasize here. First, to reiterate, even with suspension, a sizable portion of the potential tax gains from service-compensatory profits interests—namely those attached to character conversion and the sizable gap in current law between the rate on ordinary income and the rate on capital gains—remains tethered to the zero-sum analysis that we have put forth.

Second, the joint deferral generated by service-compensatory profits interests in the face of a suspended deduction is readily available by other means (as discussed in Part III). That is, if the partners' goal is merely to align the timing of the general partner's service compensation with that of the limited partner's deduction, service-compensatory profits interests are not needed. The partners can do this contractually by arranging to pay the general partner in year two for his year one service provision. Consequently, it would probably be inaccurate to describe joint deferral generated in the face of suspended deductions as a tax advantage of service-compensatory profits interests.

Lastly, the likelihood that the limited partner's deduction will be suspended is probably not as great as it may at first seem.

The deduction would probably not be suspended as a capital loss,¹²⁵ because it derives from a salary payment at the partnership level and this characterization would pass through to the limited partner. It would probably not be suspended by virtue of the at-risk rules,¹²⁶ because the limited partner's investment (\$1 million) exceeds his distributive share of the general partner's year one salary (which will

¹²⁴ For a discussion of how capitalization might be combined with ordinary income cost recovery, see note 84 and accompanying text.

¹²⁵ IRC §§ 1211(a) (imposing capital loss limits for corporations), 1212(a) (allowing carry-back and carryforward of capital losses for corporations), 1211(b) (imposing capital loss limits for noncorporate taxpayers), 1212(b) (allowing carry forward of capital losses for noncorporate taxpayers), 702(a)(1)–(2) (requiring a partner to separately account for partnership capital gains and losses).

¹²⁶ IRC § 465 (limiting taxpayer's deductions for "losses" to the amount she has "at risk"; discussed in more detail in note 127); Treas Reg § 1.702-1(a)(8)(ii) (requiring a partner to separately account for items of partnership income and loss whenever such separate accounting results in different tax liability).

presumably often be the case).¹²⁷ It would probably not be suspended by virtue of the fact that it zeroes out the limited partner's adjusted basis in his partnership interest,¹²⁸ because, again, the limited partner's contribution, which increases his basis, is likely to exceed his distributive share of the deduction.

The deduction might be suspended if it were deemed a loss from a passive activity (which characterization seems likely), but only if the limited partner had inadequate offsetting income from other passive activities in year one.¹²⁹ Even if the limited partner had adequate offsetting income from other passive activities in year one (or if, however unlikely, the partnership enterprise were not deemed a passive activity), the deduction might still be suspended if the limited partner's gross income were inadequate to offset her full set of allowable de-

¹²⁷ The "at-risk" rules (IRC § 465) are also unlikely to limit the *general* partner in taking her distributive share of the deduction. The general partner is allowed *losses* from the partnership only to the extent to which she is "at-risk" in the partnership enterprise. IRC § 465(a), (c). "Losses" are defined for purposes of § 465 in IRC § 465(d). Section 465(d) does not define "losses" to be (otherwise) allowable deductions allocable to the activity. Rather, it defines "losses" as the excess of such deductions over "income received or accrued by the taxpayer during the taxable year from such activity." Presumably, the general partner's salary income would qualify as "income received or accrued by the taxpayer during the taxable year from such activity." Therefore, netting the deduction against the salary, there would be no "loss" for purposes of § 465.

¹²⁸ IRC § 704(d) (limiting a partner's distributive share of partnership losses to partner's adjusted basis in partnership).

¹²⁹ IRC § 469(c), (h) (defining "passive activity" and "material participation"), 469(a), (d), (g) (allowing, in any taxable year, deductions derived from a passive activity only to the extent of net income, if any, (not counting such deductions), from all passive activities in such taxable year, or upon a fully tax-recognized disposition of the taxpayer's entire interest in the particular passive activity), 469(b) (treating losses disallowed by § 469(a) as passive losses in the next tax year).

In the typical private equity scenario, it seems likely that the partnership enterprise would be deemed a passive activity for the limited partner. See IRC § 469(c), (c)(1)(A), (c)(1)(B) (defining "passive activity" to generally include any activity in connection with a trade or business or the production of income in which taxpayer does not "materially participate"), 469(h)(1) (defining "material participation" generally). See also IRC § 469(h)(2), (1)(3); Temp Treas Reg § 1.469-5T(a)(1), (a)(5), (a)(6), (e)(3), (d) (deeming the limited partner to not materially participate in the partnership enterprise, unless, roughly speaking, the limited partner participates more than 500 hours in the activity in the current year or in any five of the last ten years).

See also IRC § 469(c)(2), (c)(4), (j)(8) (defining "rental activities" to be those "where payments are principally for the use of tangible property," and deeming rental activities passive without regard to whether the taxpayer materially participates), which is only partially modified by IRC § 469(c)(7) (restoring the material participation test, including its special application to limited partners, for rental *real* estate trades or businesses, if a substantial portion of the taxpayer's personal services supplied to any trade or business are supplied to the class of rental real estate trades or businesses).

ductions,¹³⁰ but only if the limited partner were unable to carry the net operating loss back to prior tax years.¹³¹

But even in both of these cases, it is important to recognize that the limited partner would be able to offset the deduction with income from activities other than the particular partnership enterprise in question. (In the passive activity case, these other activities would have to be deemed passive as well.) Importantly, the question is not whether the *partnership* has current income against which to offset the salary deduction; plausibly, private equity partnerships have little if any positive income in their early years. Rather, the question is whether the *partner* has such income.

D. Employment and Self-employment Taxes

Adopting the imputed salary plan reduces the partners' joint tax base for employment/self-employment taxes. Under the cash salary reinvestment plan, the partnership and the fund manager would each owe their respective shares of social security and Medicare taxes, and the partnership would owe unemployment tax on the fund manager's salary.¹³² Under the imputed salary plan, however, neither the general partner nor the limited partner would owe any such taxes on the gen-

¹³⁰ This could occur, despite the hypothesized existence of offsetting *passive* income, were the deductions attributable to *nonpassive* activities in excess of the gross income attributable to such nonpassive activities.

¹³¹ IRC § 172(c) (defining "net operating loss"), 172(a)–(b) (allowing two year carryback and 20 year carryover of net operating losses). Note that the limited partner's distributive share of the salary expense deduction would most likely count toward her net operating loss, and so be available for carryback or carryover. See note 94 and accompanying text.

¹³² Sections 3201–41 of the Internal Revenue Code impose two taxes on "wages" for each of employers and employees. See IRC § 3121(a) (defining "wages"). The first tax is for purposes of providing old-age, survivors, and disability insurance (commonly referred to as "social security"). This tax is imposed once on the employee and once on the employer, in each case at a rate of 6.2 percent on the first \$97,500 (for 2007) of wages paid to such an employee. See IRC §§ 3101(a) (setting rate for employee), 3111(a) (setting rate for employer), 3121(a)(1) (limiting tax base to \$97,500 of wages by reference to social security "contribution and benefit base"); 42 USC § 430 (2000) (determining "contribution and benefit base").

The second tax on "wages" is for purposes of providing hospital insurance to the aged and disabled (commonly referred to as "Medicare"). It is imposed once on the employee and once on the employer, in each case at a rate of 1.45 percent on *all* wages without limit. IRC §§ 3101(b) (specifying rate for employee), 3111(b) (specifying rate for employer).

Sections 3301–11 of the Internal Revenue Code impose an additional unemployment tax upon employers only. The tax is 6.2 percent of the wages paid to each employee up to a wage limit of \$7,000. IRC §§ 3301(a) (setting rate), 3306(b)(1) (limiting tax base to \$7,000 of wages).

In calculating her *income* tax, the employer takes an "above-the-line" deduction for her share of the three aforementioned taxes paid with respect to each employee. IRC §§ 164(a) (allowing deduction), 62(a)(1) (allowing deduction above the line).

To varying extents, according to a complex set of rules, and subject to congressional will, the individual's payment of these taxes is tied to her receipt of specific government benefits under the corresponding benefit programs.

eral partner's implicit earnings from service provision. Furthermore, the elimination of such employment taxes would not seesaw with the imposition of self-employment tax¹³³ on the general partner: the general partner's service compensation would, by assumption, accrue in the form of capital gains under the imputed salary plan, and such income is excluded from the self-employment tax base.¹³⁴ Thus, by adopting an imputed salary plan wherein salary is paid in capital gains, the partnership dodges not only employment taxes (via removing the compensation from the definition of "wages"), but also self-employment taxes (via the capital gains character of the compensation as eventually paid).

However, figuring in wage ceilings and employer deductions for taxes paid, the relevant rate for these tax savings is only between 2.39 percent and 2.90 percent.¹³⁵ Thus, even when we include employment and self-employment taxes in the analysis, it is still true, as argued in this Article, that the bulk of the tax advantage for service-compensatory profits interests is a "joint tax arbitrage" that exploits differing rates in the income tax. Thus, with appropriate qualifications, we will continue

¹³³ Sections 1401–03 of the Internal Revenue Code impose two taxes on "self-employment income," which consists roughly of the nonportfolio trade or business income of sole proprietors and (nonlimited) partners. IRC § 1402 (defining "self-employment income"), 1402(a)(1)–(3) (excluding portfolio income), 1402(a)(13) (excluding earnings of limited partners). The first tax is for purposes of providing old-age, survivors, and disability insurance (commonly referred to as "social security"). This tax is imposed at a rate of 12.4 percent on the first \$97,500 (for 2007) of self-employment income. IRC §§ 1401(a) (specifying rate), 1402(b)(1) (limiting base to \$97,500 via reference to the social security "contribution and benefit base"); 42 USC § 430 (determining "contribution and benefit base").

The second tax is for purposes of providing hospital insurance to the aged and disabled (commonly referred to as "Medicare"). It is imposed at a rate of 2.9 percent on all "self-employment income." IRC § 1401(b). In calculating "self-employment income" for purposes of applying either of these taxes, the taxpayer does not take the income tax deduction under IRC § 164(f), as described in the next sentence, but rather deducts one half of what his total tax liability summed across the two taxes would be were "self-employment income" determined in the absence of any deduction for such self-employment tax payment. IRC § 1402(a)(12).

In calculating her *income* tax, the individual takes an above-the-line deduction for one half of her self-employment tax liability. IRC §§ 164(f)(1) (specifying deduction amount), 164(f)(2) (treating deduction as nonemployee trade or business expense), 62(a)(1) (allowing above-the-line deduction for nonemployee trade or business expense).

To varying extents, according to a complex set of rules, and subject to congressional will, the individual's payment of these taxes is tied to her receipt of specific government benefits under the corresponding insurance programs.

¹³⁴ IRC § 1402(a) (defining "self-employment income," the tax base for the self-employment tax and specifically treating a partner's distributive share of partnership income or loss). As this section indicates, if the returns to the general partner's service provision via her profits interest came in the form of pass-through partnership income, rather than partnership liquidation, the general partner might owe *self-employment* tax on this amount depending on the character of such income. Partners owe self-employment tax on pass-through partnership income, but not income from the sale or exchange of capital assets or real or depreciable property used in a trade or business, or dividends, interest, or rents.

¹³⁵ See notes 132–33.

to characterize the tax advantage to service-compensatory profits interests in this way throughout the remainder of the analysis.

III. THE TAX ADVANTAGE(S) OF SERVICE-COMPENSATORY PROFITS INTERESTS

Part I established a base case for the effect of service-compensatory profits interests on the timing, character, and magnitude of partners' incomes. Relative to its explicit salary equivalent, compensation by profits interests effects a "diagonal swap" between the fund manager/general partner and the investors/limited partners. The general partner transfers X amount of ordinary income to the limited partners, who give X amount of long-term capital gains in return. Part II evaluated several potential qualifications to this base case conception, finding that such qualifications complicate the story, but leave intact the conceptual understructure laid out in Part I. This Part returns to the base case, setting out its chief implications and emphasizing the important role played by differences in partners' tax rates.

The base case proposition that service-compensatory profits interests effect a diagonal swap among the partners has several corollaries, each with its own implications for policy as well as for the interpretation of existing commentary. Part III.A explains these corollaries and their implications in general terms. The rest of Part III lays them out more systematically in the context of the extended example introduced in Part I.B.

A. Implications of the Diagonal Swap in General Terms

The first corollary concerns the constancy of each partner's total adjusted gross income. If we aggregate over time and character of income, each partner taken individually has the same adjusted gross income (for tax purposes) under either compensatory plan (imputed salary or cash salary reinvestment). That is, in terms of adjusted gross income of all types and for all tax years, the swap is not only zero-sum across the partners, but also zero-sum for each partner taken individually. The dollar amount of adjusted gross income given by each partner equals the dollar amount that he or she receives.

This, in turn, means two things. Because the general partner has the same adjusted gross income under both plans, there is, in fact, no *untaxed* imputed income under the imputed salary plan. In contrast, some commentators portray untaxed imputed income as a third tax benefit of service-compensatory profits interests—distinct from and in

addition to conversion and deferral. Indeed, some regard it as the chief benefit.¹³⁶

Furthermore, because adopting the imputed salary plan does not shift adjusted gross income among the partners, the plan has no pure income-shifting tax advantage—as taxpayers might attempt to obtain by shifting adjusted gross income to low-tax-rate spouses or children. No one appears to have explicitly made the claim that service-compensatory profits interests do offer pure income-shifting advantages similar to those that are available (or prevented) elsewhere in the Code. And yet income shifting often seems to lurk ambiguously in the background in existing explanations of the tax advantage to compensatory profits interests. It is, therefore, worth clarifying that there is no *pure* income-shifting tax benefit, in order to distinguish more complex forms of income shifting that do occur—forms that combine income shifting with conversion and deferral.

The second corollary concerns the amount of each type of income aggregated across the partners. The total amount of capital gains income across all partners is the same across the two compensatory plans, as is the total amount of ordinary income. That is, shifting to the imputed salary plan is zero-sum in yet another sense: it is zero-sum in aggregate across all partners *within* each category of tax character. The fact that the general partner does not eliminate ordinary income in favor of capital gains, but rather merely swaps it for capital gains

¹³⁶ Fleischer, 83 NYU L Rev (forthcoming 2008) (cited in note 6):

One largely overlooked anomaly in the system is the treatment of sweat equity. Sweat equity, as I define it here, is the ability to invest with pre-tax dollars in one's own business. Sweat equity is more lightly taxed than other forms of labor income. . . . [T]he subsidy . . . does not stem only from the capital gains preference. Rather, it comes from the choice we make not to tax the imputed income that accompanies working for oneself—the ability to invest with pre-tax dollars.

...

The model just described breaks down in two ways, however, revealing the subsidy for entrepreneurship. The first is in the assumption of constant tax rates. . . . The second way the model breaks down . . . is its failure to tax the imputed income that comes from investing in a self-created asset. In more familiar terms, the service partner has the ability to invest in his own business using pre-tax dollars. As we shall see, it is the failure to reach this imputed income that provides much of the subsidy.

...

Surprisingly, treating all carried interest allocations as ordinary income does not eliminate the tax advantage associated with a profits interest in a partnership. Specifically, it fails to tax the imputed income from investing labor in one's own business using pre-tax dollars.

See also Ordower, 7 UC Davis Bus L J at 361 (cited in note 1) (“Rather than investing in a partnership with assets or money that had been taxed before the partner used that capital to invest in the partnership, as other partners do, partners who received only profits interests for services invest with untaxed service income. A change in the rule makes sense.”).

with the other partners, means that there is no real tax advantage to the imputed salary plan unless the general partner is taxed differently from the other partners. Were all partners taxed in the same way, compensatory profits interests would reduce the fund manager/general partner's tax bill only nominally. The other partners would most likely demand compensation (perhaps via a rearrangement of partnership interests) for an offsetting increase in their own tax bills. In effect, the general partner would end up paying no less in "tax," broadly defined.

Third, understanding the nature of the swap affecting character—as opposed to timing—allows us to pinpoint the kind of tax differences that are necessary and sufficient to make such symmetric conversion advantageous for the partnership as a whole—and so for the general partner in particular. Importantly, what matters is not a difference in tax rates per se, but a "difference in differences": that is, a difference across partners in terms of a difference in applicable tax rates across kinds of income and deductions. One, but only one, example of a tax difference sufficient for a character-based tax advantage is when the general partner is an individual subject to 35 percent on ordinary income and 15 percent on capital gains, and the other partners are tax exempt—as are many limited partners in private equity funds. In that case, the limited partners are indifferent to being on the "bad side" of the character swap. But tax-exempts provide just one example. Corporate limited partners, who do not have access to the lower rate on long-term capital gains, would also be indifferent. It is conceptually important to note that this is so even if the corporate limited partner's income falls in one of the ranges wherein the tax rate for corporations is larger than the maximum rate for individuals. The swap works when the limited partner's rate *difference* is lower than the general partner's. The *level* of the limited partner's rate (or rates) may be higher or lower.

Fourth, the character swap would be tax *disadvantageous* if a sufficient number of other partners were individuals who had even more reason than the general partner to prefer capital gains over ordinary income. Such might be the case, for example, if such other partners had carryover capital losses or anticipated basis step-ups prior to the realization of their partnership interests.

More generally, a private equity fund may collect a mixed set of partners. In this case, even if the character swap effected by service-compensatory profits interests means a lower tax bill in aggregate across all partners, the partnership agreement(s) would have to be tailored to the tax position of each limited partner. Otherwise, in the process of compensating the partners who end up with higher taxes, the agreement would also compensate those who end up with the same or lower taxes.

Fifth, the swap in *timing*—as opposed to character—that is effected by service-compensatory profits interests also requires a tax difference for there to be a joint tax advantage for the partnership as a whole. The general partner must prefer later to earlier tax payment to a greater extent than (a sufficient number of) the other partners. This condition is, of course, satisfied if the other partners are tax exempt, since zero paid now is the same as zero paid later. But the important tax difference across partners is not the same as for the character swap examined above. A corporate partner, for example, who is otherwise happy to swap capital gains for ordinary income, would not be happy to swap later income for earlier, and might even be less happy to do so than the general partner. In general, the higher the level of a taxpayer's tax rate, the more the taxpayer dislikes shifting adjusted gross income forward.

From this follows the sixth point: the ideal other partner for maximizing the tax benefits of service-compensatory profits interests is the tax-exempt partner. Not only is the tax-exempt partner indifferent to taking ordinary income for capital gains, but he is also indifferent to shifting income forward. The fact that tax-exempt partners are ideal for this tax benefit is reflected in the fact that many of the limited partners in private equity are indeed tax exempt. It is interesting to note that the tax-exempt partner only becomes preferable to the corporate partner when the timing dimension is added to the picture. Considering the character swap on its own, these limited partners are equally preferable.

Seventh: that said, even though the timing swap plays an important role in shaping how best to reap the tax benefit of service-compensatory profits interests, it is not clear that such benefits can really be considered a tax advantage of service-compensatory profits interests per se—or at least not an *incremental* tax advantage, or one limited to private equity, or even, more generally, partnerships with service partners. This is because the same tax benefit can be accessed by other means to more or less the same extent. For example, the partners could contractually defer fund manager compensation under a so-called nonqualified deferred compensation plan.¹³⁷

Thus, the timing swap effected by service-compensatory profits interests stands in a complicated relationship to what can really be considered the true tax advantage of such profits interests. The true tax

¹³⁷ Rev Rul 60-31, 1960-1 Cum Bull 174 (giving tax effect to certain deferred compensation plans). See also Daniel Halperin and Ethan Yale, *Deferred Compensation Revisited 6-7* (Georgetown University Law Center, Business, Economics, and Regulatory Policy Working Paper Series Research Paper No 969074, Feb 2007), online at <http://ssrn.com/abstract=969058> (visited June 8, 2008) (explaining the taxation of nonqualified deferred compensation).

advantage over other arrangements is the ability to swap tax character with partners who are differently taxed. Packaged with this character swap is a timing swap—one that could be accomplished by other means but that does affect the overall tax consequences of service-compensatory profits interests, and so shapes the determination of the ideal tax position for the partners on the other side of the transaction.

The remainder of this Part considers these issues in more detail, making frequent use of the example introduced in Part I.B.

B. Imputed Income

The tax advantage of service-compensatory profits interests has been associated with the Code's failure to tax imputed income from self-provided goods and services. Some commentators have gone so far as to assert that it is this feature of service-compensatory profits interests—and not character conversion or deferral—that constitutes the chief source of the tax advantage.¹³⁸

The precise nature of this third tax advantage is not always clearly delineated. If we view the issue in the context of the extended example from Part I.B, it appears that at least three distinct issues are being referenced: (1) the general partner's year one salary is merely imputed and not actually paid under the imputed salary plan; (2) the general partner may to some extent be providing investment management services to *herself* under the imputed salary plan; and (3) the general partner has more left to invest in year one under the imputed salary plan because she is not required to pay taxes in that year.¹³⁹ Let us consider these issues in turn.

1. Imputed income.

It is true that the general partner's salary in year one is merely imputed, and not actually paid out, under the imputed salary plan. And it is, therefore, tempting to associate this with other examples of imputed income in the tax code wherein such income escapes taxation: as when an individual paints her own house and pays no tax on the imputed income that accrues to her in the form of her personal enjoyment of a fresh paint job.

But it must be clarified that imputed income is not the same as *untaxed* imputed income. And in the case of the imputed salary plan, unlike the case of the housepainter just described, the imputed income is indeed taxed.

¹³⁸ See note 136.

¹³⁹ *Id.*

As we have seen, under the imputed salary plan, the general partner's basis in her partnership interest going into year two is lower by precisely the extent to which she is not taxed in year one on her imputed salary. Such imputed salary is thus taxed in year two upon realization of her partnership interest. Yes, it is taxed at a lower rate—but that is a character conversion issue. Yes, it is taxed in a later year—but that is a deferral issue. The point right now is that there seems to be no logically distinct *untaxed* imputed income story to tell for the imputed salary plan, because the imputed salary is taxed eventually and in some manner.

In other words, the general partner under the imputed salary plan is really *not* similar to the self-help house painter who personally enjoys her fresh paint job, but rather similar to the self-help painter who paints her house right before she sells it for a price that is higher as a result of sprucing up her house. Unable to add the value of her painting services to her basis in the house, she effectively pays tax on the imputed income from painting in the form of a higher gain on the sale of her home (but for the limited exclusion for such gains, that is¹⁴⁰).

2. Self-help.

This paint-to-sell example also makes clear the problem with emphasizing the self-help aspect of general partner service provision. Just as imputed income is not the same as untaxed imputed income, imputed income that is specifically in the form of *self-help* is also not necessarily untaxed.

Thus, it may well be true that the general partner is to some extent *self-providing* investment management services. We can temporarily modify the base case example to bring this out by imagining that the general partner contributes some portion of the \$1 million cash input in year one. In that case, some of the effort that she exerts in managing the partnership is attributable to the management of her own investment.¹⁴¹ Yet, when the manager works to increase the value of her own investment, the amount she *realizes* from her investment increases, and, under the imputed salary plan, the value of labor so deployed is not added to her basis. Consequently, even under the imputed salary plan, she pays tax on her self-provided investment services in the form of higher gain upon realization.

¹⁴⁰ IRC § 121 (excluding from income a portion of the gain from the sale of a principal residence).

¹⁴¹ Alternatively, or in addition, we might imagine that the general partner is, at any given time, managing her own prior investment of labor value.

In the interest of logical precision, it is also worth emphasizing that imputation and self-help are logically separate issues. Under the imputed salary plan, *all* of the value of the general partner's labor contribution is imputed salary, but presumably only part of it is self-help; the rest is "help" provided to others, namely to her partners. Nevertheless, the two issues do share something important in this setting, in that neither can really be said to house a tax advantage for service-compensatory profits interests—at least, not one distinct from conversion and deferral.

3. Investing pretax.

Lastly, what are we to make of the fact that the general partner "invests with pretax dollars" under the imputed salary plan, but "invests with after-tax dollars" under the cash salary plan? In other words, what should be said about the fact that the general partner has more left to invest in year one in the partnership enterprise under the imputed salary plan because she does not pay the tax on her salary income in that year?

Perhaps the best answer is that nothing should be said—at this point—because this is a classic deferral issue, not an imputed income/self-help issue.

To wit: under the imputed salary plan, the tax on the salary does not go unpaid. Rather, the general partner pays the tax on the salary later in the form of capital gain. (The tax is at a lower rate, but again, that is a character conversion issue.) Thus, although the cash salary reinvestment plan leaves the general partner with less to invest in year one than the imputed salary plan (that is, she "invests out of after-tax dollars" rather than "out of pretax dollars"), it leaves her with *more* to invest in year two. This is simply a matter of timing. Existing accounts explicitly aim to distinguish the supposed imputed income tax advantage of the imputed salary plan from any tax advantage that may be produced by deferral.¹⁴² Yet, if we consider the fact that the general partner pays tax later under the imputed salary plan as a tax advantage (somehow) related to imputed income and self-help, we are likely to end up double counting the tax benefits of the imputed salary plan.

¹⁴² Consider, for example, that Fleischer organizes his analysis of the tax benefit into a discussion of deferral and a discussion of conversion, and places his discussion of the supposed imputed income benefit from profits interests in the section on conversion. See Fleischer, 83 NYU L Rev (forthcoming 2008) (cited in note 6).

4. Other interpretations?

These appear to be the only three possible interpretations of the claim found in the literature that the imputed salary plan has a tax advantage distinct from conversion and deferral, and somehow related to the nontaxation of imputed income elsewhere in the Code. Possibly, there are other interpretations of this claim that we have not covered. Pending clarification, we will have to leave this possibility open.

But we can at least be certain of this: such other interpretations cannot accurately make the assertion—as can be made for imputed rent from owner-occupied housing or for the imputed wage and salary income from the self-provision of household and childcare services—that the general partner's return to labor is absent from her lifetime tax base, in whole or in part, under the imputed salary plan. As noted, the general partner's adjusted gross income—aggregated over time and tax character—is the same (\$3 million) under both compensation plans. This is true no matter what the value of the general partner's labor contribution, no matter what her distributive share of the partnership's corresponding salary expense deduction, and even no matter what limitations may apply to the limited partner's ability to deduct his own distributive share of the partnership's salary expense deduction, as discussed in Part II.B.

C. Pure Income Shifting

Indeed, *both* partners' adjusted gross incomes—aggregated over time and character—are invariant across the two compensatory plans. The general partner's aggregated adjusted gross income is \$3 million under both plans. The limited partner's aggregated adjusted gross income is \$2 million under both plans.

This has the additional implication that the tax advantage of the imputed salary plan is not of the pure income-shifting variety—as when individuals attempt to shift income to their lower-tax-rate children, spouses, or relatives.¹⁴³

To be sure, no one appears to be claiming that such pure income shifting is, in fact, a source of tax advantage for the imputed salary plan. Nevertheless, as we shall see, income shifting in a more complicated form is a necessary component of the true tax advantage of the imputed salary plan. Income shifting operates *in conjunction with* conversion and deferral. For purposes of analytical clarity, we note that the

¹⁴³ Income shifting is limited in a variety of ways throughout the Code. See, for example, the “kiddie tax” imposed by IRC § 1(g) (taxing certain unearned income of children as if it were the parent's income). In other ways it is permitted, as when spouses with diverse incomes are permitted to file jointly. IRC § 6013 (allowing a husband and wife to jointly file a single return).

simplest form of income shifting—income shifting on its own—is not in fact at play. In doing so, we can more clearly mark the boundaries of the higher-order form of income shifting that may occur.

D. Pure Conversion and Pure Deferral

Just as pure income shifting cannot be counted as a tax benefit of the imputed salary plan, neither can pure conversion or pure deferral—or even pure conversion combined with pure deferral. This is inherent in the fact that the imputed salary plan effects a zero-sum timing/character *swap* among the partners rather than a simple conversion or deferral for the general partner.

We have seen that moving to the imputed salary plan reduces the general partner's year one ordinary income by \$900,000, while reducing the limited partner's ordinary deduction—and so increasing his ordinary income—by the same amount. Assuming, for ease of calculation, that the tax rate applicable to both of these adjustments to ordinary income is one-third (which is, of course, close to 35 percent), this lowers the general partner's year one tax bill by \$300,000 and raises the year one tax bill of the limited partner by the same amount.

In addition, adopting the imputed salary plan increases the general partner's year two long-term capital gain by \$900,000, and reduces the limited partner's year two long-term capital gain by the same amount. Assuming, again for ease of calculation, that the rate applicable to both of these adjustments to year two long-term capital gains is one-sixth (which is roughly 15 percent, and precisely half of one-third), this increases the year two tax bill of the general partner by \$150,000, and reduces the year two tax bill of the limited partner equally.

Therefore, the general partner trades \$300,000 of year one tax liability for \$150,000 of year two tax liability. And the limited partner does the opposite: taking \$300,000 more of year one tax liability in return for \$150,000 less of year two tax liability. In effect, the limited partner is giving the general partner \$300,000 in year one and in return the general partner is giving the limited partner \$150,000 in year two—with the tax authority acting as a zero-fee intermediary in both cases.

Why would the limited partner agree to trade \$300,000 now for half that amount later? He probably would not. Instead, if the general partner for some reason insisted on the imputed salary plan, the limited partner would most likely only agree to go along if offsetting adjustments were made to other aspects of the partnership agreement.

How, precisely, this adjustment would be made is a complicated issue, but one that is, fortunately, ancillary. What is important is that, in the end, the general partner's nominal conversion and deferral tax advantage from the imputed salary plan would likely be offset by her

need under that plan to compensate the limited partner for his equal and opposite tax disadvantage.

Consequently, the general partner's nominal tax advantage under the imputed salary plan has no real economic meaning, unless the other partners—who, we should remember, must be “sophisticated” to participate in the private equity fund in the first place—are somehow asleep at the negotiating table. Or . . . unless income shifting is also added to the picture.

E. Conversion Combined with Income Shifting

To summarize: first, there appears to be no imputed income-like tax advantage to the imputed salary plan because adopting the plan does not alter the general partner's adjusted gross income. Second, because, in addition, adopting the imputed salary plan does not change the adjusted gross income of the *limited* partner either, the imputed salary plan provides no tax advantage from income shifting in its pure form. Third, the imputed salary plan offers no real tax advantage when conversion or deferral is considered *without the possibility of income shifting*.

To locate the tax advantage, we need to add income shifting *on top of* conversion and/or deferral.

For analytical clarity, it is best to begin by focusing on the combination of conversion and income shifting, leaving deferral temporarily to one side. To this end, we will implicitly collapse the two periods in the base case example into one in the analysis in this Part III.E: that is, the input-output activity underlying the partnership enterprise will be treated as if it were an instant recipe.

Following on our discussion above regarding the possibility of compensating adjustments in the partnership agreement,¹⁴⁴ we will be interested in whether and when adopting the imputed salary plan reduces the *joint* tax liability of the two partners.

1. General point.

The first order of business is to make the general point that the tax advantage from the character swap effected by the imputed salary plan does not turn on a difference, across the partners, in the tax rates applicable to any particular type of income per se. Rather, the advantage turns on a difference, across the partners, *in each partner's difference* in tax rates across kinds of income and loss. That is, the key is not a difference but a “difference in differences.”

¹⁴⁴ See Part III.D.

Under the swap effected by adopting the imputed salary plan, each partner, in effect, gives some form of adjusted gross income to his partner and takes another form of adjusted gross income in return. Each partner's tax bill goes up by the adjusted gross income that she receives times the tax rate applicable to that increment. And each partner's tax bill goes back down again by the adjusted gross income that she gives times the tax rate applicable to that decrement. As noted, for each partner, though differing in kind, the parcels of adjusted gross income that are given and received are the same in dollar amount, and equal what we have called the general partner's "net salary income" under the cash salary reinvestment plan.

Therefore, the swap causes the general partner's tax bill to go down by the product of: (a) her net salary income and (b) the amount by which the rate applicable to the kind of adjusted gross income that she gives exceeds the rate applicable to the kind of adjusted gross income that she receives (where we are thinking of such rates in decimal form—as in "0.35" rather than "35 percent"). With regard to (b), the kind of adjusted gross income that she gives is salary income less her distributive share of the salary expense deduction. The kind of adjusted gross income that she receives is long-term capital gains. It will be helpful to give the rate difference described in (b) a name: let us call it the general partner's "character rate gap." Adopting this definition allows us to make the relatively concise statement that for every dollar of net salary income swapped, the general partner's (nominal) tax bill goes down by her character rate gap. For concreteness, we may think of this rate gap as 0.35 less 0.15, or 0.20, which is to say 20 cents per dollar—though the rate gap may well differ from this, as the examples below make clear.¹⁴⁵

Conversely, the swap causes the *limited partner's* tax bill to go *up* by the general partner's net salary income multiplied by the amount by which the rate applicable to the kind of adjusted gross income that the limited partner *receives* exceeds the rate applicable to the kind of adjusted gross income that he gives. The limited partner receives adjusted gross income in the form of forgoing his distributive share of the salary expense deduction. He gives adjusted gross income in the form of long-term capital gains. Using symmetric terminology, for every dollar of net salary income swapped, the limited tax partner's tax bill goes *up* by *his* character rate gap.

The swap reduces the *joint* tax liability of the partners, of course, if the general partner's tax bill goes down more than the limited part-

¹⁴⁵ Note, in particular, that not all long-term capital gains are taxed at 15 percent. IRC § 1(h) (prescribing different tax rates for long-term capital gains, ranging from 0 percent to 28 percent).

ner's tax bill goes up. The general partner's tax bill goes down by her character rate gap per each dollar of her net salary income. The limited partner's tax bill goes up by *his* character rate gap per each dollar of the general partner's net salary income. Therefore, the joint tax liability of the partners is reduced if and only if the general partner's character rate gap exceeds the limited partner's character rate gap.

Indeed, we can pinpoint the precise amount of joint tax reduction due to the character swap. For every dollar (of net salary income under the cash salary reinvestment plan) that the partners swap in moving to the imputed salary plan, the joint tax liability of the partners is reduced by the difference in their character rate gaps: more precisely, by the amount (possibly negative) by which the general partner's character rate gap exceeds the limited partner's. This is the key difference in differences.

2. Examples.

The fact that what matters is a difference in differences, rather than an ordinary first order difference, makes the conversion/income shifting issue subtler than it may at first appear. Consider the following examples.

We have already seen that the imputed salary plan does not reduce joint tax liability when the partners are subject to the same rates. In this case, the partners' character rate gaps are equal *a fortiori*. And so we see that a difference in rates is a *necessary* condition for joint tax advantage.

A difference in rates is not, however, sufficient. Suppose, for example, that the general partner pays 35 percent for additions to ordinary income and 15 percent for long-term capital gains. Imagine (without regard to what may be possible under the current Code) that the ordinary deductions taken by the limited partner under the cash salary reinvestment plan lower his tax at a rate of 20 percent and that he pays 0 percent for long-term capital gains. In this case, every dollar converted from ordinary income to capital gain for the general partner by virtue of adopting the imputed salary plan reduces the general partner's tax bill by 20 cents, while simultaneously increasing the limited partner's tax bill by 20 cents. Thus, there is no joint tax gain from the conversion effected by adopting the imputed salary plan. This is so even though there is a rate difference between the partners (two rate differences, to be exact).

The point is that the rate differences are consistent with there being no difference in rate *gaps*, and it is the latter, not the former, that determines the conversion/income-shifting tax advantage that we are now considering.

Now suppose that the limited partner is tax exempt. In point of fact, roughly half of limited partners are reportedly pension funds and university endowments.¹⁴⁶ The character rate gap for tax-exempt limited partners is trivially zero. Assuming that the general partner is still a “35-15” taxpayer, every dollar converted from ordinary income to capital gain for the general partner by virtue of adopting the imputed salary plan still reduces the general partner’s tax bill by 20 cents. It has no effect on the limited partner’s tax bill. Therefore, joint tax liability is reduced by 20 cents for each dollar paid as imputed salary rather than cash salary that is reinvested. Twenty cents is precisely the difference in the partners’ character rate gaps.

In the academic literature and in the press, the supposed conversion benefits of the imputed salary plan are often presented without reference to the requisite income-shifting component of the story. When any reference to the income-shifting component *is* made—and the reference is often tentative and ambiguous—the tax-exempt case is often the only one discussed. It is important to recognize, however, that what makes the tax-exempt case “work” (with regard to conversion) is not that the limited partner is subject to zero tax rates, or even that the limited partner’s rates are lower across the board than those of the general partner, but rather that the limited partner’s rate *gap* is lower.

To bring this point home, suppose that the limited partner is not tax exempt, but is rather a corporation that is taxed at 39 percent on both additions to capital gains and additions to ordinary income.¹⁴⁷ This is not terribly unrealistic: over some ranges, 39 percent is indeed the marginal rate for corporations.¹⁴⁸ Furthermore, corporations pay this same rate on long-term capital gains.¹⁴⁹ In this case, each dollar of zero-sum conversion from the imputed salary plan still decreases the general partner’s tax bill by 20 cents and *still* has no effect on the tax

¹⁴⁶ Treasury Report at 28 n 95 (cited in note 1) (stating that approximately 20 percent of funds invested in private equity come from endowments and approximately 30 percent come from pension funds). See also Private Equity Council, Press Release, *Raising Taxes on Private Equity Investments Could Hurt U.S. Companies and Competitiveness, PEC Tells Congress* (cited in note 15) (“Private equity investment firms between 1991 and 2006 returned more than \$430 billion in profits to their investors, nearly half of which are public and private pension funds, university endowments and charitable foundations, [PEC Board Chairman Bruce Rosenblum] said.”).

¹⁴⁷ Note that the existence of partners who are themselves C corporations may force the partnership to adopt the accrual method of tax accounting. IRC § 448 (describing this limitation on the use of cash method of accounting).

¹⁴⁸ IRC § 11(b). The marginal rate for corporations is 39 percent for taxable incomes between \$100,000 and \$335,000 and 38 percent for taxable incomes between \$15,000,000 and \$18,333,333.

¹⁴⁹ IRC §§ 1(h) (providing preferential treatment for long-term capital gains and dividends), 1(a) (effectively restricting application of § 1(h) to individuals), 11 (imposing tax on taxable income of corporations and providing for no capital gains rate preference).

bill of the limited partner. Notice, however, that, in this example, not only is the limited partner not tax exempt, he is also taxed *more heavily* than the general partner across the board. Nevertheless, the imputed salary plan still offers the opportunity to reduce joint tax liability.¹⁵⁰ In fact, each dollar of net salary income reduces joint tax by precisely the same amount as in the tax-exempt case: 20 cents. This is because the difference in character rate gaps is the same in both cases.

The difference in rate gaps need not favor the imputed salary plan over the cash salary reinvestment plan. Imagine that the limited partner is an individual who can fully deduct net salary income, and who will die “between the time” of his potential net salary income deduction and the realization of his partnership interest. In this case, any capital gains income that the limited partner enjoys will be taxed neither to the limited partner nor to his heirs (by virtue of their taking a stepped-up basis¹⁵¹ in the partnership interest they acquire).¹⁵² Therefore, the limited partner’s rate gap is now 0.35 less zero, or 0.35. This is *greater* than the 0.20 rate gap for the general partner (if we keep this partner’s tax situation the same as above). Therefore, the zero-sum conversion effected by adopting the imputed salary plan *increases* joint tax liability by 15 cents per dollar of net salary income.

For another example, suppose that the limited partner is an individual with a carryover capital loss of \$2.9 million from previous years. Such a loss cannot be used to offset ordinary income (except up to \$3,000, which we shall disregard).¹⁵³ However, such a loss may be used to offset capital gains. If we ignore all future years (and so ignore the tax cost of using up the carryover loss in this year), then the limited partner’s rate on capital gains is zero. If she can take the deduction for net salary income, therefore, her rate gap is again 0.35 less zero, or 0.35. Again, this is greater than the 0.20 rate gap for the general partner. Therefore, the zero-sum conversion effected by adopting the imputed salary plan *increases* joint tax liability by 15 cents per dollar of net salary income.

¹⁵⁰ Note that, to the limited partner’s shareholders, the tax consequence of the fact that the limited partner is organized and separately taxed as a corporation is orthogonal to a comparison of the imputed salary and cash salary reinvestment plans.

¹⁵¹ IRC § 1014 (“Basis of property acquired from a decedent.”). This basis step-up is scheduled to be eliminated in 2010. Economic Growth and Tax Relief Reconciliation Act, 115 Stat at 38. However, the provisions of this act “sunset” on December 31, 2010, see id § 901, 115 Stat at 150 (general sunset provision for act), and the step-up will thus be automatically reinstated in 2011, unless Congress makes the change permanent.

¹⁵² Note that the estate tax is irrelevant to the comparison of compensatory plans because the estate tax applies to both plans in the same way.

¹⁵³ IRC § 1212(b)(1).

Of course, the limited partner's real tax rate on capital gains is not zero, since in applying the previous year's capital loss against current year capital gains she uses up a loss carryover that might have reduced future years' taxes. What is most important, however, is that her capital loss carryover reduces her real rate on capital gains below 15 percent *to some extent*. In this case, her rate gap is larger than that of the general partner in this example—who is assumed to have no carryover. The result is an increase of some amount in joint tax liability upon adoption of the imputed salary plan.

Let us now return to the set of circumstances wherein there *is* a conversion/income shifting tax advantage to the imputed salary plan. Recall that the tax-exempt case is not the only such circumstance. Indeed, it is not even necessarily the circumstance with the largest tax advantage.

Consider the case where the limited partner is an individual who is limited in the extent to which he can deduct his distributive share of the partnership's corresponding salary expense under the cash salary reinvestment plan.¹⁵⁴ Let us imagine that this limited partner is completely unable to take the deduction—without specifying why this might be. (We will discuss his ability to carry this deduction forward in the Part on deferral.) Let all other rates be the same as above. In this case, the limited partner's character rate gap is, in fact, negative: it is zero less his capital gains rate of 0.15. The general partner's character rate gap is still 0.20. Therefore, if we are right about the difference in rate gaps being the magnitude of the joint tax reduction for each dollar of net salary income, the tax advantage here should be a full 35 cents per such dollar.

In fact, this is the case. If the partners switch from the cash salary reinvestment plan to the imputed salary plan, the general partner's tax bill still goes down by 20 cents for each dollar of net salary income under the cash salary reinvestment plan. With regard to the limited partner, recall that in previous examples, switching to the imputed salary plan either caused the limited partner's tax bill to go up or left it at the same level. Here the limited partner's tax bill actually goes down: by 15 cents per dollar of net salary income. The fact that the limited partner's deduction for his share of the partnership's salary expense is eliminated in moving to the imputed salary plan has no impact on his tax bill; he was unable to take the deduction anyway. The corresponding reduction in capital gains lowers his tax bill by 15 cents on the dollar. Therefore, per dollar of net salary income, the general partner's tax bill goes down by 20 cents, and the limited partner's goes down by 15 cents, for a total reduction of 35 cents, as projected.

¹⁵⁴ See Part II.B for a discussion of potentially applicable limitations.

The previous example suggests that the imputed salary plan might be tax advantaged even where there is no difference in the rates at which ordinary income and capital gains are taxed, so long as there is a difference between: (a) the rate applicable to the net salary income of the general partner and (b) the rate *effectively applicable* to the limited partner's distributive share of that salary expense deduction, taking account of limited deductibility.

In fact, it is worth noting that there would be no less of a tax advantage to the imputed salary plan were we to modify the previous example by removing the capital gains preference. The general partner's character rate gap would be zero were there no difference in the rate on her net salary and the rate on her capital gains. The limited partner's character rate gap would be *negative* 0.35: removing the deduction would not reduce the limited partner's taxes at all; lowering his capital gains would now lower his taxes by a full 35 cents on the dollar. Therefore, the difference in rate gaps *would still be* 0.35, just as above. Thus, the tax advantage would be just as large. In particular, while the general partner would gain less (now nothing) from converting ordinary income into capital gains, the limited partner would gain precisely that much more from his equal and opposite reduction of capital gains (on which he is now taxed at a full 35 percent) in return for forgoing a deduction that offers him no tax benefit.

It must be noted that both of the previous two examples, though conceptually interesting and important, are probably somewhat artificial because it is likely that the partnership enterprise can be structured in such a way that the limited partner is able at *some* point to deduct at least *some* portion of his distributive share of the salary expense deduction under the cash salary plan. For example, if the loss is initially disallowed under the passive activity loss rules, the limited partner may be able to take the loss in later years via carry forward, or in any event upon liquidation of her entire interest in the partnership.¹⁵⁵ The possibility and effect of limited or suspended deductions was analyzed in Parts II.B and II.C.

What if capital gains were taxed *more highly* than ordinary income? Could there still be an advantage to the imputed salary plan? The somewhat counterintuitive answer is "yes"—and this is true even without limitations on the limited partner's salary expense deduction under the cash salary plan. There would still be a tax advantage if the amount by which the capital gains rate exceeded the ordinary income rate for the general partner were less than the amount by which the

¹⁵⁵ IRC § 469(b) (governing disallowed loss or credit carried to next year), 469(g) (prescribing dispositions of the entire interest in passive activity).

capital gains rate exceeded the ordinary income rate (applied to the deduction) for the limited partner. That is to say, the general partner's character rate gap can still exceed the limited partner's rate gap even if both rate gaps are negative. Suppose, for example, that capital gains are taxed at 50 percent for the general partner and 60 percent for the limited partner, while ordinary income is taxed at 35 percent for both partners. In this case, the imputed salary plan *increases* the general partner's tax bill by 15 cents per dollar of net salary income; yet it also *reduces* the limited partner's tax bill by 25 cents per such dollar. The joint tax bill, therefore, goes down.

F. Deferral Combined with Income Shifting

Adopting the imputed salary plan also effects a timing swap between the partners. The general partner "gives" the limited partner year one adjusted gross income (in the amount of her net salary income under the cash salary reinvestment plan), and the limited partner gives back the same amount to the general partner in year two adjusted gross income.¹⁵⁶

Of course, the tax character of what is given is not the same as the tax character of what is received, as discussed above. But timing, not character, is our concern in this Part. To isolate the effect of the timing swap on joint tax liability, we will proceed in this Part as if there is no character rate gap for either partner.

1. Two effects of a timing swap in general.

In general, a timing swap has two potential effects on joint tax liability. The first effect, the "rate change effect," derives from changes in the parties' tax rates over time, and is conceptually similar to the effect of a character swap. Suppose, for instance, that the general partner's tax rate will, for some reason, fall over time, while the limited partner's tax rate will remain constant. To isolate the rate change effect (from the time value effect described below), let us also suppose that the partners are indifferent between paying a given amount of tax in year one and paying the same amount in year two. We may, therefore, measure their individual and joint tax liability by simply summing over the two years. Then the partners reduce their joint tax liability when (in adopting the imputed salary plan) the general partner gives year one income to the limited partner and the limited partner gives back the same amount of year two income. The limited partner

¹⁵⁶ This timing swap should be distinguished from the joint deferral caused by adopting an imputed salary plan when the limited partner's deduction would be suspended. The latter was analyzed in Part II.C.

pays the same amount of time-aggregated tax. But more of the general partner's adjusted gross income is taxed under her lower year two rate.

More generally, as with the character swap analyzed above, the rate change effect acts to reduce joint tax liability if and only if the general partner's "timing rate gap" exceeds the limited partner's "timing rate gap," where the definitions of these "timing rate gaps" are analogous to the definitions of the partners' respective character rate gaps.

The second effect of the timing swap, the "time value effect" derives from a combination of: (a) the partners' preference for paying any given amount of tax in year two rather than in year one, and (b) first order differences in tax rates across the partners (as opposed to differences across the partners in tax rate *differences* over time). This second, time value effect, which is explained in detail in Part III.F.2, is conceptually distinct from the first, rate change effect, and not analogous to the effect of a character swap. The time value effect may exist even if each partner's applicable tax rate is constant over time—that is, even if neither partner has a timing rate gap—so long as the partners' time-constant rates differ from each other. In contrast, because the rate change effect requires, as discussed, a difference in timing rate gaps across the partners, it requires, a fortiori, that the partners' timing rates gaps are not both zero. Conversely, the time value effect would not exist were money worth the same today as tomorrow. The rate change effect, on the other hand, does not turn on the difference between paying a fixed amount of tax now rather than later.

The rest of this Part will focus on the time value effect, rather than the rate change effect. The rate change effect is probably generically important in some settings outside the private equity context, like retirement savings. And it may even be an important consideration in particular private equity partnerships. But it is most likely not a general feature of the private equity tax landscape. And, in any event, it is conceptually similar to the effect of the character swap, which has already been discussed.

2. The time value effect of the timing swap.

To isolate the effect of the timing swap from the effect of the character swap, we have already assumed that, for each partner taken individually, adjusted gross income is subject to the same tax rate regardless of its character. To further isolate the time value effect of the timing swap from its rate change effect, let us additionally assume that, for each partner taken individually, adjusted gross income is taxed at the same rate whenever it is accrued. To fix ideas, we can imagine that each partner's time-and-character-uniform rate equals her rate on ordinary income. We will, however, allow for the possibility that the uniform rate for each partner differs *across* the partners.

For each partner, time-aggregated adjusted gross income is the same across the two compensatory plans. Therefore, even if the partners are subject to different tax rates, the time-aggregated tax liability of the partnership as a whole is the same across the two compensatory plans. However, the timing of the partnership's time-aggregated tax liability may differ across the plans. Since there are only two periods, such differences are fully described by the amount (possibly negative) of the time-aggregated tax liability that the partnership must pay in year one.

The less time-aggregated tax liability that the partnership must pay in year one, the better for the partnership. That is, the partnership would rather pay any given dollar of time-aggregated tax liability in year two than in year one. If a dollar of tax liability need only be paid in year two, it can be invested in the meantime at the partnership's greatest available after-tax return (which might be provided by investment in the partnership enterprise itself). If the dollar must be paid in year one, the partnership must either forgo this after-tax return, or borrow to maintain it, at the cost of after-tax interest.

Note that the cost to the partnership of the fact that any given dollar of time-aggregated tax liability must be paid in year one rather than in year two is not a function of the identity of the partner to whom that tax liability attaches legally. This is so even if the partners individually have different after-tax returns or interest costs—perhaps as a result of their different tax rates. The reason for this is that the partners can borrow from each other, either explicitly or by rearranging the partnership agreement. Suppose, for instance, that a given dollar of year one tax liability attaches to the general partner, but the limited partner can borrow more cheaply after tax. The limited partner can borrow this dollar, and contribute it to the partnership in lieu of the general partner's contribution thereof. The general partner can take the dollar she would have contributed to the partnership and pay the tax instead. And the partners' shares of year two partnership value can be accordingly rearranged, as if to effect a repayment of the dollar by the general partner to the limited partner with interest.

Which plan requires the partnership to pay more of its time-aggregated tax liability in year one? This depends on the relative sizes of the partners' tax rates. The imputed salary plan requires a lower year one tax payment for the partnership than the cash salary reinvestment plan—and the imputed salary plan is therefore tax advantaged—if and only if the limited partner's tax rate is lower than the general partner's tax rate. Under the imputed salary plan, no tax payments are made by either partner in year one. Under the cash salary reinvestment plan, the general partner pays an amount of tax in year one equal to her tax rate times her net salary income. (Recall that the general partner's "net salary income" is her salary income less her

distributive share thereof.) The limited partner “receives” an amount of tax in year one equal to his tax rate times his distributive share of the partnership’s salary expense deduction. This distributive share equals the general partner’s net salary income. Since in both tax calculations, the partners’ respective rates are applied to the same amount—the net salary income of the general partner—the partnership pays positive tax in year one under the cash salary reinvestment plan if and only if the general partner’s tax *rate* exceeds the limited partner’s.

Thus, the time value component of the deferral tax advantage from the imputed salary plan turns on differences in tax rates, whereas the character conversion benefits turn on a higher-order difference in (rate) differences (across income character). Hence, there are time value deferral benefits to the imputed salary plan when the limited partner is tax exempt. This was also true of conversion benefits. But it is not also true of time value deferral benefits, as it was for conversion benefits, that such time value benefits accrue when the general partner is an individual and the limited partner is a corporation in the 39 percent bracket.

3. Other means of deferral.

Perhaps the most important point to make about the deferral tax benefits of service-compensatory profits interests is that such benefits are available by other means, wherein the considerations discussed above apply in a very similar fashion. That is, if we were to take away the character conversion/income-shifting benefits of the imputed salary plan, leaving only the deferral/income-shifting benefits, although the imputed salary plan would still be tax advantageous relative to the cash salary reinvestment plan, the imputed salary plan would *not* be tax advantageous relative to other plans that are workable under the current Code.

For example, the general partner could contract with the partnership to be paid in year two rather than in year one. That is, the partnership could adopt a “nonqualified deferred compensation plan” for the general partner. Even though the services being compensated would still be provided in year one, so long as the general partner had no right to receive the compensation in year one,¹⁵⁷ and so long as her right to receive the compensation in year two was not shielded from

¹⁵⁷ Otherwise, the compensation would be treated as “constructively received” in year one. Treas Reg § 1.451-1 (describing the general rule for taxable year of inclusion); Treas Reg § 1.451-2 (governing constructive receipt of income).

the partnership's creditors,¹⁵⁸ the general partner would have a (net) salary income only in year two. Correspondingly, year two is also when the partnership would deduct the salary expense and when the partners would deduct their distributive shares thereof.¹⁵⁹ That is, such contractual deferral would shift the general partner's net salary income to year two, while also shifting to year two the limited partner's deduction for the same.

Putting aside character conversion, contractual deferral of this kind has essentially the same tax effect as adopting the imputed salary plan. With regard to the general partner, moving to the imputed salary plan from the (original) cash salary reinvestment also effectively shifts to year two her net salary income. Her adjusted gross income in year one no longer includes her net salary income. Her adjusted gross income in year two now additionally includes her net salary income amount because she is no longer subtracting it in the form of basis. With regard to the limited partner, shifting to the imputed salary plan effectively shifts to year two her subtraction from her adjusted gross income of the general partner's net salary income. She no longer deducts this amount from her adjusted gross income in year one. Instead, she subtracts this amount from her adjusted gross income in year two in the form of a basis that is no longer reduced by a year one deduction.

In addition to their similarity with regard to tax deferral, the imputed salary plan and nonqualified deferred compensation plan also seem similar economically. In particular, the vesting and subordination requirements of contractual deferral do not markedly distinguish the nonqualified deferred compensation plan from the imputed salary plan. There seems to be no reason why the general partner's risk of not getting paid in year two would be any greater under a nonqualified deferred compensation plan than under the imputed salary plan.

To be sure, § 409A, passed in 2004, imposes certain limits on contractually deferring compensation for tax purposes.¹⁶⁰ But these new

¹⁵⁸ Otherwise, the right to future compensation might be deemed a cash equivalent and currently taxed. See Rev Rul 60-31, 1960-1 Cum Bull 174 (explaining the general rule for the taxable year of inclusion).

¹⁵⁹ IRC § 404(a)(5):

[I]f compensation is paid or accrued on account of any employee . . . [it] shall be deductible under this section . . . if the plan is not one included in paragraph (1), (2), or (3), in the taxable year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan.

¹⁶⁰ See Halperin and Yale, *Deferred Compensation* at 4-7 (cited in note 137) (explaining how § 409A limited taxpayer flexibility by preventing, among other things, "some do-it-yourself income averaging"). The application of § 409A to profits interests is unsettled. See generally Notice 2005-1, 2005-2 Int Rev Bull 274, 279 ("[Section] 409A may apply to arrangements between a partner and a partnership which provides for the deferral of compensation under a nonqualified deferred compensation plan. However, until additional guidance is issued, for pur-

restrictions are, for the most part, orthogonal to the present discussion. The restrictions target service providers' attempts to end run the requirement, mentioned above, that their promise of future payment remain subject to creditors' claims, if the receipt of such promise is not itself to be treated as current income. Prior to the passage of § 409A, service providers were deferring inclusion of their compensation even though they had contracted that deferred payments could be accelerated or would become secured if it began to look as though they might not be paid out. Thus, the new restrictions in § 409A do not change the fact that the deferral features of the imputed salary plan—under which the general partner incurs a substantial risk that he will not receive his promised compensation—can be essentially replicated with contractual deferral. The new restrictions under § 409A prevent the general partner from doing *better*—with regard to deferral—than under the imputed salary plan. They do not prevent the general partner from doing *as well*.

G. Multiple Tax-diverse Partners

Thus far, we have been analyzing a simplified scenario in which there is one general partner and one limited partner. In fact, private equity investment projects typically involve several investors. The other investors may differ among themselves in their tax positions. Some may be tax-exempt entities, some wealthy individuals, some corporations, some financial institutions with special tax rules.¹⁶¹ Moreover, some wealthy individuals may have other passive income against which to deduct their distributive share of the salary expense deduction; others may not. Some wealthy individuals may be carrying unused capital losses. Some may think it less likely than others that there will be a basis step-up in the foreseeable future. Furthermore, tax-exempt investors may be specially concerned about avoiding unrelated business income tax.¹⁶²

In many cases it may be possible to structure separate partnership agreements with different classes of investors, even though all are

poses of § 409A taxpayers may treat the issuance of a partnership interest (including a profits interest), or an option to purchase a partnership interest, granted in connection with the performance of services under the same principles that govern the issuance of stock.”).

¹⁶¹ See, for example, Carried Interest Part II Hearings (cited in note 5) (testimony of William D. Stanfill, Founding Partner, Trailhead Ventures, LP) (“Our [private equity fund’s] limited partners include state and corporate retirement funds, university endowments, and the occasional high net worth individual.”).

¹⁶² IRC § 511 et seq (imposing unrelated business income tax). See notes 16 and 101 for a discussion of unrelated business income tax in the private equity context.

effectively participating in the same underlying investments.¹⁶³ Even so, some tax-diverse investors may still find themselves grouped together under the same partnership agreement. Moreover, some aspects of distinct partnership agreements—and, in particular, the form in which the fund manager is compensated—may still be determined *as if* the agreements were a single unit. It is, therefore, worth considering what happens to the joint tax advantage of paying the fund managers with profits interest(s) when investors are tax diverse.

The presence of a set of tax-diverse investors complicates the condition for the existence of a joint tax benefit from the imputed salary plan (as well as the adjustments to the partnership agreement(s) that would be necessary to ensure that all investors shared in any joint tax benefit).

For example, leaving aside deferral/income shifting, the joint tax benefit of conversion/income shifting from each dollar of net salary income for the particular service partner in question will now be the amount by which this service partner's character rate gap exceeds the *average* of all investors' rate gaps (including that of the service partner). The relevant average here is not a simple average but a weighted average. The weight for each investor equals her share of the corresponding dollar of salary expense deduction.¹⁶⁴

Because the relevant condition is a matter of (weighted) averages over several investors, the existence of a joint tax advantage does not require that each and every investor have a smaller character rate gap than the fund manager. However, the presence of other investors with large rate gaps will lower the joint tax advantage. More precisely, each percentage point increase in an investor's rate gap lowers the joint per-dollar tax advantage of the imputed salary plan by that investor's share of the corresponding salary expense deduction under the cash salary reinvestment plan.¹⁶⁵

Rearranging the partnership agreement(s) to compensate the tax losers will generally require adjusting contributions and interests sepa-

¹⁶³ Edward Hayes, *SEC Turns Attention to Hedge Fund Side Letters*, CCH Wall Street (June 9, 2006), online at <http://www1.cchwallstreet.com/ws-portal/content/news/container.jsp?fn=06-19-06> (visited June 8, 2008) (describing how hedge funds often provide different terms to different investors through the use of individualized agreements called "side letters"); Ordower, 7 UC Davis Bus L J at 346 (cited in note 1) ("In order to avoid confrontation with the bulk of the fund's investors, hedge fund managers tend to contract separately for such fee arrangements and do not disclose their details to other investors."); Carried Interest Part III Hearings (cited in note 5) (written testimony of Russell Read, Chief Investment Officer, California Public Employees' Retirement System) (emphasizing the negotiated and variable terms of private equity partnership agreements).

¹⁶⁴ This is shown formally in a web appendix, online at www.cstone.net/~csanchir/Sanchirico_Private_Equity_Web_Appendix_082307.pdf (visited June 8, 2008) (cited in note 27).

¹⁶⁵ See *id.*

rately for differently tax-situated investors. Tax-exempts who, taken individually, are indifferent as regards the two compensatory plans, may wish only to share in the general partner's tax benefit. Wealthy individuals, on the other hand, may also need to be compensated for their affirmative tax loss—from deferral and from conversion—before also being provided with a share of the “tax surplus.” As noted, private equity firms do reportedly often negotiate separate agreements with each limited partner.¹⁶⁶

IV. THE PERVASIVE AND PROBLEMATIC ANALOGY TO SWEAT EQUITY¹⁶⁷

Among the arguments made in favor of retaining the current taxation of service-compensatory profits interests, perhaps the one that has gained the most traction—and is increasingly the most often voiced¹⁶⁸—attempts to draw a favorable analogy to another tax benefit elsewhere in the Code. Most frequently referred to under the rubric “sweat equity,” this analogue tax advantage is thought to be available to a self-employed individual who devotes skill and effort to building her own business. The business owner may currently forgo fully compensating herself for her labor contribution, and instead take the compensation later when she sells all or part of her business for a greater profit. By doing so, she delays and potentially converts what is really income from labor into long-term capital gains. A shop owner, for example, who works day and night to build a business with a loyal customer base, and who is compensated for that effort largely in the form of proceeds from the eventual sale of her business's going-concern value, a capital asset,¹⁶⁹ sees those labor-produced gains taxed at long-term capital gains rates.

¹⁶⁶ See note 163.

¹⁶⁷ This Part develops and extends the ideas in Chris William Sanchirico, *Taxing Carry: The Problematic Analogy to “Sweat Equity,”* 117 Tax Notes 239 (2007), which was first circulated and posted on SSRN on September 20, 2007.

¹⁶⁸ See, for example, note 17.

¹⁶⁹ Self-created goodwill is treated as a capital asset and is thereby taxed at preferential capital gains rates. IRC § 1221(a) (defining “capital asset”). See generally IRS Private Letter Ruling No 200243002 (2002) (describing the statutory, judicial, and regulatory authority under which self-created goodwill qualifies as a “capital asset”). *Purchased* goodwill is not generally treated as a capital asset per se. But if it is used in a trade or business and held for more than one year, it is taxed at the same preferential rate, except to the extent previously amortized or depreciated. IRC §§ 1231 (allowing long-term capital gains treatment for property used in the trade or business that is regarded as depreciable under § 167), 197(a) (allowing deduction for amortization of acquired goodwill), 197(f)(7) (prescribing that acquired goodwill generally be regarded as property depreciable under § 167), 1245(a)(2)(A) (requiring ordinary income treatment for gain on property that is regarded as used in a trade or business and depreciable under § 167 to the extent that such gain is attributable to deductions for amortization).

Because the apparent tax advantage of sweat equity is thought to be deeply engrained in our tax system,¹⁷⁰ and because it tends to be specifically associated with the virtues of entrepreneurialism and small business, it remains far from the chopping block of tax reform. It has thus provided a solid mooring for supporters of the current law governing profits interests, who argue that private equity fund managers who are paid for their services in profits interests, and thereby taxed at long-term capital gains rates, are really no different from business owners who pay themselves with similarly taxed sweat equity.

Meanwhile, opponents of the current tax treatment of service-compensatory profits interests have struggled to distinguish sweat equity by arguing that what private equity fund managers do is distinct from what entrepreneurs do. Entrepreneurs, it is said, start up new enterprises; private equity fund managers restructure enterprises that already exist. One problem with this response is that it seems to neglect the fact that the logic behind sweat equity is apparently as applicable to Johnny-come-lately owners as to founders. This response also seems to neglect the fact that the tax benefits of service-compensatory profits interests are as available to venture capitalists—who are involved in starting up new businesses—as to private equity fund managers. But most importantly, the attempt to distinguish entrepreneurs from private equity fund managers does not explain why any of the obvious and emphasized distinctions between them make a difference. Why, for instance, is starting from scratch—perhaps with slim chance of success, perhaps redundantly with competitors—inherently more valuable than innovatively resuscitating a stagnating enterprise—one with real, but fragile, going concern value whose survival implicates the reliance interests of creditors, employees, and suppliers? Can one really make the claim that one sort of activity is even generally more valuable than the other? Is obstetrics more valuable than cardiology?

Both supporters and opponents of private equity tax reform have missed a more fundamental distinction between the income tax advantage of profits interests and the income tax advantage of sweat equity—one that largely neutralizes this otherwise compelling argument against reform. As this Article has shown, the income tax advantage of profits interests turns in the main on differences in the tax rates

¹⁷⁰ Weisbach, 94 Va L Rev (forthcoming 2008) (cited in note 6) (“[E]ntrepreneurs such as founders of companies get capital gains when they sell their shares even if the gains are attributable to labor income. . . . [P]erhaps the best thing we can say is that this approach is *built deeply into the structure of current law*. Any change in the treatment of a private equity sponsor engaged directly in their investment activity would require reexamination of these *basic principles*.”) (emphasis added).

faced by fund investors and fund managers. The supposed income tax advantage of sweat equity, on the other hand, is not associated with such tax rate differences and appears to exist only if one ignores the frequent deductibility of even investment-oriented labor costs.

Part IV.A explains in general terms why the much discussed tax advantage to sweat equity is both an inapt analogy for profits interests and problematic on its own terms. Part IV.B shows in detail why there is no tax advantage of sweat equity when labor costs are otherwise deductible.

A. The Problematic Analogy to Sweat Equity

One benefit of this Article's systematic characterization of the profits interests tax advantage is that it lays a solid foundation on which to critically evaluate the powerful and pervasive analogy to sweat equity. Comparing that characterization to the sweat equity story immediately reveals a mismatch that calls out for reconciliation. The analysis in Parts I–III indicated that the tax advantage to service-compensatory profits interests is a kind of joint tax arbitrage, an exploitation of differences in tax rates across the partners—a duet. The sweat equity story just described, however, is apparently a solo, a tax play accomplished by the business owner acting alone. What explains this discrepancy? Did our analysis of profits interests miss some aspect of the tax advantage for this form of service compensation? Or is something missing from the sweat equity story?

The answer is that there is something missing from the sweat equity story, namely the frequent deductibility of many capital gains-generating salary expenses. The sweat equity story—as thus far presented by advocates and scholars alike—describes how the owner avoids the tax disadvantage of current salary income without also discussing whether she is simultaneously denied the tax benefit of a mirroring salary expense deduction.

There is no tax advantage to sweat equity if the forgone salary would generate a deduction. Given deductibility, the tax advantage of sweat equity is similar to the tax advantage of profits interests when the limited partners/investors are taxed the same as the general partner/fund manager. That is, it is similarly nonexistent. Instead of swapping current ordinary income and future capital gains with a same-taxed partner, the owner swaps current ordinary income and future capital gains with his same-taxed self. The absence of a tax advantage for sweat equity when the forgone salary would generate a deduction is explained in detail in Part IV.B.

On the other hand, there is a tax benefit to taking compensation in the form of sweat equity if the forgone salary would have to be *capitalized*.¹⁷¹ The tax advantage to sweat equity here is similar to the tax advantage from profits interests that would arise were the partnership required to capitalize any explicit salary paid to fund managers, as described in Part II.A above. To pay oneself in sweat equity is to, in essence, immediately deduct, rather than capitalize, one's salary.

Are capital gains-generating labor costs deductible, or must they rather be capitalized? Capital gains-generating labor costs are frequently deductible—too frequently to justify continuing to regard the tax advantage of sweat equity as pervasive and obvious.

Consider that the chief source of market value for many businesses is their “goodwill” or “going-concern value.” Upon sale of the company, the goodwill generated by the current owner will likely account for a disproportionate share of the owner's capital gains income. Yet, as we have seen, the regulations under § 263 generally do not require the capitalization of costs paid to create or enhance an intangible asset, if this asset is not “separate and distinct” from a trade or business.¹⁷² Thus, the salaries paid to employees who work in the sales, marketing, advertising, and customer service departments—and are thus directly engaged in building goodwill value—are likely expensed long before the realization of the goodwill value that they generate. Indeed, one might go so far as to claim that the salary of every employee whose services help to keep the concern going is to some extent an investment in going concern value.¹⁷³

On the other hand, if the owner herself constructs a machine or other business asset that is regarded as “separate and distinct” from her trade or business, she can effectively deduct the otherwise capitalizable labor cost¹⁷⁴ by not paying herself for the task. But could this really be what people are talking about when they casually reference the tax advantage to sweat equity? We know that goodwill value is pervasive and significant. But how often do business owners construct

¹⁷¹ This Part has benefited enormously from discussions with Michael Knoll, who among other things suggested, in connection with an earlier draft, that the capitalization of labor costs was an important question for discussion.

¹⁷² Treas Reg § 1.263(a)-4(b)(1)(iii) (requiring capitalization of the cost of creating or enhancing a “separate and distinct intangible asset”); Treas Reg § 1.263(a)-4(b)(3)(i) (defining “separate and distinct intangible asset”). For more on this issue, see notes 80–81.

¹⁷³ Despite its specific holding that the taxpayer book publisher had to capitalize the cost of outsourced book production, the court in *Encyclopaedia Britannica, Inc v Commissioner of Internal Revenue*, 685 F2d 212, 217 (7th Cir 1982), expresses a similar sentiment, as quoted in note 75.

¹⁷⁴ IRC §§ 263 (disallowing deductions for certain capital expenditures), 263A (specifically requiring capitalization of the cost of producing or acquiring inventory or producing noninventory real or tangible assets used in a trade or business or other income producing activity).

their own separable business assets? And how significant are the gains from such assets when, in the sweat equity scenario, the business owner sells her business? In regard to the latter question, recall that the labor cost of producing such business assets may well be recoverable against ordinary income in the form of deductions for depreciation, amortization, or the cost of goods sold.¹⁷⁵

Even if we adopt a version of the tax advantage for sweat equity that rests upon those cases in which labor costs would otherwise be capitalized, this much shrunken tax benefit is still an inapt analogy for the tax advantage of private equity profits interests. As discussed in Part II.A, it is relatively clear that were the fund manager to take salary rather than a profits interest, such salary could be structured so that the partnership would be able to deduct the cost. Thus, even if we can say that the business owner is avoiding capitalization by taking his compensation in the form of sweat equity, the private equity partners most probably have no capitalization to avoid.

B. Sweat Equity and Deductible Labor Costs

This Part modifies the example from Part I.B to show that there is no tax advantage to sweat equity when labor costs are otherwise deductible. Consonant with this purpose, we will be maintaining two assumptions throughout this Part. First, labor costs are of a form that would generate a deduction in year one were salary paid. Second, the “investor” (perhaps a creditor) and service provider face the same tax rates. Thus, we can, in this Part, focus on joint capital gains and joint ordinary income without devoting special attention to how such income components are allocated between the parties.

The second assumption is justified by the fact that the sweat equity story, at least as presented in the debate over profits interests, makes no reference to tax rate differences. Those who draw the anal-

¹⁷⁵ See IRC §§ 167 (allowing a deduction for depreciation of certain business or income-producing assets), 168 (determining the magnitude of the § 167 depreciation deduction for certain tangible property), 197 (allowing an amortization deduction for certain business or income-producing intangibles), 263A (requiring capitalization of inventory costs and the cost of producing real or tangible property used in a trade or business or income producing activity), 61(a)(2) (including “gross income derived from business” in the definition of gross income); Treas Reg 1.61-3(a) (allowing the subtraction of “cost of goods sold” from revenues in determining “gross income derived from business” under § 61(a)(2)). Note that depreciation and amortization deductions in excess of certain assets’ true decline in value may be “recaptured” upon sale or disposition under § 1245 and partly under § 1250. See also IRC §§ 1245 (requiring ordinary income treatment of gains from disposition of certain depreciable property to the extent of depreciation deductions previously taken), 1250 (providing a similar, but more limited recapture rule for certain depreciable realty). Note also, by way of comparison, that self-created goodwill is generally not amortizable. IRC § 197; Treas Reg 1.167(a)-3.

ogy to sweat equity ask us to picture a generic entrepreneur, not specifically an entrepreneur *with tax-exempt investors*. At any rate, introducing tax rate differences into the following analysis would have an ambiguous impact. In particular, in some respects there is more latitude for exploiting tax rate differences when the employee and the employer are not the same person.

1. Example: fund manager as sole owner, investor as creditor.

Let us alter the ownership status of the two actors in our original example from Part I.B, keeping their underlying economic contributions and returns the same. The fund manager, who was formerly the general partner, will now be a sole proprietor.¹⁷⁶ The investor, who was formerly the limited partner, will now be the creditor. The fund manager, as before, will contribute \$1 million of labor effort in year one. The creditor, as before, will contribute—specifically, will *lend*—\$1 million in cash in year one. As before, there will be a realization of \$6 million in year two. To keep the example simple and pertinent, we will, as before, assume that the gain portion of this \$6 million realization is taxed at long-term capital gains rates.¹⁷⁷ This realization will inure solely to the manager/owner, but will be applied in part to repay the investor/creditor with interest. For ready comparability with our previous analysis, we will assume that the investor's return, now in the form of interest, is the same in magnitude as in the partnership case (even though this may make the interest payment seem unrealistically large).

As before, in the analysis of the partnership scenario, we will compare the cash salary reinvestment¹⁷⁸ plan with the imputed salary plan, here starting with the latter. We will find that the two plans are tax equivalent from both an individual and a joint perspective.

¹⁷⁶ The sole owner of a limited liability company can elect to be treated as a sole proprietor for tax purposes. The fund manager in this example can also be thought of as the sole shareholder of an S corporation, a pass-through entity for tax purposes. IRC §§ 1361–63, 1366–68, 1371–75, 1377–79 (governing tax treatment of “S Corporations” and their shareholders).

¹⁷⁷ In this fund-manager-as-owner scenario, we can specifically think of this \$6 million as attributable to business assets—such as goodwill or the undepreciated cost of real or depreciable property used in the business—the gains from which would be taxed at long-term capital gains rates upon the sale of the business. IRC §§ 1221(a) (defining “capital asset”), 1231 (allowing long-term capital gains treatment for property used in the trade or business that is regarded as depreciable under § 167), 1245 (requiring ordinary income treatment of gains from disposition of certain depreciable property to the extent of depreciation deductions previously taken), 1250 (providing a similar, but more limited recapture rule for certain depreciable realty).

¹⁷⁸ Recall that we stipulate that any cash salary payment be reinvested in the enterprise so that the explicit salary scenario is economically equivalent to the imputed salary scenario, and we can thereby be confident that any differences in after-tax proceeds are derived solely from differences in tax treatment.

a) *Imputed salary plan.* Under the imputed salary plan, in year one, neither party has taxable income of any form. The manager/owner carries a basis of \$1 million into year two, equal to her investment of the loan proceeds.¹⁷⁹ In year two, out of the \$6 million proceeds from selling the business, the manager/owner pays the creditor \$1 million in the form of principal repayment and \$2 million in the form of (albeit outsized) interest. On her year two tax return, the manager/owner has \$5 million of long-term capital gains¹⁸⁰ and a deduction from ordinary income of \$2 million for her interest expense.¹⁸¹ The creditor has \$2 million of interest income, which is taxed at ordinary income rates.¹⁸²

The joint tax consequences of the imputed salary plan reduce simply to \$5 million of long-term capital gain income in year two. In particular, the manager/owner's ordinary deduction from the interest expense and the creditor's ordinary income from the interest inflow cancel out. These joint tax consequences are the same as in the partnership case. Furthermore, just as under the partnership scenario, \$3 million of this \$5 million of income is attributable to some combination of the manager's year one labor contribution and her investment of implicit proceeds therefrom, while the remaining \$2 million of income is attributable to the investor's return on investment.

b) *Cash salary reinvestment plan—self-deductible salary.* Precisely the same consequences would follow, both individually and jointly, were the owner able to pay herself deductible salary. (Notice the subjunctive mood here.) In year one, she would pay herself \$1 mil-

¹⁷⁹ A sole proprietor's basis in her business is distributed among the assets of the business. For concreteness, one can imagine that this is allocated to IRC § 1231 property. See IRC § 1231 (requiring ordinary income treatment of gains from disposition of certain depreciable property to the extent of depreciation deductions previously taken). What is important is that \$1 million is the aggregate basis that is, effectively, subtracted from the aggregate amount realized in order to, effectively, calculate aggregate capital gains.

¹⁸⁰ Six million dollars is the "amount realized," and from this is subtracted a \$1 million basis.

¹⁸¹ This note considers the investment interest limitation in IRC § 163(d). We shall assume that the manager/owner is either deemed to use the loan principal in a trade or business in which she materially participates, IRC § 163(d)(5)(A) (defining "property held for investment"), or has sufficient "net investment income," as defined in IRC § 163(d)(4), from other sources. In either event, the investment interest limitation in IRC § 163(d) would not affect the deductibility of this interest expense.

If it were applicable, the investment interest limitation would prevent the manager/owner from taking an ordinary income deduction for interest used to finance capital gains income. Instead, the manager would have two choices. First, she could take an ordinary deduction for the interest, but then she would have to take as much of the capital gain as ordinary income. IRC §§ 163(d)(4)(b)(iii) (allowing taxpayer to elect to count net capital gain as "investment income"), 1(h)(2) (eliminating capital gains tax preference for net capital gain elected under § 163(d)(4)(b)(iii)). Second, she could carry forward the interest deduction and deduct "net investment income" again in future years. IRC § 163(d)(2).

¹⁸² IRC §§ 61 (defining "gross income"), 1221 (defining "capital asset").

lion of salary out of the loan proceeds. She would have \$1 million of salary income and a salary expense deduction for the same amount. As under the imputed salary plan, there would be no tax consequences for her, or the investor/creditor, in year one. That is, the negative tax consequence for the manager/owner of including salary income would immediately undo itself, leaving the tax bottom line as though nothing had happened—that is, as if the salary had been merely imputed.

The manager/owner would again enter year two with a \$1 million basis¹⁸³ (now sourced, not directly from the loan proceeds, but from salary, in turn sourced from loan proceeds). The manager/owner would again have \$5 million of long-term capital gain, and \$2 million of interest expense. The investor/creditor would again have \$2 million of interest income. And jointly, the parties would again have only \$5 million of capital gain income, precisely the same as under the imputed salary plan.

Therefore, *were* the manager/owner able to pay herself deductible salary, there would be no tax advantage to sweat equity.

c) *Cash salary reinvestment plan—salary not self-deductible.* Unfortunately, the significance of the tax equivalence between the imputed salary plan and cash salary reinvestment plan—under the assumption that such salary would be deductible for the owner—is substantially clouded by the fact that sole proprietors cannot, in fact, pay themselves deductible salaries.¹⁸⁴ And so there is a sense (specious and distracting for our purposes) in which there is indeed a “tax advantage” for the manager/owner in forgoing salary. Specifically, if a manager/sole proprietor paid herself currently for her labor contribution, this payment would be regarded not as self-deductible salary, but as a “draw” from the business. Such a draw would be treated as current ordinary income for the sole proprietor—as if she had received a dividend—and there would be no offsetting business deduction. This is true no matter how plausibly the sole proprietor might be able to characterize the draw as compensation to herself for services rendered. On the other hand, if the sole proprietor had forgone the draw (and so imputed her salary), she would have delayed and potentially converted the income into capital gains.

¹⁸³ See note 179.

¹⁸⁴ Further adding to the confusion is the fact that the sole owner of an S corporation, which is treated similarly for tax purposes, could pay herself deductible salary. See, for example, Deborah H. Schenk, *Federal Taxation of S Corporations* § 10.02[1] (Law Journal Press 2007) (“The corporation is permitted to take a deduction for reasonable compensation or salary paid to employees. . . . [I]n the case of an employee-shareholder, the tax results are almost always the same whether the amount received is salary or a distribution.”).

But the word “advantage” in the phrase “tax advantage” is a term of comparison. And so, whenever we say that there is a tax advantage, we need to carefully specify the baseline. The tax advantage to sweat equity discussed in the policy debate on private equity is meant to be relative to the tax treatment of service contribution elsewhere in the economy, and in particular to the tax treatment of nonowner employees. The quite different “tax advantage” to sweat equity discussed in the prior paragraph, however, is relative to paying oneself for one’s labor without being able to deduct the payment as a business expense. These are two different baselines. Consequently, the existence of the “tax advantage” described in the last paragraph does not prove the existence of the only tax advantage to sweat equity that is relevant to the private equity debate. Quite the contrary, the “tax advantage” of sweat equity relative to nondeductible salary merely allows sole proprietors to put themselves on equal footing with labor compensation under other ownership structures. That is, the advantage of sweat equity is only that it allows sole proprietors to avoid the *disadvantage* relative to the rest of the economy that is created by the prohibition on deducting their own salaries.

d) Example: fund manager as employee, investor as sole owner. How can it be that owners who pay themselves with sweat equity do no better than non-owner employees? Employees themselves do not enjoy the (nominal) deduction that corresponds to their salary income. And it would thus seem that currently salaried employees¹⁸⁵ are like sole proprietors who pay themselves nondeductible salary, and so are at a disadvantage relative to sole proprietors who take their salary only in imputed form.

But, while the employee does not enjoy a deduction for her salary income, her employer *does*. Consequently, the joint tax consequences for the business enterprise are precisely the same for the employer/employee as for the owner with imputed salary. In the former case, the employee and employer share both the tax burden of the employee’s current ordinary income and the tax benefit of the employer’s current ordinary income deduction. The fact that the deduction is not *nominally* assigned to the employee is of no consequence for real tax burdens, given the adjustability of wages and salaries.

We can illustrate this by again altering the ownership structure in our example, while continuing to retain the same underlying economics. Imagine, now, that the *investor* is the sole owner and the fund manager is a nonowner employee. The manager/employee is paid an

¹⁸⁵ Of course, employees have some leeway in deferring compensation. See, for example, the discussion of nonqualified deferred compensation in Part II.C.

explicit salary of \$1 million in year one. We will suppose that she then lends this amount back to the investor/owner and is repaid the loan amount plus \$2 million of interest in year two.

In a more realistic, but needlessly complicated variant of this scenario, the manager/employee deposits the salary in a bank that, in turn, lends it to the business. What is important for our purposes is that the \$1 million of initial cash contribution to the enterprise, which here flows out as salary in year one, is invested in the same manner as is the imputed salary, in the scenario wherein the fund manager is the owner.

In another variant, a bank or other financial intermediary takes an *equity stake* in the business. The salary reinvestment in the current scenario is assumed to be in the form of debt rather than equity in order to retain the current scenario's simple ownership structure, wherein the investor is sole owner throughout.

In year one, the manager/employee has \$1 million of salary income and the investor/owner has a \$1 million salary expense deduction.¹⁸⁶ The investor/owner takes a \$1 million basis from the invested loan proceeds into year two.¹⁸⁷ When the investor/owner sells the business for \$6 million, he realizes \$5 million in capital gains, and pays the manager/employee interest of \$2 million and a principal return of \$1 million. The manager/employee has interest income and the investor/owner has an interest expense deduction.

The joint tax consequences again reduce solely to \$5 million of capital gain in year two. In particular, in year one the manager/employee's ordinary income for salary cancels the investor/owner's ordinary deduction for the salary payment, while the manager/employee's ordinary income from interest in year two cancels the investor/owner's deduction for interest expense. These joint tax consequences are the same as those we encountered when the investor was the creditor, the manager was the sole owner, and the manager's salary was imputed. They are also the same as those we encountered in the investor-as-creditor/manager-as-sole-owner case when the manager/owner was able to pay herself deductible salary. And they are also the same as the case wherein the manager and investor each own part of the business as partners, as analyzed in Parts I-III.

One response to this analysis is to point out that the extent to which the employee and employer share their respective tax burdens and benefits depends on many factors, including labor market conditions. This is true, but beside the point. How the parties share the benefits and burdens, tax or otherwise, of their joint enterprise is or-

¹⁸⁶ Assume for now that the owner can take the deduction.

¹⁸⁷ See note 179.

thogonal both to the ownership structure (at least in our simple example without risk) and to the manner in which the service contributing partner is compensated for that labor contribution. The parties will allocate these benefits and burdens according to the relative scarcity and value of the economic contributions that they offer (and, outside our example, also according to what risks they bear under the business structure that is adopted). This is true whether the parties' relationship is best described as a bilateral bargain or a market sale and purchase. Apart from considerations of risk allocation—which would cause the examples to differ in their underlying economics, and so complicate any analysis of tax advantages across the various scenarios—there is no reason to believe that the manager-as-employee would be left with more of the tax burden of her salary income and less of the tax benefit of the corresponding deduction than the manager-as-owner.

V. NORMATIVE ANALYSIS

This Part attempts to excavate and critically appraise the sometimes tacit and often unexamined normative claims that give the profits interest issue its unusual salience.

Two factors appear to be the source of the issue's normative charge. First is the comparison of private equity fund managers—who pay 15 percent capital gains rates on compensation for services—to other workers and professionals—who pay up to 35 percent on the same kind of income. Second is the fact that the earnings of some private equity fund managers are extraordinarily large.

The chief purpose of this Part is to look more closely at these two factors. But the Part also takes up two other issues raised by the tax treatment of service-compensatory profits interests: the true incidence of the tax advantage and the tax implications of the fact that profits interests are risky.

A. Horizontal Equity and the Third Hand

The chief source of normative concern with profits interests appears to reside in a comparison of service partners, such as fund managers, with other kinds of service providers in the economy.¹⁸⁸ In other industries and other business entities, those who contribute labor to a business enterprise generally pay tax at ordinary income rates on the compensation they receive in return for that contribution. But the

¹⁸⁸ This claim has been made by policymakers and tax scholars. See note 21.

general partner who is compensated for her services with a profits interest pays tax at capital gains rates on her labor contribution.¹⁸⁹

In explaining what is wrong with this state of affairs, commentators are apt to hold these two cases out, one in each hand, and ask rhetorically why one form of labor receives more favorable tax treatment than another.

If only these commentators had a third hand, their analysis would arguably be more complete—and certainly more complex. Their third hand would hold those who contribute to the business enterprise not their labor, but their capital, and who in return for that contribution receive capital gains treatment as a matter of course.

Much of the normative analysis that has been applied—implicitly or explicitly—to the partnership profits issue evaluates the general partner's tax advantage against the touchstone of “horizontal equity”: the principle that “like should be treated alike.” The general partner, so the reasoning goes, is *like* other service providers elsewhere in the economy, and so should be taxed like them.

Horizontal equity analysis is plagued with many serious problems.¹⁹⁰ One of its major drawbacks is that it presupposes a previous sorting of individuals into the horizontal strata within which equality comparisons are made. Application of the principle that like be treated alike requires first answering the question, “who is like whom?”

This indeterminacy is particularly problematic when the principle of horizontal equity is applied to a situation with preexisting inequalities, as is arguably the case here. There is always the temptation to take preexisting inequalities as natural and given, and to sort people into horizontal layers that correspond to their initially disparate treatment. The result is not just that these initial inequalities are ignored in the analysis, but that what otherwise might be regarded as equalizing, or at least ambiguous, may come to seem definitely disequalizing.

Imagine, for example, that a number of individuals are gathered in a train station waiting at the top of the stairs to be let down onto the

¹⁸⁹ But see the discussion in Part V.C regarding the incidence of this tax benefit.

¹⁹⁰ See generally Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 Natl Tax J 139 (1989) (questioning the justification for horizontal equity as an independent welfare principle); Richard A. Musgrave, *Horizontal Equity, Once More*, 43 Natl Tax J 113 (1990) (arguing for horizontal equity as an independent welfare principle); Louis Kaplow, *Commentary on Tax Policy and Horizontal Equity*, in Kevin A. Hassett and R. Glenn Hubbard, eds, *Inequality and Tax Policy* 75 (American Enterprise Institute 2001) (critiquing Auerbach and Hassett and further arguing that horizontal equity is unjustified as an independent principle); Alan J. Auerbach and Kevin A. Hassett, *A New Measure of Horizontal Equity*, 92 Am Econ Rev 1116 (2002) (deriving a measure of inequality that is “decomposable into components that are naturally interpreted as horizontal and vertical equity”).

platform to board an overbooked train. Suddenly, someone waltzes over to the top of the stairs and is allowed down onto the train.

One way to formally express normative dissatisfaction with this situation is to say that the principle of horizontal equity has been violated. Why should this one individual, apparently no different from the others, be given special treatment?

But what if there is another group of individuals—separate from those gathered at the top of the stairs—who have already been allowed down to the train early, perhaps by elevator? And what if our line-cutter, because he is also let down early, meets up with these others on the platform and so has as good a choice of seats as they?

Allowing the line-cutter through may well increase horizontal inequality *within* the horizontal stratum consisting solely of those who were or still are waiting upstairs in the station. But if we expand the relevant stratum to include the elevator group with special prior boarding privileges—and thus acknowledge the preexisting inequality in our example—can we really say that inequality has increased? In one respect, it has decreased: those with prior boarding rights are now sharing their seating privileges with one more person from upstairs.¹⁹¹

Why should we judge the equity impact of allowing the line-cutter through solely with regard to those whom he leaves behind, and not also with regard to those to whom he catches up? Similarly, why should we judge the equity impact of allowing capital gains treatment for the labor contributor solely with regard to those other labor contributors in the economy who still pay tax at ordinary income rates, and not also with regard to those capital contributors who are already paying at capital gains rates for the return on their contribution?

Perhaps the reason is that capital contributors are not “like” labor contributors, because capital contributors have already been taxed on the capital that they are now contributing. In many cases, that may be a valid response.¹⁹² If an individual, such as our limited partner, con-

¹⁹¹ Whether inequality increases or decreases depends on the precise structure of the problem and the precise manner in which inequality is measured. A web appendix, online at www.cstone.net/~csanchir/Sanchirico_Private_Equity_Web_Appendix_082307.pdf (visited June 8, 2008) (cited in note 27), shows that inequality *can* decrease in a simple example under similar circumstances.

¹⁹² This response is related to the arguments for a consumption tax—and even more so, the arguments for an endowment tax—as summarized in Daniel Shaviro, *Beyond the Pro-consumption Tax Consensus*, 60 *Stan L Rev* 745 (2007). The assertion, more precisely stated, is that we should strive to tax the present discounted value of individuals' lifetime endowments, and that taxing the return to savings (for example via taxing capital gains) moves us away from this ideal. As Daniel Shaviro notes, however, taxing “once”—more precisely taxing only the present discounted value of endowment value—may not be the optimal tax structure when other factors, like incomplete financial markets and incomplete information regarding individual endowments, are taken into account. *Id.* at 770–80. The importance of the latter factor is analyzed at

tributes \$1 million of capital to a business enterprise, and this enterprise generates proceeds of \$3 million for him, his taxable gain from this enterprise is \$2 million. The \$1 million contribution is subtracted, as basis, from the \$3 million realization in calculating the tax that he owes from this enterprise. To complete the picture, however, we may wish to add to this tax any previous tax that the individual may have already paid on the \$1 million that he contributes. If this individual, say a surgeon, had just earned this \$1 million from the provision of medical services, then one-third of his \$3 million realization would, in effect, be taxed at ordinary income rates and two-thirds at capital gains rates. Certainly, if we compare *this particular* capital contributor to the fund manager under the imputed salary plan in our numerical example, then the manager does seem tax advantaged. Similar to the surgeon, the general partner provides \$1 million of labor. Yet, all of the general partner's \$3 million realization is taxed at capital gains rates, whereas the surgeon enjoys capital gains rates only on two-thirds of this amount.

Comparing the fund manager only to the surgeon, however, is like comparing the line-cutter only to the crowd waiting at the top of the stairs. What about other investors who do not contribute from their already taxed labor earnings, but rather from inherited funds? What justifies leaving these comparators out of the analysis? The best data, cautiously interpreted, suggest that a substantial portion of private investment capital in the economy is sourced from gifts and inheritances rather than from labor earnings. Some researchers estimate that as much as 60 to 80 percent of the existing private wealth was received by gift or inheritance rather than earned by current holders.¹⁹³

Imagine, then, that the investor contributes \$1 million that he has received via gift or inheritance. Inheritances and gifts are not income-taxed to the recipient,¹⁹⁴ and it is also possible to avoid estate and gift tax on this amount (and more).¹⁹⁵ Consequently, while two thirds of the

length in Chris William Sanchirico, *Deconstructing the New Efficiency Rationale*, 86 Cornell L Rev 1003 (2001).

¹⁹³ See Laurence J. Kotlikoff and Lawrence H. Summers, *The Role of Intergenerational Transfers in Aggregate Capital Accumulation*, 89 J Polit Econ 706, 730 (1981) ("Intergenerational transfers appear to be the major element determining wealth accumulation in the United States."). Compare Franco Modigliani, *The Role of Intergenerational Transfers and Life Cycle Saving in the Accumulation of Wealth*, 2 J Econ Perspectives 15, 18–21 (1988) (critiquing Kotlikoff and Summers), with Laurence J. Kotlikoff, *Intergenerational Transfers and Savings*, 2 J Econ Perspectives 41, 43 (1988) (responding to Modigliani), and William G. Gale and John Karl Scholz, *Intergenerational Transfers and the Accumulation of Wealth*, 8 J Econ Perspectives 145, 156–57 (1994) (finding evidence consistent with Kotlikoff and Summer's original results).

¹⁹⁴ IRC § 102 (governing gifts and inheritances and excluding such from gross income).

¹⁹⁵ IRC § 2010(c) (allowing a credit against estate tax equal to the amount obtained by applying the tax rate tables to \$2 million, in 2007 and 2008, and \$3.5 million in 2009). The estate tax is

investor's \$3 million proceeds are still taxed at capital gains rates, one-third, the contributed funds, are never taxed at all. In this case, adopting the imputed salary plan moves the fund manager *closer* to the investor—but, even so, only part of the way, since the entire amount of the fund manager's \$3 million proceeds are taxed (at capital gains rates).¹⁹⁶

Arguably, the true inequity in the train example, viewed in its entirety, is that some riders board earlier than others, not that the line cutter is allowed to join the group of early boarders. Likewise, if we view the problem of partnership profits interests broadly enough to take into our field of vision how the fund managers' wealthy heir investors are taxed, we might conclude that our primary equity concern should be the favorable taxation of capital endowments, rather than the fact that some labor endowments also partly enjoy such favorable treatment.

B. Private Equity's Outsized Earnings

Another source of normative discomfort with partnership profits taxation appears to derive from the enormity of some private equity fund managers' earnings. After all, the capital gains treatment of partnership profits has been around for many years.¹⁹⁷ Only recently has it garnered the kind of media attention that it now enjoys. Indeed, some commentators explicitly invoke the large amounts that fund managers earn in calling for reform in this area.¹⁹⁸

There are two intuitively unsettling ways in which fund manager earnings might be viewed as oversized. First, the percentage of profits that fund managers claim might seem large: fund managers' profits interests are typically 20 percent, and have been reported to be as high

scheduled to be completely eliminated in 2010. Economic Growth and Tax Relief Reconciliation Act, 115 Stat at 38. However, the provisions of this Act eliminating the estate tax "sunset" on December 31, 2010, see id § 901, 115 Stat at 150 (general sunset provision for act), and the estate tax will thus be automatically reinstated in 2011, unless Congress makes the repeal permanent.

Regarding the gift tax, which is scheduled to survive potential repeal of the estate tax, see IRC § 2505(a) (allowing a credit against gift tax liability in any year equal to the amount obtained by applying the tax rate table to \$1 million and then subtracting the portion of such amount that could be taken as a credit in prior years). See also IRC § 2503(b) (excluding from the definition "taxable gifts" for any given year \$12,000 (for 2007) per spouse of gifts made to any person during such taxable year).

¹⁹⁶ One might claim that the investor's donor/bequeather had already been taxed when this donor/bequeather earned the money. Whether this counts as taxation to the investor herself is an issue subject to intense controversy.

¹⁹⁷ Laura E. Cunningham and Noël B. Cunningham, *The Logic of Subchapter K: A Conceptual Guide to the Taxation of Partnerships* 134 n 22 (West 3d ed 2006) ("[T]he receipt of a profits interest in exchange for services has been a contentious issue for 35 years.").

¹⁹⁸ See, for example, Fleischer, 83 NYU L Rev (forthcoming 2008) (cited in note 6) ("Almost nine times as many Wall Street managers earned over \$100 million as public company CEOs; many of these top-earners on Wall Street are fund managers.").

as 30 percent.¹⁹⁹ Second, fund managers' payments might appear large in absolute dollar amounts.²⁰⁰ This Part considers each of these two senses of largeness, before addressing the question of what implications the size of fund manager earnings should have for tax policy.

Is 20 percent an obscenely large share of profits? In attempting to answer this question, it is worth starting with the obvious point that 20 percent *of profits* is not the same as 20 percent of assets under management. Twenty percent of profits is 20 percent *of some percent* of assets under management. Thus, if the fund invests \$1 million and the investment appreciates by 10 percent in one year, the fund manager is paid not 20 percent of \$1 million, but 20 percent of 10 percent of \$1 million, which is to say, 2 percent of \$1 million.

Even so, we might still ask whether 20 percent *of profits* is large. In answering this question, it is worth considering that 20 percent is not, in fact, large compared to other similar pay arrangements in the economy. Consider, for example, the contingent fee arrangements that are now commonplace in legal practice. Such arrangements have more in common with profits interests than meets the eye. The contingent fee lawyer, who absorbs the legal cost of the suit, which consists mainly of the cost of her own services, is like the fund manager who contributes services to the fund. The claimant, who contributes the "chase in action," is like the limited partner who contributes cash to the partnership. Litigation winnings are not quite like profits, because litigation winnings are not calculated net of the value of the chase in action before the lawyer has added her services. Litigation winnings are perhaps more like revenues. Contingent fee lawyers typically take 33 percent of such "revenues." Compared to fund managers, who take 20 percent of profits, then, contingent fee lawyers take a larger share of a larger base.

Let us next consider the absolute dollar amount of compensation that fund managers actually receive. Is this too large? Press reports highlight the spectacular earnings of certain fund managers, because spectacular earnings are newsworthy. But it may be that fund managers are capable of winning big, and of losing big, and that what we see in press reports is just the upper tail of a distribution that also has a long lower tail.

¹⁹⁹ David D. Kirkpatrick, *Romney's Fortunes Tied to Business Riches*, NY Times A1 (June 4, 2007) ("Mr. [Mitt] Romney [] persuaded investors to let the Bain partners keep 30 percent of the profits—an arrangement that is still rare.").

²⁰⁰ Anderson and Sorkin, *Congress Weighs End to Tax Break for Hedge Funds*, NY Times at A1 (cited in note 7) ("This tax break has helped add to the record level of wealth among hedge fund managers. . . . Private equity executives alone took home more than \$45 billion in pay in the past six years.").

None of this, of course, rules out the possibility that fund managers make “too much.” But then the question arises: why have other potential fund managers not entered the market and underbid them, thus driving down their fees? Perhaps the reason has to do with persistent information asymmetries or market imperfections due to cartelization. Or perhaps private equity firms have figured out how to exploit a “minor” regulatory exception²⁰¹ that has turned out to have enormous unintended consequences. All this is possible and worth investigating, as others have done.²⁰²

But even if the enormous earnings of private equity fund managers are symptomatic of a serious regulatory malfunction in financial markets, the problem is unlikely to be wholly or even mostly a matter of tax policy. The earnings are, after all, enormous *pretax*. Indeed, it is not entirely implausible that changes in tax policy could distract Congress and the public from what really needs fixing. A change in the tax structure for private equity might satisfy political appetites without doing anything to solve the real underlying problem.

C. Sharing of the Tax Advantage with Tax-exempt Partners

When an enterprise can be restructured so as to reduce the joint tax liability of the participants, it is reasonable to suppose that all participants—even those who are nominally tax disadvantaged by the restructuring—will share in the overall tax advantage. Those who are nominally tax advantaged can be expected to make what are, in effect, side payments to those who are either substantially less nominally advantaged, neutral, or nominally disadvantaged. One general means of making such side payments is to give the nominally tax advantaged less of an interest in the enterprise in return for a given value of contribution.

In the case of service-compensatory profits interests, these other partners, who will likely share in the tax advantage, have a particular identity. Taking both the timing and character swap aspects of the tax advantage into account—and even accounting for the potential qualifications discussed in Part II—the joint advantage of service-compensatory

²⁰¹ See the sources cited in note 1.

²⁰² See, for example, SEC Report at 76–88 (cited in note 1) (reviewing the operations and practices of hedge funds and the regulatory concerns addressing them); Role of Hedge Funds in our Capital Markets, Hearings before the Subcommittee on Securities, Insurance, and Investment of the Senate Committee on Banking, Housing, and Urban Affairs, 109th Cong, 2nd Sess (May 16, 2006), online at <http://banking.senate.gov/public/index.cfm?Fuseaction=Hearings.Detail&HearingID=40b5e58b-b448-4a8a-8bb6-63d314289b8d> (visited June 8, 2008) (same); Regulation of Hedge Funds, Hearings before the Subcommittee on Securities, Insurance, and Investment of the Senate Committee on Banking, Housing, and Urban Affairs, 109th Cong, 2nd Sess (July 25, 2006), online at <http://banking.senate.gov/public/index.cfm?Fuseaction=Hearings.Detail&HearingID=e5cd2741-2416-465a-b3e8-ae27c4bcadb4> (visited June 8, 2008) (same).

profits interests is clearest and largest when the other partners are tax-exempt entities such as pension funds and university endowments.

Therefore, not only is the general partner likely to be sharing the tax advantage of the service-compensatory profits interest with her partners, but she is also specifically likely to be sharing this advantage with tax-exempt entities. That is, there is good reason to believe that tax-exempt entities pay lower fees to fund managers because of the double tax benefit (deferral and character conversion) that general partners enjoy in partnering with such entities.

Arguments against the tax advantage for service-compensatory profits interests that rest on the identity of those receiving the advantage—and corresponding judgments about whether these individuals are appropriate recipients—should probably take this into account. This is not to say that fund managers do not enjoy substantial real tax advantages, or that additional tax benefits for pension funds (which is to say, for pension fund participants) and university endowments are necessarily desirable, or that, even were additional tax benefits desirable, the current tax treatment of profits interests is the best way to provide them. Rather, it is merely to acknowledge that the integral income-shifting component of the tax advantage makes the matter of incidence more complicated than it may at first appear.

D. The Significance of the Risks Borne by Private Equity Fund Managers

Private equity firms and their lobbyists assert that profits interests should be accorded capital gains treatment because profits interests are inherently risky.²⁰³ If profits are meager, fund managers are compensated less for their effort. If profits are nonexistent, so are profits interests.

But risk bearing can hardly be considered the touchstone for capital gains treatment. Consider, first, that the return to labor is often *explicitly* risky. Salespeople, stockbrokers, real estate brokers, and many others in the economy are paid at least in part on commission. Many employees are compensated in part with bonuses that fluctuate according to individual performance, market conditions, and vagaries of the assessment process. All these employees are directly exposed to risk. Yet there is little question that all of these forms of compensation are ordinary income.

²⁰³ Anderson and Sorkin, *Congress Weighs End to Tax Break for Hedge Funds*, NY Times at A1 (cited in note 7) (“The industry argues that the portion of profits they receive from investments should receive preferential treatment because of the risk involved.”).

Moreover, even those workers and professionals in the economy who are compensated with fixed wages only avoid risk in their compensation because they are in effect insured against such risk by their employers. The value of what the employees produce is certainly not fixed. Rather, it depends on uncertain market demands for the good or service that they help produce. Their employer fixes their wage and absorbs this variation in value product. No doubt, the fixed wage is somewhat lower than it might otherwise be, because the employee is paying a premium to the employer for the implicit insurance that the employer provides. And yet, for tax purposes, there is no question that the entire fixed wage is ordinary income, and no part is a capital asset combined with insurance.

A moment's reflection confirms that risk could never be what distinguishes the return to labor from the return to capital. Labor and capital are both inputs into economic activities. The economic activities house the risk. Neither input is inherently more or less subject to that risk. The risk of the activity might be, and is, divided between capital and labor in a variety of different ways.

CONCLUSION

The taxation of private equity profits interests is now under the lens of public scrutiny. This Article argues that academic and policy discourse on the topic needs to both sharpen its focus and expand its field of vision.

The most pressing need is to gain a clearer understanding of what the tax advantage of such profits interests really is. The real tax advantage is a form of joint tax arbitrage that exploits differences in the tax positions of fund managers and their investors. Neglect of this basic point has led to misguided attempts to analogize the tax advantage of profits interests to the putative tax advantage accorded to sweat equity.

Furthermore, it may be worth widening our angle of vision with respect to the (albeit unsettling) fact that fund managers are taxed at lower rates on their service compensation than other workers. Also relevant is the increasingly favorable taxation of other forms of lifetime value besides labor earnings. Arguably, the most telling and urgent juxtaposition is not the fund manager versus her secretary, but the fund manager *and* her secretary versus the wealthy heir investor that they both service.

Lastly, although the enormous returns enjoyed by private equity fund managers may well be a source of policy concern, taxation is unlikely to be the root of the problem. It is thus vitally important that the current focus on changing the tax law not distract attention from the potential need for broader regulatory reform.