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# The Taxation of Compensatory Profits Interests: The Blind Men and the Elephant

*Philip F. Postlewaite*<sup>♠</sup>

## INTRODUCTION

According to the famous poem, six blind men approach a stationary elephant from different angles.<sup>1</sup> Each places his hand on a portion of the elephant and exclaims that the elephant is really something other than what it is. The declarations range from a spear (a tusk) to a snake (the trunk).

The advocacy at this symposium suggesting that the current tax treatment of compensatory profits interests is improper from the standpoint of tax policy is reminiscent of that story. Each of the worthy presenters<sup>2</sup>

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\* "The Blind Men and the Elephant," is a poem in which six blind men come upon an elephant, touch its distinct parts, and fail to recognize that the whole is a combination of its parts. Saxe, John Godfrey, *The Blind Men and the Elephant*, in THE OXFORD ILLUSTRATED BOOK OF AMERICAN CHILDREN'S POEMS, 24 (Donald Hall ed., 1999). Of the six, one hits the elephant's side and concludes it is a wall, the next thinks that based on its tusk it is a spear, another the trunk is a snake, then its leg is a tree, the ear is a fan, and the tail is a rope. *Id.* Of particular applicability to this symposium is the concluding stanza serving as the moral of the poem which cautions: "So oft in theologic wars, The disputants, I ween, Rail on in utter ignorance Of what each other mean, And prate about an Elephant Not one of them has seen." *Id.*

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<sup>1</sup> Another contender for the title, suggesting a failure of the presenters and the majority of academics who have expressed themselves on the topic to see clearly what is before them, was "The Emperor's New Clothes" by Hans Christian Anderson. Therein, particularly in their eagerness to please, all of the Emperor's subjects are convinced that his new finery is beyond compare. It remains for a small child (similar to the distinct minority of academics defending the *status quo*) to enlighten others to the fact that their "clarity of vision" is not what it should be. HANS CHRISTIAN ANDERSON, THE EMPEROR'S NEW CLOTHES (Virginia Lee Illustrator, 1949).

<sup>2</sup> Adam Rosenzweig and Darryll Jones begin their assault in a similar fashion. Each has latched on to but a portion of the overall beast, i.e., the tax treatment of the receipt of a compensatory profits interest in a partnership, and has advanced his analyses on the basis of

focuses upon but a portion of the topic of executive compensation through the transfer of an equity interest in a business enterprise.<sup>3</sup> Exploring but one component of the whole, i.e., the transfer of a profits interest in a partnership, they exclaim that its essence is so overwhelmingly similar to compensation received for the rendition of services by an employee from an employer that its tax treatment should be identical, i.e., ordinary income taxed at progressive rates should be accorded the entirety of the return thereon.<sup>4</sup>

Services are rendered to the partnership by the recipient of the profits interest as is the case in the employee and the employer context. The employee renders only services and is taxed at progressive rates. In the latter case, the entirety of the compensation for the duration of the relationship is taxed at ordinary income rates. Accordingly, like the blind man who touches the elephant's tail and is thus certain that it is a rope, the presenters assert that the receipt of a profits interest or a carried interest<sup>5</sup> should similarly generate ordinary income throughout the duration of the recipient's relationship with the enterprise because he or she is nothing

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comparison with the employee/employer context instead of a comparison with the other categories of equity compensation in a business enterprise. Darryll K. Jones, *Sophistry, Situational Ethics, and the Taxation of the Carried Interest*, 29 NW. J. INT'L L. & BUS. 675 (2009); Adam H. Rosenzweig, *Not All Carried Interests Are Created Equal*, 29 NW. J. INT'L L. & BUS. 713 (2009). The landscape for the transfer of compensatory equity interests in a traditional business enterprise is broad and includes stock and restricted stock in the corporate context and a capital interest, a restricted capital interest, and a profits interest in the partnership context. In such a setting, the taxation of a compensatory profits interest is not aberrational.

<sup>3</sup> Surprisingly, they continue to do so even after having read my prior publication on the topic in which I summarized the entirety of the tax treatment of compensatory equity transfers and illustrated the consistency of the taxation of profits interests in a partnership with that accorded the treatment of compensatory transfers of stock in a corporation and compensatory transfers of capital interests in a partnership. See generally Philip F. Postlewaite, *Fifteen and Thirty Five: Class Warfare in Subchapter K*, 28 VA. TAX REV. (forthcoming Spring 2009). Obviously, my powers of persuasion leave something to be desired.

<sup>4</sup> Professor Rosenzweig innovatively offers a somewhat different approach which generates short-term, rather than long-term, capital gain. Rosenzweig, *supra* note 2. But for its ability to absorb capital loss, which given the economic meltdown is more valuable than is normally the case, his proposal produces similar results, because short-term capital gain is not entitled to preferential tax treatment.

<sup>5</sup> The substitution by the presenters of the term "carried interest," descriptive of the partnership interest received by the general partner of a private equity or hedge fund, does not change the essence of the proprietary interest. In spite of the populist efforts to engage in class warfare which is made easier if the target is more narrow: a "carried interest" is a "profits interest." One cannot alter the tax treatment of one without altering the other. Accordingly, any proposed change must apply throughout the world of commercial enterprises and must be equally applicable to the small commercial partnership as well as the gigantic private equity firm.

more than a service provider.

The position increasingly held by academics is that the current tax treatment of such receipts is improper and should be obvious to all.<sup>6</sup> Apparently, the small but determined group which defends the *status quo*<sup>7</sup> not only fails to appreciate the clarity of the situation,<sup>8</sup> but their analysis is derisively dismissed as sophistry and their motives impugned for acting as tools of the establishment.<sup>9</sup>

As the lowly representative of the Gang of Three, and the only one apparently not smart enough to be paid for his advocacy,<sup>10</sup> notwithstanding the intensity and inventiveness of the presenters' advocacy, I remain unconvinced. My support for the *status quo* appears elsewhere and is most detailed and recommended for those with further interest.<sup>11</sup> Herein, I will limit my response to the larger themes of equity compensation in the business enterprise context, with cross references to my prior work for those who wish to pursue the matter further. The overriding criticism by the presenters of the *status quo* for recipients of compensatory profits interests is the lack of parity among similarly-situated recipients. Both make their case for changing the current tax treatment of carried interests because of this defect. The virtues of horizontal equity are extolled by the presenters.<sup>12</sup> However, the difficulty in the application of the tax policy

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<sup>6</sup> Jones, *supra* note 2, at 683–84; Rosenzweig, *supra* note 2, at 721–24. See Laura Cunningham, *Taxing Partnership Interests Exchanged for Services*, 47 TAX. L. REV. 247 (1991); Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1 (2008); Mark P. Gergen, *Reforming Subchapter K: Compensating Service Partners*, 48 TAX. L. REV. 69 (1991); Leo L. Schmolka, *Taxing Partnership Interests Exchanged for Services: Let Diamond/Campbell Quietly Die*, 48 TAX. L. REV. 287 (1991).

<sup>7</sup> See Howard E. Abrams, *The Taxation of Carried Interests*, 116 TAX NOTES 183 (2007); Postlewaite, *supra* note 3; David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 VA. L. REV. 715 (2008) [hereafter *Gang of Three*].

<sup>8</sup> Jones states that “[t]he overarching assertion made in this Article—that arguments in support of the *status quo* cannot be explained by logic, reason, or deduction—is intended to allow readers to draw the conclusion implicit in the Article’s title.” Jones, *supra* note 2, at 679.

<sup>9</sup> “Instead, I seek only to insist that proponents are not entirely disinterested in the outcome.” Jones, *supra* note 2, at 678 n.9. “With due respect to the proponent, this Article categorically labels that path sophistry . . .” *Id.* at 699.

<sup>10</sup> See Abrams, *supra* note 7; Weisbach, *supra* note 7, at 715.

<sup>11</sup> See Postlewaite, *supra* note 3.

<sup>12</sup> Jones elevates horizontal equity as a governing principle of taxation: “Horizontal equity—basic fairness—is the ethic that is so obviously violated by the taxation of the carried interest vis-à-vis the taxation of other yields to services.” Jones, *supra* note 2, at 710. Jones also states that “horizontal equity has a preeminent place in tax jurisprudence.” *Id.* at 684. Rosenzweig asserts that “proponents of changing the taxation of carried interest claim that this disparate treatment violates the norm of horizontal equity, which provides that similarly situated taxpayers should bear similar tax burdens.” Rosenzweig, *supra* note 2, at

guideline emphasizing horizontal equity is in ensuring that one is comparing the relevant parties, i.e., apples to apples, in making the assessment. Many advance the employee as the center point for comparison because the return on their services is taxed at progressive rates.<sup>13</sup> I instead offer the corporate or partnership executive as the appropriate focal point, whose return from his expenditure and investment of services under the current tax law is frequently entitled to preferential treatment.

The presenters collectively ignore a number of critical factors in their analysis, each of which will be discussed further below. Most importantly, they focus exclusively upon the recipient of a profits interest and the tax consequences therefrom without comparing those consequences with the other categories of recipients of compensatory equity interests. Furthermore, they ignore the fact that a profits interest in a partnership without withdrawal becomes a capital interest and the failure to take a salary in lieu of the equity interest results in an investment of that amount in the enterprise. Finally, they minimize the dictates of § 702(b) and the congressionally mandated equality of treatment of all members of the partnership regardless of whether their contribution to the enterprise is of property or services.

#### BOOTSTRAPPING WITH THE RENDITION OF SERVICES ROPE

Instead of focusing on the whole (the tax treatment of all compensatory equity recipients), the presenters address but a small part (profits interests) of the field of equity compensation. Having discovered a rope with which to elevate their analysis to the center of attention, they narrow their focus accordingly. Advocates, as the *sine qua non* of their assault, rely on the fact that the return from the rendition of services is treated as ordinary income taxed at progressive rates.<sup>14</sup>

Employees pay taxes at regular rates. Accordingly, private equity managers should be treated similarly in order to foster horizontal equity.<sup>15</sup> Notwithstanding the difficulty of determining who is similarly situated with whom, the presenters assert that horizontal equity dictates that similarly-situated taxpayers be treated similarly.<sup>16</sup> From this base they elevate their

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724. The difficulty again is their assumption that the similarly-situated party is a non-equity service provider rather than other recipients of compensatory equity interests in a business enterprise.

<sup>13</sup> Jones, *supra* note 2, at 682–83.

<sup>14</sup> *Id.*

<sup>15</sup> *Id.* “Thus, that a service provider may very well be referred to as ‘partner’ under state and even federal law is of no logical consequence to the determination of whether the service provider ought to be taxed more favorably than a service provider who is not so labeled by any definition.” *Id.* at 682. As discussed below, the obstacle to this result imposed by the enactment of § 702(b) is apparently of little concern.

<sup>16</sup> *Id.* at 698 (suggesting that those who support the *status quo* acknowledge the deviation

argument, one advocating taxing income from a profits interest as ordinary income<sup>17</sup> while the other adopts a less pure approach that functionally produces the same result.<sup>18</sup>

According to them, the return from the rendition of services in some manner must be taxed at the progressive rates.<sup>19</sup> Thus, the profits interest (aka carried interest) recipient should be taxed on the entirety of his or her return at progressive rates.<sup>20</sup> Yet neither advocate subjects other equity recipients to the same treatment.<sup>21</sup> There is no such advocacy for the extension of such treatment to equity recipients of the four other categories of executive equity compensation. If the presenters' views were adopted, the recipient of a profits interest would be discriminated against by the federal tax laws because they would receive worse tax treatment than their counterparts. In fact, they would be the only category of recipients of compensatory equity interests in a business enterprise subjected to tax at ordinary income rates on the entirety of their return.<sup>22</sup>

There are five categories of compensatory equity recipients in the

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from horizontal equity: "The most telling aspect of the various arguments offered in support of the *status quo* is that they all implicitly admit that taxing fund managers for their services in a manner preferential to the compensation received by other service providers is contrary to horizontal equity."); Rosenzweig, *supra* note 2, at 724. My position in fact is to the contrary. Postlewaite, *supra* note 3, at 1–66. The *status quo* for the taxation of a profits interest is consistent with the treatment of other compensatory recipients of equity interests in a business enterprise.

<sup>17</sup> Jones, *supra* note 2, at 684–98.

<sup>18</sup> Rosenzweig, *supra* note 2, at 755–62 (utilizing a short-term capital gain approach which would not be entitled to preferential treatment).

<sup>19</sup> Rosenzweig, *supra* note 2, at 722. The presenter states that "[i]n general, for tax purposes, when a service provider receives property in exchange for services, the value of the property is treated as salary, or ordinary income, on the date of issuance." *Id.* Later, the presenter attempts to utilize holding period doctrines to produce short-term capital gain for private equity firms. *Id.* at 734–35. While such gain does not qualify for preferential rates, it has some value superior to that of ordinary income. Under the general rules, only \$3,000 of capital loss can offset ordinary income. I.R.C. § 1211 (2009). However, short-term capital gain may offset an equivalent amount of capital loss, which may prove significant given the economic meltdown of 2008 and 2009 and the tremendous amount of market loss sustained by investors. Even his fellow presenter is critical of such an approach: "In other words, the short term holding period solution actually supports the *status quo*, even as the proponent admits that capital gain taxation is incorrect." Jones, *supra* note 2, at 709.

<sup>20</sup> According to Rosenzweig, "managers of private equity funds were effectively being compensated for their services while receiving income in the form of capital gain for tax purposes." Rosenzweig, *supra* note 2, at 723–24.

<sup>21</sup> Jones, *supra* note 2, at 696 (failing to acknowledge the extension of preferential treatment to other recipients of compensatory equity interests: "Every entrepreneur is a risk-taker, but only entrepreneurial investors of previously taxed income are taxed at lower rates . . ."). As I have documented previously, this is not true for the four other categories of compensatory equity recipients.

<sup>22</sup> See generally Postlewaite, *supra* note 3, at 16–29.

traditional commercial enterprises which utilize either the corporate or partnership vehicle for the conduct of business activities. In the corporate context, a corporate executive can receive a compensation package of salary and/or stock.<sup>23</sup> If stock is received, ownership may vest upon receipt or instead upon the completion of service upon which the grant is conditioned.<sup>24</sup> Similarly, in the partnership context, a service provider can receive a compensation package of a guaranteed payment (salary) and/or a capital interest in the enterprise and/or a profits interest.<sup>25</sup> If an equity interest is received, ownership may vest upon receipt or instead upon the completion of service upon which the grant is conditioned.

Under existing law, a service provider in receipt of corporate stock is taxed at the progressive rates on the value of the stock upon receipt or its vesting if restricted. That amount becomes his or her basis for the stock.<sup>26</sup> Upon the disposition of the stock, even though the executive provided services to the enterprise over the entirety of the ownership period, the gain on the disposition of the stock will be taxed as long-term capital gain, which receives preferential treatment.

In the partnership context, a service provider in receipt of a capital interest is taxed at progressive rates on the liquidation value of the stock upon receipt or its vesting if restricted.<sup>27</sup> That amount becomes his or her basis for the partnership interest. Upon the disposition of the capital interest, even though the equity partner provided services to the enterprise over the entirety of the ownership period, while not as favorable as that accorded the corporate context, the gain on its disposition will also be taxed as long-term capital gain if the underlying assets are similarly classified.

Thus, under current law, the service provider in receipt of an equity interest in a corporation or a partnership has the overall gain from the rendition of services over the life of the enterprise taxed both at progressive rates and at preferential rates. Congress has decided to bifurcate the service provider's return from the rendition of services by treating the value of the equity interest upon receipt or vesting as ordinary income and the remaining gain upon disposition as long-term capital gain.<sup>28</sup> Some of this treatment derives from the re-investment of funds in the enterprise which the service

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<sup>23</sup> *See id.*

<sup>24</sup> *See id.*

<sup>25</sup> *See id.*

<sup>26</sup> *See id.*

<sup>27</sup> *See id.*

<sup>28</sup> *See Rosenzweig, supra note 2, at 713 (suggesting to the contrary: "Historically, one way the law has attempted to address the issue was not by deconstructing such returns into constituent parts, but by imposing a 'holding period' requirement."). As evidenced above, the Code with respect to blended labor/investment returns has done the opposite by providing generally for ordinary income upon receipt and capital gain upon disposition of the interest.*

provider relinquished by taking an equity interest rather than a salary.<sup>29</sup>

Accordingly, the adoption of the presenters' proposals would discriminate against the recipient of a profits or a carried interest. Contrary to their rhetoric about the privileged treatment available to such holders under the current law, the adoption of their proposals would leave the recipient of a compensatory profits interest in a partnership as the only category of service providers to business enterprises compensated with equity interests liable for tax at progressive rates on the entirety of their return.

In addition, those advocating reform in this area are forced to address the ramifications of such a change in the international arena.<sup>30</sup> The possible "unintended consequences" of such a modification range from the relocation of industries offshore, attempted manipulation of the international taxing provisions, and the possible need for collaboration by the United States with its European trading partners. An additional benefit of retaining the *status quo* is that none of these issues needs to be addressed. A maxim of tax policy is that an old tax is a good tax. Everyone has adjusted to the prevailing regime and the issues created by a prospective change are avoided.

#### THE IMAGINARY WALL BETWEEN A PROFITS INTEREST AND A CAPITAL INTEREST

Another difficulty with the presenters' advocacy is their belief that a wall of meaningful distinction separates a profits interest in a partnership from a capital interest therein.<sup>31</sup> Accordingly, because they view each as different from the other, their proposals need not acknowledge the symbiotic relationship between the two.

The difficulty is that such is not the case under the current taxation regime of Subchapter K of the Code.<sup>32</sup> Even the presenters acknowledge that most recipients of a carried interest acquire a capital interest as well in order to have "skin in the game."<sup>33</sup> The focal point of their advocacy is the disproportionate amounts of each, e.g., a three percent capital interest and a twenty percent profits interest.<sup>34</sup> However, as time marches on,

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<sup>29</sup> For intense criticism of my position, see Jones, *supra* note 2, at 699 describing the argument as "sophistry."

<sup>30</sup> See Jones, *supra* note 2, at 676; Rosenzweig, *supra* note 2, at 747–55.

<sup>31</sup> Pink Floyd's refrain from *The Wall* that "we don't need no education" appears descriptive of their position. PINK FLOYD, *Another Brick in the Wall Part 2, on THE WALL* (Capitol 1979). Both have read my prior work, yet seem resistant to accepting the insights presented therein.

<sup>32</sup> See generally Postlewaite, *supra* note 5, at 44–45.

<sup>33</sup> Jones, *supra* note 2, at 704; Rosenzweig, *supra* note 2, at 718.

<sup>34</sup> Jones, *supra* note 2, at 705–09; Rosenzweig, *supra* note 2, at 718.



unwithdrawn profits from year one increase the service provider's capital account in year two. Furthermore, those amounts are available for utilization in the business operations of the enterprise.

In fact, but for the year of receipt, the recipient of a compensatory capital interest is treated in an identical fashion to the recipient of a compensatory profits interest. For example, the service provider in receipt of a compensatory twenty percent capital interest and his counterpart in receipt of a twenty percent profits interest will be taxed on the same amount and at the same character on everything produced by the partnership except the initial grant.<sup>35</sup> Thus, the proffered chasm in treatment between the two categories of compensatory equity recipients is *de minimis* at best.

#### FANNING AT THE SIGNIFICANCE OF CHARACTERIZATION AT THE LEVEL OF THE PARTNERSHIP

The presenters assume that all profits interests in a partnership generate preferentially taxed returns.<sup>36</sup> However, due to the governance of § 702(b), enterprise receipts are characterized at the partnership level.<sup>37</sup> Thus, if the nature of the income-producing activities of the partnership or the character of its assets is such, profits interests can generate exclusively ordinary income taxed at progressive rates.<sup>38</sup> Therefore, the current law

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<sup>35</sup> For a documentation of these results, see generally Postlewaite, *supra* note 3, at 24–26.

<sup>36</sup> Jones, *supra* note 2, at 695 (asserting that all profits interests generate preferential tax treatment: “Implicit in proponents’ arguments is that the extent to which a taxpayer risks transferring her services for no compensation—as is the case when a taxpayer agrees to be compensated only if the venture proves successful—she is entitled to a reward in the form of lower tax rates.”). As documented elsewhere, such is not the case. As every profits interest holder in a law firm knows, their share of the firm’s income is not taxed preferentially. See generally Postlewaite, *supra* note 3, at 52–56.

<sup>37</sup> The presenters miss the focal point in the partnership context for the determination of capital gain entitlement. They erroneously attempt to impose the *raison d’être* of capital gains, e.g., the factors of lock in, bunching, investment motivation, etc., on the recipient of the equity interest rather than on the enterprise in which he received the interest. Congress instead through the enactment of § 702(b) mandated that it is determined at the partnership level vis-à-vis its relationship to the assets which it holds. Rosenzweig states that “proponents of reform also contend that such taxation violates the underlying policies supporting the distinction between ordinary income and capital gains.” Rosenzweig, *supra* note 2, at 725. Later, he reiterates this distinction: “Similarly, the concern over carried interest is that the GP is effectively being compensated for services, which do not suffer from bunching and lock-in, but is receiving the benefit of long-term capital gains preferential rates.” *Id.* at 741. See also Jones, *supra* note 2, at 702–03 (same).

<sup>38</sup> Initially, one of the presenters appears to embrace this distinction as governing the appropriate tax treatment. Rosenzweig, *supra* note 2, at 734. “Accordingly, the focus in the carried interest debate should not be on the method of compensating the manager of a private investment fund, but rather on the types of income being generated and allocated by the fund to the manager.” *Id.* In the next section of his analysis, he strays from this approach and centers his focus on the essence of the equity interest rather than the underlying assets:

already ensures that “not all carried interests are created equal.”<sup>39</sup> The scope of the problem, should it even exist, is not as great as the presenters assume.<sup>40</sup>

### THE FOREST POSSESSES MORE THAN ONE TYPE OF TREE

The presenters appear to assume that there is but one type of tree deriving improper tax treatment in the forest. Accordingly, they are not on ready alert when they survey the landscape of Subchapter K for needed reform.

If one elevates horizontal equity to the be all and end all and commands that the rendition of services begets ordinary income taxed at progressive rates, then he or she must similarly insist that the contribution of capital generates capital gain. The presenters evidence little or no concern with the impact of § 702(b) on a contributor of capital, yet complain about its distortion in the service provider context.

However, Subchapter K, with its focus on the entity rather than its members, consistently undercuts such maxims by insisting upon consistent treatment for all partners.<sup>41</sup> As the presenters have properly noted, § 702(b) may generate ordinary income or long-term capital gain to service providers depending upon the nature of the activities and the assets of the enterprise.<sup>42</sup>

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“[T]he line-drawing debate which has received the bulk of attention in the recent carried interest literature is whether carried interest should be treated as capital gain or ordinary income.” *Id* at 734.

<sup>39</sup> Rosenzweig, *supra* note 2, at 715 (recognizing that profits interests do not always generate preferential treatment: “Most notably, the tax treatment of the equivalent of carried interest in most hedge funds raises little of the same preferential rate concerns that plague carried interests in private equity funds, precisely because *even under current law* the profits paid to hedge fund managers are generally not entitled to preferential rates.”)(emphasis in original). Even recognizing that distinctions exist between hedge funds and private equity firms due to the underlying activities of the enterprises, he nevertheless forges ahead to generate equivalent results in both settings while acknowledging that their activities are dissimilar.

<sup>40</sup> See Rosenzweig, *supra* note 2, at 715, where he asks: “The question that follows is: if the concern is over preferential rates for carried interest, why is there such a problem with the taxation of carried interest for private equity but not for other private funds?” While he articulates that the distinction is due to the types of assets held and the activities performed by private equity firms compared to hedge funds, he appears unwilling to accept that this is a meaningful distinction upon which sound tax policy principles can be based.

<sup>41</sup> I.R.C. § 702(b) (2009).

<sup>42</sup> Rosenzweig and Jones acknowledge that income characterization occurs at the partnership level. Jones, *supra* note 2, at 700; Rosenzweig, *supra* note 2, at 755. Accordingly, a short-term partner would be entitled to preferential tax treatment on his share of the partnership’s long-term capital gain notwithstanding his abbreviated holding period. After having documented the distortion it can produce, Jones suggests that the common law of taxation can override the congressional mandate where the transaction is sufficiently offensive:

By way of example, a service provider equity owner in a law firm typically derives ordinary income while a similar holder in a private equity fund derives capital gain.<sup>43</sup> Alternatively, a capital contributor to a restaurant derives ordinary income while a similar holder in a private equity fund derives capital gain. Parity among service providers and capital contributors does not exist in Subchapter K.

Importantly, has a word emanated from the forceful presenters about this departure from the principles of horizontal equity? Some contributors of capital in the partnership context will not derive preferential capital gains.<sup>44</sup> Yet, this distortion apparently is of such minimal concern that it escapes their notice and commentary. Given the presenters' emphasis on horizontal equity, one would expect similar outrage at this imperfection in the Code and legislative proposals to follow.

Another blind spot in the presenters' analysis is the issue of value.<sup>45</sup> Again, they assume that all valuation issues must be determined with the same criteria and assert that the focus in such a determination be on the economic reality of the setting. Because the receipt of a profits interest has

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Simply put, proponents argue that partnership level characterization of income is inviolate. That is, the benefit of the rule is so great that it ought to be followed even in the rare circumstances where it causes a distortion of the partner's true circumstances. . . . Unfortunately, the argument is belied by a very conspicuous provision in Subchapter K.

Jones, *supra* note 2, at 700. In his effort to disprove the applicability of § 702(b) in all cases, he references the "conspicuous provision" of § 724, which characterizes gain or loss based upon the prior activities of a partner, rather than the nature of the asset to the partnership. *Id.* at 700. However, notwithstanding his suggestion that this undercuts the universality of § 702(b), in fact it does the opposite. The re-characterization affects all partners and not merely the contributor. Furthermore, the existence of the supposed exception proves too much. Congress has the power to act if it decides that such is needed. It has not deemed other areas worthy of modification. Also, the presenter does not suggest an extension of such a "look through" approach to those who contribute capital to a partnership but, due to § 702(b), derive ordinary income.

<sup>43</sup> This blind spot in the presenters' analysis is evidenced by their tenacious, yet erroneous, assumption that all profits interests are taxed preferentially. As documented above, it is the nature of the activities of the enterprise which will dictate the character of the income to the service provider. Thus, a profits interest in a law firm, which subjects the holder to dramatic economic risk as evidenced by events of the first quarter of 2009 in the legal community, invariably generates ordinary income.

<sup>44</sup> See generally Postlewaite, *supra* note 3, at 52–56.

<sup>45</sup> Jones asserts that "the grant is capable of quantification in monetary terms . . ." Jones, *supra* note 2, at 687. Jones also asserts that "[t]o say that the right has no value is also to stipulate that the services used to acquire that right have no value. This is incorrect as a matter of rationality." *Id.* at 703. See also Rosenzweig, *supra* note 2, at 722 ("the carried interest must have some economic value to the GP since the GP accepted it in the first place and could earn substantial amounts in the future.").

economic value, the tax treatment of a profits interest as having no value cannot be justified. Their error is the failure to distinguish between economic value and liquidation value and to integrate the latter concept into the conduit nature of the taxation of partnerships.<sup>46</sup>

The standard for taxing the receipt of an equity interest (capital or profits) in a partnership is liquidation value. This is necessary because all subsequent derivation of profit will be taxed to the holder annually. Given that mechanism and design, one need only capture the liquidation value upon receipt of the partnership interest or at its time of vesting.<sup>47</sup> If a greater amount is included, distortion of results will arise because the recipient's share of subsequently derived profit, upon which he would have been taxed upon receipt, would be taxed again.<sup>48</sup>

Current liquidation value upon receipt is the very factor that differentiates a capital interest (current liquidation value) from a profits interest (no current liquidation value) with regard to the amount to be included in income upon receipt.<sup>49</sup> All future accretions from the ownership of the interest will be taken into account annually as they arise and will be identical for both types of recipients.

#### DRIVING A SPEAR INTO THE HEART OF THE ABUSE

Identifying the targeted category of equity recipient and eager to slay the opposition, the presenters launch their weapons of mass deconstruction.<sup>50</sup> One of the presenters contents himself with the assertion

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<sup>46</sup> See generally Postlewaite, *supra* note 3, at 44–48.

<sup>47</sup> While I do suggest that the overall treatment of the receipt, retention, and disposition of compensatory equity interests is logical and arose by congressional and administrative intent, others suggest that “capital gains taxation of carried interest arose by mistake rather than by intelligent design.” Jones, *supra* note 2, at 684.

<sup>48</sup> Given the interrelationship of the conduit aspects of Subchapter K, the additional income will be offset upon the recipient's exit from the partnership by an equivalent amount of loss. Nevertheless, timing and characterization imperfections have prevented the adoption of an economic, rather than liquidation, standard.

<sup>49</sup> See also Jones, *supra* note 2, at 687: “Even though the grant is capable of quantification in monetary terms, it is not income as that term is popularly understood.” The assertion is somewhat contradictory because if it were susceptible of proper valuation, then theoretically it should be subject to tax as is the compensatory receipt of corporate stock or a capital interest in a partnership. Neither presenter addresses the double taxation issue arising from the use of economic, rather than liquidation, valuation, first upon receipt and again on subsequent earnings. Furthermore, the tax policy principle of realization, when combined with conduit taxation, errs on the side of accuracy. The current tax treatment of an equity recipient of a profits interest is no different than that for the equity recipient of a capital interest, the value of which in the recipient's hands is likely greater than its liquidation value. Thus, the “imperfection” in utilizing liquidation value is not unique to profits interests.

<sup>50</sup> One of the presenters asserts that the tax law avoids deconstructing in this area, noting that “[h]istorically, one way the law has attempted to address the issue was not by deconstructing such returns into constituent parts, but instead by imposing a ‘holding period’

that the rendition of services as a recipient of a profits interest in a partnership by definition mandates that the return thereon be taxed at progressive rates.<sup>51</sup> Services are services and whatever distinctions can be advanced by proponents for such treatment are inadequate and/or irrelevant.<sup>52</sup> However, by doing so, he ignores the differing treatment accorded the other four categories of recipients of equity compensation in a business enterprise. The fact that his proposal will actually discriminate against a category of equity recipient is of no consequence to his advocacy.

The other presenter, in an effort to “produce the right result” without having to dismantle Subchapter K, suggests that the holding period concept should be utilized to prevent preferential tax treatment.<sup>53</sup> Accordingly, he advocates the application of the straddle rules of § 1092 to the recipient of a profits interest.<sup>54</sup> Because the profits interest is unaccompanied by a loss interest in the partnership, he asserts that this minimizes/eliminates the risk of loss.<sup>55</sup> Among the other consequences of a straddle, the holding period for the partnership interest tolls. As a consequence, the presenter maintains that the recipient’s share of the partnership’s gains would be characterized as short-term capital gain taxed at progressive rates.<sup>56</sup>

Apparently, this presenter assumes that the interest holder is immune from all losses incurred from the holdings of the enterprise. However, in many cases, a profits interest is accompanied by an equivalent interest in loss.<sup>57</sup> While not addressed by the presenter, it would appear that such risk

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requirement.” Rosenzweig, *supra* note 2, at 713. However, as I have surveyed the *status quo*, the tax law deconstructs the receipt as generating ordinary income to the extent of its value (liquidation in the partnership context) upon receipt and capital gain upon its disposition. See generally Postlewaite, *supra* note 3, at 12–29.

<sup>51</sup> Jones states: “Thus, that a service provider may very well be referred to as ‘partner’ under state and even federal law is of no logical consequence to the determination of whether the service provider ought to be taxed more favorably than a service provider who is not so labeled by any definition.” Jones, *supra* note 2, at 682.

<sup>52</sup> “In short, sometimes extraordinarily well-paid fund managers receive compensation taxed at capital gains rates. All other, usually very much lower-compensated, service providers are taxed at ordinary rates.” Jones, *supra* note 2, at 675. As I have documented herein and in my prior work, this is simply not the case. See Postlewaite, *supra* note 3, at 1–66.

<sup>53</sup> See Rosenzweig, *supra* note 2, at 755–62.

<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

<sup>56</sup> *Id.* at 755. “One major benefit of the holding period proposal to the taxation of carried interest is that it is arguably not only the proper policy answer, but that it also would be much simpler to integrate into current law.” *Id.*

<sup>57</sup> To the extent they do not possess an interest in losses, other arguments as to whether a genuine partnership exists or whether the holder is an actual partner may apply. Jones suggests that: “Subchapter K has long since addressed the mischief that results when partners receive gain or profit while nominally occupying the status of partner but substantively performing as an employee or in some capacity other than a partner.” Jones,

would immunize the recipient from the application of his proposed treatment. In light of the assumed profitability of private equity funds, a mere extension of the recipient's interest in loss would be a meaningless gesture economically yet an effective means of circumvention, rendering the proposal meaningless in its application.

However, in contrast to true straddles, it would appear that the analogy falls short for a number of reasons. Even if the approach applied in the first year to the recipient's share of the partnership's gains, unless withdrawn, the funds blossom into a capital interest thereby creating a potential risk of loss against which the second year's profits interest may no longer be immune.

Additionally, under § 1092, the positions must offset. According to the legislative history, the properties must vary inversely in value.<sup>58</sup> The offsetting positions must bear a one to one ratio. To suggest that positions are "offsetting" when gain is possible but loss is not appears to constitute a broader application of the Code provision than intended by Congress. While his innovative effort at reverse engineering to produce equivalent treatment between hedge and private equity funds is striking, logic would dictate the extension of such a doctrine to all profits interests. It is uncertain whether the presenter would support an extension to the recipients of all profits interests.

#### THE TEMPTATION OF THE SERPENT

Like the Biblical temptation when the snake offered Eve the apple, one of the presenters cannot resist the opportunity to impugn the motives and the analysis of those with whom he disagrees. While he is in the majority of those academics to date who have commented upon the issue, he concludes that the matter is of such importance that the small minority suggesting to the contrary are sophists and opportunists engaged in situational ethics.<sup>59</sup> Such are the consequences of populist uprisings. Instead of relying upon reasoned discourse, they reach for pitchforks and torches in their eagerness to paint their opponents as evil rather than merely wrong.

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*supra* note 2, at 702. Rosenzweig also describes the factual particulars of the relationship of the fund managers with the enterprise which arguably suggest an employment rather than equity relationship. Rosenzweig, *supra* note 2, at 718–20. Whether this approach to the presenters' problem would provide a preferable solution in the private equity context does not minimize my advocacy for the *status quo*. If the recipient is not a partner, § 702(b) is not applicable to the return from the enterprise. However, that is a topic for another paper.

<sup>58</sup> S. REP. NO. 97-144, at 150 (1981) (stating "[g]enerally, values vary inversely if the value of one position decreases when the value of the other position increases.").

<sup>59</sup> Jones states that "[t]he fundamental thread that should answer tax questions without the need for convoluted statutory explanation becomes frayed each time sophistry and situational ethics are allowed to trump fundamental principles." Jones, *supra* note 2, at 681.

Another temptation which undercuts the analysis of the presenters is the Midas assumption. They assume that everything touched by the world of private equity turns to gold. Because the assault on the tax treatment of profits interests coincided with an economic period of prosperity, the assumption is that such activities are always profitable and thus risk free.<sup>60</sup>

One of the presenters attempts to minimize the presence of risk by suggesting that the management fee (the two) which accompanies the profits interest (the twenty) in the standard two and twenty compensation package for private equity fund managers eliminates risk.<sup>61</sup> Apparently, in his mind, if the profits interest does not generate any revenue, the recipient does not experience a loss. He maintains that the negotiation of a salary and an equity interest carries no risk because the amount of the salary component equals the full value of his services. Accordingly, the economic results from the profits interests are only upside and risk free.<sup>62</sup>

However, if that is the case, then it applies to virtually every recipient of a compensatory equity interest in a corporation or a partnership since virtually all of them receive a salary along with the corporate stock or a guaranteed payment with their capital interest. The presenter fails to take into account that this is a characteristic common to virtually all compensatory receipts of equity. If true, all must be subjected to ordinary income on the entirety of their return, which is not currently the case.

## CONCLUSION

As is evidenced by the presenters' offerings, change is in the air. The *status quo* is unacceptable, even though it has continued intact for over sixty years. They suggest that "there is nothing as powerful as an idea whose time has come," and in their mind the time is now. The difficulty is that the populist uprising over the taxation of profits interests was driven by a bubble in the economy, when the Midas touch appeared to be

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<sup>60</sup> Rosenzweig provides an example, in which gargantuan profits are assumed: "[T]he LP received a return of slightly higher than forty percent on the initial capital investment . . . . The GP, on the other hand, earned a staggering return of one thousand percent on its invested capital." Rosenzweig, *supra* note 2, at 720. Jones argues that "[t]he 'entrepreneurial risk' argument is deficient for several reasons, including the initial fact that the fixed portion of fund manager compensation eliminates any risk of loss." Jones, *supra* note 2, at 682. Even government statistics during the era of prosperity showed that one-third of all private equity funds did not yield a return on their profits interests. See Postlewaite, *supra* note 3, at 35. Certainly, after the economic meltdown, it should be clear that loss is a possibility. Risk permeates these interests.

<sup>61</sup> See Jones, *supra* note 2, at 682.

<sup>62</sup> Assuming arm's length behavior, this is most unlikely. If the managerial talents of a person were worth \$400,000, one would not expect another to pay \$400,000 and twenty percent of the profits for his services. Instead, the management fee would be lowered, e.g., \$250,000 plus the twenty percent profits interest. In such a case, if no profits are generated, the service provider will certainly conclude that he bore and sustained a risk of loss.

omnipresent. Tax rates were low, the market hit 14,000, unemployment was low, and private equity firms and hedge funds (most legitimate but some Madoff-like) were profiting enormously.

However, those days are gone, and with them, the momentum fueled by populism and class warfare is in decline. Ironically enough, Congress may need to consider greater, not lesser, incentives to lure such firms into the massive challenge of revitalizing our economy.<sup>63</sup>

At a minimum, notwithstanding the best efforts of the presenters, I remain convinced that the *status quo* on the taxation of compensatory profits interests (which subsumes carried interests) is as good as we can do with the overall fabric in which we operate. As opposed to the myopic view of the presenters, once one focuses on the elephant as a whole, rather than only a portion of it, the system appears to be well designed. At a minimum, the treatment of a recipient of a compensatory profits interest in a partnership is consistent with the treatment of the other categories of recipients of compensatory equity interests in a business enterprise.

The true culprit which causes the heated debate of fairness is not private equity firms and their compensatory packages. Instead, it is the presence of preferential treatment for a class of income, long-term capital gains, which is not all inclusive. Whether such distinctions should exist is a matter for another debate. However, assuming its continuation, the *status quo* and the conversion and deferral potential for the recipient of a profits interest is consistent with the overall framework for executive equity compensation.

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<sup>63</sup> Even one of the presenters acknowledges that such a change could be possible. Jones states that “[i]f it were proven that fund managers are so risk averse that the market cannot account for that aversion, preferential tax treatment of those scarce labor suppliers would be justified. That case has not and likely cannot be made.” Jones, *supra* note 2, at 682.



