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Fifteen and Thirty Five--Class Warfare in Subchapter K of the Internal Revenue Code: The Taxation of Human Capital Upon the Receipt of a Proprietary Interest in a Business Enterprise

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Fifteen and Thirty Five--Class Warfare in Subchapter K of the Internal Revenue Code: The Taxation of Human Capital Upon the Receipt of a Proprietary Interest in a Business Enterprise

By
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Service providers (aka executives) to partnerships and to corporations confront a number of choices as to how their compensatory arrangement may be structured and the tax consequences thereof. In the simplest case, an individual may render services to an enterprise in return for cash payments over the period of service. In this non-equity setting, the issue is straightforward and non-controversial. The service provider is treated as receiving ordinary income for services rendered. The return on his or her expenditure of human capital is taxed at progressive rates.

Once the relationship between the service provider and the enterprise becomes more complicated through the service provider’s receipt of an equity interest in the enterprise, the tax treatment of the return becomes more complex. If the service provider receives an equity interest in return for services, the issue of whether the receipt of, and return on, the equity interest is attributable to human capital or invested capital is confronted. A tension arises between conceptualizing the receipt of and return on an equity interest and the economic enhancement which it generates as a return on human capital, generating ordinary income, or as a return on invested capital, which in certain settings may be taxed preferentially as capital gain.

In the corporate context, stock in the corporation may be issued in return for the rendition of future services. It may be transferred outright, i.e., free and clear, or be restricted, i.e., conditioned upon the rendition of services for a fixed period of time. Various tax issues are confronted—when is the income taken into account, what amount is taken into account, what is the character of the income from such receipt, and whether and to what extent its compensatory origin must be segregated from any subsequent appreciation in the equity interest.

Subchapter K raises similar issues in the services-for-equity context regarding partnerships, but the tax consequences arise under a single tax, rather than double tax, regime for the enterprise. However, in the partnership context, three types of equity interests may be utilized for compensatory purposes, i.e., a capital interest with an attendant right to profits, a restricted capital with profits interest, and a pure profits interest.

1 Harry R. Horrow Professor of Law and Director of the Graduate Tax Program, Northwestern University School of Law. © by Philip F. Postlewaite 2008. The Article will appear in the Spring 2009 issue of the Virginia Tax Review. I would like to thank the following individuals for their insightful commentary: Tom Brennan, Stephanie Hoffer, Jeff Kwall, Adam Rosenzweig, Robert Wootton, and Eric Zolt. Notwithstanding their efforts regarding the Article, any defects in, or shortcomings of, the work are exclusively attributable to my inadequacies. Additional thanks are due to Krystle Lamprecht, my research assistant, who diligently assisted in organizing, critiquing, and improving the Article. Finally, I am most appreciative of the invitation to discuss my views on this issue with the Tax Section of the Indianapolis Bar Association in October, 2008, the invitation from which was the genesis for this Article.
Critics have recently advocated a change in the tax treatment of the return from a compensatory profits interest in a partnership. They conclude that the current tax treatment of the receipt of and return on such an interest is seriously flawed, violating fundamental principles of tax policy. Unfortunately, such advocacy is limited to a narrow analysis of the results generated by a compensatory receipt of a profits interest and lacks a thorough comparison with, and analysis of, the treatment of the traditional compensatory equity transfers in the two dominant business contexts employed in the United States economy, i.e., partnerships and corporations. This Article provides a broader discussion of compensatory equity transfers (capital interests as well as profits interests) in the partnership context and discusses the similarities and dissimilarities between these compensatory arrangements and those arising in the corporate setting. By doing so, this Article illustrates the erroneous assumption that profits interests derive unique and unfair tax treatment.

The recent assault on the status quo treatment of a profits interest in a partnership has gathered momentum, in large part due to the inflammatory rhetoric which attends the academic commentary and the focus by the media on the economic success of private equity ventures. Bills have been introduced in Congress to mandate that such receipts generate ordinary income, rather than preferential capital gain, to the recipient. To date, none has been enacted. However, with the economic freefall and the Congressional need to generate additional tax revenues, the issue of the proper taxation of a compensatory transfer of a profits interest in a partnership will likely be revisited in the next legislative session.

By focusing on but one of the five traditional types of available equity transfers (a profits interest), most of the academic commentary has confused, rather than clarified, the need for reform. The treatment of the return on human capital and on invested capital has never been as clear or as singular as commentators suggest. The Code, for sound policy reasons, refrains from disentangling the return on human capital from the return on invested capital when the service provider “re-invests” his or her return on human capital in the enterprise by foregoing annual compensation. With regard to profits interests, the role of § 702(b), which requires that all partners in a partnership, regardless of how they acquired ownership of their interest, characterize the nature of their share of the income at the partnership, not the partner, level, is overlooked. Additionally, compensatory profits interests possess implicit, if not explicit, restrictions on transfer and thus require treatment akin to that accorded restricted capital interests in a partnership and restricted corporate stock. Finally, some of the treatment accorded profits interests is attributable to the fundamental differences between the tax treatment of partnerships (single level of tax) and corporations (double level of tax), which some critics either minimize or ignore.

Accordingly, this Article critiques proposals for change with regard to the suggested modification of the tax treatment of profits interests, in large measure by illustrating the misperception of the current operation of Subchapter K of the Code and enterprise equity compensation as a whole. The entire field of compensatory transfers of equity interests and the allocation of the return therefrom to human capital and/or invested capital is surveyed from a tax policy standpoint. In this broader context, the status quo (subject to an elective defect) from a normative standpoint is equal, or superior, to any of the proposals recently advanced.

Finally, with the misdirected emphasis on the tax treatment of profits interests, the real opportunity for reform of the area is overlooked. The ability to recognize income in the year of receipt of a restricted compensatory equity interest under § 83(b) permits recipients to minimize the impact of the progressive rates. This treatment is far more inconsistent with the taxation of human capital than is the current tax treatment of compensatory profits interests. As a modest proposal for reform, this Article advances the repeal of § 83(b) which, if enacted, would constitute significantly broader reform than recent proposals and would result in an overall improvement of the current tax law from a policy standpoint.
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I. Introduction
A recent article, entitled “Two and Twenty: Taxing Partnership Profits in Private Equity Funds,” has received significant attention not only in the academic world, but on Capital Hill as well. The author joined issue with the current tax treatment of a compensatory transfer of a profits interest in a partnership. The article built on prior academic criticism of the current tax treatment of compensatory transfers of such interests and has spawned additional academic commentary.

This topic is but one piece of a persistent and perplexing policy issue of the tax law: how is the receipt of a compensatory interest in an enterprise taxed in cases where the recipient contributes only his or her services toward its success? What are the tax consequences under current law and is that treatment consistent across the continuum of possible receipts of compensatory interests in an enterprise?

Of equal importance, regardless of the current treatment of such receipts, from a theoretical tax policy standpoint, how should compensatory transfers of proprietary interests in an enterprise be taxed? Arguably the recipient is investing exclusively human capital in the endeavor. When should he or she be taxed and at what rate? What is the relationship, if any, between returns on human capital and returns on invested capital? When does one end and the other begin? Is the expenditure of human capital different from the investment of human capital?

Instead of addressing the tax treatment of compensatory transfers of equity interests in partnerships and corporations as a whole, critics focus on a detailed evaluation and critique only of the taxation of compensatory transfers of profits interests in a partnership. Thus, instead of an overall comparison of each of the five traditional compensatory transfers of equity interests in an enterprise and an evaluation of the similarities and differences among them, the analysis is limited to a single type of compensatory transfer in the partnership context.

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Dissatisfied with the status quo of those tax consequences, a wide range of proposed improvements are advanced for the area. Regardless of the particular proposal advanced, as regards the current tax treatment of a compensatory transfer of a profits interest in a partnership, some assert that “the status quo is untenable as a matter of tax policy.”

Ignoring the adage that “fools rush in where wise men fear to go,” I suggest that the current tax treatment of a profits interest is in fact logical by illustrating the consistency of that treatment when integrated into the overall approach of the Internal Revenue Code with regard to the compensatory receipt of an equity interest in a business enterprise. Critics examine only part of the evidence in compiling their case against the status quo. Furthermore, they fail to integrate the full fabric of Subchapter K and the taxation of partners and partnerships into their assessment of the area.

While I share their concern about the development of sound tax policy for the treatment of any and all compensatory receipts, I conclude that the populist rhetoric is hyperbolic and critics have focused on a small and relatively insignificant part of the “problem.” The recent, intense scrutiny of a single industry comprised of private equity firms and hedge funds precludes a full understanding of the tax consequences of a compensatory receipt of a profits interest, which in actuality comports with, rather than diverts from, the goals of sound tax policy. Thus, the conclusion that compensatory transfers of profits interests in a partnership are treated more favorably than other transfers under current law is mistaken.

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5 Fleischer, supra note 2 at 4.


7 Criticism of the current treatment of the tax law of compensatory transfers of partnership interests, as discussed in greater detail below, ignores the factor of risk and how it differentiates some equity transfers from others; fails to appreciate the Congressional recognition that returns on human capital are entitled to conversion from ordinary income taxed at the highest progressive rates to capital gain which is taxed preferentially; minimizes the implicit, if not explicit, restrictions inherent in a compensatory transfer of a profits interest in a partnership; inaccurately assumes that most profits interests result in a character conversion of the return; and fails to integrate the legislative purpose behind § 702(b) of characterizing income at the partnership level into their analysis.

8 See, e.g., Fleischer, supra note 2, at 4: “The conversion of labor income into capital gain is contrary to the general approach of the Internal Revenue Code and diverges from the treatment of other compensatory interests. Partnership profits interests are treated more favorably than other economically similar methods of compensation, such as partnership capital interests,
The narrowness of this inquiry precludes consideration of the overall proper tax treatment of human capital in compensatory transfers of equity interests in an enterprise. The exclusive focus on high-profile, recent developments in a single industry foreclosed an examination of the entirety of the issue of compensatory equity transfers across the continuum of business enterprise. In fact, under current law, returns on human capital frequently become invested capital if not withdrawn from an enterprise. With a broader focus, the current tax treatment of such transfers on the whole becomes rational and defensible from a tax policy standpoint.

Finally, the true “theoretical” quirk in the congressional treatment of the area under current law is the elective provision of § 83(b). This taxpayer option undermines the proper taxation of human capital and generates greater abuse to the tax system than the current tax treatment of profits interests in a partnership.

II. Tax Consequences Under Current Law to a Service Provider of a Compensatory Transfer of an Equity Interest in an Enterprise

In order to determine whether the tax treatment of a profits interest in a partnership is more favorable than the treatment of other compensatory transfers of enterprise equity, a review is necessary of the current treatment of a service provider upon the receipt of an equity interest in an enterprise in the traditional contexts, i.e., a corporation, the tax consequences of the use of which are specified in Subchapter C of the Internal Revenue Code, and a partnership, the

restricted stock, or at-the-money nonqualified stock options (the corporate equivalent of a partnership profits interest)."

See supra notes 2 and 6. While Congress has permitted the recipients of compensatory interests in partnerships and corporations generally to be taxed on the return from human capital at preferential rates, it has deviated from its own treatment through the enactment of the elective provision of §83(b). I.R.C. § 83(b) (allowing for recognition of restricted property received in return for services in the year such property was received).

See discussion infra at notes 32-62 and accompanying text.

Fleischer, supra note 2, at 5: “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.” As discussed infra at notes 116-117 to and 192-194 and accompanying text, the § 83(b) election permits the recipient of a restricted compensatory interest to accelerate the time at which the tax consequences will be taken into account, which thereby affords the recipient the opportunity of minimizing the amount of income taxed at progressive rates.
tax consequences of the use of which are specified in Subchapter K.\textsuperscript{12} Without an examination of the topic as a whole, any analysis of the transfer of a partnership profits interest is incomplete and misleading.

By comparing the results in the partnership and corporate context throughout the \textit{entire} range of the traditional types of equity receipts\textsuperscript{13} by a service provider, one can glean the themes for the statutory and regulatory treatment of compensatory transfers. Thereafter, consistencies and inconsistencies can be identified and proposals for reform can be advanced or critiqued.

This survey will be generalized and offered in summary form. For those with greater interest, treatises are available with thorough coverage of the tax consequences of compensatory transfers of equity interests in partnerships\textsuperscript{14} and corporations.\textsuperscript{15} Any assessment of the status quo must focus on the various stages of the service provider’s relationship to his or her enterprise, i.e., from birth to grave. For purposes of illustration, I will utilize numerical examples involving simple, and at times somewhat unrealistic, settings. Behavior in the real world is far more complex.\textsuperscript{16} Nevertheless, the simplified settings should suffice for illustrating why advocates err when they conclude that the current tax treatment of a compensatory profits interest in a partnership violates sound tax policy.

A. Pure Employee Status

Advocates for reform typically examine the tax consequences of rendering services as a pure employee, which is utilized as a baseline and a point of comparison. In order to grapple with the proper treatment of the return on the expenditure of human capital, this baseline is compared with the results arising

\textsuperscript{12} Typically, limited liability companies are taxed as partnerships for tax purposes. See generally Arthur B. Willis, John S. Pennell, and Philip F. Postlewaite, \textit{PARTNERSHIP TAXATION} ch 1, 3 (WG&L 6\textsuperscript{th} ed. 1997).

\textsuperscript{13} The dominant enterprises in the current economic environment through which to conduct profit making activity are the partnership (which includes limited liability companies) and the corporation. With respect to traditional compensatory transfers of an equity interest, two are possible in the corporate context (stock and restricted stock) while three exist in the partnership context (capital interest, restricted capital interest, and profits interest).

\textsuperscript{14} See \textit{generally} Willis et al, \textit{supra} note 12.

\textsuperscript{15} See \textit{generally} Boris I. Bittker and James S. Eustice, \textit{FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS} (WG&L 7\textsuperscript{th} ed 2006).

\textsuperscript{16} For purposes of comparison, the examples contrast pure employee status with an exclusive receipt of a compensatory equity interest. In the real world, the latter settings typically involve a combination of receipts through which the service provider receives both an annual salary or compensatory payment (“A man’s gotta eat.”) \textit{and} an interest in the equity of the enterprise.
when human capital is expended in return for the receipt of an equity interest in an enterprise.

In the case of pure employee status, the executive draws regular compensation without sharing in the economic results of the enterprise. The enterprise may profit immeasurably or teeter on the verge of bankruptcy—increasingly an everyday experience for even the wealthiest of enterprises. In either case, the employee is similarly situated and unaffected, except for the possible discontinuation of his or her employment, by the success or failure of the enterprise.

Assume that Corporation C and Partnership K both produce $1,000,000 in net profit annually. Enter highly-paid executives Charlotte and Bob. Charlotte is hired by Corporation C and Bob by Partnership K. Both enterprises anticipate that the participation of these top executives in management will generate sizeable additional profits of $2,000,000, resulting in a net profit of $3,000,000, through the purchase/expenditure of the executives’ human capital. Accordingly, each enterprise agrees to an annual salary of $200,000. Both enterprises experience a 180 percent increase (from $1,000,000 to $2,800,000\textsuperscript{17}) in net profits after taking the salaries of Charlotte and Bob into account.

Charlotte and Bob derive a financial return on the expenditure of his or her human capital in the amount of $200,000. Under the current tax law, each will be taxed annually on the compensation.\textsuperscript{18} The tax law characterizes such receipts as ordinary income. The compensation is not entitled to preferential treatment under the Code and is taxed at the progressive rates. It is assumed that the need for survival (food, housing, and other personal needs) affords sufficient motivation for such recipients to find the economic means through which to provide for their support. Preferential tax rates theoretically are reserved for motivational purposes in settings where taxpayers might not otherwise invest.

Accordingly, under current law, compensation, if taxed at the highest rate currently in force, will carry a maximum rate of 35 percent. Thus, highly-paid executives receiving an annual salary will not be able to defer its receipt to another year or convert its characterization to preferentially treated capital gain. Importantly, after taxes, Charlotte and Bob each will retain $130,000 to spend or invest as they like.

Possibly of greater importance, their earnings from the first year are not at risk regardless of the success of their respective enterprises in the future. They are immune from forces in the marketplace involving their employment and their

\textsuperscript{17} While the income generated by the enterprise through Charlotte’s and Bob’s expenditure of human capital increases from $1,000,000 to $3,000,000, expenses increase by the $200,000 salary payment. Thus, the net increase to the enterprise is $2,800,000 ($3,000,000 - $200,000).

\textsuperscript{18} IRC § 61(a)(1) (2008).
expenditure of human capital. While job retention may be a consideration, there is little or no uncertainty as to their overall economic enhancement for the year.

Too often, critics assume that all compensatory relationships are similar, without meaningful distinction and that the employee baseline should govern the analysis. In their view, the only issues to be addressed are whether the income must be taken into account currently or in the future and whether it generates ordinary income or preferentially treated capital gain upon receipt. Infrequently do they accord any significance to the existence of risk or the failure to withdraw “foregone” salary. Given their baseline of employee status, they limit their focus to the tax treatment upon receipt of the equity interest and ignore the tax consequences thereafter of the ownership of the equity interest during the operational and dispositional phases of the investment.

However, a fundamental distinction exists between employee compensation and equity compensation. In equity ownership contexts, the economic enhancement, i.e., what the service provider otherwise would have extracted from the enterprise had he or she been paid, remains with the enterprise. By contrast, in the employee setting, the economic enhancement (the salary) of the service provider exits the enterprise. Thus, the issue arises as to whether that retention by the enterprise attributable to the service provider’s investment of human capital converts the characterization of the recipients’ return in whole or in part to invested capital. If so, this would permit the return to be deferred until a realization event and to be taxed preferentially.

In the equity ownership context, the elements of risk and uncertainty enter the equation, which further distinguishes the situation from that of the employee. As a consequence, the utilization of the tax consequences of a pure employee setting for purposes of comparison with compensatory transfers of equity interests is not identical and thus, is imprecise, at a minimum, and possibly irrelevant.

19 Employee compensation can be viewed as the expenditure of human capital, while equity compensation involves the investment of human capital.

20 See also Senate Comm. On Finance, 98th Cong., 2d Sess., Deficit Reduction Act of 1984, S. Prt. No. 169 at 227-28 (Comm. Print 1984) (explaining that partners, unlike non-partner third parties (such as employees), “extract the profits of the partnership with reference to the business success of the venture,” while employees “generally receive payments which are not subject to this risk”).

21 In assessing the variations in compensatory arrangements, settings arise in which the employee and the enterprise possess a closer relationship than third parties and yet the nature of the compensatory arrangement is closer to that of a pure employee. A service provider may possess an ownership interest in the enterprise through a prior contribution of capital in return for the proprietary interest. In both Subchapter C and Subchapter K, notwithstanding such ownership, third-party treatment is permitted if the investor is employed by the enterprise to render services.
B. Receipt of a Compensatory Interest in the Equity of an Enterprise by the Service Provider

Continuing across the continuum of compensatory receipts in a business enterprise, we encounter settings in which the service provider does not have a pre-existing or concurrent investment in the enterprise and transacts exclusively for an equity interest therein in return for the rendition of services. Receiving an entrepreneurial stake in the enterprise rather than a pure salary makes the issue of the tax treatment of the return on invested human capital more complex.

An initial distinction with the pure employee model is that the equity interest transaction involves a payment in kind rather than in cash. Nevertheless, the equity recipient service provider may possess immediate rights to realize upon his or her entrepreneurial investment by liquidation or sale of the interest. Alternatively, the economic ownership of the interest may be conditional and subject to restrictions. If no limitations are imposed on the full ownership and transferability of the equity interest, i.e., the recipient’s ownership is vested, two questions are confronted. Is there a current taxable event on that receipt, and to what extent are future financial returns from its ownership attributable to human capital or invested capital?

In our example, if the service provider withdraws from the enterprise on the day of receipt, he or she would receive the value of his or her interest, which we will assume to be $500,000. The tax issue under current law is simple as the transaction is closed. Money in hand, there would be no reason to defer taxation on the receipt, which would be characterized as ordinary income derived from the anticipated investment of human capital.

The setting becomes only slightly more problematic where the service provider’s equity interest is vested with regard to the ownership of his equity interest, and the service provider continues to provide services to the enterprise. Under the tax law, in-kind receipts are subject to tax upon receipt with the recognized

In the partnership context, this issue begins to strain the pure employee model. See generally Willis et. al., supra note 12, at ch. 11. In contrast to the corporate context where the enterprise is taxed separately, a partnership for tax purposes is a conduit, with the income taxed but once to the partners. While the income is determined in large part utilizing an entity approach, once determined, it is imputed to its members.

Thus, a payment by a partnership to a partner could be viewed as the rendition of services to oneself with respect to his or her interest in the partnership and the remainder of the efforts on behalf of his or her partners. Congress legislatively addressed the issue by specifying third-party treatment, which results in the full payment constituting income to the recipient which is offset by the provider’s share of the deduction available to the partnership. The net result is that he or she is viewed as receiving the payment in part from himself or herself and the remainder from the other partners.
difficulty of valuation. That difficulty in our example is easily overcome because we have stipulated its worth to be $500,000.\textsuperscript{22} Thus, gross income of $500,000, characterized as ordinary income, arises upon the service provider’s receipt of the equity interest.

Unfortunately, critics conclude that the treatment of this receipt sets the proper standard for the taxation of the entire return from the receipt of an equity interest and that any and all additional receipts from its ownership should be treated as derived from the expenditure of human capital rather than its investment. In the example, services continue to be rendered to the enterprise and the return on those efforts almost without exception is not fully measured by the value of the equity interest on the date of receipt. Issues are confronted as to how the further return on the receipt attributable to the service provider’s efforts during the operational and dispositional phase of the ownership is to be treated from a tax policy standpoint. Under the Code, that return frequently receives preferential treatment akin to that accorded the return on invested capital.

The service provider must be convinced that the ultimate return on the receipt of equity will be greater than the present value of a pure salary every year or else he or she would not accept the equity interest. Thus, future appreciation in the value of the enterprise may be a part of the return from the investment of human capital. If so, consistency in their criticism of the current tax treatment for such receipts would require ordinary income treatment regardless of the timing of the return because the service provider has contributed only services to the enterprise.\textsuperscript{23} However, seldom is the analysis extended to its logical conclusion.

The service provider’s willingness to render future services without additional direct recompense results in an increase in the overall assets of the enterprise. The salary expense which otherwise would have been incurred is no longer a drain on the corporate or partnership coffers. In the example, a full $200,000, which otherwise would have been expended by the enterprise, remains for its use and investment. Thus, future appreciation, if any, in the value of the

\textsuperscript{22} It is recognized that the value of a compensatory partnership interest may differ from that of compensatory stock in identically-situated enterprises, because the partnership interest is valued generally on its liquidation value while the worth of the corporate stock takes other factors into account. The primary reason for such a distinction is that the partnership interest will impose additional annual tax consequences upon the holder under § 702(a) which does not occur in the corporate context. Thus, the use of liquidation value acts as a means of avoiding double taxation.

enterprise to some extent may be attributable to the invested return of the retained amounts attributable to the receipt of human capital.24

At this point, however, only the current tax treatment of such receipts is being considered. The goal in this portion of the Article is to illustrate the inaccuracy of the charge that compensatory transfers of partnerships profits interests are treated more favorably than other compensatory equity transfers. Later in the discussion, the issue of whether improvements to the Code are necessary will be addressed.

It is important to understand that the tax law currently fashions a compromise, frequently treating the overall return on a compensatory transfer of an equity interest as neither exclusively one on human capital nor one on invested capital. As we shall see, the current treatment of compensatory transfers comforts itself with a solution possessing the wisdom of Solomon by treating the taxable amount on receipt of the equity interest as attributable to human capital and amounts received thereafter frequently as a return on invested capital. Regardless of whether this is ideal, an issue explored below, current law permits it. To alter that treatment solely for the receipt of profits interests in a partnership would discriminate against such receipts.

III. The Difficulties in Measuring the Return on Human Capital

Much of the difficulty in this area stems from the failure to define what constitutes a return on human capital in the equity context. Some assume that if an equity transfer involves the rendition of services, ordinary income taxed at progressive rates is appropriate for the entire return from its ownership.25 However, while their target is the tax treatment of compensatory profits interests in a partnership, had they addressed other equity receipts, e.g., the receipt of corporate stock, they would have had to reconcile their advocacy with the bifurcated treatment under current law requiring ordinary income on the receipt of the interest yet permitting preferential treatment of the gain upon its disposition.

In other contexts under the current tax law, the investment of human capital in return for an equity interest in an enterprise does not generate ordinary income. In fact, such results frequently are the exception, not the rule. Thus, with respect to a consideration of both the current tax treatment of compensatory equity receipts and the normative treatment which an improved system would employ, a

24 The transaction could be conceptualized as the enterprise transferring $500,000 in cash to the service provider as taxable compensation which is then contributed to the enterprise for an ownership interest. Of course, the service provider would still need to procure additional funds with which to pay the tax owing of $175,000 (35% x $500,000).

25 See references at note 23 supra.
definitional issue is confronted. When is a financial return to a service provider from a business enterprise attributable to the rendition of services and when is it attributable to invested capital?

Returning to our hypothetical, let us assume that Charlotte and Bob receive an equity interest in their respective enterprises. In return for the equity interest, each is willing to assume greater risk for the possibility of a greater return. Comparing their settings to that of their pure employee counterparts, he and she are willing to forego an annual salary of $200,000 in return for a 20 percent equity interest in the enterprise.

Important to the comparison and the analysis is that Charlotte and Bob forego their annual salary of $200,000. Thus, the enterprise now derives annual income of $3,000,000, of which Charlotte and Bob are entitled to 20 percent, rather than the $2,800,000 of net income when they were mere employees. From a pure economic standpoint, each has increased their economic annual return by 20 percent of the annual income (whatever that may be) derived by the enterprise over what their salary otherwise would have been. In this case, the economic increase is $400,000 (20% x $3,000,000 = $600,000 - $200,000).

In isolating the human capital component, one approach is a determination focused upon the cost of procuring that human capital in the pure employee context, i.e., at a minimum, the service provider should have $200,000 of ordinary income per year. He or she continues to render services during the coming years. However, the future return will also be through appreciation, if any, in the worth of the enterprise in which they now possess an equity interest. Under such an approach, the compensatory equity interest holder would be taxed on $200,000 of ordinary income annually.

A variation on this approach would be the postponement of the realization of the return on human capital until actual receipt, by distribution or from the sale or liquidation of the interest, of cash or property with the amount received attributable first to a return on human capital over the period during which services were rendered. The remainder, if any, would be viewed as a return on invested capital. In our example, if the service provider rendered services for four years and then sold or liquidated the interest for $2,700,000, the first $800,000 ($200,000 per year times four years) under this approach would be ordinary income and the remainder capital gain.

Another approach would be to treat everything received from the ownership of the equity interest as constituting a return on human capital taxed at progressive rates. Whether a current or liquidating distribution, any and all returns would be ordinary income because the totality of his or her “contribution” to the enterprise was of services only. The parties transacted for the rendition of services, and thus any return derives from the expenditure of human capital. Using the
example, if the interest were sold for $2,700,000, ordinary income in that amount would arise.

Another variation from which to choose would be the determination of the return on human capital at the time of the receipt of the interest, based on its current value. Everything thereafter in excess of that amount would be treated as attributable to invested capital and taxed preferentially. Thus, if the interest were worth $500,000 upon the grant, it would be taxed upon receipt as ordinary income and the recipient thereafter would be entitled to capital gain, regardless of the nature of the activities of the enterprise.26

Some of these variations are premised on the assumption that the return on human capital is determined exclusively by the rendition of services. Others accord significance to the fact that the funds which the service provider would have otherwise extracted from the enterprise have instead remained/were re-invested in the enterprise.27 To what extent, if any, should an approach acknowledge that future appreciation in the enterprise may be attributable to the extra amounts now available to the enterprise for investment and use in the ongoing business activities?28

The purpose of the above discussion is to illustrate the range of the possible tax treatments of the return from the investment of human capital in return for an equity interest in an enterprise. More importantly, before one can assail the particular tax treatment of a compensatory receipt of an equity interest as aberrational, the contours of the guidelines for making the determination of what

26 Current law is identical to this variation in the corporate context, but the treatment of the additional return in the partnership context turns on the nature of the profits generated by the enterprise. If the partnership generates business income from its daily operations, the entirety of the excess over the initial value would be taxed at the progressive rates and would be included in income on an annual basis.

27 Cf. IRC § 704(e) in the family partnership context.

28 If the tax treatment is premised on the assumption that the future return from ownership is attributable to the invested capital which the service provider has committed to the enterprise by leaving his return on human capital for the use of the enterprise, different results ensue. Failing to withdraw compensation from the enterprise has economic significance and arguably converts the investment from one of human capital to one of invested capital.

Other variations are possible, including a bifurcated approach in the year of receipt. For example, $130,000 could be attributable to human capital, i.e., the after tax amount in the pure employee setting, and the remainder ($70,000 of tax owing) attributable to invested capital. In contrast to the pure employee setting in which he or she has the cash (most likely, it has been withheld by the employer and paid directly to the Service), the service provider has received only an ownership interest in an enterprise. Utilizing these ratios, taxation could be postponed until realization and, similar to the tax treatment for installment sales, 65 percent would be attributable to the rendition of services and taxed accordingly at ordinary rates, while the remaining 35 percent would be a return on invested capital and taxed preferentially.
constitutes a return on human capital must be specified. To date, critics have generally avoided the issue.  

Regardless of whether the issue of how to treat the overall return on the compensatory receipt of an equity interest generates unanimity of opinion as to its determination and treatment from a tax policy standpoint, the above discussion illustrates that a number of differing approaches have some logical basis for their adoption. The purity and simplicity of the employee setting has been replaced with complexity in the compensatory equity interest setting. The latter category involves the difficulty of disentangling the mixture of contributed human capital and the re-investment of the return as invested capital.

Notwithstanding this range of possibilities and the normative arguments which can be advanced regarding the improvement of the current treatment by the adoption of any of the approaches, the current approach under the Code is to value the property interest upon its receipt by the service provider and treat only that amount as a return on human capital in the year of receipt. Any additional return is considered as attributable to invested capital. Thus, the $500,000 worth of an equity interest in the examples above is ordinary income in Year 1, resulting in a basis of an equal amount to the service provider for his “investment.” Any amount received thereafter (whether operational or dispositional) frequently is a return on invested capital. Thus, under current law, the initial receipt caps the return on human capital, and much of the future return is treated as flowing from invested capital.

At a minimum, try as one may, the two settings, pure employee rendering services for cash and service provider rendering services for an equity interest in the enterprise, are not comparable. Significant distinctions exist with respect to the degree of risk, time of ownership, and types of return. The ownership of stock in a corporation or a capital interest in a partnership permits a second possible stream of an ongoing economic return, i.e., dividends with respect to the stock and profits with respect to the capital interest, as well as gain upon disposition of the interests. Accordingly, the tendency to utilize the pure

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30 This treatment does not guaranty preferential treatment in the partnership context due to the presence of § 702(b) which characterizes the income by the activities of the enterprise and imputes that characterization to all regardless of whether the partner contributed invested capital or human capital. However, preferential treatment is assured in the corporate context. Importantly, in the partnership context, it is possible to derive ordinary income or capital gain during the operational and/or dispositional phase of the equity ownership, regardless of whether the partner is a service provider or a capital investor.

31 I fully recognize, and emphasize in the text, that loss is a possibility. Nevertheless, to achieve an economy of verbiage and to illustrate general misconceptions, except where necessary, I will typically reference and address the positive side of such investments and assume that gain is forthcoming.
employee setting as the basis for comparison is inappropriate. Instead, the treatment of a compensatory transfer of a profits interest in a partnership should be compared with the results of compensatory transfers of other equity interests in business enterprises.

A. Unrestricted Equity Interests in Corporations or Partnerships—Treatment in Year of Receipt

In this variation, the compensatory grant to the service provider of stock in a corporation or a capital interest in a partnership is assumed to be without restriction or conditions. Thus, Charlotte and Bob receive entrepreneurial interests without conditions, e.g., a four-year period of service before the interest vests. Under the current tax law, unrestricted transfers of equity interests differ dramatically from restricted transfers with regard to risk, time of vesting, and economic significance. Accordingly, such differences under current law justify differing tax treatment.

An unrestricted ownership interest permits the recipient to exit the enterprise without penalty, e.g., one week later, should he or she decide to move in a “different direction” and seek an affiliation with another enterprise. Because the equity interest vested upon receipt, Charlotte or Bob possess the right to terminate the relationship with Corporation C or Partnership K at any time. Given the nature of their economic bargain with the enterprise, they are entitled to free and clear ownership of their equity interest. Upon their exit, they have a glorious windfall—$500,000 in hand, receiving virtually “something for nothing” as they worked but a fraction of their expected, albeit not required, tenure.

The enterprises will never receive the benefits of their labor, and Charlotte and Bob will have derived an economic windfall. Even the classification of their receipts in tax policy terms is difficult because they never rendered significant services to the enterprises. Is this a return on human capital, invested capital, or a third category of a pure windfall? At a minimum, this component of the overall economic bargain documents the complexity in attempting to draw consistent lines in the treatment of the receipt of compensatory equity interests from the standpoint of sound tax policy principles.

The tax treatment of such receipts is settled under current law and, in the year of receipt, closely approximates the tax treatment of the pure employee. Charlotte and Bob both have ordinary income in the amount of $500,000 taxed at a rate of 35 percent.32 Under existing Regulations, Charlotte and Bob both receive a

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32 Some suggest that the deduction available to the enterprise is important to the analysis. See Noel B. Cunningham & Mitchell Engler, The Carried Interest Controversy: Let's Not Get Carried Away, 61 Tax L. Rev. 121 (2008) (allowing an interest deduction); Fleischer, supra note 2, at n.56 (denying an interest deduction); Leo L. Schmolka, Taxing Partnership Interests Exchanged for Services: Let Diamond/Campbell Quietly Die, 47 Tax L. Rev. 287, 312 n. 105 (1991) (also
basis in the enterprise of $500,000, which at a minimum gives the appearance that a conversion from human capital to invested capital occurs.\textsuperscript{33} As we will see, gain on the subsequent sale or liquidation of the interest is treated as a return on invested capital and taxed preferentially even though the grant was for the rendition of services.\textsuperscript{34}

Critics suggest that a compensatory receipt of an equity interest produces the same results as those generated in the pure employee context.\textsuperscript{35} They content themselves with an assessment of the tax treatment of the initial receipt of the equity interest; in our example, each has $500,000 of ordinary income. However, if the quest is for the proper tax treatment of the return on human capital, then a more thorough inspection of the totality of the ownership period is required. By doing so, one discovers that significant distinctions exist between the employee and the equity setting.

Due to their in-kind receipt, Charlotte and Bob have a tax obligation on the value of their economic enhancement, which requires the use of funds from other sources in order to meet their tax liabilities. More importantly, they are not similarly situated to their employee counterparts, because future appreciation in the value of the enterprise as well as potential earnings from its operations may inure to their benefit during the ownership period.

denying an interest deduction). However, for purposes of my analysis, I have chosen to avoid that aspect of compensatory transfers of equity interests.

\textsuperscript{33} See Treas. Reg. §§ 1.61-2 (d) and 1.83-2(a).

\textsuperscript{34} Critics take as a given the similarity in treatment of the tax consequences of the receipt of a compensatory interest in equity, regardless of whether it is in a corporation or a partnership. However, such is not the case. In the corporate context, once the receipt is taken into account, everything thereafter is taxed preferentially if the holding period requirement of more than one year has been met. Future dividends from the enterprise and gain on the sale of the stock are treated preferentially. I.R.C. § 1(h)(11) (2008) (dividends taxed at long-term capital gain rate for individuals); I.R.C. §§ 1221, 1222 (defining capital asset and specifying holding period threshold for long-term and short-term capital gain or loss).

In the partnership setting, such treatment will not arise in every case. The return on a partnership interest is annual as each member must report his share of the partnership’s operations for the business year. I.R.C. § 706(a) (2008). Additionally, upon the sale or liquidation of the interest, an aggregate “look-through” approach which focuses on the nature of the assets held by the partnership comes into play. I.R.C. §§ 741, 751(a) (2008) (gain or loss recognized on the sale of an interest in a partnership treated as attributable to the sale of a capital asset, except to the extent that it reflects gain or loss in the ordinary income assets of the partnership). In contrast to the corporate model utilizing an entity approach and thus generating capital gain, the partnership model is capable of producing ordinary income on the sale or liquidation of the interest. I.R.C. § 751(a) (2008).

\textsuperscript{35} See Fleischer, supra note 2, at 3-4. Cf. Schmolka, supra note 3 at 105 (suggesting the taxation of carried interest be modeled after Subchapter S).
An analysis which limits its tax policy comparisons to the first year only is incomplete. More is required. Charlotte and Bob receive their economic interests in return for an obligation to continue rendering services into the future. Assuming that they do so annually, without additional recompense and without the payment of dividends or the derivation of additional profits, future appreciation or depreciation may occur in the value of the enterprise. Given their equity ownership, they will share in the success or failure of the enterprises.

Critics fail to distinguish between the tax consequences of the receipt of unrestricted corporate stock and those derived from the receipt of an unrestricted capital interest in a partnership. The tax consequences diverge dramatically depending upon which interest the service provider receives.

The ownership interest in a corporation and one in a partnership are fundamentally and philosophically different. I have previously complained of the increasing tendency to conflate Subchapter K with Subchapter C. Too frequently, commentators assert that consistent treatment must arise in both areas. They apparently assume that the Subchapter C treatment for a particular transaction is the same as that which arises under Subchapter K, which is not the case. Instead, in many areas, significant differences between the two exist.

Regarding the current taxation of operational earnings, these fundamental differences are evidenced by the governance of the entity approach for corporations and the aggregate/conduit approach for partnerships. The service provider in the partnership setting, in contrast to his or her counterpart in the corporate context, has additional tax consequences on an annual basis. In the corporate context, without the payment of dividends, no additional tax consequences will take place on an annual basis during the operational phase of the equity ownership.

Returning to the example and comparing the treatment accorded Charlotte and Bob, their treatment begins to diverge by the end of the first year. Charlotte has $500,000 of ordinary income in Year 1 and an attendant basis of an equivalent amount for the stock. Unless dividends are paid, she will have no further tax consequences until the sale or redemption of the stock. All amounts in excess of her basis of $500,000 will be entitled to preferential tax treatment. Earnings of the corporation will be subject to a first level of tax and Charlotte will have a second level imposed upon her.

36 Compare Willis et. al., supra note 12 at ch 9 with Bittker and Eustice, supra note 15.


38 In the interest of simplicity, the paper does not address these issues in the S corporation context.
Bob receives very different treatment after the receipt of his equity interest in the partnership. While he too has $500,000 of ordinary income and an equivalent basis for his partnership interest, he also has a profits interest in the partnership. If he received a capital interest equal to 20 percent of the partnership’s capital, most likely he received an equivalent interest in profits and losses. While flexibility is the hallmark of partnership taxation and the parties can agree to variations in which the percentage interest in profits of a partner can exceed his interest in capital, for purposes of illustration, we will assume that the percentage interests for Bob in profits, capital, and losses of the partnership are 20 percent. Accordingly, at year end, under § 702, he will include 20 percent of the partnership’s income for the year on his personal return and pay tax on that income as characterized at the partnership level.

Assuming the partnership is earning $3,000,000 per year, per the example above, Bob will report annually 20 percent of that amount, i.e., $600,000, as additional income under § 702(a). Furthermore, the income will be characterized at the partnership level pursuant to the legislative instruction of § 702(b). Thus, depending upon the character of the income to the partnership, Bob’s 20 percent share of the income could range from exclusively ordinary income to exclusively long-term capital gain to any combination in between dependent upon the activities of the partnership. In our example, Bob would report the $600,000 as ordinary income annually.

Importantly, notwithstanding assertions to the contrary, the service provider in the partnership context, Bob reporting $600,000 of income annually (his 20 percent share in profits), is treated differently than his counterpart in the corporate context, where Charlotte is reporting $0 annually. Neither party will report the same amount of income over the life of their equity ownership in the enterprise. Furthermore, Charlotte indirectly will bear her share of the corporate tax, 34 percent of the $3,000,000, on an annual basis, since her amount realized on the sale or liquidation of the stock will reflect the reduction in the amount of corporate assets due to the payment of its tax obligations.

Additionally, Charlotte will report the amount received on liquidation or sale, to the extent it exceeds the basis for the stock of $500,000, exclusively as long-term capital gain. Bob, reporting the same $500,000 in Year 1, will report $600,000 annually, as ordinary income or capital gain depending upon the character of the income to the partnership, which will increase his basis for his partnership interest. The sale or liquidation proceeds less the increased basis will be taxed at the same time as Charlotte’s, but in contrast to Charlotte, it is far from certain that the entirety of any gain will receive preferential treatment. The aggregate-entity approach of Subchapter K possesses additional safeguards through § 751 to prevent the conversion of ordinary income into capital gain which no longer exist in Subchapter C. 39

39 See Willis et. al., supra note 12 at ch. 14.
Of critical importance, as illustrated above, the settings are not similar. Corporations and partnerships function differently for tax purposes, and the dual-level of taxation attendant to the corporate enterprise differs dramatically from the single-level tax on an annual basis inherent in the treatment of partnerships. They are fundamentally different, which is why direct comparisons between the two for a "snapshot" period of their existence are misleading.

In summary, assume that Charlotte and Bob received their interests, valued at $500,000 at the close of business on December 31, Year 1. They each spend the next four years with their respective enterprises before selling their interests on December 31, Year 5. During each of those years, the enterprises earned $3,000,000. When Charlotte and Bob received their 20 percent equity interests, they were worth $500,000, which resulted in $500,000 of ordinary income to each.

As noted above, Bob reports $600,000 annually as his share of the profits and under Subchapter K adjusts his basis in order to ensure that he is not taxed twice on the same income. At the end of the ownership period, he sells his interest for $2,900,000, assuming no unrealized appreciation of assets, and reports no additional gain. Thus, in the partnership setting, in addition to the $500,000 of ordinary income upon receipt, Bob has reported income annually (even though there have been no distributions made to him), without the benefit of deferral, and, depending upon the activities of the partnership over this four-year period, characterized either as ordinary or capital.

40 See Postlewaite, supra note 37, complaining of efforts to ignore the fundamental differences between Subchapter K and Subchapter C.

41 See, e.g., Fleischer, supra note 2, at 5, 10, & 18 (drawing direct comparisons between partnerships and corporations and calling for consistency between the two forms).

42 The corporate interest was anticipated to be less profitable than actually occurred. Accordingly, the value on receipt equaled the value of the partnership taking into account various factors in addition to liquidation value. Thereafter, to Charlotte’s good fortune, the corporation proved to be more profitable than anticipated.

43 The examples are simplified for purposes of comparison and differ dramatically from the real world. Constant earnings are assumed over a four-year period in a world without inflation. Furthermore, the assets of the enterprise are assumed to stay constant in value without appreciation or depreciation. All of these factors are confronted in the conduct of real world business operations. One could integrate further assumptions into the examples in order to comport with the real world. However, the general tax consequences illustrated by the examples would not change.
Government statistics suggest that approximately 3,000,000 tax returns are filed by partnerships annually. Most likely, a 20 percent equity interest in a majority of those enterprises would produce a sizeable amount of ordinary income annually, particularly in business, as opposed to investment, enterprises such as law and accounting firms.

Given the fundamental difference between the taxation of corporations and partnerships, Charlotte’s results differ from Bob’s. While reporting an equivalent amount of ordinary income in Year 1, she reports nothing for the next four years. Her basis for her corporate stock is $500,000. Her sales price for her interest would be $2,084,000 ($600,000 share of annual earnings less corporate tax at 34 percent rate of $204,000 times four years plus $500,000 value of initial receipt). Charlotte would be taxed at preferential rates on $1,584,000 ($2,084,000 - $500,000) of gain.

Thus, in total amounts taxed to each, Charlotte is taxed on $2,084,000 and Bob $2,900,000. Of those amounts, the character of Charlotte’s is $500,000 ordinary and $1,584,000 as capital gain. Bob’s is $2,900,000 as ordinary income. Bob “derived” income annually over the full four-year period while Charlotte did not. Without time value considerations, Bob’s net income after taxes is $1,885,000 ($2,900,000 less taxes at a rate of 35 percent of $1,015,000). Charlotte’s is $1,631,400 ($2,084,000 less taxes of $412,600 ($500,000 at 35 percent, $175,000, and $1,584,000 at 15 percent, $237,600)).

At a minimum, Charlotte and Bob clearly are not taxed similarly on the overall return from their investment of human capital. Differences arise regarding when they are taxed, the character of the return and the rate at which it is taxed, and the impact of an entity level tax.

**B. Restricted Compensatory Transfers of Corporate Stock or Partnership Capital Interest—Year of Vesting**

The more likely scenario with regard to compensatory transfers of equity interests involves the imposition of various restrictions prior to the vesting of ownership in the service provider. Fearing the consequences described above, i.e., the departure of the service provider with current rights to the equity of the enterprise without the rendition of the bargained for services, the more typical setting involves a transfer of the equity interest conditioned upon the completion

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44 For example, in 2006, 2.9 million partnership tax returns were filed. See Internal Revenue Service, *Tax Facts at a Glance*, available online at [http://www.irs.gov/taxstats/article/0,,id=102886,00.html](http://www.irs.gov/taxstats/article/0,,id=102886,00.html).

45 If the income generated by the partnership had been long-term capital gain, Bob would have been taxed at a 15 percent rate on his annual income, thereby reducing the overall tax liability and increasing his net income after taxes to $2,265,000.
of a fixed period of service before vesting, e.g., four years. Upon the fulfillment of
the conditions, ownership of the interest is transferred to the service provider.

The tax law has addressed the treatment of restricted compensatory transfers of
equity interests in § 83. Utilizing the fact patterns described above, i.e., the grant
of a 20 percent interest in either corporate stock or partnership capital
conditioned upon four years of service, which at the time of the grant was worth
$500,000 without regard to the restriction, the tax consequences to the service
provider are postponed. The restrictions are such that the tax law does not
equate such a receipt as true and complete current ownership of the equity
interest.

From a tax policy standpoint, this is a logical and sound approach. The Supreme
Court in Commissioner vs. Glenshaw Glass Co. held that "accessions to wealth,
clearly realized, over which the taxpayer exercises complete dominion and
control" constitute gross income.\footnote{348 U.S. 426, 431 (1961).} The tax law embraces the concept of
realization. If one does not currently possess all rights to ownership, income is
generally deferred until a time at which the economic enhancement is clear and
certain.

The tax consequences of the transaction differ dramatically from those involving
the transfer of unrestricted equity interests. In the case of restricted transfers, at
the time of the transfer, there is no certainty of vesting. Actual ownership is
dependent upon future events which are uncertain and subject to risk.
Accordingly, postponing the tax consequences is logical, even though the value
of the potential receipt is certain at the time of the grant, until the transaction
equates with the compensatory transfer of an unrestricted interest. Tax
consequences should be suspended until the point in time at which the recipient
has complete dominion and control over the equity interest. At that time, he or
she possesses the same ability to insist upon a share of the assets of the
enterprise through sale or liquidation as does the recipient of an unrestricted
equity interest.

Under the Code,\footnote{IRC § 83(a) (2008).} no tax consequences ensue for restricted equity transfers until
the conditions have been fulfilled and the property vests (Year 4 in our example).
Upon the completion of the service requirement, the service provider is taxable
on the value of the stock or the partnership interest at that time. As the transfer
involved a 20 percent interest in the enterprise, that percentage of the overall
valuation of the enterprise at the end of Year 4 is includable in the service
provider’s income as ordinary income. The 20 percent interest, which initially

\footnote{348 U.S. 426, 431 (1961).}

\footnote{IRC § 83(a) (2008).}
had a value of $500,000, has appreciated to a liquidation value of $2,900,000 if the enterprise is a partnership and a value of $2,084,000 if a corporation.\footnote{As the enterprise earned $3,000,000 per year over four years, none of which was distributed, the overall appreciation totaled $12,000,000 in the partnership context. Of that amount, a 20 percent interest would be entitled to $2,400,000, which when combined with the initial valuation on the date of the grant of $500,000 would total $2,900,000. In the corporate context, the value at the end of four years would be reduced by the amount of the corporate tax, resulting in a value of $2,084,000.}

From a theoretical tax policy standpoint, the presence of the restriction generated a greater return on human capital, $2,900,000 or $2,084,000 rather than $500,000 in the case of unrestricted receipts. Under the current tax law, the service providers would take a basis of $2,900,000 and $2,084,000 in the enterprise respectively upon vesting.

Future appreciation in the value of the enterprise is considered to be a return on invested capital, even though Charlotte and Bob continue to render services to the enterprise.\footnote{As noted above, in the partnership context, a return on invested capital does not always generate capital gain.} Had the critics extended their scrutiny of compensatory transfers of equity interests past the point of initial receipt, they might complain that human capital by such tax treatment is improperly being converted to investment capital because the service provider’s commitment to the enterprise has been nothing more than the rendition of services, i.e., the investment of human capital.\footnote{We will return to consider the mischief caused by the § 83(b) election. See infra at notes 190-194 and accompanying text.} However, they would also have to acknowledge that the conversion feature which they deem to be unacceptable in the profits interest context exists in other types of compensatory transfers of enterprise equity interests.

Importantly, the overall results for Bob in the partnership context, if the partnership’s earnings are characterized as ordinary income, may be identical to the tax consequences which would have arisen if the compensatory transfer of the equity interest had been unrestricted. The overall results for Charlotte, and

Additional complexity arises due to the differences in valuing the receipt of a partnership interest and corporate stock. Liquidation value typically controls in the partnership context while additional factors come into play in the corporate context. While an integration of these factors could change the numbers of our examples, the general conclusions would be unaffected.

Technically, the enterprise would be entitled to a deduction for the amount included in income (I.R.C. § 162(a) (2008)) which would alter the results somewhat in the corporate context by lessening the tax liability on the corporation and thereby increasing Charlotte’s share of the worth of the corporation. In the interest of simplicity, this additional adjustment has been omitted. In the partnership context, the deduction would be allocated to the other partners (I.R.C. § 83(h) (2008)) and thus Bob’s results should be unchanged.
Bob if the partnership annually derives long-term capital gain income, are dramatically worse in the restricted setting, because the entirety of the income received will be taxed as ordinary income at the rate of 35 percent, rather than the preferred rate of 15 percent. Importantly, this analysis illustrates differing tax consequences for the same receipt due exclusively to its restricted status.

C. Compensatory Receipts of Profits Interests in Partnerships

Compensatory transfers of equity interests in an enterprise differ in the corporate world of Subchapter C and the partnership world of Subchapter K. In the corporate world, typically the enterprise can transfer an interest in stock only, whether common or preferred.\(^{51}\) It is generally not possible under the tax law to transfer rights to dividends of a corporation without transferring the stock.

In the partnership context, the enterprise and its members are subject to a different taxing regime designed for the imposition of a single level of tax. Taxation takes place when income is derived by the enterprise and is taxed not to the enterprise but instead to the members, regardless of whether the income is distributed to them. Furthermore, the characterization of the income earned by the partnership is determined at the partnership level without regard to the business activities of its partners and their degree of involvement in the conduct of the partnership’s operations.\(^{52}\)

Another facet of partnership taxation ignored by some is that capital interests are accompanied by profits interests regardless of whether the equity interest is acquired in return for capital contributions or in return for the rendition of services. It is misleading to describe a service provider as receiving only a capital interest. Without exception, a capital interest and a profits interest in the partnership is received by the service provider.

However, it is also possible for a partnership to transfer an equity interest in profits only to the service provider. The distinction between the receipt of a profits interest and that of a capital interest is that the latter has liquidation value at the time of receipt while the former does not. As illustrated above, a profits interest is dependent upon the future successful conduct of the partnership’s business in order to produce an economic return to its holder. Significantly, a capital interest has liquidation value upon receipt; a profits interest does not.

Accordingly, a “pure” profits interest, i.e., one not tied to an interest in capital, is not taxed upon receipt. The reason for this treatment is the difficulty in valuation,

\(^{51}\) Income earned in the corporate context is potentially subject to an additional level of taxation. Dividend distributions or gain from the sale or liquidation of the stock will precipitate the imposition of another tax on the corporate earnings.

\(^{52}\) I.R.C. § 702(b) (2008).
the lack of certainty that anything will be received, and the complexity arising from the potential for "double taxation," i.e., once upon receipt followed by a second tax as earned. 53 Arguably, such an interest is implicitly, if not explicitly, a restricted interest. Only as services are rendered is the service provider entitled to the receipt of a share of the profits generated.

Significantly, a profits interest at year end, if the profits are not withdrawn, transforms in the following year into an interest in capital as well as an interest in profits. The prior year’s undistributed profits become an interest in partnership capital in Year 2. Thus, most recipients of pure profits interests after the year of receipt also possess an interest in partnership capital.

The Service in 1993 removed any doubt about the income inclusion and valuation issues of a compensatory transfer of a profits interest with its publication of Revenue Procedure 93-27. 54 Therein, the Service held that the receipt of such an interest generally does not constitute a taxable event either for the partner or for the partnership. Focusing upon the rights of such a service provider, if liquidation occurred the next day, he or she would be entitled to nothing. The service provider would walk away from the partnership empty-handed. As a consequence, the Service concluded that there is no policy rationale for current taxation. 55

Using the same example as above but with Bob receiving only a 20 percent interest in profits, there are no tax consequences upon the receipt of the interest. Bob would report $600,000 of income per year for the four-year period, subject to either a 35 percent or a 15 percent rate of tax depending upon the character of the partnership’s income determined at the partnership level. Significantly, the tax consequences for the compensatory receipt of the profits interest and the compensatory receipt of an unrestricted capital interest are identical in every respect except for the additional liquidation value of the interest to which the service provider is entitled on the date of receipt of a capital interest.

53 As explained below, double taxation will never occur due to the built-in “homeostasis factor” inherent in Subchapter K. See discussion infra at note 177. However, time value and possible character distortions may attend taxation upon receipt.

54 1993-2 C.B. 343.

55 Three exceptions were provided in the release, each of which involves variations undercutting the underlying premise that the interest is uncertain of value. Regulations have been proposed, accompanied by a proposed Revenue Procedure, to further embrace this treatment with an expansion of the present treatment as well as a consideration of particular problem areas regarding the forfeiture of a compensatory interest for which there was a lack of guidance. See Prop. Treas. Reg. Preamble 5-24-2005 and Notice 2005-43.
Notwithstanding advocacy to the contrary,\textsuperscript{56} compensatory receipts of profits interests in a partnership are not treated more favorably than transfers of capital interests in a partnership under current tax law.\textsuperscript{57} Upon receipt, they are taxed on the basis of their current liquidation value, because all future economic to the interest will be taxed to the holder currently as realized by the partnership under Subchapter K. After receipt, their treatment is identical.

A receipt of a compensatory capital interest in a partnership possesses current liquidation value while a profits interest does not. As the enterprise conducts business operations, both the holder of a compensatory capital interest and the holder of a compensatory profits interest will take their share of profits into account annually. Furthermore, the future value of the profits to be generated by the partnership is not taken into account upon receipt of the interest due to the conduit treatment of the enterprise. As illustrated above, both recipients will be taxed on the same amount of future earnings, at the same time, and at the same character. The only difference in tax consequence will be the liquidation value of the initial receipt, which is attributable to something that the profits interest holder will never receive and thus upon which he or she should not be taxed.\textsuperscript{58}

\section*{D. Dispositional Return on Compensatory Transfers of Equity Interests}

An additional return may arise to the holder of a compensatory equity interest on its disposition through liquidation or sale. In the case of a capital interest, once vested, any appreciation in the assets of the partnership will impact the value of the interest. Depending upon the composition of the partnership assets, capital gain characterization is likely, but ordinary income is possible as well upon the disposition of the partnership interest.\textsuperscript{59} Importantly, under § 706(c) of the Code, the taxable year closes on the date that the interest is retired or sold. The results

\textsuperscript{56} Fleischer, \textit{supra} note 2 at 12; Schmolka, \textit{supra} note 3, at 289. In the case of a restricted interest, the availability of a § 83(b) election results in the minimization of any difference between the receipt of a capital interest and a profits interest.

\textsuperscript{57} See, e.g., Fleischer, \textit{supra} note 2, at 4: “The conversion of labor income into capital gain is contrary to the general approach of the Internal Revenue Code and diverges from the treatment of other compensatory interests. Partnership profits interests are treated more favorably than other economically similar methods of compensation, such as partnership capital interests, restricted stock, or at-the-money nonqualified stock options (the corporate equivalent of a partnership profits interest).”

\textsuperscript{58} Significantly, many recipients of a restricted capital interest will receive similar treatment, because they will avail themselves of the § 83(b) election in order to minimize the ordinary income component upon receipt.

for the year are tallied and allocated to the exiting partner and may result in varying amounts of ordinary income and/or capital gain.

In the corporate context, future appreciation in the value of the stock generates capital gain on the sale or liquidation of the stock, regardless of the nature of the underlying corporate assets. Thus, a shareholder of a corporation with significant inventory which if sold by the corporation would generate ordinary income is entitled to capital gain on the sale of his or her stock. The return generates preferential treatment even though the stock was issued exclusively in return for the rendition of services.

**E. Summary of the Current Tax Treatment of Compensatory Transfers of Equity Interests**

This brief overview of the tax law’s treatment of compensatory transfers of equity interests in an enterprise is an important prerequisite to an assessment of criticism regarding the current state of the law and its treatment of the transfer of compensatory equity interests. As illustrated, there are five traditional types of equity interests which can be received in the future by a service provider exclusively in return for the rendition of services—corporate stock, restricted corporate stock, partnership capital interest, restricted partnership capital interest, and partnership profits interest.

Under the current tax law, there are differences in the overall treatment between compensatory transfers of corporate equity interests and partnership equity interests. Thus, the assumption that there is uniform tax treatment for the return on human capital through the receipt of equity interests in an enterprise is erroneous. Importantly, the treatment of compensatory partnership profits interests is not a “quirk” and is not unique.

An appreciation of the current tax treatment for the compensatory transfer of all five interests is essential in order to evaluate proposals for reform and improvement of the status quo. Too frequently, the entirety of the events which constitute the return on the service provider’s investment of human capital is ignored. Instead, the focus is limited to the tax consequences upon receipt. \(^{60}\) Accordingly, many assumptions and assertions about the current state of the law are inaccurate and such criticism is premised on a faulty foundation.

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\(^{60}\) See, e.g., Fleischer, *supra* note 2, at 10 (looking only to tax treatment upon receipt of the profits interest to conclude that current tax law is in this regard counterintuitive and inconsistent with treatment of other “equivalent” methods of compensation); Schmolka, *supra* note 3, (proposing proper tax treatment upon receipt based upon whether the service partner was acting in its capacity as partner in performance of the services), See generally Aron-Dine, *supra* note 23 (treating receipt of a profits interest as comparable to receipt of any other type of compensation and decrying the perceived unfairness of taxation of the former at preferential rates).
To summarize, pure employee status results in a fixed and certain monetary receipt, taxed as ordinary income. With respect to compensatory equity interests in an enterprise, the current treatment under the tax law of such receipts is settled.

In the corporate context, the entirety of the return to the service provider is never exclusively ordinary income. Instead ordinary income is mandated for the receipt of the equity interest to the extent of its value and capital gain arises on its disposition. Unless there is a payment of dividends, no other tax consequences are forthcoming during the interim. Thus, under the current tax law, the entirety of the return on the investment of human capital is not taxed at progressive rates.

In the partnership context, ordinary income to the extent of liquidation value is similarly derived upon receipt of an equity interest, ordinary income and/or capital gain arises annually during the ownership period dependent upon the operations of the enterprise, and ordinary income and/or capital gain is recognized upon its disposition dependent upon the nature of the assets held by the enterprise. Again, under the current tax law, the entirety of the return on the investment of human capital is not necessarily taxed at progressive rates. In fact, post-acquisition returns in the partnership context will more likely be taxed at progressive rates than in the corporate context. However, current law does not mandate taxation of the entirety of the return at progressive rates.

In keeping with the three-fold purpose of this Article, the goal has been initially to examine thoroughly the current state of the law and to illustrate that the issue of the return on human capital and return on invested capital, while clear upon the receipt of an equity ownership interest, becomes intertwined over the life of the ownership of the equity interest. The two concepts meld together, and there is no effort to disentangle them after the receipt of the equity interest in the enterprise.

61 Identical treatment is derived by service providers who possess an equity interest and negotiate with their enterprise on an arm’s length basis to receive a fixed and certain monetary amount for services provided to their enterprise. They possess a dual relationship with their enterprise as both an equity interest holder and a service provider compensated directly for his or her labor.

62 If the interest is restricted, the value is determined when the conditions are fulfilled and the ownership interest vests. I.R.C. § 83(a) (2008). An available election under § 83(b) is permitted through which the recipient can accelerate the tax consequences based on the value of the equity interest on the date of receipt. I.R.C. § 83(b) (2008). As will be discussed below, the election is indefensible from a tax policy standpoint and thus a discussion of its effects has been reserved until later. See infra notes 186 - 190 and accompanying text.
IV. Is the Receipt of a Profits Interest in a Private Equity Fund Inconsistent with the Current Tax Law? 63

Some have recently questioned the ability to compensate service providers with a profits interest in a partnership, particularly in the context of private equity funds, because, in their view, current law fails to tax the return on human capital at progressive rates. They assert that the treatment of such interests under the current tax law deviates from the norm for other compensatory transfers of equity interests in an enterprise. Criticizing the use of compensatory transfers of profits interests to unfairly minimize their tax burden, they posit an urgent need for reform.64

Allegedly, equity fund managers are improperly permitted to take their share of the enterprise’s profits as “the equity portion of their compensation.”65 Furthermore, the liberal tax rules for compensating service partners under Subchapter K create tax planning opportunities which are not available in other compensatory contexts. These managers, through their willingness to accept profits, rather than capital, interests in the partnership, benefit from both the deferral of the payment of tax and the conversion of ordinary income into capital gain.66

It is asserted that this “quirk in the tax law allows some of the richest workers in the country to pay tax on their labor income at a low rate.”67 Framed in this fashion, the passions of the public and Congress are aroused.68 However, by failing to survey the entirety of the tax consequences to the recipient of a compensatory transfer of an equity interest in an enterprise, these advocates mischaracterize the current tax treatment of such transfers. As illustrated above,

63 Some critics assert that their view is almost universally held by the academic community. See Victor Fleischer, Two and Twenty: Taxing Partnership Profits in Private Equity Funds 51 (U of Colorado Law Legal Studies Research Paper No. 06-27, 2007), available at SSRN: http://ssrn.com/abstract=892440: “[I]t’s worth noting that there is (near) academic consensus on one issue: the status quo treatment of a profits interest in a partnership is no longer a tenable position to take as a matter of sound tax policy.”.

64 Vice President elect Biden would likely embrace such advocacy as it reflects his view of a patriotic duty to pay taxes at the highest rates.

65 See, e.g., Fleischer, supra note 2, at 3.

66 I return to this point regularly; however, deferral and conversion are central to most compensatory transfers of equity interests. Mistakenly, critics appear to ignore the risk factor in their analysis. The fact that the recipient may never receive a return on his labor is discounted and/or minimized in their analysis.

67 Id.

68 Id. For a sample of reactions from the press and Congress, see supra note 6.
a fuller exploration of the tax consequences during the entirety of the service provider’s ownership of the equity interest reveals that the tax treatment of a profits interest is neither unique nor extraordinary.

A fundamental misconception about the current tax law is that the investment of human capital under the Code generates ordinary income. As illustrated, much of the return on compensatory transfers of equity interests in an enterprise is taxed preferentially. In fact, a profits interest in a partnership frequently generates ordinary income while an equity interest in a corporation, if profitable, invariably results in preferential capital gain. Thus, the assertion that the treatment of profits interest is inconsistent with other compensatory transfers of equity interests is mistaken.

Nevertheless, regardless of whether a compensatory profits interest receives preferential treatment under current law, an additional issue arises as to whether the tax treatment of compensatory equity interests overall should be improved. I return to this topic below.

Some suggest “that reconsideration of the partnership profits puzzle is overdue,” and advance proposals, albeit narrowly fashioned, for reform. They arrive at this conclusion even though the issue of the proper taxation of the receipt of a partnership profits interest has received an inordinate amount of time and effort over the past 35 years by the courts, the Treasury, the Service, and numerous commentators. Nevertheless, it is alleged that the evolution of the law and its consideration by government officials, practitioners, jurists, and academics has fallen short of the mark.

One of the difficulties with this recent academic commentary is that it fails to clarify its target. Is its purpose to reform the treatment of compensatory transfers of all profits interests of any partnership or instead to address the issue only in the context of private equity firms and the activities of the mega rich? If the

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69 In both settings, it is assumed that the enterprise does not distribute cash or property prior to the disposition of the equity interest.

70 Id.

71 See Willis et. al., supra note 12 at ch 4. See also supra notes 3-4 (containing academic commentary on the issue).

72 See, e.g., Fleischer, supra note 2. Compare the author’s statements in his article regarding the tax treatment of profits interests (see e.g., pages 1, 4, 16, 20, 25, 49, 58, and 59) with those regarding the tax treatment of private equity firms (see, e.g., pages 1, 3, 6, 8, 17, 26, 35, 49, and 53). See also Victor Fleischer, Taxing Blackstone, 61 Tax L. Rev. 89 (2008). The author appears conflicted in his determination of the ideal scope of reform. Targeting the mega rich creates the “unsatisfying impression” that these firms are “being punished simply for having too much money,” (Id. at 117) implying that the scope of such reform should be broad—perhaps applying to all partnerships. Yet, he also appeals to “the populist goal of preventing the concentration of wealth” as a rationale for eliminating the possibility of capital gains treatment for profits interests,
intent is to prevent excessive benefits for the super rich, thereby targeting investment structures solely on the size of the return, the goal must be questioned. Changing major structural components of the tax treatment of partners and partnerships which have been in place for more than 50 years is ill-advised if the reason for reform is the profitability of a single industry.

However, if the concern is broader, i.e., the proper theoretical taxation of a compensatory receipt of a profits interest in a partnership, such concerns arise with respect to any receipt of a profits interest. Reform, if needed, should be broadly-based, applicable to all. A fundamental principle of tax policy is horizontal equity, i.e., similarly-situated individuals should be treated similarly. The net worth and/or net income of the recipient is irrelevant to the development of sound tax policy principles. If the current treatment of compensatory profits interests is inappropriate for private equity firms, it is similarly so for all other business enterprises, regardless of size.

Most, if not all, of the perceived problem was caused by the death of the Reagan revolution in the area of taxation. During his presidency and with his leadership, the Code was reformed by effectively eliminating the rate preference for capital gains. The disparity in the tax treatment of capital gain and ordinary income is central to these concerns. The proper taxation of human capital and invested capital would be a non-issue if preferential treatment for capital gains were eliminated from the Code. Nevertheless, for purposes of our analysis, one must assume that the tax preference for capital gain income will continue into the foreseeable future.

Critics argue that change is long overdue. For example, recent commentary asserts: “[T]he status quo is untenable as a matter of tax policy.” I argue to the contrary—the status quo is the second best approach to the issue. Given the administrative difficulties in disentangling in any meaningful way the return on human capital and the return on invested capital, the current system is the best we can do.

The current tax treatment of compensatory transfers of equity interests in enterprises did not occur by happenstance. Instead the treatment is by

(Id. at 118-19) suggesting that only a few privileged sectors should be reformed. On the one hand, he decries the Blackstone IPO for having less tax liability as a publicly traded partnership than it would have as a public corporation (Id. at 96); while, on the other hand, he applauds the Blackstone IPO for being accessible to the general investing public (Id. at 119).

73 See Fleischer, supra note 64, at 96 (“Carried interest distributions are often taxed at the long-term capital gains rate of 15%. Corporations, however, cannot take advantage of the capital gains preference; corporations pay tax on such gains at a 35% rate. So if Blackstone were treated as a corporation for tax purposes, it would pay substantially more tax on the compensation it earns for managing funds.”).

74 Fleischer, supra note 2, at 4.
Congressional design. The tax consequences upon the receipt and ownership of a compensatory profits interest in a partnership are no different than the consequences of other compensatory transfers of partnership equity interests and in many cases are worse than the tax treatment of corporate compensatory transfers. The tax treatment of profits interests is not unique.

Critics have erroneously concluded that the taxation of compensatory profits interests differs dramatically from the taxation of other compensatory equity interests. They assert that the adoption of various reform proposals would tax profits interests “in a manner that more closely matches how our tax system treats other forms of compensation, thereby improving economic efficiency and discouraging wasteful regulatory gamesmanship.” 75 However, our current system for taxing compensatory transfers of equity interests fails to treat the majority of the return thereon as attributable to the rendition of services, taxed at progressive rates.

In most corporate cases, after receipt, virtually all of the remaining return on the investment of human capital receives capital gain treatment. This treatment holds even though the service provider throughout the life of his relationship with the enterprise does nothing more than provide services. Neither is this the case in the partnership context, either with respect to the transfer of compensatory capital interests or profits interests. In fact, after receipt, in many cases, much of the return from a profits interest may be characterized as ordinary income, depending upon the business activities of the partnership.

By limiting their focus to a single industry and by failing to look generally to the entire field of compensatory transfers of equity interests, they erroneously suggest that in most settings the return on human capital results in ordinary income. 76 Furthermore, they mistakenly assert that profits interests in partnerships receive better tax treatment than that available for other compensatory transfers of equity in an enterprise.

However, the general treatment of compensatory treatment of equity interests in an enterprise can be improved. As will be discussed further below, I offer a modest proposal for reform, which would treat compensatory transfers of equity interests in a business enterprise consistently and would ensure that the return on human capital is taxed at ordinary rates at the appropriate time. Current law

75 Id at 2 (abstract).

76 See Fleischer, supra note 2, at 3 (implying that in most settings the return on human capital results in ordinary income) and 49 (asserting that profits interests in partnerships receive preferential tax treatment under current law); Cunningham & Engler, supra note 4 at 4 (return on human capital should result in ordinary income and profits interests receive preferential tax treatment under the status quo); Aron-Dine, supra note 20 at 1 (also assuming that returns on human capital result in ordinary income and assuming preferential tax treatment for profits interests).
possesses an elective provision through which recipients of a restricted equity interest can elect to value it for tax purposes as of the date of receipt, i.e., prior to vesting. This feature is one of the least defensible aspects of the current tax treatment of compensatory transfers of equity interests from the standpoint of tax policy.

V. Private Equity Funds—Organization and Compensatory Treatment of Fund Managers

The standard package for fund managers of a private equity fund is “two and twenty.” The managers “take a share of partnership profits as the equity portion of their compensation.” They typically insist upon a management fee equal to two percent of the capital contributed to the enterprise by the other investors. The two percent is generally assessed on committed capital, regardless of whether it has been contributed to date. In addition, the fund manager, as its “upside potential,” receives a 20 percent interest in the future profits of the enterprise.

If the fund does well, the manager shares in the bonanza. If unsuccessful, the manager “can walk away.” Heads I win and tails you lose, the critics would have us believe. Apparently, in their minds, the possibility of receiving nothing for one’s time and effort does not differentiate the relationship from other compensatory settings such as those of a pure employee or the unrestricted receipt of compensatory equity interests.

The typical private investment fund is organized as a limited partnership or a limited liability company, the significance of which from a tax standpoint is that it is treated as a partnership, unless it elects to the contrary, for tax purposes. Thus, the enterprise and its members are governed by the rules of Subchapter K for tax purposes. Investors commit capital to the enterprise and a general partner manages the business for a fee of two percent of the contributed capital on an annual basis.

Should the life of the partnership extend for seven years, the general partner would receive 14 percent of the investors’ capital in return for its management services. With respect to these amounts, the general partner service provider is

77 Id at 3.

78 Management fees are taxed as ordinary income. Depending upon the percentage of these fees compared to the return generated by the profits interests, the imperfection in the current treatment of private equity firms is not as extreme as alleged.

79 See Fleischer, supra note 2, at 3.

working for the partnership without risk and the return is determined without regard to entrepreneurial ownership. The return on this expenditure of human capital is taxed appropriately as ordinary income.

Additionally, the general partner typically puts “skin in the game” by contributing capital to the partnership similar to that of the investors. The amount varies from one to five percent of the total contributions to the fund.81

Subchapter K is intended to afford partners and partnerships flexibility in structuring their relationships. In contrast to Subchapter C, in which equity ownership is typically consistent in its overall percentage ownership (dividend rights, liquidation rights, and dispositional rights) of the enterprise, Subchapter K openly permits, with various safeguards inapplicable in this context, variations in the partners’ percentage ownership of rights to capital, profits, and losses of the partnership.82

The purpose for transferring the larger interest in profits than capital to the general partner apparently is reflective of a capitalistic transaction: “Because the GP can earn significant compensation if the fund performs well, the fund managers are driven to work harder and earn profits for the partnership as a whole.”83 The tax treatment of the disproportionately larger profits interest is called into question.

After formation of the private equity fund, the contributed capital is utilized for investment in failing or underperforming enterprises. Using its expertise in selecting, rehabilitating, and financing the selected enterprises, after a period of time (typically two to seven years), the value of the underperforming businesses has either been restored or enhanced or has been determined to be no longer worth pursuing. In either case, ownership of the enterprises is sold to others at a gain or a loss.

Under the current tax law, the disposition of the rejuvenated businesses is determined at the partnership level and typically gives rise to capital gain or

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81 See Fleischer, supra note 2, at 8, acknowledging a capital contribution by the general partner: “The GP also contributes some of its own capital to the fund so that it has some ‘skin in the game.’” The fund manager makes an outright capital investment and thus has an overall investment of human capital and invested capital, rather than the targeted transaction involving exclusively the investment of human capital. Thus, the proffered quintessential example of a private equity fund deviates from the target of reform, i.e., the mere receipt of a compensatory profits interest.

82 I.R.C. §§ 701-704 (2008). See generally Willis et. al., supra note 12, at ch 10. Section 704(b) imposes safeguards against excessive behavior in the allocations of partnership items by requiring them to possess substantial economic effect or to be in accord with the partners’ interests in the partnership. I.R.C. § 704(b) (2008).

83 Fleischer, supra note 2, at 8.
The resuscitated businesses are assets which are not being held for sale in the ordinary course of the partnership’s trade or business. As a consequence, gain or loss is characterized as capital in nature.

Under Subchapter K, each partner reports annually his distributive share of the partnership’s gain or loss as characterized at the partnership level. The partner is taxed currently even if the profits generated are not distributed to the partner. Once all of the partnership’s investments have been sold, the fund liquidates and distributes the remaining cash to the partners.

In the compensatory context, critics misperceive the difference between a profits interest which is dependent upon uncertain future events and a capital interest which has liquidation value upon receipt. While acknowledging that, if the fund performs poorly, the manager can walk away, it is assumed that a compensatory receipt of a profits interest has current and certain value worthy of current taxation. However, in the example, the “carry” received by the fund manager has no liquidation value and is performance based; should the fund perform poorly, 20 percent of zero is zero. Risk and uncertainty exists for both the manager and the fund’s investors. In fact, the managers of over 30 percent of private equity funds started between 1991 and 1997 never received a financial return on their profits interests.

**VI. The Case Against the Current Tax Treatment of Profits Interests**

It has been alleged that the “tax rules treat partnership profits interests more favorably than other forms of compensation.” By utilizing the carry component of the compensatory arrangement, the recipients “defer the tax on income derived from their human capital.”

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85 IRC § 702(b) (2008). See generally Willis et. al., supra note 12, at ch 9. Regarding the legislative history of the provision, see Mary Louise Fellows, Partnership Taxation: Confusion in Section 702(b), 32 Tax L. Rev. 67 (1976).

86 See Staff of the Joint Comm. On Taxation, 110th Cong., Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests at 39. An assumption that all, or even most, partnerships are profitable in any given year is often erroneous. For example, “historically, partnerships classified in the real estate and rental and leasing sector have dominated the statistics for both the number of partnerships and partners.” Tim Wheeler & Nina Shumofsky, U.S. Government Printing Office, Statistics of Income, 9/22/07 Stat. Income 69, available at 2007 WLNR 26139102, para. 17. Yet, “prior to 1994, these partnerships reported total net losses for most (if not all) years on record.” *Id.*

87 See Fleischer, *supra* note 2, at 3.

88 *Id.*
Unfortunately, while arguing for taxation at progressive rates from the investment of human capital in return for compensatory transfers of equity interests, critics fail to address and define the circumstances of when human capital has been invested as well as how much of the return on that investment should be attributed to human capital rather than invested capital. In contrast to the discussion presented above illustrating the definitional issues and difficulties in disentangling returns on human capital from those on invested capital, critics frequently assume that the entirety of the return from the receipt of a compensatory equity interest should derive ordinary income treatment. However, such is not the treatment under current law.

While questioning the deferral component derived from the receipt of a profits interest in a partnership, they fail to acknowledge that opportunities for deferral arise in other compensatory transfers of equity interests. The deferral feature is present to some extent in virtually all transfers of compensatory interests in equity.

Over and above the preferential treatment of deferral, another criticism of such compensatory arrangements is that fund managers through their receipt of a profits interests “often” are able “to convert the character of [their return on labor] from ordinary income into long-term capital gain,” which is taxed preferentially. This too is a mischaracterization of the current tax law. Many profits interests generate ordinary income, because those partnerships produce ordinary income through the conduct of their profit-making activities, e.g., service partnerships, partnerships operating apartment buildings, restaurants, or movie theaters, etc.

As mandated by § 702(b), the partner’s characterization of his distributive share of the partnership’s income is dependent upon the business-oriented or profit-oriented activity conducted by the partnership. The character of the income is determined by assessing the activities of the partnership with respect to the acquisition, retention, and disposition of its assets. If the asset is capital in nature at the entity level, the activities of the partners are deemed irrelevant.

See infra at notes 153-157 and accompanying text. Many base their proposals on the assumption that these definitional issues do not exist and the human/invested capital distinction is irrelevant. See Aron-Dine, supra note 20 (favoring ordinary income method with entire amount of carried interest attributable to compensation for human capital); Cunningham & Engler, supra note 4 (acknowledging importance of distinction between human capital and invested capital, but providing no method for disentangling the two and failing to acknowledge that definitional issues may arise).

We return later to a discussion of the normative treatment of compensatory receipts and whether current law requires reform. See infra at notes 155-163 and accompanying text.

See supra at notes 63-77 and accompanying text.

Fleischer, supra note 2, at 3-4.
That characterization holds for all members of the partnership regardless of the nature of their involvement with the enterprise.

Thus, partners contributing only invested capital nevertheless may derive ordinary income and those investing human capital may derive capital gain. Under current law, the focus is on the entity, not its members. It is the effort of the enterprise which is determinative of the character of the income and thus at what rate the income will be taxed. While challenging the ability of the return on the contribution of human capital to receive preferential treatment, critics do not insist upon consistent treatment for partners contributing invested capital who receive ordinary income treatment.93

The conversion feature exists in every traditional compensatory transfer of an equity interest in a corporation and potentially exists with respect to every compensatory transfer of a capital interest in a partnership.94 Notwithstanding assertions to the contrary, Congress has purposefully authorized the conversion feature for most compensatory transfers of equity interests.95

Such treatment is alleged to deviate from the norm: “This conversion of labor income into capital gain is contrary to the general approach of the Internal Revenue Code and diverges from the treatment of other compensatory instruments. Partnership profits interests are treated more favorably than other economically similar methods of compensation, such as partnership capital interests, restricted stock, . . .”96 However, as illustrated above, this is simply not the case. The only difference between a compensatory profits interest and a compensatory capital interest in a partnership is the tax obligation on the date of receipt. Furthermore, that difference is material as one has received something with a liquidation value on the date of the grant and the other has not. In every other respect, the recipients will receive identical treatment throughout the entirety of their ownership of the interests.

93 The concept works both ways and has been legislatively sanctioned. If critics seek a more accurate determination of the return on human capital and invested capital, then their proposals should be expanded accordingly.

94 If the partnership’s business activity produces exclusively ordinary income and all of its assets at the time of the service provider’s sale or liquidation of his interest are ordinary income assets, no conversion will occur. Partnerships in many industries as a whole report predominately ordinary income, including agriculture, mining, utilities, construction, manufacturing, wholesale trade, transportation and warehousing, information, professional, scientific, and technical services, and health care. IRS Statistics of Income Division, Fall SOI Bulletin, July 2008.

95 See supra at notes 43-53 and accompanying text.

96 See, e.g., Fleischer, supra note 2, at 4, concluding that a partnership profits interest currently is “the single most tax-efficient form of compensation available without limitation to highly-paid executives.”
The reason for the sole distinction between the two is risk. The recipient of the capital interest has liquidation value upon receipt, while the profits interest recipient’s economic enhancement is dependent upon future events as it lacks current liquidation value. But from that point on, their tax consequences from the compensatory transfers will be identical. The factor of risk is determinative. Few, if any, can predict the future accurately. Uncertainty and risk are everyday features of life. Although the country is spiraling into economic crises, critics imply that these endeavors will invariably prove profitable.

With regard to compensatory profits interests, concern is expressed about the loss of efficiency caused by the presence of compensatory arrangements motivated by tax considerations, particularly through increased agency costs for the investors. Why agency costs are increased is not revealed. The investors appear to pay less, not more, when compensatory profits interests are utilized because they have no initial compensatory outlay and only “pay” the fund managers if they are profitable. If the fund does well, the investors share in its success. If not, the investors minimize the amount of compensation paid to the managers. Thus, efficiency apparently has been improved and agency costs decreased by the use of such arrangements.

Critics further allege that this quirk in the tax law favors private investment firms over investment banks: “This tax advantage for partnerships distorts the decision as to how to organize new business entities.” In making organizational decisions, is the compensatory benefit of a profits interest, should it exist, more important than the single level of taxation for partnerships compared to the

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97 The possibility that risk could factor in to differing treatment is ignored. See Aron-Dine, supra note 20; Cunningham & Engler, supra note 4; Fleischer, supra note 2, at 4-5.

98 These assumptions were likely attributable to the economic conditions at the time criticism against the tax treatment of private equity funds began to mount. During that time, all investments seemed to appreciate. As the private equity firm Blackstone went public, its fourth quarter earnings were in excess of $800,000,000. In less than one year, its quarterly earnings in March 2008 had plummeted to $88,000,000, a decline of 89 percent. Peter Lattman, Blackstone’s Hope--Do Dark Days Mean Opportunity? Wall Street Journal Mar. 11, 2008, at C3.

Blackstone’s net income (loss) (in thousands) further reveals the genuine risk involved in receiving a profits interest: 2nd qtr 2008 $(156,531); 1st qtr 2008 $(250,993); 4th qtr 2007 $(170,000); 3rd qtr 2007 $(113,190); 2nd qtr 2007 $774,351; 1st qtr 2007 $1,132,076; 4th qtr 2008 $1,182,440; 3rd qtr 2008 $372,548; 2nd qtr 2006 $224,063; 1st qtr 2006 $487,155. One can only imagine what the bottom line results will be in the third and fourth quarter of 2008.

99 Fleischer, supra note 2, at 4-5.

100 Id at 5.
double level for corporations? If so, why are these enterprises not shifting to partnership form, rather than remaining in corporate solution?

The conversion and deferral features of a profits interest in a partnership also are indicted as violating sound tax policy. However, not every profits interest, even if profitable, produces preferentially taxed capital gain. Many produce ordinary income. Of greater importance, as illustrated above, conversion and deferral attributes exist in the other four types of compensatory transfers of an equity interest in an enterprise.

Finally, concerns over this preferential tax treatment and distributive justice have been raised. Allegedly, this societal goal is undercut by the preferential tax treatment of the return on partnership profits interests.

The proponents of change agree that important factors must be taken into account in determining the appropriate tax treatment of compensatory receipts of

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101 However, additional concerns are confronted in making organizational decisions. See Victor Fleischer, *Taxing Blackstone*, 61 Tax L. Rev. 89 (2008) (admitting that non-tax issues are reflected in organizational structure as well and identifying a number of those factors).

102 Between 1995 and 2005, the total number of new partnerships organized in the United States increased at a rate of only 5.7 percent (including both new entities and entities shifting from corporate to partnership classification). Tim Wheeler & Nina Shumofsky, U.S. Government Printing Office, *Statistics of Income*, 9/22/07 Stat. Income 69, available at 2007 WLNR 26139102. If choice of entity were so influenced by this “quirk” in the tax law, one would expect this number to be much larger.

103 On this point, such a narrow focus leads to a faulty assessment: “under current law, if the compensation is paid in the form of a profits interest, we estimate the return on human capital portion at zero and treat the entire amount, if and when it is received, as a return on investment capital.” Fleischer, *supra* note 2, at 41. However, many profits interests generate ordinary income for their recipients. Ninety-nine percent of the return from the profits interest of every lawyer who is a partner in a law firm is ordinary income. The profits interest of a partnership turns on the income generated by the partnership and under § 702(b) is characterized at the partnership level. I.R.C. § 702(b) (2008). Thus, the concern is narrower than implied.

104 Some assert that the number of fund managers earning over $100,000,000 exceeded the number CEOs similarly situated at a nine to one ratio. Fleischer, *supra* note 2, at 5-6. Unfortunately, the comparison is not of comparables as it is limited to reported income. The income from a profits interest is reported annually. However, CEOs with their corporate stock are taxed on salary, dividends, and/or stock received currently, but not on its appreciation in value. The author “compliments” the “much maligned” CEOs because they pay tax at 35 percent on most of their income in contrast to managers who inappropriately limit their civic contribution to a mere 15 percent. However, even this assertion may be erroneous, because CEO’s reported income from their corporation may include dividends and gain from the disposition of their stock, both of which are taxed at 15 percent. For a discussion of executive compensation disclosure, see Eric Dash, *Executive Pay: A Special Report – More Pieces, Still a Puzzle*, New York Times, Apr. 8, 2007 (finding even the bottom line compensation amount – meant to be an easy way of evaluating executive compensation -- to be misleading due to the numerous ways of calculating such figure).
equity interests, such as influencing entrepreneurial risk taking, complexity, and inefficiency generated through excessive tax planning. Nevertheless, numerous proposals have been advanced, including “a rule treating all carried interest distributions as ordinary income” which has been embraced as “probably the most appealing policy option.” This normative proposal will be discussed below under proposals for reform.

VII. Criticism of Current Tax Treatment of Compensatory Transfer of Profits Interests

Congress adopted specific tax treatment for the compensatory transfer of an equity interest in an enterprise which recognizes the uncertainty and tension between human capital and invested capital on the return from its receipt. The governing compromise selected by Congress is ordinary income on the receipt of the interest and possible capital gain on its disposition. In effect, current law recognizes that a return on human capital, if not withdrawn from the enterprise, may be conceptualized as a re-investment/conversion of human capital into invested capital. Thereafter, the future services are considered a de minimis adjunct to the invested capital and future growth is entitled, in certain circumstances, to preferential tax treatment.

The putative contribution thereby ends the period for measuring the return on human capital and begins the period of return on invested capital. Even though the service provider continues to render services without additional compensation, Congress has concluded that this is the appropriate point in time at which to cease treating the tax consequences of the receipt as attributable to human capital.

Regarding partnerships, an additional component, absent in the corporate context, in the characterization of the return on the expenditure of human capital is the income derived by the enterprise on an annual basis. During the operational phase, § 702(b) mandates that the income of the partnership which is passed through to its partners is characterized at the partnership level. Utilizing an entity approach, Congress concluded that the efforts of the enterprise, the vehicle though which the members conduct their profit-oriented activities, should be the focal point in the determination of whether any of its activities qualify for preferential tax treatment. A partnership producing capital gain is effectuating

105 Fleischer, supra note 2, at 5-6.

106 Id. at 6.

107 See infra at notes 170-173 and accompanying text.

108 Differences exist between the corporate treatment and the partnership treatment. See supra at notes 32-49 and accompanying text.
the tax policy behavior which Congress seeks to encourage. The reward for such endeavors is a tax rate of 15 percent rather than 35 percent.

In addressing the current state of the law, critics typically begin with the erroneous assumption that any return on human capital must be ordinary income. As illustrated above, this is not the case. They then turn their attention to the current tax treatment of carried interests.

As recognized by the Service and the Treasury, a profits interest is not taxable upon receipt given the absence of liquidation value. However, some suggest that this cannot be the case even while acknowledging that there is no certainty of success: “This treatment seems counter-intuitive. The [general partner] receives something of value at the moment the partnership agreement is signed.”

In fact, the treatment of profits interests comports with the Code’s treatment for compensatory transfers of restricted equity interests in a business enterprise under § 83. In those cases, value is certain but subject to conditions which are a prerequisite to vesting. If the determinative factor for tax purposes is merely that something of value has been received, this is clearly a stronger case for taxation upon receipt than that of a profits interest. The former requires the passage of time while rendering services. The latter requires both the passage of time and the derivation of income by the enterprise. Yet, it is without question that restricted interests are not subject to tax currently, unless the taxpayer makes an affirmative election to do so under § 83(b).

In assessing how profits interests should be taxed, the unique features of a compensatory profits interest are ignored, i.e., its use as an incentive in order to receive the services of a particular individual. This is the sine qua non of the

109 The failure to specifically define what constitutes a return on human capital clouds the issue, but it is assumed that, if the receipt of the equity interest is for services, all subsequent economic enhancement is attributable to human capital and should be taxed as ordinary income. See Fleischer, supra note 2, at 27-32 (characterizing subsequent economic enhancement as “unrealized human capital” which should be taxed at ordinary rates) and Gergen, supra note 3, at 94 ("if a partner performs services for a profits interest, and profits later are allocated to her in the form of earned income or an increase in her capital account to credit her with a share of unrealized gain, that allocation or increase should be treated as ordinary income. . . .").

110 See, e.g., Fleischer, supra note 2, at 9-16.

111 Id at 10 to be contrasted with an earlier statement that if “the fund does badly; however, the manager can walk away.” Id at 3.

112 The importance of risk in determining the proper tax treatment for such compensatory receipts is minimized in such advocacy. For example, some assert: “On the one hand, a carried interest is a valuable piece of property that often turns out to be worth millions and even hundreds of millions of dollars.” (Emphasis added) Id at 10. Nevertheless, after assuring the reader of its certainty of worth, it is subsequently noted that “the amount of carry is uncertain and unpredictable.” Id at 12.
grant. The services of another, or any transferee of the service provider, would not suffice. The vast majority of the population would lack the requisite expertise. Even those with the expertise may lack work habits, personality, and other intangibles, which likely were the reasons the enterprise did not approach him or her, rather than the service provider, with the same offer.

As a consequence, a profits interest in a partnership is effectively non-transferable, because its grant is tied exclusively to the efforts of its holder who possesses the requisite expertise sought by the enterprise. If one could find a third party willing to purchase the interest, he or she would purchase nothing of value. Without the service provider's continued rendition of entrepreneurial skill, the partnership is most unlikely to permit a third party lacking such skills to acquire the interest of the service provider and share in the future profits of the enterprise. Thus, the interest of the service provider in essence is a restricted interest for which the attendant conditions are satisfied on a daily/yearly basis and, as met, the income attributable thereto is “received.”

A frequently employed compensatory technique utilized in the corporate arena is restricted stock. In such a case, § 83 puts the service provider to a choice. The recipient can wait until the stock is vested and treat the value of the stock at that time as ordinary income. Alternatively, the recipient can include it in ordinary income at its current value (without concern for most restrictions), receive a basis for tax purposes in the stock of an equivalent amount, avoid further tax consequence upon vesting, and treat all future appreciation as preferential capital gain.

From the recipient’s standpoint, conceptualizing the election as one of choice is difficult. The well-informed service provider, almost without exception, will make the election due to the "superior skills" which he or she brings to the

113 Some might assert that the interest of the service provider after two years of service, if his annual profits have not been withdrawn, would have liquidation value. While true, as discussed below, that is because his or her past profits interest annually converts to a capital interest. See supra at notes 72-77 and accompanying text. Furthermore, because he or she has taken the income into account annually, the basis for the partnership interest has increased accordingly, and the sale of those rights would have value.

114 By way of example, assume that Charlotte in the above example receives her stock in Corporation C, but is subject to a four-year vesting period. Without the § 83(b) election, she will have no tax consequences in Year 1. When the stock vests in Year 4, assuming the value of the stock has appreciated from $500,000 to $2,084,000, she will have $2,084,000 of ordinary income and a basis of her stock of $2,084,000. If she sold her stock in Year 5 for $4,000,000, she would recognize the $1,916,000 gain as capital in character and pay tax at the preferential rate. With the election, she would have $500,000 of ordinary income, a basis for her stock of $500,000 in Year 1, and no tax consequences in Year 4. In Year 5, she would have capital gain in the amount of $3,500,000.
compensatory relationship. In light of the restrictions and uncertainty attending the vesting of the stock, the recipient would insist upon cash or find other employment if there was substantial uncertainty in his or her mind as to its prospects for appreciation.

Surprisingly, critics in an effort to ensure that the return on human capital is taxed at ordinary income rates ignore this elective tax treatment which flies in the face of their goal. If reforms are necessary to ensure that the return on human capital is taxed as ordinary income, then tax consequences should arise only upon the vesting of the restricted equity interests. In fact, some reform proposals perpetuate this distortion by offering an election to the taxpayer as to the date of income inclusion, which by definition produces different results depending upon which of the two options is chosen by the taxpayer.

I am not saying that the service provider’s assumptions will prove accurate. Instead, I am asserting that, given human behavior, the recipient in accepting stock conditioned upon the rendition of future services for a fixed period of time has clearly decided, upon the acceptance of the offer, that the endeavor will prove profitable.

Importantly, a full understanding of how the tax law treats such compensatory arrangements under the elective feature requires the consideration of what happens if loss rather than gain arises notwithstanding the best efforts of the service provider. Assuming that the stock plummets in value to $100,000 in Year 4 and $50,000 in Year 5, without the election, the executive has ordinary income of $100,000 in Year 4 and a basis of $100,000. Upon its sale in Year 5, he or she would have a $50,000 capital loss, which is of little value to a taxpayer. With the election, the executive has $500,000 of ordinary income in Year 1, a basis for the stock of an equivalent amount, no further tax in Year 4, and a $450,000 capital loss in Year 5.

To exhaust the logical possibilities, the results produced under § 83 in case of forfeiture must be addressed. Without the election, assuming the executive decides to take new employment in Year 3, no tax consequences would ensue and Charlotte would be left to ponder the wisdom of her ever having agreed to receive restricted stock as her compensatory stake in the enterprise. With the election, she would have $500,000 of ordinary income in Year 1. Even though she would receive a basis in the stock of $500,000, § 83 prohibits a corresponding loss, even one characterized as capital, upon her forfeiture.

Although a lack of hard data exists, by intuition it can be expected that service providers of new partnerships, or of partnerships embarking upon a new and hopefully profitable venture, will always believe in the future profitability of the enterprise as a result of their added expertise and will want to take advantage of the relative low initial value of their interest through a §83(b) election. See David A. Walker, Is Equity Compensation Tax-Advantaged? 84 B.U.L. Rev. 695, n.55 (2004) (“start-up company employees generally make the 83(b) election.”) (citing E-mail from Ted R. Buyinski, Buck Consultants, to David I. Walker, Associate Professor, Boston University School of Law (Mar. 26, 2003). See also Michael S. Knoll, The Section 83(b) Election for Restricted Stock: A Joint Tax Perspective, 59 SMU L. Rev. 721, 726-27 (2006) (“early stage start-up companies often sell shares to key employees at a nominal value, which can be argued to be the fair market value of the stock in the fledgling venture. Thus, employees of start-ups can make an 83(b) election and incur little or no current tax, and they generally do.”)

See infra at notes 188-190 and accompanying text.
If taxpayers are to render unto Caesar what is Caesar’s, they should not be empowered with the right to make such a determination. Sound tax policy principles dictate a fixed date and method for determination of the return on human capital. Of one thing we can be certain; an election by the taxpayer cannot be the proper measure.\(^{118}\)

Partnership equity is divided into two categories—capital interests and profits interests. Critics mistakenly consider the two compensatory devices to be separate and distinct and thus mutually exclusive. As noted above, the exact opposite is the case.\(^{119}\) Profits interests become capital interests and capital interests are accompanied by profits interests. But for the year of receipt, the tax consequences to either holder are identical over the life of the equity interest.

There is a symbiotic relationship between a profits interest and a capital interest which can be elusive. For example, some have stated that the “tax law provides a timing benefit for GPs by allowing deferral on their compensation so long as the compensation is structured as a profits interest and not a capital interest in the partnership.”\(^{120}\) This is not the case. Compensatory capital interests in a partnership can be restricted and thereby provide deferral as well under § 83. Additionally, the recipient of an unrestricted capital interest is not currently taxable on future profits, even if relatively certain, due to the use of liquidation value in determining the amount of income to be included upon receipt. Thus, the deferral benefit for profits interests is not as exceptional as others assert.

Regarding the ability of the compensatory receipt to convert the character of the service provider’s return on human capital from ordinary to preferentially treated capital gain, some lament the unfairness of it all: the equity “kicker is treated as investment income, not labor income, and is taxed at a lower rate than labor income.”\(^{121}\) The implication is that such treatment is unique to partnership profits interests.\(^{122}\)

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\(^{118}\) I will return to this issue. See infra at notes 192-194 and accompanying text. However, the willingness to accept such treatment prevents some from discovering a more significant improvement for the taxation of human capital, i.e., the repeal of § 83(b). This “quirk” is a far better target for reform than the current tax treatment of partnership profits interests.

\(^{119}\) See supra at notes 17-21 and accompanying text.

\(^{120}\) Id at 13.

\(^{121}\) Id at 15.

\(^{122}\) Importantly, the mission of my response is to focus on both of the issues raised by the critics. The first is whether partnership profits interests under the current tax law are treated differently than other receipts. On this issue, they are in error. However, the second issue, which is whether the current treatment is sound from a tax policy standpoint and whether it can be improved, is discussed in detail below. See infra at notes 136-190 and accompanying text.
Again, such is not the case. As has been fully documented above, conversion is not peculiar to partnership profits interests. Instead it permeates the treatment of compensatory receipts of virtually all equity transfers of interests in corporations and partnerships.

VIII. The Issue of the Tax Treatment of Compensatory Transfers of Profits Interests Requires Renewed Scrutiny

Spurred by the extraordinary profitability of private equity firms, some have suggested that there is an urgent need for a re-consideration of the appropriate tax treatment of the compensatory receipt of a profits interest. Based upon their assertion that the current treatment of a compensatory receipt of a profits interest is unique, providing inappropriate tax consequences, such a showing alone would warrant a re-examination of the area.

Other developments and reasons are advanced justifying a re-examination of the area. Acknowledging that the issue of the tax treatment of such compensatory receipts has become fairly well settled over the past 35 years, some inquire: “Why reopen the debate?”

Without empirical evidence, it is suggested that the use of compensatory profits interests has increased and their increased usage justifies a re-evaluation: “the increased use of partnership profits as a method of executive compensation in the context of private investment funds suggests the need for reform.” With regard to private equity firms, it is argued that changing sources of capital and the concern of economic efficiency require a re-examination of the tax treatment for profits interests. The type of investor participating in private equity funds has migrated from individuals to institutional investors such as pension funds and university endowments, due to the increased use of intermediaries and the development of new investment strategies.

However, the mere growth of a particular industry by itself should not impact the structure of partnership taxation. Something more should be required.

123 See supra at notes 42–70 and accompanying text.

124 Fleischer, supra note 2, at 16-27.

125 Fleischer, supra note 2, at 16. One wonders what the fate of any tax proposal will be after the economic meltdown of October, 2008. The evolution of the tax law over the next two years is probably more uncertain than it has been in the last 50 years.

126 Id at 16-17.

127 At some level, given the existence of partnerships and the use of profits interests through which to compensate service providers, it is hard to imagine that private equity firms did not use them previously. The more likely explanation is the size of the amounts generated by their use increased dramatically.
Centering on tax policy concerns, concern is expressed that different tax treatment is given to recipients of profits interests than the recipients of other compensatory equity interests: “Economically similar transactions are taxed differently.” While disparate treatment for similar transactions offends sound tax policy, two factors are overlooked. Of primary concern, the recipient in other compensatory transfers of equity interests has something of value at the moment of receipt. The receipt of a profits interest, surrounded by uncertainty and lack of value, is not similar to the receipt of corporate stock or a partnership capital interest, both of which possess liquidation value and marketability.

The second mistake in such advocacy is that the overall tax treatment of a compensatory transfer of a partnership capital interest is identical to the overall treatment of a profits interest except for the year of receipt. Differences exist in the year of receipt and hence the reason for different tax treatment of the receipt. However, once received, the equity interests, both annually and upon liquidation or sale, are treated identically for tax purposes.

Proceeding with a faulty premise, some maintain that this purported tax advantage distorts investment behavior. The market is tax sensitive and moves accordingly, thereby resulting in “deadweight loss” and increased use of private, rather than public, markets. Section 83 is “the cornerstone of tax policy regarding executive compensation” and it requires that “property received in exchange for services be taxed as ordinary income.” While deferral is

This populist rhetoric has resonated with Congress. In the last year, two types of reform bills have been introduced. One type of reform is industry specific, addressing the Blackstones of the world which went public. In response, the proposals deny the exception to corporate status under § 7704(c) for certain private equity funds. As they would be taxed as corporations under the proposed legislation, profits interests, specific to partnerships, would no longer be available for publicly traded private equity firms. See Baucus-Grassley Bill, S. 1624 (110th Cong. 1st Sess), introduced by Senator Baucus on June 14, 2007.

The other type of reform goes to the heart of the inquiry. Under those bills, returns on certain profits interests for many partnerships would be required to be treated as ordinary income. See the Levin Proposal, H.R. 2834 (110th Cong., 1st Sess), introduced by Representative Sander Levin on June 22, 2007.

128 Fleischer, supra note 2, at 24.

129 Id.

130 Id at 25. Advocates fail to recognize that, with the election of § 83(b), the recipients of restricted equity interests are permitted to more closely approximate the taxation of partnership profits interests even though the recipient has something of greater value and certainty than does the holder of a profits interest. The election under § 83(b) undercuts the goal of maximizing the amount of the return from the expenditure of human capital which is taxed at progressive rates. If anything, § 83(b) virtually eliminates the difference in tax treatment between a profits interest and a restricted capital interest in the same partnership with an equivalent percentage interest in profits and losses.
permitted for difficult to value receipts; conversion, i.e., ordinary income into capital gain, is not and violates the principles of sound tax policy. Because the “treatment of partnership profits interests departs from this basic framework,” it is time for change.

However, both assertions are erroneous. First, § 83 does not require that the entire return on property received for services be taxed as ordinary income. As previously illustrated, only the front end of the transaction (the value upon receipt if unrestricted or the value upon vesting if restricted) is treated as ordinary income. The rest is entitled to capital gain treatment in the corporate context. Opportunities for conversion are possible, but more limited, for partnerships.

Furthermore, the § 83(b) election permits the taxpayer to further limit his ordinary income at a revenue cost to the Treasury by electing to value the interest on the day of receipt, even though no services have been rendered. Thus, the return on human capital is not treated as ordinary income. The election under § 83(b) undercuts their goal of maximizing the amount of the return from human capital which is taxed at progressive rates. If anything, § 83(b) permits the recipients of restricted equity interests to more closely approximate the taxation of partnership profits interests even though the recipient has something of greater value and certainty than does the holder of a profits interest.

IX. The Normative Treatment of the Taxation of Human Capital Upon the Receipt of Compensatory Transfers of Equity Interests in an Enterprise

131 Id.

132 See supra at notes 110-112 and accompanying text.

133 See supra at notes 24-36 and accompanying text.

134 See Victor Fleischer, The Rational Exuberance of Structuring Venture Capital Start-ups, 57 Tax L. Rev. 137, 168 (2003) (“The C corp structure allows employees to recognize much of this amount as capital gain through 83(b), which allows employees to elect to lock in the ordinary income amount at the initial valuation of the property, ensuring that any future appreciation is treated as capital gain. . . . Because of the liquidation preference attached to the preferred stock, entrepreneurs use a low valuation for the common stock when it is first received and make the 83(b) election, which ensures capital gain treatment on the subsequent sale of the stock. This result generally can be replicated in the pass-through structure with some additional planning.”)

135 Furthermore, deferral under § 83 does not turn on the difficulty of valuation; instead, it is the uncertainty of receipt. Deferral is available under § 83 for receipts which are certain and precise. I.R.C. § 83(a) (2008) (the receipt of property in exchange for services “shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture.”).
In their quest to improve the tax law, critics isolate transfers of a profits interest in a partnership in return for the rendition of services. In their mind, this treatment is inconsistent with the treatment of other compensatory transfers of equity interests. Accordingly, they urge reform in this narrow context.\(^\text{136}\)

Nevertheless, unwittingly they have called into question a serious issue of tax policy regarding the proper treatment of all such transfers. Five such transfers are possible in the context of an enterprise.\(^\text{137}\) Even if the treatment of a profits interest is consistent with the treatment of other compensatory transfers, it does not mean that the field as a whole is not in need of improvement. Thus, proposals for improvement should be considered in a broader context.

Regardless of the current state of the law, how should the law treat such transfers as a whole? Most commentators isolate two issues (deferral and conversion) regarding the tax treatment of compensatory transfers of equity interests in an enterprise—when should the receipt on human capital be taken into account and what character should it be given for tax purposes?

**A. Deferral**

There appears to be broad agreement among tax policy theorists for deferring the tax consequences on certain transfers of compensatory equity interests. First, as a society, we are reluctant to tax “endowment” and/or unrealized human capital.\(^\text{138}\) Second, tax policy supports the joining together of labor and capital. Finally, measurement and valuation issues in some settings warrant a postponement of taxation.\(^\text{139}\) A fourth factor, frequently overlooked, arises with regard to partnerships, i.e., without postponement, the recipient would “technically” be double taxed on the same income—once as valued upon receipt of the profits interest and again as earned. In order to prevent such a possibility, additional remedial features would be needed in the Code, with a possible increase in overall complexity.

\(^{136}\) This premise is faulty. As documented above, the treatment is far more consistent than asserted. If the only reason for change is the conclusion that its treatment deviates from the treatment of other receipts, they are mistaken and the status quo should be maintained.

\(^{137}\) Transfers of a capital interest in a partnership, a restricted capital interest therein, a profits interest, stock in a corporation, and restricted stock in a corporation are the traditional types of transfers of enterprise equity.


\(^{139}\) Some assert that deferral is questionable for a profits interest because they “have enormous economic value,” even while noting that such interests are incapable of valuation and, if the enterprise is not profitable, the holder will receive nothing. Fleischer, *supra* note 2, at 27 and 12.
Regarding the five traditional types of equity interests which can be transferred in return for the service provider’s investment of human capital, three should qualify for deferral and two should not. The receipt of an unrestricted interest in corporate stock or an unrestricted capital interest in a partnership should not qualify for deferral. Consistent with the overall treatment of the current tax system for the determination of gross income, the requisites of realization and dominion and control should be determinative for normative purposes. In both cases, property rights of value without restrictions have been received and few, if any, would suggest to the contrary. Realization should take place on the receipt of cash or property.

With respect to the other three types of receipts, a restricted interest in corporate stock, a restricted interest in partnership capital, and a profits interest in a partnership, deferral is warranted. Difficulty in measurement and valuation are controlling factors justifying deferral.140 However, for normative standards, the determinative factor should be certainty of ownership; valuation issues should be irrelevant. All three of these equity interests are subject to forfeiture.141 Without the certainty of permanent uninterrupted ownership, deferral is the preferred approach. It coincides with actual economic enhancement and is dependent upon certainty of ownership and valuation once the contingencies have been satisfied.142

Some have suggested that an annual accrual of a return on human capital would be preferable to deferral.143 However, they fail to extend a similar approach to a restricted capital interest in a partnership or restricted corporate stock. Under

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140 See, e.g., Fleischer, supra note 2, at 27; Gergen, supra note 3, at 102; Aron-Dine, supra note 20, at 10.

141 Most commentators fail to recognize the inherent restrictions on the ability to transfer a profits interest. If not explicit, certainly implicit in the grant is the continued service to the partnership by the recipient service provider. Should the service provider decide to exit the partnership, almost without question, profits derived by the partnership thereafter would be reallocated to the other partners. Furthermore, no one would pay more than a de minimis sum to purchase the profits interest for the same reason. Thus, the strongest argument in favor of deferral under current law for a profits interest is that it is functionally indistinguishable from restricted stock or a restricted capital interest.

142 The valuation of a profits interest looks to liquidation value, typically resulting in a determination that value is lacking, while restricted stock is valued on a broader basis. Accordingly, some view this treatment as objectionable. While greater value may be attributed to the stock initially, no additional income other than upon disposition of the stock will be incurred by the recipient. With regard to the holder of a profits interest, tax consequences (and its attendant tax liability) will arise annually. Accordingly, any additional valuation upon receipt would result in over taxation on the front end of the ownership which would be offset later by corresponding losses. Because these future returns will be taken into account, there is no reason from a policy standpoint to ascribe a future value to them.

143 Fleischer, supra note 2, at 39-43. For an alternate method of annual accrual, see generally Cunningham & Engler, supra note 3.
any circumstances, it is difficult to accrue an indeterminate amount which is
dependent upon future events.

While the use of a surrogate for measuring the return on human capital is a
possibility, it conflicts with a strong tax-policy interest in precision and accuracy.
Any accrual approach involves an element of guesswork. Deferral alone does
not compromise these goals. Instead, it effectuates them by awaiting events
which document one’s economic enhancement. Finally, deferral may even
increase the amount of ordinary income from the return on human capital. If the
surrogate produces a figure which is less than the value of the interests once
vested, some of the return on human capital avoids ordinary income
treatment.144

Critics address only the deferral aspects of the receipt of an equity interest, not
those of the retention and the disposition of the interest. Deferral of tax
consequences during the retention phase for operational income attributable to
the equity interest until its sale or liquidation appears uncontroversial.
Measurement is certain, economic enhancement is sure, and all are premised
upon the concept of realization, upon which most income inclusions in our tax
system are based. Given the fundamental differences between partnerships and
corporations, the deferral period for the recipient of a partnership interest during
the retention period is typically shorter than that for corporations because each
partner must report his share of profits annually.

While granting that the soundest explanation for deferral is the inability to
measure the recipient’s income, either on a cash method basis or an accrual
method basis, some nevertheless advance a proxy for its determination to be
imputed to the service provider on an annual basis. A “cost-of-capital method” is
proposed, under which an annual accrual of ordinary income would occur in the
amount of a selected interest rate times the service provider’s percentage
interest in profits times the capital of the enterprise which he or she manages.145

144 Similarly, the possibility arises of over-reporting the amount of return on human capital if the
surrogate imposition over the vesting period exceeds the value of the interest on the date that the
conditions are fulfilled.

145 Fleischer, supra note 2, at 39-43. By way of example, assume that a private equity fund
begins with $100,000,000 of capital. Under the approach, the service provider receiving a 20
percent profits interest would annually take $1,600,000 (8% x 20% x $100,000,000) into ordinary
income. As a consequence, the proposal eliminates the benefit of deferral by proxy which is
“imperfect...and is likely to undervalue the true amount of the increase in value of partnership
assets that reflects a return on human capital, but it is undoubtedly more economically accurate
than current law, which estimates this amount at zero.” Id at 42.
Problematically, such an approach involves guesswork and over- or under-inclusion of the amount of income constituting ordinary income.\(^\text{146}\) Additionally, the proposal applies only to the receipt of a profits interest without extension to the other two types of equity receipts entitled to deferral. From a normative standpoint, if producing meaningful reform, critics should subject similar compensatory transfers of equity interests to the same treatment.

Comparable settings in which the general rules of realization are overridden for service providers are absent from the Code. Why in this case are proxies required and not in others? Pure capital appreciation arising from an investment in stock on a public market, while certain in value and susceptible of an annual determination, is not subject to tax on an annual basis. The tax system fails to intervene because administrative ease and certainty are fostered by embracing the doctrine of realization. A determination of the return on human capital at the time of receipt and realization is the superior method for disentangling the amounts attributable to human capital and those to invested capital.\(^\text{147}\)

The cost of capital proposal adopts an approach similar to the statutory solution to the tax treatment of interest free loans under § 7872.\(^\text{148}\) Thereunder, the income imputed to the service provider attributable to the interest-free component is accompanied by an imputed payment from the recipient to the party advancing the funds. Thus, a question arises as to whether the overall effect of both transactions currently or ultimately offset. If so, the imputed income and the corresponding deduction effectively cancel each other out.\(^\text{149}\) If premised under the operation of § 7872, they should, in which case the proposal

\(^{146}\) But see § 7872 regarding interest free loans which utilizes a surrogate. However, in those settings, without a surrogate, tax consequences would be avoided. Such is not the case for compensatory transfers of an equity interest in an enterprise.

\(^{147}\) See infra at notes 157-163 and accompanying text.

\(^{148}\) Fleischer, supra note 2, at 41. Such a proposal strays from the foundational principles of Subchapter K by suggesting that an annual measurement of return is not possible for a profits interest. Conflicting the concept with the experience a particular industry, assertions are advanced which are true in only a small number of cases: “We cannot measure the returns on human capital directly; under current law, if the compensation is paid in the form of a profits interest, we estimate the return on human capital portion at zero and treat the entire amount, if and when it is received, as a return on investment capital.” Id. However, most profits interests function in exactly the opposite way. Profits are derived annually and flow through to the service provider. Secondly, this advocacy undercuts the need for a proxy because of the uncertainty of receipt (“if and when it is received”). Id. A proxy to accelerate something which may never occur should strike one as extreme and would add additional complexity in unraveling the imputation should the actual income not equal the imputed proxy amount.

\(^{149}\) Some disagreement exists as to whether such a deduction should be allowed. See supra note 27.
accomplishes little from a deferral standpoint because the imputed income is offset either currently or sometime in the future by a corresponding deduction.\footnote{150}

Finally, from a normative perspective, if deferral is appropriate for restricted equity interests, should a recipient be able to accelerate his or her tax consequences without meaningfully restructuring the compensatory relationship? Obviously, an acceleration of tax consequences would ensue if the parties agreed to eliminate the conditions which must be fulfilled prior to a vesting of ownership.

Under current law, the use of the § 83(b) election permits the recipient of a restricted entrepreneurial interest to cap the amount of ordinary income in the year of receipt. The increase in the value of the stock or the capital interest through the rendition of services over the mandated period of service is deferred until the sale or liquidation of the interest. The best approach on the issue of deferral is to tax the service provider on his or her receipt of an equity interest on the date of realization only. Any system permitting a choice by the service provider of some other date undercuts consistency in the treatment of equally situated persons and deviates from the policy rationale that income inclusion should be tied to a realization event.

Deferral’s impact on the determination of the proper return on human capital has been lamented by some: “In sum, in circumstances where a partnership’s income is deferred by reason of the realization doctrine, current law allows deferral of returns on human capital.”\footnote{151} The difficulty with this analysis is that such treatment is the essence of the realization doctrine. Instead of guesswork and subsequent offsetting adjustments to the extent the initial estimate fails to be accurate, the law adopts a wait-and-see approach in order to ensure certainty and minimize complexity.\footnote{152} Additionally, deferral extends to any restricted equity interest, not merely to compensatory interests in partnership profits.

**B. Conversion**

Regardless of the various tax policy concerns and principles, the heart of the target is the possible conversion feature of a compensatory transfer of a partnership profits interest. Many of the tax reform proposals turn on the need to ensure that ordinary income is attributed to some portion of the return from the

\footnote{150} If such an approach were adopted, it would require further integration with the tax treatment of the actual profits generated annually. Would the annual imputation absorb, to the extent thereof, any actual profits for the year? How would overages be treated? What if lesser amounts were forthcoming?

\footnote{151} *Id* at 43.

\footnote{152} Some vacillate in selecting their target for reform by asserting that “current law works well in most contexts outside of investment partnerships.” *Id* at 43.
profits interest. If the expenditure of human capital is to be taxed properly, i.e., at ordinary income rates, the “quirk” in the current law which permits a return on human capital to be taxed at the preferential capital gain rate must be remedied, not merely for profits interest but for all compensatory equity transfers. \(^{153}\)

Advocates assert that most “tax scholars agree that we ought to tax labor income progressively so that the average tax rate rises with income.” \(^{154}\) While the general proposition is technically correct, the assertion glosses over the important definitional issue of what constitutes a return on human capital and when, if at all, such a return, if left in the enterprise and not withdrawn, converts to invested capital. \(^{155}\)

Without explanation, critics appear to assume that if a profits interest is received for the rendition of services, ordinary income taxed at the progressive rates is appropriate for the entirety of the return. \(^{156}\) However, given the absence of criticism of the other four types of compensatory transfers of equity interests and the conversion feature attributable thereto, the status quo for those receipts goes unchallenged. If so, what separates the return from human capital for the other four from that for a profits interest?

The range of possibilities for selection of the normative standard for determining the return on human capital is vast and the alternatives numerous. One approach is a characterization from the front-end of the transaction, i.e., if the equity interest was received for services, any and all financial return over the life of the interest is taxable as ordinary income. Everything constitutes a return on human capital, even upon a disposition of the interest. \(^{157}\) Any and all returns are ordinary income because the totality of the recipient’s “contribution” to the

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\(^{153}\) Surprisingly, while advocating a tracing approach in which ordinary income will be taken into account, some nevertheless propose a taxpayer election under which deferral or conversion is possible, but not both. See infra at notes 186-190 and accompanying text.

\(^{154}\) Fleischer, supra note 2, at 43. This appears to be the cornerstone of most, if not all, justifications for the proposals for change. See, e.g., Aron-Dine, supra note 20, at 2-3; Statement of Senator Max Baucus, July 11, 2005, para. 3-5; Cunningham & Engler, supra note 4, at 4.

\(^{155}\) Some mistakenly assume that most, if not all, profits interests permit conversion. See The Levin Proposal, supra note 20; Aron-Dine, supra note 20. Such is not the case to the lament of numerous doctors, lawyers, and accountants throughout the country. See supra note 94 for a sample of business sectors in which partnerships report predominately ordinary income.

\(^{156}\) While they only address profits interests and the return from human capital, under their view, the other four types of equity interests should be treated similarly.

\(^{157}\) The application of the rule in the partnership context is more difficult given the conduit approach of the Code.
enterprise was the rendition of services. The parties transacted for the rendition of services, and thus any return derives from human capital.

Under this analysis, the relationship of the service provider to the enterprise is reminiscent of the relationship between an employee and an employer and thus, deserves similar treatment. Of course a major difference is that the service provider is foregoing direct payment and, unlike the employee, possesses an ownership interest in the enterprise, with the inherent risk that attaches to the marketplace.

The difficulty with such an approach is that it ignores other factors in the marketplace. The future appreciation of an enterprise may be attributable to any combination of three factors—profitability due to the conduct of the business, inflation, and appreciation in the value of the tangible and intangible assets of the enterprise. Accordingly, an insistence upon ordinary income for the entirety of the return appears excessive. The overall appreciation in the value of the enterprise may well have occurred even if the service provider never participated in its growth. An effort to trace precisely the source of such appreciation would be administratively burdensome, possibly impossible to accomplish, and thus unworkable.

In isolating the human capital component of the overall return, another approach is to utilize an appropriate surrogate through which to approximate what the cost/value of procuring the services would have been and basing the annual or total ordinary income component on that amount. If procuring the services on the outside market from an unrelated third party would have cost $200,000, then this figure could serve as the ceiling for the amount of ordinary income to be taken into account. Anything in excess of that amount would qualify for preferential treatment.

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158 This approach is favored by some, including the Levin Bill. See The Levin Propsal, supra note 20. The Center on Budget and Policy Priorities has also taken this approach. See Aron-Dine, supra note 20.

159 See, e.g., Aron-Dine, supra note 20, at 3 (asserting that if the business entity were a corporation, rather than a partnership, the service provider would be an employee) and Fleischer, supra note 2, at n.43 (comparing receipt of profits interest to an employee’s receipt of corporate stock).

160 Assuming a four-year period prior to disposition, the equity interest recipient would be required to report $200,000 of ordinary income annually or, given the absence of funds in hand, the return could be viewed as attributable to an open transaction and taxed only upon actual receipt. Thus, the first $800,000 would be ordinary income and any excess entitled to capital gain. Of course, problems are confronted if the overall receipt is less than the amount previously taken into account for tax purposes. An offsetting loss or deduction would be required to make the service provider whole.

A similar approach exists in § 704(e) regarding family partnerships. Thereunder, in order to prevent a shifting of income from high-bracket to low-bracket taxpayers, the members’ distributive shares must be determined after taking into account a reasonable amount as compensation for
This approach prioritizes the return on the equity interest as attributable to human capital. Additionally, it ignores the risk and uncertainty of receipt. Using our models, the employee is certain of a specific return over time, with very little risk as to its receipt. In the enterprise context, the service provider is assuming real risk as to his or her return. Furthermore, any shortcoming in return may be attributable to the other components of the value of the enterprise and unrelated to the impact on the economic well being of the enterprise due to the efforts of the equity holder.

The above-discussed approaches are premised on the assumption that the return on human capital is attributable exclusively or predominantly to the rendition of services. However, the funds which the service provider would have otherwise extracted from the enterprise have instead remained in the enterprise. To what extent, if any, is future appreciation in the enterprise attributable to the extra amounts now available to the enterprise for investment and use in the ongoing business activities? Should the service provider be viewed to some extent as re-investing the foregone compensation in the operations of the enterprise?

If the service provider is viewed as committing capital to the enterprise by leaving his human capital entitlement for the use of the enterprise, different results ensue. Accordingly, an argument could be made that the service provider has contributed $200,000 per year to the partnership by failing to extract an amount equivalent to a third-party salary. This could be conceptualized as a contribution, in some measure, of invested capital.

Focusing on this side of the equation, other than the initial receipt of the equity interest which augers for characterization as a return on human capital, any return thereafter could constitute a return on invested capital which might be taxed preferentially. Importantly, foregoing the withdrawal of funds from the enterprise has economic significance and arguably converts them from human capital to invested capital.

Other variations are possible utilizing a bifurcated approach in the year of receipt. For example, if the value of the services is $200,000, $130,000 could be attributable to human capital, i.e., the after tax amount in the pure employee setting, and the remainder ($70,000) attributable to invested capital.\textsuperscript{161} Utilizing these ratios, taxation could be postponed until realization and, similar to the tax

\textsuperscript{161} In any case, the recipient will have to find other sources of funds with which to pay the attendant tax liability. In contrast to the pure employee setting in which he or she has the cash (most likely it has been withheld and paid directly to the Service), the service provider has received only an ownership interest in an enterprise.
treatment for installment sales, 65 percent would be attributable to human capital taxed accordingly at ordinary rates, while the remaining 35 percent would be a return on invested and taxed preferentially.

As illustrated, in the search for normative treatment, many possibilities present themselves. Regardless of whether the issue of how to treat the overall return on the compensatory receipt of an equity interest generates unanimity of opinion from a tax policy standpoint, a number of differing approaches have some logical basis for their adoption. However, the purity and simplicity of the employee setting is replaced with complexity due to the difficulty of disentangling the mixture of contributed human capital and the re-investment of the return as invested capital.\footnote{162} As we have seen, in attempting to separate the two, current tax policy errs on the side of treating the future return to the service provider as one on invested capital, rather than human capital.

Importantly, many of the proposals for change ultimately resort to some combination of human and invested capital as the source for the return on compensatory transfers of equity interests.\footnote{163} It is conceptually difficult, if not impossible, to deny that some portion of the return is entitled to preferential treatment under the current law.

Once one accepts the fact that the normative treatment requires the recognition of both components as producing the return, the status quo emerges as a strong candidate for the proper treatment of such returns. The current tax law generally bifurcates the return from compensatory transfers of equity interests into (1) a return on human capital and hence ordinary income upon receipt and (2) a return on invested capital, which depending upon the circumstances may generate capital gain thereafter.

The tax policy rationale supporting the conversion feature for the five traditional equity interests in the enterprise is the re-investment of human capital in the enterprise. The failure to withdraw his or her return on human capital results in an accumulation of funds in the enterprise which permits the re-investment of that amount in the capital of the enterprise, with which it can invest and engage in other activities furthering the goals of the profit-generating enterprise. At a minimum, this entanglement of contributions to the enterprise explains why Congress currently utilizes a combination treatment of the service provider in these settings, selecting a cut-off point at which the return on human capital ends and the return on invested capital begins.

\footnote{162} Some, while acknowledging that such complexity exists, propose solutions requiring the bifurcation of human and invested capital, without any suggestion for how such separation could be accomplished. See generally Cunningham & Engler, supra note 4.

\footnote{163} Some, while suggesting that the baseline for the return should be ordinary income, conclude that an elective provision affording conversion is preferred. See Fleischer infra note 2 at 16. But see Gergen, infra note 170 (advocating ordinary income treatment for the entirety of the return).
The issue is whether this current compromise treatment by Congress can be improved. Critics, albeit exclusively in the context of profits interests, advance various proposals to which I will add my own. However, once one accepts that the proper treatment will be a blended one involving features of deferral and conversion, the status quo becomes the front runner, if for no other reason than it is the product of years of trial and error by Congress, Treasury, and the Service.

**X. Reform Alternatives**

Acknowledging the complexity of determining the normative treatment of these tax issues, while minimizing their presence and continuation in the Code for more than 50 years, critics, like our recent presidential candidates, conclude that change is necessary. As a consequence, they advance a range of solutions to the problem.\(^1\)

**A. The Status Quo**

Having concluded that “the status quo is an untenable position as a matter of tax policy,”\(^2\) some nevertheless address it directly and note that the status quo of deferral and possible conversion has the benefit of “being predictable and well-understood.”\(^3\) From a policy standpoint, an old tax is a good tax, because all have come to accept it and have adjusted their activities accordingly.

Nevertheless, they speculate that existing subsidies through the use of a profits interest lower the cost of capital for venture capital start ups and disadvantages innovation for publicly-held corporations.\(^4\) The status quo ensures “gamesmanship” in the structuring of such investment vehicles, which efforts are wasteful, increase agency costs, circumvents our progressive tax system, and undermines “public confidence in the tax system.”\(^5\)

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\(^1\) Revealing the complexity of the issue, some assert that some conversion is acceptable because an: “entrepreneurial risk subsidy of some sort arguably makes sense as a matter of tax policy. The economics literature suggests that there are positive externalities associated with entrepreneurship.” Fleischer, *supra* note 2, at 47. Accordingly, “some tax subsidy for entrepreneurship will continue in any regime short of an endowment tax.” *Id* at 48.

\(^2\) *Id* at 49.

\(^3\) *Id*.

\(^4\) Again, given this assertion, it is surprising that the increase in the number of new partnerships is not larger than 5.7 percent per year. *See supra* note 91.

\(^5\) *Id* at 50. By way of example, note the populist rage underlying the class warfare as expressed by one critic: “Taxing labor income of fund managers at a low rate is a severe departure from widely accepted norms, and it ought to be addressed.” *Id*. The problem is that the advocate assumes that the income is derived from labor, which as previously discussed is not as clear as he has determined. To the extent that public confidence is undermined, it may be attributable to
However, as evidenced by a fuller exploration of the entirety of the area, the status quo is far more defensible than acknowledged. Regarding the five types of equity interests, under the status quo, deferral is justifiable for three given the failure of the recipient to receive anything of value; conversion is justifiable in all five by the re-investment of human capital rationale discussed above. Furthermore, notwithstanding allegations to the contrary, the investment of human capital in return for a profits interest frequently generates ordinary income and thus is not entitled to a preferential tax rate. Similarly, invested capital in the partnership context does not guarantee that the return will be taxed as capital gain. Depending upon the business activities of the partnership, invested capital can generate ordinary income.

Another unappreciated factor in an analysis of the status quo is that partnerships are fundamentally different than corporations for tax purposes. The latter is potentially subject to double taxation, while the former is taxed but once at the partner level. The three types of equity interests in a partnership, once vested, generate annual tax consequences. Furthermore, partnerships fall between sole proprietorships and corporations on the business continuum. It should not be surprising that the tax treatment of partnerships adopts a compromise between the two extremes. Congress specifically adopted such an approach under § 702(b) in specifying that the income derived by a partnership is attributable to all partners regardless of how they acquired their interests.169

While other improvements may come to mind, at least with regard to those offered to date, the status quo appears superior. As discussed below, it will be even more so should my proposal for reform be adopted.

**B. The Ordinary Income Method**

For some, this is the simplest method for the proper treatment for the return on the expenditure of human capital.170 Under this approach, the receipt of a profits interest constitutes an open transaction and distributions are taxed as ordinary income regardless of the nature of the partnership’s business and investment activities.171

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169 See Fellows, supra note 85. See generally Willis et. al., supra at note 12, at ch 9.


171 Such an approach overlooks the current distinction in Subchapter K between the derivation of profits and the distribution of property. Possibly, it is assumed that the profit component will not
Such treatment, i.e., taxation upon distribution, conflicts with current law which forces income inclusion as earned by the partnership, not upon distribution. Under this proposal, the service partner could derive greater deferral benefits than are currently available by postponing the distribution of his share of the business profits. Thus, with respect to the issue of deferral, the proposal would not be an improvement in the tax treatment of such receipts. In fact, it would generally extend the time for income realization, with additional complexity for its integration into the earnings process.

The proposal eliminates the conversion potential for profits interest. However, as previously discussed, the return on human capital through a profits interest frequently produces ordinary income. Additionally, the failure of the service provider to withdraw his or her share of earnings attributable to services can be conceptualized as a contribution of invested capital. For partnerships, Year 1’s profits, if not withdrawn, become Year 2’s capital.

Whether others would extend their proposed treatment to all compensatory transfers of equity interests and treat all income derived therefrom as ordinary income is unclear. The logic of their position suggests that they would, because they assume that all returns on the investment of human capital generate ordinary income.

With the adoption of such an approach, some have suggested planning techniques through which the limitation could be circumvented.172 For example, a general partner could borrow funds and purchase a capital interest which would achieve deferral and conversion, because the return would be derived from invested capital rather than human capital. The problem with this circumvention technique is that the planning device creates an unrealistic situation.173 If the equity recipient is providing services as well as capital, he or she will insist upon

be derived until the year in which the partnership is liquidated. Such an enterprise is the exception rather than the norm. See Fleischer, supra note 2, at 19. Accordingly, complexity arises with regard to ongoing enterprises, the distributions from which are not in sync with the derivation of income. A switch to such an approach would be more complex than that of the current law.

172 See Fleischer, supra note 2, at 51-52.

173 Some undermine the initial assumption of the clarity between the return on human capital and the return on invested capital by acknowledging that they may be intertwined, possibly inextricably: “the challenge of precisely separating returns on human capital from returns on investment capital suggests that rough justice might be an acceptable result.” Id at 51. Compounding the confusion of their goal, i.e., the separation of returns on human capital from returns on invested capital, they embrace the status quo of the Code by proposing elective treatment to be determined by the taxpayer because an “elective approach would be consistent with the tax Code’s general approach to executive compensation.” Id at 51-52. As I have emphasized, this elective feature dramatically undercuts the effort to tax human capital appropriately and should be repealed. See supra at notes 188-193 and accompanying text.
a profits interest for the contributed human capital as well as a capital interest for the invested capital.

Logically, such a proposal should be broadened and applied to all compensatory transfers of equity interests in enterprises since the entirety of the contribution by a service provider in their view is the rendition of services on behalf of the enterprise. As illustrated previously, current law does not treat the entirety of the return on the expenditure of human capital as ordinary income. Thus, the current treatment of a compensatory profits interest is not as aberrational as suggested. The adoption of the proposal would treat a profits interest in a more onerous fashion than the other four compensatory transfers of equity interests in an enterprise.

C. The Forced Valuation Method

Another proposal involves a greater emphasis on valuing the original receipt of a profits interest in a partnership. Accordingly, instead of relying on liquidation value which invariably leads to a valuation of zero, some would broaden the inquiry by taking other factors into account. While reducing deferral, conversion would still be possible under this method. Proponents acknowledge that everything would turn on valuation, which invariably provides opportunities through which to minimize adverse consequences.

Unfortunately, as described earlier, such an approach ignores the implicit, if not explicit, restrictions on the receipt of a profits interest. Almost without exception, it is conditioned upon the performance of services, something to be done in the future. Until they are rendered, the marketability of the interest is virtually non-existent.

Other computational difficulties are inherent in the proposal, which reveal why liquidation value has been adopted as the governing standard under current law. While not insurmountable, the possibility of “double taxation” is confronted. Technically this is a misnomer because “homeostasis” will out. Income would

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174 Id at 59.

175 Id.

176 See supra notes 53-63 and accompanying text.

177 The system of Subchapter K operates in perfect fashion to ensure that in all cases the overall result will balance out. If the original value were $100,000 and the recipient’s share of profits over four years were $70,000, he would have been taxed on $170,000. His basis would increase both on the initial taxing event and each year thereafter as profits were earned. Upon liquidation of his interest for $70,000, his share of undistributed profits, he would incur an offsetting loss of $100,000. Thus, he would have been taxed on $170,000 which would be offset by a loss of $100,000 for a net profit from his ownership of the profits interest in the partnership of $70,000. Obviously, time value and character considerations make this a less than desirable approach.
arise on valuation, leading to an equivalent amount of basis for the interest in the partnership. As profits are earned (assuming they are undistributed), income is allocated to the service provider and basis is increased. Upon liquidation, the double taxing of the profits will be offset by a corresponding loss. Time value issues will be implicated and, under the current statutory regime, one could experience the opposite of the reformers’ concern—ordinary income reported twice for tax purposes offset by a subsequent capital loss.

These concerns are seldom addressed. However, even proponents minimize the worth of this particular reform proposal: “There is little reason to believe that forcing valuation of partnership profits interests in this fashion would lead to a more salutary result.”

D. The Cost-of-Capital Method

Under this approach, deferral would be reduced but conversion possibilities would continue. Advocates maintain that the cost-of-capital method provides a greater risk subsidy, but minimizes the possibilities for manipulation. Of course, because conversion is possible, the proposal undercuts efforts at reform and acknowledges the entanglement of human and invested capital in such settings. Accordingly, any indictment of the status quo loses force.

Notwithstanding criticism of both the deferral and conversion possibilities of returns on human capital, some reformers advance their own Solomonic solution. Under this approach, recipients would be allocated an annual amount of ordinary income determined by taking a specified market rate of interest times their percentage interest in profits times the capital under management.

In essence, the opportunity for the service provider is conceptualized as the functional equivalent of an interest-free loan. Employing § 7872, ordinary income arises and is imputed annually as a compensatory receipt to the service provider. For example, assume that the fund manager general partner invested $5,000,000 in a $100,000,000 private equity firm. Using the cost-of-capital approach and a six percent rate of interest, the general partner would be imputed

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178 Another approach which would minimize the effect of valuation upon receipt would be to permit the recipient to amortize the amount of the initial valuation over a fixed time period. Accordingly, as the annual profits from the partnership were taken into account, they would be offset by the amortization deduction. Difficulties would be encountered in determining the appropriate period for amortization. See I.R.C. § 197 (2008) (utilizing a 15-year period).

179 Fleischer, supra note 2, at 18.

180 Id at 59.

181 Id at 52.

182 Id. at 53.
$1,140,000 (6% x 20% x $95,000,000) of ordinary income annually attributable to his percentage interest in profits times the capital contributions of the other partners.

Ordinary income would accrue annually, resulting in an increase in the partner’s basis for his partnership interest. All other activities of the partnership would be governed by current law. Accordingly, should the partnership invest in preferred assets, conversion to capital gain would remain possible.

Advocates characterize the proposal as one advancing the goal of neutrality, which reduces agency costs and the deadweight loss arising from tax planning. The approach “reduces the incentive to unduly favor partnership profits interests over other economically equivalent forms of compensation, and it thus reduces economic distortions in contract design and minimizes planning opportunities.”183

In point of fact, the proposal would have negative consequences. While the imputed income increases basis, actual profits derived by the partnership are taken into account as well resulting in an additional acceleration of tax. The only situation in which the “double taxation” would not arise would be years in which the partnership produced no profits.184 The increasing basis would give rise to an offsetting loss upon liquidation, but the consequence would be greatly deferred, possibly resulting in the most offensive of circumstances for an entrepreneur—an acceleration and duplication of ordinary income offset at a later point in time by a long-term capital loss.

The simplicity of the proposal deviates widely from the complexity rampant in Subchapter K. First, it assumes a fixed profits interest in all items generated by the partnership. In many partnerships, partners’ interests may vary according to the type of income generated. Thus, the executive’s investment of human capital may extend to only a portion of the partnership’s activities.

A final concern with the proposal is whether it encompasses all of the underlying assumptions of the statutory safeguard which it models. The proposal and the analogue of an interest free loan are distinguishable from that of the service provider, because no advancement of funds in a loan context has taken place between the parties.

If § 7872 is the model,185 two events are deemed to have taken place. First, foregone interest is deemed to have been transferred from the lender to the borrower, which results in the imputed income to the fund manager of

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183 Id at 54.

184 In the partnership world of taxation, “all’s well that ends well.” Homeostasis will out.

185 One advocate specifically modeling his proposal after § 7872 is Leo L. Schmolka. See Schmolka, supra note 3, at 288.
$1,140,000. However, a second component of the transaction is taken into account as well, i.e., a return transfer of the determined amount to the lender as the payment of interest. Taken to its logical extension, the amount included in income is offset by the deemed payment of interest as is typically the case for interest-free loans in a compensatory setting.

In order to avoid this quandary, some propose a basis adjustment instead of a current deduction. While avoiding one problem, it creates another. “Double taxation” with all of its difficulties is resurrected. Additionally, as discussed previously, it is far from clear why one would override firmly established principles of realization and substitute a proxy for what is actually taking place. Given that the status quo performs the same disentanglement between human capital and invested capital, i.e., segregating the initial portion of the transaction as generating the return on human capital and the remainder as attributable to invested capital, the status quo is superior because it involves actual rather than putative results.186

**E. Talent-Revealing Election**

This proposal combines the cost-of-capital proposal with the ordinary income proposal. The default rule would be ordinary income, but the entrepreneur could elect the cost-of-capital method.187 Similar to the § 83(b) election, taxpayers would make a judgment as to which approach would serve them best. Should they have a strong preference for some conversion and some deferral, it would be available. Basically, the proposal incorporates the features of two of the previously discussed alternatives.188

The difficulty with the proposal is that it dramatically undercuts its premise, i.e., because the Code has been less than precise in its taxation of human capital, it is in need of reform by developing a system that more accurately isolates the return on human capital and taxes it accordingly.189 Given my prior criticism of both proposals, their combination only increases, rather than decreases, the deficiencies attendant to the proposal.

Giving the recipient a choice in how he or she wishes to report the receipt of a compensatory equity interest grants him or her excessive and exclusive autonomy over the tax treatment of the return. An election, by definition, will produce different, rather than similar, results among similarly-situated taxpayers.

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186 As illustrated, while the status quo segregates the return on human capital from the return on invested capital, invested capital can generate ordinary income consequences as well.

187 Id at 54.

188 Id at 54-56.

189 Id at 54.
Advocates celebrate its consistency with the status quo treatment under § 83 for compensatory receipts of equity interests other than profits interests in partnerships.¹⁹⁰ In doing so, they fail to detect the deviation from the normative goal that exists in the elective provision under current law.

**XI. A Modest Proposal**

Surprisingly, none of the critics to date addresses the possible repeal of § 83(b) while considering improvement to the current taxation of human capital. In fact, some embrace elective choices as a positive, rather than a negative, feature of the Code. They dispense with a valuation upon receipt approach for a profits interest in a partnership, yet fail to recognize that the recipients of most restricted compensatory transfers of equity interests avail themselves of such “topping off” techniques under the current elective provision of § 83(b).

By doing so, the difference between the tax treatment on receipt of a profits interest in a partnership and a restricted capital interest in a partnership or restricted corporate stock is minimized, if not effectively eliminated. It is surprising that, in assessing the perceived distortion in the proper treatment of equity compensation, they would not demand such a reform.

Service providers in receipt of an entrepreneurial interest, if fully informed, almost without exception elect the acceleration of ordinary income.¹⁹¹ While sacrificing deferral, the rewards of conversion are maximized. An entrepreneur does not accept restricted stock unless he or she is confident that the period of service will be fulfilled and is eager to “hitch his or her star” to a profitable endeavor. In the typical case, if the enterprise is successful, vastly greater amounts of ordinary income will be taken into account by the service provider without the election. Deferral is not a determinative consideration in making the election. The greater concern should be about the potential conversion of compensatory income into preferential treatment, which the election improperly facilitates.

At a minimum, the election documents a congressional willingness to permit conversion in compensatory transfers of equity interests at minimal cost.¹⁹² Much of this treatment is attributable to the entanglement of, and difficulty in separating, the amount of any return attributable to an investment of human capital and the amount attributable to its re-investment in the enterprise, which is treated as invested capital. Critics ignore the re-investment of human capital as

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¹⁹⁰ “The election is consistent with our tax system’s usual method of handling executive compensation valuation problems.” *Id* at 54.

¹⁹¹ *See supra* note 105.

¹⁹² Conf. Rep. No 91-782 (1969) suggests that the subsection was a last minute addition and was done in order to “add flexibility.”
constituting a return on invested capital in their effort to determine the amount of
the return attributable to human capital.

Of all aspects of the current tax law which could be reformed, the § 83(b) election
is most in need. While concerned about tax gamesmanship, some fail to
understand that the elective provision is at the heart of such abuse and would
target the most questionable aspect of the current law regarding compensatory
transfers of equity interests.

In determining when a return constitutes a return on human capital or a return on
invested capital, the least defensible approach from a tax policy standpoint is
permitting the return on human capital to be measured on the date of receipt,
before any of the services have been rendered, at a time when the only thing
which is certain is that the service provider lacks complete dominion and control
over the interest. Only through the passage of time and the ongoing rendition of
services will economic enhancement accrue. To permit an election which
determines the return on human capital before any of it has been rendered is
counter-intuitive.

Some have focused on the right issue, but the wrong target. With assistance
from Shakespeare, “the fault lies not with [profits interests], dear Brutus, but with
[§83(b)].” Dramatic improvement in the policy principles for the taxation of
human capital can and should be made. The revenue gain from the elimination
of the election could be significant. More importantly, tax policy would be
advanced, similarly-situated parties would be treated consistently, the treatment
would extend equally to partnerships and corporations, and its implementation by
Congress would be simple, involving nothing more than the repeal of a mere
subsection of a single Code provision less than 170 words in length.

XII. Conclusion

Some assert that the current tax treatment of a compensatory transfer of a profits
interest in a partnership results in a widely-exploited tax subsidy. In fact, these
efforts have garnered Congressional attention. While unfortunately centered in a
struggle of class warfare, these efforts have begun to bear fruit, resulting in
various legislative offerings. Furthermore, the popular press has embraced
the message, quoting multi-millionaires (or is it billionaires?) as questioning the
fairness of a tax system which taxes more heavily the wages of such individuals’
administrative assistants than the returns of such high-flying service providers.

193 Shakespeare, Julius Caesar, Act 1, Scene 2, which in the original reads: “The fault lies not
with our stars, dear Brutus, but with ourselves.”

194 Fleischer, supra note 2, at 59. See also discussion supra note 20.

2007, available at
While these reform efforts fell short and were not enacted into law, possibly due to the forthcoming elections of November, 2008, predictions abound that the "issue is likely to come up again as part of a debate over tax reform in 2009." Importantly, in revisiting the issue, the tax writing committees need to ignore the populist calls for reforms and instead explore the structure of Subchapter K and Subchapter C and determine the proper policy treatment for the taxation of human capital in all contexts. Only through a consideration of the entirety of the spectrum can there be a full appreciation of the tax treatment developed to date.

The difficulty with the current class warfare rhetoric is its myopic focus upon a single industry and its inaccurate assumption that profits interests always generate deferral and conversion. As has been illustrated, the deferral aspect of the receipt of a profits interest comports with tax policy principles of realization, valuation, and vesting. Furthermore, deferral in the partnership context is far more abbreviated than it is in the corporate context. Regarding the conversion feature, it is not unique to compensatory transfers of a profits interest. It equally exists with respect to the other four traditional types of equity interests of business enterprises. In fact, the conversion feature in the partnership context is far more limited than it is in the corporate context.

The allegation that a compensatory profits interest receives preferential tax treatment superior to the other four types of equity interests is erroneous. Furthermore, instead of achieving the neutrality to which any tax system should aspire, if the proposed treatment were adopted, virtually all other forms of compensatory transfers of equity interests would generate tax results superior to those of a profits interest in a partnership.

Notwithstanding the lack of theoretical or tax policy distinctions between profits interests and carried interests, some call for selective application of reform only to large investment partnerships, revealing a class warfare strategy as opposed to a uniform overall improvement in the operation and application of the tax law. Attack the superrich, even when their return on compensatory endeavors is indistinguishable in every respect from the profits interest received by others except for the number of dollars involved. Sound tax policy deserves more than arbitrary line-drawing based on the number of zeros which follow the initial digit in the amount of the compensatory return.

http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article1995931.ece. See also supra note 6 (listing a sample of incendiary articles appearing in the media).

196 President elect Barack Obama was one of the co-sponsors of S. 1624, the Baucus-Grassley Bill, which may impact the future of any such proposed legislation. See supra note 116.

197 Fleischer, supra note 2, at 59. However, any prediction has become more suspect than usual due to the economic meltdown of October 2008.
Some boldly assert that the “status quo treatment of a profits interest in a partnership is no longer a tenable position to take as a matter of sound tax policy.”\textsuperscript{198} Considering the above discussion, such a conclusion is questionable. All five types of equity interests share common treatment with respect to the issues of deferral and conversion. More importantly, upon studying the statutory treatment of the entirety of compensatory equity transfers, one appreciates the complexity encountered in attempting to determine what constitutes a return on human capital and what constitutes a return on invested capital.

This conceptual challenge is particularly difficult in the case of a compensatory receipt of an equity interest in an enterprise. Once a compensatory equity interest is received, the clarity of the return on human capital begins to blur. Human capital begets invested capital, which begets invested capital, which begets invested capital, \textit{ad infinitum}. Like conjoined twins, delineation between the two is virtually impossible, and any attempt to disentangle them is fraught with difficult obstacles.

As has been illustrated by the analysis of the advanced proposals, none appears to be superior to the status quo. In fact, the current tax treatment of the issue, with some slight improvement, may be the “second best’ solution to the difficulty encountered in segregating the respective components of the overall financial return from the receipt of compensatory equity interests in an enterprise.

Returns on human capital, if not withdrawn, generate invested capital throughout the period of equity ownership by the service provider. The value of the interest, provided the enterprise proves profitable, becomes attributable to the investment of both human capital and invested capital. Disentangling the two could be accomplished by any number of means. However, upon recognizing that the return is neither attributable exclusively to human capital nor invested capital, the current status quo has as much justification for its continuation as the adoption of other proposals.

The current tax treatment of such recipients produces a reasonable compromise, reflecting the re-investment of human capital which becomes invested capital. While it may begin as one, it transforms into another. The governing structure of the Code provides clear and certain rules for the taxation of returns as ordinary income or capital gain in the context of partnership and corporate transactions. Similarly, the law has addressed the range of compensatory transfers including the receipt of profits interests, restricted stock, etc.

\textsuperscript{198} Id. In an earlier version of an article placed on SSRN, possibly having surveyed the tax professoriate, one advocate asserted: “In the midst of the chaos and controversy that has followed, it’s worth noting that there is (near) academic consensus on [the] issue. . . .” Victor Fleischer, \textit{Two and Twenty: Taxing Partnership Profits in Private Equity Funds} 51 (U of Colorado Law Legal Studies Research Paper No. 06-27, 2007), available at SSRN: \url{http://ssrn.com/abstract=892440}. Apparently, I fall into the parenthetical.
As illustrated above, unifying themes bind the various available compensatory techniques and profits interests, whether termed carried interests or otherwise, are consistent therewith. Once evaluated in the overall context, it is apparent that the hue and cry over private equity funds is much ado about nothing. Ironically, as our economic meltdown continues, instead of withdrawing incentives to rehabilitate underperforming businesses, Congress may actually be forced to consider increasing the benefits associated with risk taking.

Nevertheless, reform opportunities in the area present themselves. The election of § 83(b), which permits an undervaluation of the return on human capital before it has even been received, is a far more serious affront to the proper tax treatment for compensatory transfers of equity interests in an enterprise than the current tax treatment for profits interests in a partnership. Yet, there appears to have been deafening silence regarding its deviation from what normative tax treatment should be. The repeal of § 83(b) would constitute meaningful tax reform with regard to the proper taxation of human capital.