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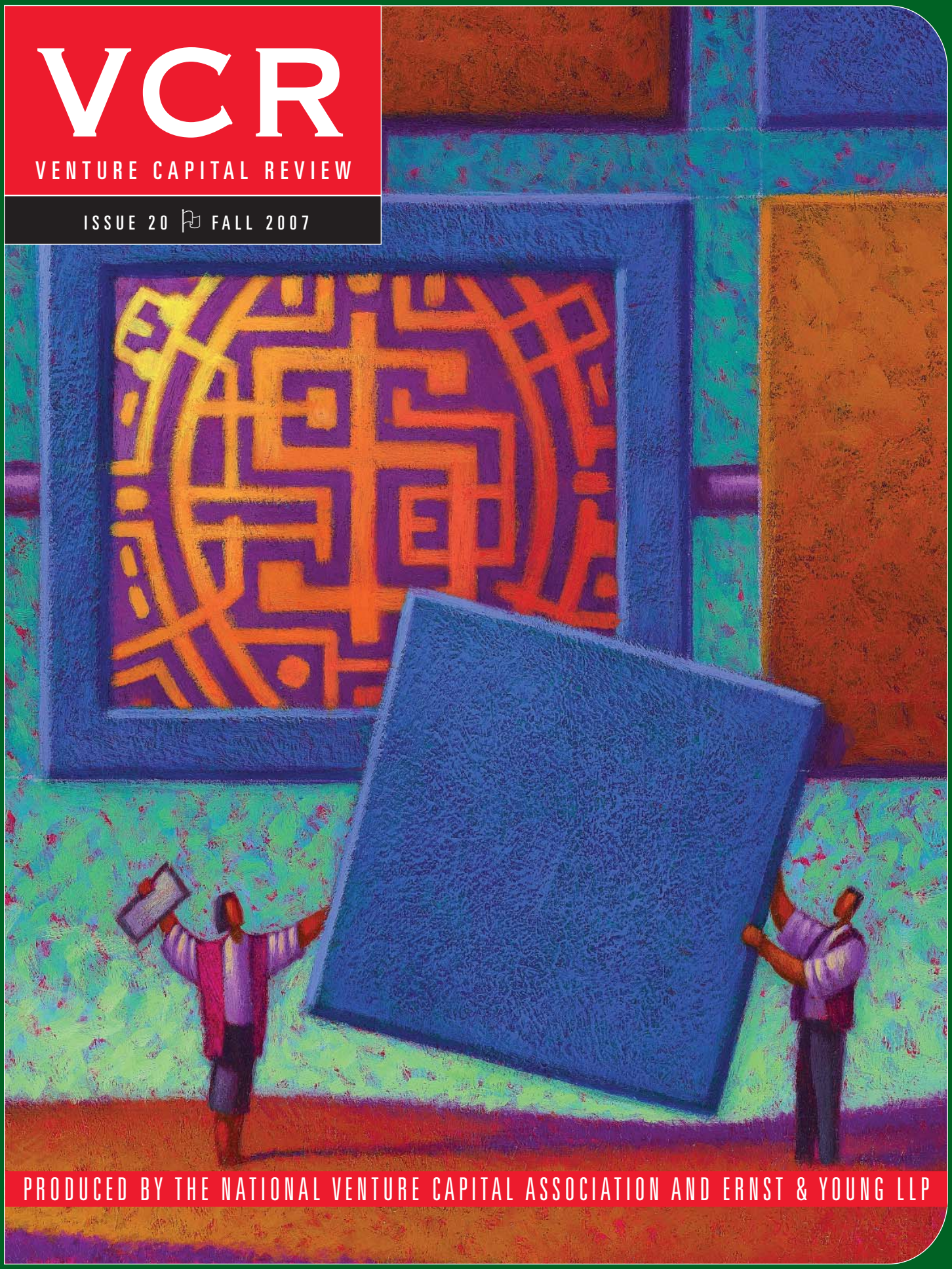

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National Venture Capital Association (NVCA)

The National Venture Capital Association (NVCA) represents more than 450 venture capital and private equity organizations. NVCA's mission is to foster the understanding of the importance of venture capital to the vitality of the U.S. and global economies, to stimulate the flow of equity capital to emerging growth companies by representing the public policy interests of the venture capital and private equity communities at all levels of government, to maintain high professional standards, facilitate networking opportunities and to provide research data and professional development for its members.

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Beyond Two and Twenty

By
Mary Kuusisto

On November 1, 2007, the House Ways and Means Committee voted in favor of a bill introduced by Chairman Charles Rangel on October 25, 2007 (the Rangel Bill), that would recharacterize and tax as ordinary compensation income those profits, referred to as "carried interest," received by venture capitalists and other private investment fund managers.[1] A similar version of this bill had been previously introduced on June 22, 2007, by Rangel and US Representative Sander Levin, together with a dozen other members of the House of Representatives, and those sponsoring the bill indicated in their press release that they view carried interest as akin to compensation income that should be taxed at the same rates applicable generally to service income.[2]

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1 H.R. 3970, 110th Cong. §1201 (2007). The Rangel Bill will require approval of the full House of Representatives, the Senate and the President prior to being enacted into law. A more comprehensive tax bill, which included the Rangel Bill without significant amendment from the version discussed here, was passed by the House of Representatives on November 9, 2007 by a vote of 216 to 193. Votes were cast along party lines with all Republicans and eight Democrats voting in opposition of the bill. The bill will have to work its way through the Senate and the President to be enacted into law.

2 H.R. 2834, 110th Cong. §1 (2007); Charles B. Rangel and Sander M. Levin, *Levin, Democrats Introduce Legislation to End Carried Interest Tax Advantage: Bill seeks fairness in tax code*, Washington, June 22, 2007 *available at* http://www.house.gov/apps/list/press/mi12_levin/PR062207.html.

Victor Fleischer, associate professor of law at the University of Illinois, in his draft article entitled "Two and Twenty: Taxing Partnership Profits in Private Equity Funds," which has received significant attention from Congress, tax practitioners, the trade press, and the mainstream media, also proposes a change in the taxation of carried interest.[3] Fleischer's article proposes that it be taxed, at least in part, (1) before any realizable income or gains are generated by the partnership and (2) as ordinary compensation income.

Accordingly, both the Rangel Bill and Fleischer propose increasing the tax rate on carried interest to a higher rate than is currently imposed on other returns from human capital, such as certain types of equity compensation, or on returns from financial capital. While Fleischer, unlike the Rangel Bill, proposes applying this higher tax rate to only a portion of the carried interest, he proposes taxing it earlier than it would be taxed under either the Rangel Bill or current law.

The press release issued by Rangel and Levin in June compares carried interest taxation with the taxation of wages and salaries in its appeal for tax fairness. It does not address, however, the fact that carried interest taxation is consistent with the taxation of similar types

3 Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, N.Y.U. L. Rev., (forthcoming 2008), Working Paper Number 06-27, March 2006, revised August 2, 2007; *Taxing Private Equity*, N.Y. Times, Apr. 2, 2007, at A22.

of compensation—restricted stock or founder's stock received by corporate managers. Given that carried interest reflects the investment of human capital (labor) in exchange for ownership rights in the equity of a partnership, comparison of carried interest to other forms of equity compensation is more appropriate.

Fleischer's analysis, while extensive, simplifies many of the practical realities confronted by private investment funds that operate within existing partnership tax rules. More troubling, his article confuses rather than illuminates tax policy. Sifting through the sensationalism (yes, some fund managers are very wealthy) and eliminating concerns that apply to all forms of equity compensation, Fleischer's article deals almost exclusively with a valuation conundrum—that is, how carried interest should be valued upon grant. This issue has been addressed by the courts, by Treasury, and by the Internal Revenue Service (IRS) for decades. It is not novel, although it is complex. Insightful tax professionals have addressed this problem over the years to devise workable, if imperfect, solutions. Even though the solutions have taken varied forms, remarkably, they have all achieved a consistent result reflecting sound tax policy. A true partnership profits interest received by a service partner (such as carried interest received at inception of a private investment fund), with limited exceptions, should not be taxed upon receipt. This treatment has been consistently applied to all partnerships, not just private investment funds.

Both Fleischer and the Rangel Bill drafters seem to understand that changing the tax rules regarding the tax-free receipt of a compensatory partnership profits interest would be difficult, and neither propose such a change. Further, because there are sound tax policy reasons for taxing equity compensation preferentially, neither propose taxing *all* equity compensation as ordinary compensation income. Instead, they isolate one type of equity compensation (carried interest) in one particular industry (certain private investment funds) and assert that it, but no others, should be subject to ordinary compensation income taxation.

The taxation of equity compensation, however, reflects larger questions of tax policy that should not be resolved exclusively within the world of private investment funds. These larger tax policy questions must be considered in order to avoid unintended consequences to the US economy and global markets. For example, should long-term capital gain be taxed at preferential rates? How should unrealized human capital, or labor, that is invested in a business entity be taxed? Should the owners of the partnership form of business entity be afforded one level of tax when corporate owners face an additional, entity-level tax? These are all important and interesting questions. But their careful consideration should take place within the context of our society, economy, and tax policy as a whole, rather than applied arbitrarily and inconsistently only to private investment funds.

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This article explains (i) why the Rangel Bill and the alternative approaches proposed by Fleischer would represent a fundamental shift in tax policy; (ii) that Fleischer's alternatives would reflect a tax policy in support of taxing all equity compensation before the value of the human capital contributed to a business enterprise has been realized; and (iii) that both the Rangel Bill and Fleischer's alternatives would reflect a tax policy in support of eliminating the preferential capital gains rate for all equity compensation.

Alternatively, the Rangel Bill and Fleischer's approaches would arbitrarily apply only to equity compensation received in the partnership form of business enterprise (and, in the case of the Rangel Bill, only to certain types of investment partnerships). This, in turn, would undermine an integral form of business (the partnership form) that recognizes the benefits of (i) pooling the disparate contributions of labor and capital and (ii) permitting those disparate interest holders the flexibility to share profits in a manner designed to reward the entrepreneurial risk taken by each. Further, those alternative tax treatments of carried interest would result in unnecessary complexity, avoidable through other structures.

This article then will demonstrate that existing partnership tax rules work to prevent perceived tax gamesmanship in the venture capital industry.

The appendices to this article are included as reference material for those unfamiliar with venture capital funds. Appendix A describes the general structure and operations of a venture capital fund. Appendix B sets forth the current rules of taxation governing management fees and carried interest. Appendix C illustrates various economic risks undertaken by venture capitalists.

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I. Tax Policy Should Encourage and Reward Entrepreneurial Risk That Builds Long-Term Value in Companies.

Equity compensation, very generally, is compensation paid to a service provider in the form of an ownership interest in the business entity for which the services are provided.

Tax policy in support of the current tax treatment of equity compensation is based on (1) not taxing unrealized human capital or labor ("sweat equity") upon receipt of an ownership interest in a business in order to encourage the value of the business to increase in direct relationship to those efforts; and (2) taxing the gains from sales of businesses by owners who hold them for a longterm at a preferential tax rate in order to encourage investment and stimulate the economy. Similarly, tax policy supports pooling capital and labor in an economically flexible form (the partnership form) so that the parties can determine how best to reward those disparate contributions.

These policies encourage service providers to be risk-takers—to build valuable businesses that will fuel the economy—by incentivizing them with investment of pre-tax dollars, deferral of tax (to an extent), and a preferential tax rate. *In exchange, the entrepreneur accepts a contingent benefit; that is, only if the business succeeds will the business owner profit.*

A. Compensatory Partnership Interests Are Analogous to Other Forms of Equity Compensation That Are Entitled to Long-Term Capital Gain Tax Treatment.

Earlier this year, the media circulated a compelling sound bite. Why do investment fund managers pay tax at 15% on their carried interest when investment bankers and public company CEOs pay tax at 35% on their annual bonuses?[4] Both carried interest and annual bonuses presumably reflect performance-based compensation.

The media poses the wrong analogy. It should compare the venture capitalist to Bill Gates when he pays tax at 15% upon sale of his Microsoft stock; to "Mom and Pop" sole proprietors when they pay tax at 15% upon the retirement sale of their corner drugstore to CVS; and to the founder of a cable communications company formed as an LLC when he pays tax at 15% upon sale of his LLC interest to Comcast. In each case, the business owner's share of the profits can be disproportionate relative to the capital that he and his financial backers contributed to the business—just like a venture capitalist's carried interest. Few are troubled by these transactions—and, in fact, each of these transactions advances important tax policy considerations.

Bill Gates, for example, is a household name today based as much on his great wealth as on the industry he helped create. At one point, however, he was an entrepreneur who held corporate founder's stock in a start-up company. The tax rules have been constructed to reward Bill Gates with a preferential tax rate when he sells that stock, partly in recognition of the entrepreneurial risk that such service providers take when they found companies and develop industries that can significantly enhance our economy and society. Further, he can continue to sell that stock and pay tax at that preferential tax rate at a time when he possesses enormous personal wealth. The venture capitalist—

[4] Andrew Ross Sorkin, *Sound and Fury Over Private Equity*, N.Y. Times, May 20, 2007, at Sec. 3. Variations of this sound bite abound. It was recently reported, "But the central question to the whole debate is this: Why should a partner in a publicly traded fund who makes hundreds of millions of dollars a year pay just 15% on most of his or her income, while someone who earns a salary of $175,000 is subject to a 35% income tax? Even after spending $5 million on lobbying, the private equity industry has not come up with the answer to that one." Brian Wingfield, *King of the Lobby*, Forbes.com, August 29, 2007.

whose partnership interest is almost indistinguishable from founder's stock and whose efforts are as valuable as those of a corporate founder—should be taxed in a similar manner when the venture capital fund's portfolio companies are sold.[5]

Equity compensation, whether received from a corporation or a partnership, generally is taxed as ordinary compensation income when received by a service provider, based on its value. As discussed more fully in I.B. below, the only distinction between equity compensation received from a partnership rather than from a corporation is the manner in which the equity interests are valued upon their receipt.

Any increase in value after receipt, however, is potentially taxable as long-term capital gain when the equity is later sold. Economically, therefore, the venture capitalists are in the same position as the founders. The venture capitalists and the founders will only profit from the carried interest and the founders' stock, respectively, to the extent that the proceeds from a sale or public offering of the company exceed the capital provided by the investors (plus a minimal return, if applicable).

A venture capitalist, however, often faces more entrepreneurial risk than a company founder. Even if a particular investment made by a venture capital fund is profitable, there is an additional risk that such profits will be offset by losses on other investments, resulting in less carried interest or no carried interest at all. A typical venture fund holds 20 to 30 portfolio companies, and carried interest is determined by aggregating the gains and losses of those portfolio companies.

Fleischer states that "this quirk in the partnership tax rules [the tax treatment of a partnership profits interest] allows some of the richest workers in the country to pay tax on their labor income at a low effective rate."[6] He further states that "a profits interest in a partnership is treated more like a financial investment rather than payment for services rendered" and that "[p]artnership profits are treated as a return on investment capital, not a return on human capital."[7] These statements imply that partnerships are unique in this regard. This same result, however, occurs with respect to all equity compensation, regardless of whether it takes the form of corporate stock or a partnership interest. All ownership interests in companies, when sold by service providers, are taxed as long-term capital gain when held by the service provider for more than one year. The only distinction is initial valuation of the ownership interest when received.[8]

To refashion the question posed by the media—why is the taxation of *all equity compensation* different from the annual bonus to the public company CEO[9] or the investment banker? Generally, in order to receive preferential capital gain treatment, equity compensation must meet at least three criteria.

1. Contingent on building value in the business. Most service provider remuneration is paid in the form of guaranteed fee income—wages or salary. Our tax rules treat such guaranteed amounts as ordinary compensation income. Carried interest, however, is only received if the partnership's underlying portfolio companies appreciate in value and are sold. Similarly, founder's stock will only result in a benefit to the founder if the company increases in value and is sold. In most cases, the service provider (the venture capitalist or the founder) agrees to provide services for a lesser guaranteed fee or salary in exchange for value that is contingent upon an increase in the value of the business enterprise. In other words, the service

5 It is important to note that carried interest is not taxed at long-term capital gain rates if it is attributable to other types of income such as interest, dividends or short-term capital gain. As a result, carried interest that is taxed at preferential tax rates can be attributable only to a long-term increase in value in a portfolio company.

6 Fleischer, *supra* note 4, at 2-3.

7 Fleischer, *supra* note 4, at 12.

8 Fleischer, *supra* note 4, at 9, 26, 29, 44.

9 Fleischer is concerned that the public and media have focused on the excessive pay of public company CEOs, but have missed the "real story" of private investment fund managers carried interest taxation. Fleischer, *supra* note 4, at 3. The public and media are concerned with public company CEOs, however, precisely because they work for public companies. They are concerned about the amount of compensation, not the taxation of it. Public companies are regulated by the Securities and Exchange Committee in order to protect the small investor who acquires stock on the public markets, thereby protecting the integrity of those markets. Private investment funds are limited to highly sophisticated investors who are represented by highly sophisticated lawyers. The typical minimum investment size in a private investment fund is $2 to $5 million. Moreover, each investor must be an accredited investor or a qualified purchaser under the securities laws.

provider "invests" his or her labor into the business. Since any remuneration requires value to be built in those companies, our economy is made stronger, a laudable goal upon which to base tax policy.

Critics might concede that wages and salary are not dependent on value being built in a company, but that annual bonuses and stock appreciation rights such as "phantom stock" or "tracking units," both of which are taxed as ordinary compensation income, are so dependent. Those amounts, however, can be distinguished from equity compensation under criterion 2 or 3 below.

2. Long term. Annual bonuses generally are paid in recognition of services performed during the taxable year. Even phantom stock and tracking units, which are based on stock value, generally reward value created within the year. As a result, neither of these generally meets the one-year holding period that is currently required in order to qualify for long-term capital gains tax rates. While the long-term capital gain holding period has varied over the years, the goal of such a holding period is to encourage long-term investment in order to provide stability in the economy through the creation of actual value, rather than to encourage arbitrage or market timing plays.

Again, critics might assert that some stock appreciation rights do, or easily could be adjusted to, reflect value built up over the requisite holding period. Nonetheless, those rights would still fail to meet the important requirement for long-term capital gain treatment set forth in point 3 below.

3. Sale of a capital asset. A key component to long-term capital gain tax treatment is the sale or disposition of a capital asset. Equity compensation, unlike other types of compensation, involves ownership of a business. Both the benefits and burdens of ownership accrue to the owner; specifically, owners are at risk. As discussed more fully in Appendix B and Appendix C, holders of carried interest (who must be "partners" for federal income tax purposes in order to be eligible for long-term capital gain tax treatment) are subject to various economic risks associated with their ownership of partnership equity.

It is this factor that also distinguishes equity compensation from royalties received from a movie or from a book. The receipt of royalties does not involve the disposition of a capital asset. Instead, the actor or writer retains his or her interest in the created work and is entitled to receive an income stream from such work indefinitely. Holders of stock appreciation rights or tracking units do not actually own any portion of the underlying business and, therefore, do not bear the risks and burdens of true ownership. A venture capitalist, on the other hand, only receives carried interest that is taxed at capital gains rates if the venture capital fund disposes of a portfolio company. A venture capitalist is a direct owner of the venture capital partnership and an indirect owner of the portfolio companies in which that partnership invests. A technical description of the attendant ownership risks is set forth in Appendix C. It is the sound goal of our current tax policy to reward those who do assume the risks and burdens of ownership in companies, whether directly or indirectly as partners.

Under these three criteria, returns on human capital invested in a business are taxed in the same manner as returns on financial capital invested in a business. Given the fact that the success of a business is dependent on both financial capital and labor, and given that neither type of investor will be remunerated unless and until a buyer agrees that value has been created, placing the tax treatment of equity compensation on a par with financial investment makes sense. Both types of investors are subject to the same entrepreneurial risk, and their interests are aligned. In fact, if only financial investors were to receive this tax benefit, then only those with existing financial wealth would be "subsidized" by the government for their investment. But if the contributions of time, effort, and counsel—as well as the intangible contributions made by venture capitalists in the form of customer and supplier contacts, business-process knowhow, and reputation—are as valuable to the success of the business as contributions of financial capital, and if the venture capitalists do not receive their share of that value until after the financial investor receives

its share, then both should be subject to the same tax treatment.

Congress intended to achieve particular goals by instituting a tax policy of preferential tax treatment for equity compensation. Those goals may or may not reflect current Congressional intent. Any change in carried interest taxation, however, should consider that the tax policy supporting the taxation of equity compensation generally applies fully to carried interest. The Rangel Bill would only apply to carried interest from "investment services" partnerships (as described below) and not to other types of equity compensation nor to other industries. It would not apply to corporate founder's stock nor to carried interest from other types of partnerships.

B. Current Equity Compensation Tax Policy Avoids the Taxation of Unrealized Sweat Equity Upon Receipt

As set forth in Appendix B, equity compensation generally is taxed as ordinary compensation income, when received by a service provider based on the value of the equity received. The only distinction between equity compensation received from a corporation and from a partnership is the manner in which the equity interests are valued upon their receipt. Both are based on fair market value. For corporate stock, fair market value is determined as the amount that a willing buyer would pay a willing seller in an arm's length transaction. As discussed more fully in Appendix B, in most cases, the value of a partnership profits interest is presumed to be its fair market value based on a current liquidation—i.e., the value that would be realized under the terms of the partnership agreement if the assets of the partnership were sold for their fair market value.

Even though there is no explicit application of "liquidation value" to corporate stock, upon the founding of a corporation, the two determinations of fair market value might be quite indistinguishable. In the early stages of a portfolio company, when the founders receive common stock, the company generally has no assets and no, or very little, value. The receipt of founder's stock, therefore, often does not trigger any tax. Similarly, when venture capitalists form a fund and receive the inchoate right to a carried interest, the fund has no assets and, therefore, the carried interest has no value.

In the case of the receipt of either corporate stock or partnership interests, current value received in excess of the amount paid for that stock or interest (whether that value is realized or unrealized) is subject to tax as ordinary compensation income. For example, if a venture capital fund's portfolio companies had appreciated in value at the time carried interest was received by a service partner, then the receipt of carried interest would be subject to ordinary compensation income taxation—even under current law. It is only the manner in which the speculative future value of the business is determined—which is dependent, in part, on the services themselves—that distinguishes the current tax treatment of compensatory stock and compensatory partnership interests. If speculative enough, however, the future value of a corporate entity would be valued similarly to that of a partnership.

A different system of taxation—one that would tax a service partner upon receipt of a profits interest based on the expected value that *might* be created by services to be performed in the future—would impose a tax on those services even if no value were ever received in exchange. Such a system of taxation would result in an accountant, consultant, or lawyer being subject to tax upon promotion to partner in that person's firm. Outside of the partnership context, that system would be similar to taxing a person on any change in status that conferred an economic opportunity, such as a teacher receiving tenure, a doctor completing an internship, or even someone graduating from high school. Further, if the service partner were taxed upon receipt of the interest in anticipation of that value, then the service partner would be subject to tax even if that service partner stopped providing services (so that the value was never realized).

Fleischer proposes that, although it is not always practicable to value a partnership interest upon grant, those concerns should not prevent taxation as the services are performed or as the value accrues. He further supports such taxation even if the partnership has not realized any income or gain for federal income

tax purposes.[10] Such a proposal would result in taxation when the taxpayer had no liquidity event. It would also result in significant complexity. Moreover, since unrealized values likely will fluctuate over time, taxation on this unrealized basis could depart from a general tax policy of seeking to tax actual economic entitlements.

C. Under the Aggregate Theory of Partnerships, Compensatory Profits Interests Are Treated Consistently with Other Forms of Equity Compensation

A well-settled principle of partnership tax law is that a partner should be taxed as if the partnership's income, gain, loss, or expense had been earned or incurred by an aggregate of individuals, rather than as an entity.[11] Although this "aggregate" theory of partnership taxation exists in conceptual tension with the "entity" theory—since the timing and character of items of partnership income, gain, loss, or expense are determined by reference to the timing and character at the partnership, or entity, level[12] —the ultimate tax consequences to a partner and a sole proprietor should be consistent. A sole proprietor generally would not be taxed on the value of his business that is attributable to his labor until the business generates a profit or is sold, and, in general, a sale would result in capital gain taxation.

Since 1916, partners have been required to include their shares of partnership income on their individual tax returns, and, since 1932, the term "partnership" generally has included a "syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on and which is not a corporation or trust or estate."[13] Today, most such unincorporated business entities can "check the box" or elect to be classified as a partnership or corporation for federal income tax purposes.[14]

Under the partnership tax provisions of the Code[15], the partnership itself functions as the earner and owner of income produced by the pooled capital and services of its partners. Rather than analyzing—under common law principles—whether there has been an "assignment of income" among the owners, these provisions provide that partnership income, gain, loss, and expense is allocated among the partners according to their distributive shares.[16] Under these rules, the agreement of the partners, rather than the assignment of income doctrine, determines how partnership items are shared among the partners.[17] The partnership tax rules merely (but importantly) require that the tax allocations reflect each partner's economic entitlements as determined by the partners contractually.[18] They further dictate that the tax character of each item allocated among the partners is determined at the partnership level.[19]

This flexibility in economic sharing, and the flow-through tax treatment of partnerships generally, provides a powerful tool for incentivizing and rewarding partners based on their varying contributions to the business entity. The venture capital fund structure, in particular, encourages the pooling of labor and capital by allowing the partners to divide the profits from the enterprise—whether created by the venture capitalists' labor or the combination of the venture capitalists' and investors' capital—in the manner they determine best rewards the long-term, entrepreneurial risk taken by each partner. This flexibility is essential to creating efficient and productive businesses and to attracting new talent to the venture industry. Any change in these rules, which have been in effect since tax partnerships have existed, such as the recharacterization of tax items, should, however, be considered in light of the effect on all partnerships, not just private investment funds. And no change should be effected without considering

10 Fleischer, *supra* note 4, at 31-33.

11 Code Section 701 and 702; Reg. § 1.701-2(e).

12 Code Section 702(b).

13 Code Section 761(a) and 7701(a)(2); Section 1111(a)(3) of the Internal Revenue Code of 1932; Section 8(b) of the Revenue Act of 1916.

14 Reg. § 301.7701-3.

15 All references to "Code" and "Section" refer to the United States Internal Revenue Code of 1986, as amended, and sections therein, respectively.

16 Code Section 704(b). *See also*, Reg. § 1.704-1(a) (2007).

17 Code Section 704(a).

18 Reg. § 1.704-1(a).

19 Code Section 702(b).

Continued on page 34

the potential consequences to the intricately related provisions of the Code applicable to partnerships.[20]

Although tax fairness might be justified in seeking uniform treatment for workers who receive and dispose of equity compensation, seeking uniformity for businesses themselves is not feasible. Subchapter K (which contains the partnership tax rules in the Code) has been constructed to reflect that the partnership does not incur an entity-level tax like a corporation. Similarly, the rules and regulations of Subchapter C (which contains the corporate tax rules in the Code) have been constructed to reflect entity-level taxation plus an additional tax on the corporation's shareholders. While this seems an obvious point, the conclusion follows that there will not be full identity of tax consequences to owners of one form of business and another.[21] As a result, while pooling of labor and capital can certainly be accomplished in either partnership or corporate form (and even in sole proprietorship form, through the use of debt), the partnership tax construct provides the most flexibility for the pooling parties to determine the sharing of profits. The parties themselves are able to weigh their relative contributions—financial capital and human capital—and share profits accordingly. That same construct provides for the timing and character of such profits to be determined at the partnership level.

As mentioned, the only real distinction regarding the tax treatment of the receipt of *compensatory* equity interests in a partnership rather than in a corporation is initial valuation. Consistent across both forms of business entity, however, is an overarching tax policy that human capital that is invested into a business should not be taxed until realized, where realization is determined by reference to the tax construct developed under the form of business entity chosen.

II. Alternative Approaches Disregard Current Tax Policy and/or Create Unnecessary Complexity

A. The Rangel Bill (the Modified Gergen Approach)[22]

The Rangel Bill, in general, changes the character of income allocated to a partner with respect to its carried interest. Instead of flow-through characterization (determined at the partnership level), all carried interest is characterized as ordinary compensation income.[23]

Interestingly, the Rangel Bill applies only to "investment services partnership interests" (ISP Interests). Working through the technical definitions of the Rangel Bill, an ISP Interest generally refers only to a compensatory partnership interest (*i.e.,* a profits interest that is

[20] This analysis assumes that the service provider partner is a "partner" as determined under the subchapter K rules. Further, it assumes that all of the current partnership taxation rules are respected by the partners in their relationships to one another. Certain of the media and Fleischer suggest that "tax gamesmanship" is not prevented by the current partnership tax rules. *See*, Fleischer, *supra* note 4, at 16-17; *see also*, Editorial, *Taxing Private Equity,* N.Y. TIMES, April 2, 2007, at A22; s*ee also* Ryan J. Donmoyer, *Hedge-Fund Strategy Gets Senate Scrutiny (Update 1),* BLOOMBERG.COM, May 8, 2007, *available at* http://www.bloomberg.com/apps/news?pid=20601087&sid=aKKEUHXyfB_E&refer=home. In part III. below, this article sets forth current partnership tax provisions that exist and work to prevent those perceived abuses.

[21] Throughout his article, Fleischer appears concerned that owners of partnerships should receive more beneficial tax treatment than owners of corporations. *See*, Fleischer, *supra* note 4, at 1, 2, 8, 13, 19, 25 and 26. The fundamental structure of the U.S. tax system, however, provides that corporations will be subject to an entity-level taxation while partnerships will not – obviously, a tax benefit for the partners. Now that limited liability company statutes exist in every state, the only real advantage of the corporate form, other than the significant advantage of simplicity, is the ability to take advantage of the public capital markets (notwithstanding the attempts by certain publicly traded partnerships to maintain partnership tax status by virtue of the "qualifying income" exception under Code Section 7704(c)). Since any business owner can choose to organize in any form the owner sees fit, one wonders – since it cannot be a matter of a fairness that simply has never existed – whether Fleischer advocates the elimination of the partnership form. This would explain his concern, set forth over many pages, that the partnership profits interest puzzle is important because more business owners are choosing the partnership form of business entity. *See* Fleischer, *supra* note 4, at 14-15.

[22] H.R. 3970, *supra* note 2. Although he does not necessarily favor it, Fleischer had presented a variation of the Rangel Bill, the "Modified Gergen Approach" (named after Professor Mark Gergen, who testified on this matter at the Senate Finance Committee hearing (Carried Interest II) on July 31, 2007)), as a reform alternative. The Modified Gergen Approach would operate similarly to the Rangel Bill, but it would apply to all service partners who received allocations of profits disproportionate to their capital interests, not just those types of service partners specified in the Rangel Bill who hold "investment services partnership interests". Fleischer, *supra* note 4, at 43.

[23] In addition to the recharacterization of carried interest allocations, the Rangel Bill recharacterizes the gain or loss from the sale or redemption of carried interest as ordinary compensation income or loss. Further, distributions of property with respect to carried interest would be taxable as if the property were sold for its fair market value. Under current partnership tax law, distributions in kind generally are not taxable until the property is sold by the recipient partner. Finally, all income recharacterized as ordinary income would be subject to employment taxes. Assuming that the states (not to mention local jurisdictions) will also take their share, the effective tax rate on carried interest easily could approach 50% if the Rangel Bill is enacted into law.

disproportionate to financial capital contributions) like carried interest. Even more significantly, it refers only to carried interest in certain investment partnerships, rather than to carried interest in all partnerships or even in all investment partnerships.[24]

As a result, not only does the Rangel Bill isolate equity compensation received from a partnership and treat it differently from equity compensation received from a corporation, it treats equity compensation received from certain partnerships differently from equity compensation received from other types of partnerships. Although Reps. Rangel and Levin indicated that "[i]nvestment fund employees should not pay a lower rate of tax on their compensation for services than other Americans,"[25] they failed to indicate why recipients of other types of equity compensation (whether from corporations or other types of partnerships) should pay a lower rate on their "compensation for services" than other Americans.

Fleischer also fails to analyze why the service partner should be treated differently than the corporate founder. As stated previously, a corporate service provider would be afforded long-term capital gain treatment when his or her equity was sold. But if that equity were held through a partnership, the Modified Gergen Approach described by Fleischer (which is similar to the Rangel Bill but would apply to all partnerships) would change the character of the income to ordinary compensation income. Given that partnership theory has long held that the character of income is to be determined at the partnership level and taken into income by its partners as if each had recognized such income individually, such recharacterization would undermine the partnership form by recharacterizing a partner relationship as a service provider-service recipient relationship.

Further, the ensuing complexity seems more than unnecessary. For example, if recharacterization occurs, the recharacterized income is treated as compensatory service income. Does this then create a deductible expense?[26] If so, to whom—the partnership, the investors, or the portfolio companies (which, arguably, are the actual service recipients)? If it is a partnership expense, will allocation of such expense to all partners, including the general partner, be permitted? How will the mechanical capital account provisions account for this, and how will these rules interact with Code Section 83? Will allocable expenses from an investment partnership now be treated as deductible business expenses rather than an expense that is limited under Code Section 212? What if cash distributions exceed basis—willthose also be recharacterized as ordinary income? Each of these questions is further complicated if there are non-US members of the general partner.

With any thought, no venture capitalist would agree to this arrangement. At a minimum, a service provider partner would opt to receive a fee from the institutional investors, which—if payable at a time similar to carried interest distributions—would be taxed after the associated allocation. This would permit tax deferral beyond that which currently exists for most venture capitalists (since carried interests distributions are generally delayed until investors' contributed capital has been returned).[27] With a little more thought, new structures would be introduced—although the Rangel Bill does contain sweeping anti-avoidance provisions in an attempt to pre-empt creative tax planning, as well as a heightened, no-fault, 40% underpayment penalty provision.

Tax rules are known to affect behavior. The Rangel Bill (and the Modified Gergen Approach) would have a stifling effect on entrepreneurial endeavors. Some venture capitalists will move to more stable, less risky enterprises. This will result in a smaller supply of

[24] ISP Interests are defined as any interest in a partnership which is held by any person if such person provides (directly or indirectly), in the active conduct of a trade or business, a substantial quantity of certain services to the partnership. These services include (1) advising as to the advisability of investing in, purchasing or selling any specified asset, (2) managing, acquiring or disposing of any specified asset, (3) arranging financing with respect to acquiring specified assets, or (4) any activity in support of any of the preceding services. A specified asset includes securities, real estate and commodities, as well as options or derivative contracts with respect to the foregoing. H.R. 3970, *supra* note 2.

[25] Rangel and Levin, *supra* note 3.

[26] Under the Rangel Bill, a deductible expense presumably is not created since the allocation provisions remain unchanged (in other words, the financial partners are not subject to tax on the carried interest which would require an expense deduction for the carried interest received by the venture capitalists). Rather, the income allocated to the venture capitalists is simply taxed at a higher rate than the current tax rules otherwise would provide.

[27] *See* Appendix B, part III.C.

capital available to start-up companies and increased costs of capital to them. Some venture capitalists will charge their investors a higher guaranteed management fee, thereby providing less incentive to build value in the underlying businesses. Some venture capitalists will charge a higher carried interest, resulting in lower returns to investors. Some institutional investors, instead of investing in higher-cost investment funds, will invest in lower-cost non-US managed funds. This could cause the US to lose its critical competitive advantage on the world stage of innovation- and knowledge-based industries.

As a matter of tax policy, the Rangel Bill (and the Modified Gergen Approach) asserts that sweat equity should not receive the same preferential long-term capital gains rate as financial equity. If that is the case, then all forms of equity compensation should be "reformed," not just partnership profits interests and not just in the private investment services industry. Taken to its logical conclusion, this type of tax policy would force an entrepreneur who invests real labor, effort, and thought into a business to pay tax at ordinary income rates but would permit an investor who invests cash in that business and walks away to enjoy the preferential taxation afforded long-term capital gain.

The effects of the Rangel Bill, if enacted in the form proposed, will not be evident immediately, and the magnitude will be difficult to measure, but it will have an impact, and that impact could jeopardize entrepreneurial activity in the US

B. Forced Valuation Approach

After turning the partnership profits puzzle over and returning to the one anomaly that exists—that a partnership interest is valued upon grant by reference to its fair market value assuming liquidation of the partnership—Fleischer dismisses an alternative that would change this value.[28] The Rangel Bill drafters also avoid changing the current taxation of the receipt of a compensatory partnership interest. For this I give them credit, although such an approach might advance tax fairness.

Fleischer states, accurately, that to be consistent with corporate equity compensation, partnership interest valuation would need to account for the option value of the interest.[29] He states that "[t]he problem, of course, is that given the speculative nature of the enterprise, an appraisal necessarily resorts to rules of thumb, is easily gamed, and will tend to understate the option value of the interest."[30] He also states that this difficulty is "especially strong in the context of venture capital and private equity funds, where the underlying investments are illiquid."[31] Each of these situations, however, already exists in the corporate context, with respect to restricted stock grants.[32]

The very nature of the venture capital industry is risk and speculation.[33] The carried interest might have no value or it might have great value. It is nearly impossible to predict upon grant. Further, the tax complexities associated with taxing the receipt of a typical compensatory partnership interest are mind-boggling. Would an upfront tax result in additional partnership basis? Would there be an election to adjust the inside basis of the partnership assets to match that additional outside basis, as in the case of a sale or transfer of a partnership interest? Presumably, all income, gain, loss, and deduction would continue to be allocated to all the partners. Would the losses or expenses be characterized as deductible losses or expenses to offset the earlier ordinary income inclusion? Would a positive capital account balance at

[28] Fleischer, *supra* note 4, at 43-44.

[29] *Id.* at 44.

[30] *Id.*

[31] *Id.* at 31.

[32] During one phase of our tax history, the courts seemed to support the taxation of the receipt of profits interests. But regardless of the technical analysis in that case, *Diamond*, the partnership interest was taxed only because a *determinable* market value was found to exist. In *Diamond*, the court held that the partnership profits interest (in a partnership that held an office building, the mortgage financing of which Diamond secured as his contribution) was sold less than three weeks after it was received for $40,000 thereby indicating an obvious fair market value of $40,000. It should be noted that the court taxed Sol Diamond under Code Section 61, not under Code Section 83, thereby potentially putting limited partners also at risk of taxation under *Diamond* upon inception of a venture capital fund. The *Campbell* court (on appeal), however, found that a profits interest received in exchange for services in organizing and financing real estate limited partnerships had no fair market value due to the speculative nature of the projected profits of the partnerships. *See Diamond v. Commissioner*, 56 T.C. 530 (1971), *aff'd,* 492 F.2d 286 (7th Cir. 1974); *Campbell v. Commissioner,* 943 F.2d 815 (8th Cir. 1974).

[33] *See* Appendix C.

the end of the partnership term result in an ordinary loss, as opposed to a capital loss?

In the end, Fleischer, like the decades of tax professionals before him—the courts, Congress, Treasury, the IRS and practitioners—concludes that the inseparable capital and profits interests that comprise a partnership interest cannot be valued in a manner that works more optimally (though admittedly not perfectly) than fair market value assuming liquidation of the partnership. One assumes that the Rangel Bill drafters arrived at a similar conclusion.

C. Cost of Capital Approach

After dismissing a change to the long tax history of partnership interest valuations, Fleischer unfortunately advocates for partially taxing human (as opposed to financial) capital returns on equity as ordinary income.[34] Moreover, he suggests doing this at a time when the return might still be unrealized. Fleischer bases his position on a flawed assertion that "we would presumably like to tax [the relative value of the returns on human capital] currently as the services are performed."[35] Rather, as stated above, there is a strong tax policy, as evidenced by the current tax treatment of other types of equity compensation, to avoid taxing human capital until the returns thereon are realized in a market transaction.

Under this approach, Fleischer suggests allocating an annual cost-of-capital charge to the service partner as ordinary income. He asserts that the service partner has received an interest similar to a no-interest, nonrecourse loan—*i.e.,* the use of the financial partner's capital has been shifted to the service partner.[36] Since a market rate of interest is not charged to the service partner, he states that interest should be imputed and treated as cancellation of debt income, resulting in a modified form of accrual taxation.[37] Any other gains or losses of the partnership would retain their character and be allocated to the partners as they otherwise would be allocated.[38]

While Leo Schmolka (whom Fleischer credits with originating this theory) concludes that the allocations of current income in a partnership achieve this same goal,[39] Fleischer does not accept the basic tenet of partnership tax law regarding realization, stating that Schmolka's argument only holds up if the partnership has current income from business operations.[40] As a result, Fleischer reverts to a system of taxing unrealized human capital. This would be similar to taxing a new partner of an accounting firm, consulting firm, or law firm based on an amount lawmakers think he should earn, rather than on the amount he does in fact earn.

Fleischer does not explain why a part of a service partner's gain from building a business should be taxed as ordinary income while that of a corporate founder is entitled to be taxed as long-term capital gain. Presumably, he would impose this result on the founder of an operating LLC as well, just like the venture capitalist, although he provides no explanation for the anomalous treatment between the two types of company founders. In fact, he concedes that this treatment would be inconsistent with subchapter K principles, stating that it is intended to be consistent with Code Sections 83 and 7872.[41] But there is no acknowledgement of its inconsistency with the treatment of other forms of equity compensation.

As with the Modified Gergen Approach and the Forced Valuation Approach discussed above, the Cost of Capital Approach raises numerous questions regarding the appropriate interaction of the highly integrated partnership tax structure of subchapter K. For example, would the annual tax result in additional partnership basis? Would there be an election to adjust the inside basis of the partnership assets to match that additional

[34] Fleischer, *supra* note 4, at 44-46.

[35] *Id.* at 33.

[36] *Id.* at 32.

[37] *Id.* at 44-45.

[38] *Id.* at 44-46.

[39] Leo L. Schmolka, *Taxing Partnership Interests Exchanged for Services: Let Diamond/Campbell Quietly Die*, 47 TAX L. REV. 287, 308 (1991).

[40] Fleischer, *supra* note 4, at 30.

[41] *Id.* at 31. Code Section 7872 generally requires that interest income be imputed to the recipient of a "below-market loan" to the extent that a related lender does not charge a market rate of interest.

outside basis? Would the regular partnership losses or expenses be characterized as ordinary losses or business expenses to offset the earlier income inclusion? Would a positive capital account balance at the end of the partnership term result in an ordinary loss, as opposed to a capital loss?

Fleischer believes, however, that this approach would provide "precious few planning or gamesmanship opportunities."[42] Contrary to that belief, much more thought will go into gaming this "reform" than that which might exist under the current system. While he states that any such plan would likely alter the underlying economic arrangements between the partners[43] (which he presumably believes is an advantage), he does not acknowledge the devastating effect this could have on the entrepreneurial investment culture or on the constituencies that invest in those entrepreneurs.

III. Existing Partnership Tax Provisions Prevent Perceived Tax Gamesmanship

Part of the debate surrounding the taxation of carried interest seems to arise because the private investment funds industry, including the venture capital industry, is just that—private. This privacy exists because venture capital funds largely have been exempt from securities regulation and because they are sold only to highly sophisticated, qualified investors that are required to make very large investments—there is no reason for the average person to cross paths with them. Privacy, however, has resulted in a lack of understanding of how venture capital funds operate and, in some cases, in an implication that tax gamesmanship activities are being hidden. As set forth in Appendix A and Appendix B, however, the venture capital fund economic and tax structure is relatively simple.

There are also perceived concerns that run along the lines of "Aren't the venture capitalists just service providers?" "A venture capitalist's compensation looks pretty stable and guaranteed." "What about the "conversion" of management fees into carried interest?"[44] "Aren't games being played with carried interest when value does actually exist?"

These are all good questions, and they are questions that have been addressed over many years by Congress, Treasury, and the IRS, and through the implementation of numerous partnership tax rules. The partnership tax rules provide a construct that the private investment funds must operate within. As complex and burdensome as it may be, the construct has permitted our technology- and knowledge-based economy to be successful in creating companies and industries. To add unnecessary complexity would disregard that tax policy and likely would tax, contrary to most areas of US tax law, unrealized human capital.

The following sections provide a glimpse of the partnership tax construct within which venture capital funds operate, preventing perceived tax gamesmanship concerns.

A. "Partner" Classification Guidance

The partnership tax rules providing flow-through treatment of the timing, character, and amount of partnership income, gain, loss, or expense are predicated on such amounts being allocated to the partnership's "partners" in their capacities as such.[45] To the extent that the parties exist in a different relationship to one another, partnership treatment is not permitted.[46] If, for example, the relationship reflects that of a debtor and creditor or a service recipient and service provider, the rules of Subchapter K will not apply. The courts, Congress, Treasury, and the IRS have determined this to be one measure to prevent compensatory relationships from receiving more preferential treatment in a partnership form.

[42] *Id.* at 44.

[43] *Id.* at 45.

[44] Some venture capital funds take a lower guaranteed "2%" management fee and take a higher contingent "20%" carried interest which has become colloquially referred to as a "conversion." In most cases, this additional profits interest is allocated in a manner that is similar to the manner in which carry is allocated, although the general partner might receive these allocations before the regular 20% carried interest allocations are made.

[45] *See*, Reg. §§ 1.701-1 and 1.702-1(a).

[46] Under Reg. § 1.704-1(b)(1)(v), "[s]ection 704(b) and [the regulations] do not apply to a purported allocation if it is made to a person who is not a partner of the partnership (see Reg. § 301.7701-1(a)(2) and paragraph (d) of Reg. § 301.7701-3) or to a person who is not receiving the purposed allocation in his capacity as a partner (see I.R.C. § 707(a) and paragraph (a) of Reg. § 1.707-1)."

The partnership tax rules governing classification of parties as "partners" allow for varying interpretations, but under those rules, general partners and venture capitalists should be viewed as being in a partner relationship with their investors. First, under Code Section 704(e)(1), "a person shall be recognized as a partner for income tax purposes if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person."[47] Furthermore, under the associated legislative history, "however the owner of a partnership interest may have acquired such interest, the income is taxable to the owner, if he is the real owner. If the ownership is real, it does not matter what motivated the transfer to him or whether the business benefited from the entrance of the new partner."[48]

Although Code Section 704(e) originally was intended to address family limited partnerships, there is no indication (regardless of the heading under which it falls) that the current version is limited in any way to any particular type of partnership. As a result, for a partnership, like a venture capital fund, in which capital is a material income-producing factor, one must determine whether the purported owner has a capital interest. While debate can take place over how much of a capital interest is required, if a general partner contributes 1% to 5% of the capital of a fund, this should be sufficient.[49]

If Code Section 704(e) does not apply—for example, in the case of service partnerships or owners of a capital-intensive partnership who do not hold a capital interest—partner status is determined under case law. Under the leading cases, the courts look to "whether the parties really and truly intended to join together for the purpose of carrying on business and dividing the profits or losses or both."[50] The factors considered include whether the purported partner possesses a proprietary profit share, shares in venture losses, has a capital interest, has the right to participate in management, provides substantial services, and is held out as a partner to third parties in partnership agreements or on partnership tax returns.[51]

Because of the entrepreneurial risk that general partners of venture capital funds encounter, the sharing of profits and losses, and their management of the funds, partner status should be accorded them. If, however, a general partner arranged its affairs with its investors so as to eliminate its entrepreneurial risk within the venture capital fund enterprise, then the IRS would have a basis for challenging the general partner's carried interest as a partner interest and treating it instead as generating compensatory service income.[52]

B. Capital Shift Rules

As discussed in some detail in Appendix B, if a capital interest is transferred to a service partner, that service partner is taxed on the fair market value of that interest.[53] This places a significant restraint on the ability of the venture capitalists to replicate a discretionary compensatory structure in place of the partner structure.

For example, assume that of the 20 "points" of carried interest received by the general partner, the four venture capitalists (who are partners of the general partner) want to hold 5 points, or 25%, each. Now assume that, in year five, the four venture capitalists would like to

47 Under Reg. § 1.704-1(e)(1)(iv), capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business conducted by the partnership. In general, capital is not a material income-producing factor where the income of the business consists principally of fees, commissions, or other compensation for personal services performed by members or employees of the partnership.

48 Revenue Act of 1951, Pub. L. No. 82-183, 1951 U.S.C.C.A.N. 1968, 2008.

49 *See*, Rev. Proc. 89-12, 1989-1 CB 798, section 4.02 (obsoleted by Rev. Rul. 2003-99, 2003-34 IRB 388).

50 *Commissioner v. Culbertson*., 337 U.S. 733, 741 (1949); *Commissioner v. Tower,* 327 U.S. 280, 287 (1946).

51 *See*, *e.g.*, *Culbertson*, 337 U.S. at 742; *Tower,* 327 U.S. at 286; *TIFD III-E, Inc. v. United States*, 459 F3d 220 (2d Cir. 2006); *Bergford v. Commissioner*, 12 F3d 166 (9th Cir. 1993), aff'g sub nom. *William G. Alhouse*, 62 TCM 1678 (1991); *Arthur Venneri Co. v. United States*, 340 F2d 337 (Ct. Cl. 1965).

52 Under the entity classification regulations finalized in 1997 under Code Section 7701, no specific guidance is provided as to "partner" status, although a "partnership" is the default categorization of a business entity with two or more members that is not a "per se" corporation. As a result, it is possible that *any* persons who own interests in legal entities that are not otherwise corporations (or trusts) should be treated as "partners." It is not necessary for most general partners and venture capitalists to resort to this argument, however, since under Code Section 704(e)(1) or the case law intent factors, they would qualify as partners.

53 As also discussed in anguishing detail, that fair market value is determined based on the current liquidation value of the partnership as of such time; any amount in excess of that value would be ascribed to the associated profits interest.

rearrange the carried interest-sharing percentages in order to reward one of the partners, Partner X, who provided greater services to the partnership over those years. If each of three partners transferred 1 of their 5 points to Partner X, they will now hold 4 points, or 20%, each, and Partner X will hold 8 points, or 40%. If, however, the venture fund has appreciated in value (so that the additional 4 points transferred to Partner X has a current liquidation value at the time of transfer), Partner X will be subject to tax on this "compensatory" capital shift.

Partner X could avoid this tax by paying the other partners for this value, or by providing for the assets of the venture capital fund to be "marked to market" so that any current unrealized value accrues to the benefit of the partners in the earlier percentages. In that case, Partner X will only have received a true profits interest, not a capital interest.

This mechanism achieves certain tax policy goals. First, it supports the desire not to tax unrealized human capital by acknowledging that such a shift reflects a realization event for the increasing partner. That is, because the shifted interest has a determinable value that was granted in recognition of prior services, it has been realized in the same manner as the initial receipt of a capital interest is taxable to the service recipient partner. Second, it encourages the long-term equity holding by service providers, or at least acknowledges that shifts will cause the loss of long-term capital gain treatment. Third, it supports the partner categorization of the partners by preventing discretionary changes to the profit-sharing ratios that reflect a compensatory relationship.

C. Section 707(a) Payments for Services by Partners

Payments made to a partner in exchange for services to the partnership generally are treated in one of three ways currently under the Code. If the payments are made without regard to the income of the partnership, then they are treated as "guaranteed payments" under Code Section 707(c). If the payments are made with regard to the income of the partnership but are made to a partner other than in his capacity as a member of the partnership, then they are governed by Code Section 707(a). Finally, if the payments are made with regard to the income of the partnership and in respect of such person's partner capacity, then they are governed by Code Section 704 (along with Code Section 731).

If the payments are guaranteed payments or Code Section 707(a) payments, the partner recipient generally must include such amounts in income as ordinary compensation income. While the partnership will have an expense to allocate to its partners, the recipient partner might or might not be allocated this expense item. Further, any such item might be limited in its deductibility. This could result in the partner recipient being taxed on services that partner provides to him or herself.

As a result, it is generally more tax efficient for a partner to receive a payment if it is not dependent on income of the partnership and if it is made in a partner capacity. This will ensure that the partner is allocated its distributive share of partnership income under Code Section 704, but the actual payment is not separately taxed nor treated as an item of expense or deduction. Furthermore, if the items of income allocated by the partnership include long-term capital, then the partner will likely also be taxed, at least in part, at a lower tax rate.

Code Section 707(a)(2)(A), however, provides that service providers that are "disguised" as partners will not be afforded distributive share treatment under Code Section 704.[54] The legislative history of Code Section 707(a)(2)(A) lists five factors to distinguish distributive shares from disguised non-partner service (Code Section 707(a)) payments.[55] The most significant factor is whether the payment is subject to an appreciable entrepreneurial risk as to amount and probability of payment.[56] Gross income allocations, because they are far more certain to be

[54] Code Section 707(a)(2)(A) generally provides that if (i) a partner performs services for a partnership, (ii) there is a related direct or indirect allocation and distribution to such partner, and (iii) the performance of such services and the allocation and distribution when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a partner, such allocation and distribution shall be treated as a Code Section 707(a) payment.

[55] 1 Senate Comm. on Finance, 98th Cong., 2d Sess., Deficit Reduction Act of 1984, S. Prt. No. 169, at 227-8 (Comm. Print 1984).

[56] *Id.*

satisfied, should be heavily scrutinized according to the legislative history. Capped allocations are also suspect, although net income allocations generally are viewed as implicating entrepreneurial risk. The risk profile of the business in which the partnership engages is also relevant. Under these criteria, the carried interest would be viewed as being subject to appreciable entrepreneurial risk, based on the high-risk nature of the investments made by a venture capital fund as well as the netting of gains and losses.

Other factors that are indicative of a Code Section 707(a) payment include (i) transitory partner status; (ii) allocations that are close in time to the performance of services; (iii) indication that the recipient became a partner primarily to obtain tax benefits for himself or the partnership; and (iv) the value of the recipient's interest in general and continuing partnership profits is small in relation to the allocation in question.[57] All of these factors support distributive share treatment under Code Section 704 with respect to a venture capital fund general partner's carried interest.

D. Section 704(b) Substantial Economic Effect Allocation Rules

Many of the investors in venture capital funds are tax-exempt or non-US investors. This has raised concerns that the tax-exempt nature of the investors will be used to optimize the taxation of all of the partners.[58]

Treasury regulations promulgated under Code Section 704(b), providing that all allocations of income, gain, loss, or deduction have substantial economic effect, are quite effective at preventing this result. First, to the extent there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden.[59] This is either accomplished by the partnership satisfying the three safe harbor requirements (capital account maintenance, liquidation per capital accounts, and capital account deficit restoration or qualified income offset)[60] or by allocating in accordance with each "partner's interest in the partnership."[61]

Then, for that economic effect to be substantial, there must be a reasonable possibility that the allocations will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences.[62]

Further, the economic effect of an allocation is not substantial if, at the time the allocation becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation were not contained in the partnership agreement.[63] Significantly, "[i]n determining the after-tax economic benefit or detriment to a partner, tax consequences that result from the interaction of the allocation with such partner's tax attributes that are unrelated to the partnership will be taken into account."[64]

The regulations then go on to discuss two types of allocation provisions that will not be treated as substantial—shifting allocations and transitory allocations. Shifting allocations result if there is a strong likelihood that (1) the net increases and decreases that will be recorded in the partners' respective capital accounts for such taxable year will not differ substantially from the net increases and decreases that would be recorded if the allocations were not contained in the agreement, and (2) the total tax liability of the partners will be less than if the allocations were not contained in the partnership agreement (taking into account tax consequences that result from the

[57] *Id.*

[58] *See*, Fleischer, *supra* note 4, at 14.

[59] Reg. § 1.704-1(b)(2)(ii)(a).

[60] Reg. § 1.704-1(b)(2)(ii)(b)(1)-(3).

[61] Reg. § 1.704-1(b)(3).

[62] Reg. § 1.704-1(b)(2)(iii)(a).

[63] *Id.*

[64] *Id.*

interaction of the allocation with partner tax attributes that are unrelated to the partnership).[65]

Transitory allocations result from the possibility that one or more allocations ("original allocations") will be largely offset by one more other allocations ("offsetting allocations")—generally within five years and other than from offsetting allocations attributable to gain or loss from the disposition of partnership property—if there is a strong likelihood that the consequences described in (1) and (2) above will result.[66]

The substantial economic effect regulations provide the IRS with a powerful tool for challenging allocations in partnerships whose partners have differing tax attributes. They require that any tax allocation reflect an actual economic entitlement. For this reason, the regulations also provide a strong incentive to venture capitalists to avoid spending time, money, and effort on tax-gaming structures. Institutional investors, especially those not subject to tax, are not amenable to receiving a less determinate economic deal in order to achieve an optimal tax result for taxable venture capitalists.[67]

E. Partnership Anti-Abuse Rules

The partnership anti-abuse rules are the bazooka in the IRS's arsenal. They are broad and far-reaching. Because typical venture capital fund structures and economic arrangements are so straightforward, most venture capital funds (and their tax advisors) do not pay these rules much attention. But they play a significant role in deterring tax professionals from getting too fancy.

Under these rules, if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K, the IRS can recast the transaction as appropriate to achieve tax results that are consistent with that intent.[68] The anti-abuse regulations encompass concepts such as substance over form, the step transaction doctrine, business purpose, clear reflection of income, and economic substance to give the IRS the power to challenge technical implementation of the partnership tax rules.

The regulations specifically provide that subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. Implicit in the intent of subchapter K are the following requirements: (1) the partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose; (2) the form of each partnership transaction must be respected under substance-over-form principles; and (3) generally, the tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income.[69]

Even though a transaction may fall within the literal words of a particular statutory or regulatory provision, it can be determined, based on the particular facts and circumstances, that to achieve tax results consistent with the intent of subchapter K, (1) the purported partnership should be disregarded in whole or in part, and the partnership's assets and activities should be considered, in whole or in part, to be owned and conducted, respectively by one or more of its purported partners; (2) one or more of the purported partners of the partnership should not be treated as a partner; (3) the methods of accounting used by the partnership or a partner should be adjusted to reflect clearly the partnership's or the partner's income; (4) the partnership's items of income, gain, loss, deduction, or credit should be reallocated; or (5) the claimed tax treatment should otherwise be adjusted or modified.[70]

[65] Reg. § 1.704-1(b)(2)(iii)(b).

[66] Reg. § 1.704-1(b)(2)(iii)(c).

[67] Business people have great derision for the proverbial tax tail wagging the economic dog.

[68] Reg. § 1.701-2(b).

[69] Reg. § 1.701-2(a)(1)-(3).

[70] Reg. § 1.701-2(b)(1)-(5).

Based on the broad powers afforded the IRS in determining the relationships among the partners under these rules, there is little incentive or ability for venture capitalists to employ structures in attempts to game the partnership tax system.

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The current tax system—as well as the economic reality faced by the venture capital industry—has resulted in a straightforward venture capital fund structure, and legitimate tax policy incentives encouraged by that system have assisted in creating an enviably strong US entrepreneurial economy. Current partnership tax rules provide the government with many weapons to attack any perceived tax gamesmanship in the venture capital industry. If tax gamesmanship is a concern, more draconian measures need not be implemented by Congress.

Existing tax policy, moreover, is the same tax policy that has recognized the importance of providing incentives to invest in US businesses to stimulate the economy. This tax policy has not differentiated between investment of financial capital and investment of human capital—returns on both are permitted to be taxed at the long-term capital gain rate. To deny this treatment to human capital, or sweat equity, would encourage workers to strip profits out of their businesses in the form of guaranteed, non-profit-based salaries rather than building value in those same companies. It would also result in the taxation of human capital before the value created by the associated labor was realized. This type of change could have far-reaching consequences to all workers. To deny long-term capital gain treatment or partnership flow-through taxation generally to equity compensation recipients would affect even more workers. But applying any such change only within the isolated context of the private investment funds industry would contradict a policy of tax fairness.

The only real issue left on the table, therefore, is valuation of a partnership profits interest. While it might appear attractive to value all forms of equity compensation in an identical manner, each is part of a unique tax construct. Congress, the courts, Treasury, and the IRS have expended enormous effort to date in effecting an imperfect, but optimal, solution for valuing partnership interests by reference to current liquidation value. Walking away from that is sure only to create needless complexity and economic distortions.

Appendix A: General Venture Capital Fund Structure and Economics

I. Legal Structure

Venture capital funds are organized as limited partnerships or as limited liability companies (LLCs) under state or non-US law. In all cases to which this article applies (and almost all cases in practice), the venture capital fund is classified as a partnership for US federal income tax purposes. The fund qualifies for such treatment either under the default rules for entity classification or as a result of making an affirmative election to be classified as a flow-through entity under those regulations.[71]

II. Formation of Investment Team and Strategy

The venture capital fund formation process starts with the individual venture capitalists. The typical venture capitalist possesses an advanced scientific degree or other technological background. Very often, the venture capitalist also has had operational experience with start-up companies. That background and experience typically give a venture capitalist unique skills to identify, invest in, and grow start-up companies in a specific technical field.

The typical venture capitalist will band together with either (i) a group of other individuals with similar technological backgrounds to form a fund to invest specifically in start-up companies in that technological space or (ii) a group of individuals with other types of technological backgrounds to form a fund to invest in companies across a spectrum of technologies. The majority of venture capitalists invest in information technology or life sciences, although many specialized sub-sets exist within those categories. Some of the industries that have been developed or created by venture-backed companies include biotechnology,

[71] Reg. § 301.7701-3(a)-(c).

medical devices, network security, on-line retailing, web-based services, and clean-energy technology.

Once assembled, the team determines how much money to raise, based on what it expects to invest. This generally depends on the number of venture capitalists on the team and the approximate amount of funding necessary to build a company in their targeted industry. Venture capitalists typically sit on the board of directors of each portfolio company in which they invest, providing strategic counsel regarding financings, sales and marketing, operations, intellectual property rights, recruiting, liquidity, and all other aspects of the company's business. Most venture capitalists sit on no more than five to ten active boards. Although most venture capitalists invest significant portions of their personal wealth in their portfolio companies, the capital needed by emerging-technology companies outpaces the assets of individuals.[72]

III. Formation of Relationship Between Venture Capitalists and Institutional Investors

Venture capitalists typically partner with institutional investors such as public and private pension funds, universities, and endowments and private foundations. Other investors include high net worth individuals and corporations, especially those with cash reserves such as insurance companies and banks. Some investors in each of these categories might be non-US persons. These cash-intensive entities generally seek to diversify their investment portfolios with a small percentage of the type of high-risk investments offered by venture capital funds.

Although lengthy negotiations often determine the specific rights and obligations of the venture capitalists (some group of whom own the "general partner" of the fund and the "management company" to the fund) and the investors (the "limited partners" of the fund), certain broad market terms have evolved over the years.

[72] Venture capital funds generally are smaller than funds formed in other alternative asset classes such as hedge funds and buy-out funds. In 2005, over 70% of venture capital funds were $250 million or smaller and over 90% were $500 million or smaller. *See, National Venture Capital Association* VentureXpert™ Database, *available at* http://www.nvca.org.

The management company, which is usually formed as an LLC or a C-corporation, typically enters into a non-partner, contractual arrangement with the fund to perform its day-to-day operational activities. In exchange, it receives a guaranteed, annual management fee from the fund, usually at a rate of 2% of fund commitments. This rate often declines after the first four- to six-year period, during which all of the fund's portfolio companies are expected to be identified. The management fee pays for the office space of the venture capitalists, the furniture and computers, insurance costs, salaries, and payroll taxes for analysts and staff, as well as the salaries of the venture capitalists themselves. Essentially, the management fee is used to run a business.

The general partner, on the other hand, which is usually formed as another limited partnership, makes the investment and divestment decisions for the fund. It typically contributes between 1% and 5% of the capital of the fund and receives 20% of the cumulative net profits of the fund (the "carried interest"), as well as 1% to 5% of the remaining 80% as an investor. The limited partners generally view the carried interest as a necessary incentive to reward the general partner for the entrepreneurial risk it takes regarding whether its efforts will lead to financial success. The carried interest aligns the interests of the parties by focusing the general partner's attention on building value in the underlying portfolio companies. That is, the venture capitalists will not achieve financial success unless the underlying portfolio companies they are advising perform well.

IV. Venture Capital Fund Operations

The fund typically is closed-end, has a finite term of 10 years, plus one to three one-year extensions, with additional time permitted to liquidate any remaining portfolio companies. Often, the fund lasts between 13 and 17 years. Investors are not permitted to withdraw or redeem their interests during this time. Transfers of interests are highly restricted.

During the first four to six years, the general partner finds companies and the fund invests in them. During this time and thereafter, the venture capitalists work

with company management to build the company and, in many cases, an industry. With a handful of exceptions (most notably the "Internet bubble"), this process typically lasts between four and eight years, but it can be longer for those life science companies that require significant regulatory processes and approvals.

Ultimately, the venture capitalists spend the last years of the fund guiding portfolio companies to acquisitions or initial public offerings. Because the venture capital industry focuses on high-risk technologies, however, many venture-backed companies fail.[73] As the companies are sold or go public, the fund distributes the proceeds (either in cash or in public company stock) to the partners. After the last portfolio company has been sold, distributed to investors, or written off, the fund itself liquidates.

Because gains and losses (and usually expenses, including the management fee) are netted for purposes of determining the cumulative net profits upon which the carried interest is calculated, the amount of carried interest, if any, to which the general partner is entitled cannot be calculated definitively until the fund liquidates. At any time during the term of the fund, the cumulative net profits to date can be determined, but unless the future profit or loss of each of the remaining portfolio companies can be predicted with accuracy, this will only be an interim determination. Moreover, because the partners' capital is usually called on a "just-in-time" basis as investments are made and expenses incurred, investments made with later-called capital can produce a loss or gain as well.

As a result, the partners negotiate for provisions to safeguard the overall economic deal. In the venture capital industry, this typically means that the general partner is not entitled to receive distributions attributable to its carried interest until *all* contributed capital has been returned to the limited partners. For practical purposes, this often results in no distributions of carried interest to the general partner within the first six to eight years of the venture capital fund's term. In almost all cases, the governing documents also provide for a "clawback" mechanism requiring the general partner to return to the limited partners—at the end of the term of the fund—any over-distribution of carried interest as determined after all investments have been liquidated.

[73] *See, Mergers and Acquisitions Continue to Dominate Exit Scene for Full Year 2006*, (Nat'l Venture Capital Ass'n, Wilmington, Va.) January 2, 2007, *available at* http://www.nvca.org/pdf/Q406exitpoll_final.pdf; *Venture Impact: The Economic Importance of Venture Capital Backed Companies to the U.S. Economy* (Global Insight, Inc., Waltham, Mass.) 2007, at 10-11.

Appendix B: Current Partnership Taxation of Carried Interest

I. Taxation of Management Fee

The management company usually does not become a partner of the fund. Instead, it typically receives the management fee directly from the fund pursuant to a management contract for services. Since the management company is engaged in the trade or business of providing those services, the management fee is ordinary business income when received or accrued by the management company. The expenses of the management company generally constitute ordinary and necessary business expenses, deductible under Code Section 162.

If the management company is formed as a C-corporation, the salaries paid to the venture capitalists, analysts, and other staff are generally deductible by the management company as business expenses, to the extent not otherwise disallowed. If the management company is formed as an LLC, the salaries paid to its owners (typically, the core group of VCs) are deductible as "guaranteed payments" under Code Section 707(c). In either case, the salaries or guaranteed payments are included in income by the recipients as ordinary compensation income and are subject to employment taxes and estimated tax payments.

Because of the relatively small size of most venture capital funds, most, or all, of the management fee typically is used on an annual basis to pay for ongoing operational expenses, salaries, and bonuses. Because the carried interest (described below) is speculative and often is not distributed to the venture capitalists for years (if at all), the management fee is large enough to permit the venture capitalists to run their businesses as well as to provide them sufficient, competitive

salaries. According to the Holt Compensation Study, the median salary (before bonus and carry) paid in 2006 to general partners of independent venture capital firms was $400,000 (for regular partners) to $680,000 (for managing general partners).[74] Including bonuses (but not carry), those amounts were $493,000 and $958,500, respectively.[75]

Unlike other private equity, there are few, if any, other types of fees or income that are earned by the typical venture capital management company. Because venture capital funds invest in start-up companies and because venture capitalists do not typically provide investment banking services in connection with portfolio company transactions, venture capitalists rarely, if ever, receive transaction, monitoring, breakup, or other fees from their portfolio companies. While they sometimes receive fees in their capacities as members of a portfolio company's board of directors, most such fees are nominal reimbursement amounts. In some cases, however, grants of non-qualified stock options result in greater value. Often, the management fee payable by the fund to the management company is reduced by some amount if the venture capitalists receive such fees. These fees would also be subject to tax at ordinary income tax rates.

II. Taxation of Grant of Carried Interest

A. Profits Interests/Capital Interests—Taxation. At the inception of a venture capital fund, the general partner's carried interest generally is viewed as a partnership "profits interest." The appropriate taxation of a profits interest has aroused much tax angst over the years, in part because a profits interest itself is a slippery concept.

A profits interest is defined by reference to its partnership interest complement—the "capital interest." A *capital* interest in a partnership is defined under Treasury Regulations as "an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership."[76] The Treasury Regulations further state, "[t]he mere right to participate in the earnings and profits of a partnership is not a capital interest in the partnership."[77] Similarly, the IRS has stated in published guidance that a capital interest is an "interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership."[78] That guidance also states that the "determination generally is made at the time of receipt of the partnership interest"[79] It concludes by stating that a "*profits* interest is a partnership interest other than a capital interest."[80]

Under Code Section 83, when property is received in connection with the performance of services, the recipient will recognize taxable compensation income in an amount equal to the excess, if any, of the fair market value of that property over the amount paid for that property. Property includes a partnership interest. The interesting (and slippery) issue is the determination of the fair market value of a partnership interest. As stated above, a *capital* interest is, by definition, an amount equal to fair market value assuming a liquidation of the partnership at such time. As a result, its fair market value cannot exceed that liquidation value. The *profits* interest is an interest in the partnership's future value, if any, above the current liquidation value.[81] As will be discussed below, the receipt of a *profits* interest in exchange for providing services to a partnership is generally not treated as a taxable event to either the partner or the partnership unless the *profits* interest relates to a substantially certain and predictable stream of income from partnership assets or if the profits interest is disposed of within two years of receipt. Each

74 *Private Equity Analyst-Holt Compensation Study* (Dow Jones & Co, Inc., Wellesley, Ma.) 2006, at 42.

75 *Id.*

76 Reg. § 1.704-1(e)(1)(v).

77 *Id.*

78 Rev. Proc. 93-27, 1993-24 I.R.B. 63.

79 *Id.*

80 *Id.*

81 A profits interest is an interest in future value, but that should not be confused with future profits. Future profits could consist of value that is currently unrealized, and that value would be part of the capital interest.

of those situations is indicative of a value above and beyond the liquidation value.

B. Carried Interest Granted at Inception of Fund—Only a Profits Interest. At the inception of a venture capital fund, no investments have yet been made. The fund is a "blind pool." In fact, in most cases, no capital has even been drawn down from investors. Since there are no assets to liquidate, there is no capital interest (or the capital interest has no value).

Now assume all capital has been drawn down. The general partner's carried interest would still only be a profits interest. The general partner would also have a capital interest, but that interest would not be attributable to its 20% carried interest. That is, if the general partner contributed $1 million to a $100 million fund and it liquidated immediately thereafter, the general partner would be entitled to $1 million in distributions from the fund (and this would be its capital interest). Since the fund only held cash at that point, there would be no gain or loss to allocate to the general partner. As a result, the carried interest (a 20% share of the fund's profits) would be only a profits interest.

Further, since the general partner paid $1 million for the capital interest, the general partner, upon receipt of that capital interest, would have no tax liability (since there would be no excess between the fair market value of the capital interest which is defined by reference to its liquidation value and the amount paid for such interest). The capital interest takes into account the actual fair market value of the assets that would be realized if all of the fund's assets were liquidated—whether that value is realized or unrealized at the time—but it does not take into account value above and beyond that which could be realized if the assets were liquidated currently.

If, however, the carried interest were granted at a time when the fund's portfolio companies had appreciated value, then a portion of the carried interest received at that time would be a taxable capital interest (see Part II.C. of this Appendix B, below). For example, assume all capital has been drawn down and invested before the general partner was granted its carried interest.[82] Assume further that the investments had appreciated in value from $10 million to $12 million. The general partner's carried interest would now consist of both a profits interest and a capital interest. If the fund could sell the securities immediately upon granting the general partner its carried interest for $12 million, the general partner would recognize 20% of the $2 million gain or $400,000. That $400,000 would be the capital interest portion of the carried interest and would be subject to tax at ordinary compensatory tax rates. The profits interest portion of the carried interest would be any profits that ultimately could be earned above and beyond the $400,000. The profits interest, therefore, is the portion of the partnership interest that constitutes what could be earned by the partnership in the future—beyond what could be realized if the partnership were to liquidate currently. It is an inchoate value, dependent in part on the partners' ability to build value in the portfolio companies held by fund in the future.

The $64 million question in partnership tax law is how that inchoate profits interest should be valued upon receipt, or whether it should be taxable at all.[83] When the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease, or if the profits interest is disposed of within two years, the IRS has indicated that a current liquidation value approach is not necessarily appropriate.[84] But if the income stream is not substantially certain and the interest is not disposed of within two years, and if the profits interest was received in exchange for the provision of services to the partnership, then the IRS would not treat such receipt as a taxable event.[85] Proposed regulations have affirmed this result, though through a different mechanism, by allowing taxpayers to elect a "liquidation value" safe

[82] This situation would not happen since it is the general partner that forms the funds and makes investment decision, but is used for illustrative purposes. This situation could happen, however, with respect to shifts in carried interest among the owners of the general partner as discussed at Part I.C.3. and as occurred with Client C.

[83] *See Diamond v. Commissioner*, 56 T.C. 530 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974); *Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1974).

[84] Rev. Proc. 93-27; Rev. Proc. 2001-43, 2001-43 I.R.B. 191.

[85] Rev. Proc. 93-27; Rev. Proc. 2001-43.

harbor for purposes of valuing profits interests in these situations, effectively resulting in zero tax.[86]

C. Carried Interest Granted During Term of Fund—Profits Interest/Maybe Capital Interest. If a venture capitalist is granted a portion of the general partner's carried interest during the term of a venture capital fund, that carried interest likely will comprise both a capital interest and a profits interest, as described above. As a result, if the carried interest is transferred among venture capitalists or to a new venture capitalist member of the general partner, then a taxable event likely will occur.[87]

During the term of the fund, some portfolio companies may appreciate in value. Even if this value is unrealized and will generate realized profits for the fund in the future, this value does not constitute a profits interest. Rather, because this value would be realized if the fund were to liquidate, these unrealized profits constitute a capital interest. As a result, if that capital interest is transferred in connection with the performance of services (*e.g.,* as the result of a transfer of carried interest when unrealized appreciation exists in the portfolio), the transferee generally will recognize taxable compensation income in an amount equal to the excess, if any, of the fair market value of that capital interest over the amount paid for such interest.

Certainly, such a carried interest will also have a "profits interest" component, and that component will not be subject to tax as described above under current tax law. But it is critical to note that the carried interest can also include a capital interest component with a value that is subject to taxation as compensation income upon receipt.

D. Interaction with Code Section 83. Under Code Section 83, the receipt of property in connection with the performance of services is taxable as compensation income in an amount equal to the amount by which the fair market value of that property at the time of the transfer exceeds the amount paid for the property.[88] If, however, the property is subject to a "substantial risk of forfeiture," such as the vesting restrictions that typically apply to carried interest received by venture capitalists, then the property is not treated as transferred for tax purposes until the risk of forfeiture lapses.[89] In that case, the amount of compensation income (if any) would be based on the then-fair market value of the transferred property as of the time that the risk of forfeiture lapses (*i.e.,* when the carried interest vests).[90] The carried interest granted to most venture capitalists is subject to some type of vesting restrictions.

Although vesting provisions have the effect of deferring the tax liability arising from a compensatory transfer until a later date, this deferral is more likely to result in a higher tax liability for the recipient. For example, if the fund's portfolio companies increased in value over that time, then the carried interest would have a higher liquidation value at that later date and a part of the carried interest would not be a profits interest, but would constitute a taxable capital interest. Taxpayers are entitled, however, to make an election under Code Section 83(b) to have the taxable event for the receipt of unvested property determined as of the date the property is issued, rather than the later vesting date.[91] Although the IRS has stated that a Section 83(b) election need not be made upon a service provider's receipt of a profits interest, many venture capitalists still make Section 83(b) elections because (1) the guidance is not applicable if the interest is disposed within two years (or the other qualifications discussed above regarding the taxation of a profits interest generally), and (2) the proposed regulations would require a Section 83(b) election in order to avoid treating the vesting as a taxable event.[92]

If a Section 83(b) election is made, then the tax treatment of the carried interest upon grant will

[86] Prop. Reg. § 1.83-3(l); Rev. Proc. 2005-43, 2005-24 I.R.B. 1221.

[87] Some commentators and practitioners take the view that changes in profit-sharing ratios among existing partners are permitted without tax effect pursuant to Code Section 761 if effected prior to the partnership's tax return filing date (without giving effect to extensions), although this does not appear to be the prevalent view.

[88] Reg. §1.83-1(a)(i).

[89] Reg. §1.83-3(c).

[90] Reg. §1.83-1(a).

[91] Reg. § 1.83-2(a).

[92] Rev. Proc. 2001-43; Prop. Reg. § 1.83-3(l).

require the inclusion in income of the difference, if any, between the price paid for the capital and profits interests and the fair market value of those interests at the time of issuance (determined without regard to the vesting restrictions).[93] As stated above, if the carried interest is granted at the inception of the fund, this is likely to result in no income inclusions. It very well could result in income inclusions if the carried interest is granted after the fund has made investments in portfolio companies.

Consistent with the treatment accorded to profits interests generally (as described above), the proposed regulations provide a "liquidation value" safe harbor for valuing a partnership interest, assuming that the same conditions described above are met.[94] Under this safe harbor, the value of a partnership interest is the amount that would be distributed in respect of that interest if all partnership assets (including goodwill) were sold for fair market value, all liabilities paid, and the remaining amounts distributed in accordance with the terms of the partnership agreement.[95]

III. Taxation of Carried Interest As a Result of Fund Operations.

A. All Income, Gains and Losses Must Be Allocated Annually. Because a partnership is a flow-through entity for US tax purposes, it is not taxed at the entity level.[96] Instead, each partner of the partnership is taxed on his or her share of each item of income, gain, loss, deduction, or credit of the partnership, regardless of whether or not the partnership actually distributes any cash to the partners.[97] The entire amount of income or loss for any taxable year must be allocated to the partners on an annual basis.

93 Reg. § 1.83-2(a).

94 Prop. Reg. § 1.83-3(l).

95 *Id.* If the election to use the liquidation value safe harbor is not made, code Section 83 generally specifies that property is valued at its fair market value determined without regard to any lapse restriction. Reg. § 1.83-1(a). Fair market value is generally understood to be the price a willing buyer would pay to a willing seller, neither being under any compulsion to buy or sell. *United States v. Cartwright*, 411 US 546, 551 (1973).

96 Code Section 701; Reg. § 1.701-1.

97 Code Section 702(a); Reg. § 1.702-1.

B. Flow-through Tax Treatment to Partners. Once it is determined that the general partner is a partner of the fund and that the venture capitalists are partners of the general partner (as described in more detail below) and assuming that the venture capitalists have made Section 83(b) elections if their carried interests are subject to a substantial risk of forfeiture, then the partnership tax rules of subchapter K of the Code apply to determine how the venture capitalists should be taxed.[98] As such, the partnership is treated as the owner of property and the earner of income and gains generated by the fund, and the partners are subject to tax on their "distributive shares" on an annual basis.[99] Under Code Section 702(b), the character of each item of income, gain, loss, or expense flows through to the partners. The partners are allocated and pay tax on such items in accordance with the "substantial economic effect" provisions of Code Section 704(b). These rules ensure that each partner's tax allocations reflect each partner's economic entitlement from the fund.

C. Overview of Partnership Taxation as Applied to Venture Capital Funds. A venture capital fund's operations are straightforward. In its early years, the fund makes investments in portfolio companies and pays expenses. It might have some nominal interest income earned on partners' capital during the short time between the draw-down of capital and investment in portfolio companies or payment of expenses. In the first three to five years, however, the fund likely will generate a net loss from expenses, and these cumulative net losses generally will be allocated to all partners in proportion to their capital contributions.

When portfolio companies are sold at a gain, the net profit typically first is allocated in proportion to the partners' capital contributions to "reverse" the net losses previously allocated to date (though in some cases, the economic arrangement is such that expense allocations are not reversed). Thereafter, the *cumulative* net profit typically is allocated 20% to the general

98 Reg. § 1.701-2.

99 Code Section 702; Reg. § 1.702-1.

partner and 80% to all partners in proportion to the partners' capital contributions.

The allocation provisions included in the governing documents of many venture capital funds comply with the Code Section 704(b) safe harbor for substantial economic effect. They provide for capital accounts to be maintained in accordance with the capital account maintenance rules set forth in Treasury Regulations; they provide for liquidating distributions to be made in accordance with positive capital account balances; and they require deficit capital accounts to be restored and/or the limited partnership agreement includes a "qualified income offset" provision.[100] Other venture capital funds liquidate in accordance with the regular distribution provisions contained therein and allocate in accordance with each "partner's interest in the partnership."[101]

Most venture capital funds invest only in stock and securities of start-up and growth companies for long-term appreciation. These companies generate very little current income such as interest and dividends. Moreover, most of the portfolio companies are formed as C-corporations.[102] As a result, most venture capital funds are viewed as being engaged in "investing" activities and not as engaged in a trade or business.[103] This results in the expenses of the venture capital fund (including the management fee) being treated as a Code Section 212 expense, limited under Code Sections 67 and 68 and not deductible by taxpayers who are subject to the alternative minimum tax regime.[104]

In short, the vast majority of partnership allocations to venture capitalists consist of long-term capital gain or loss and non-deductible expenses. Because the expenses likely are non-deductible and likely subject venture capitalists to taxation under the alternative minimum tax regime, the venture capitalists' effective tax rates likely are higher than the long-term capital gain rate.

Furthermore, because of the economic arrangements with their limited partners, most venture capitalists are not entitled to receive distributions of carried interest until long after they have paid tax on it. The venture capitalists must pay tax on 20% of the fund's cumulative net profit as it is realized, but generally do not receive carried interest distributions until the fund has returned its investors contributed capital. It is unlikely, however, that the fund will return all contributed capital to its investors until late in the fund's term. That is, before the general partner is entitled to receive carried interest with respect to profitable investments, all contributed capital—including contributed capital used to purchase investments that have not yet been sold—must be returned to investors. In effect, this results in "reverse deferral," or an acceleration of the venture capitalists' taxation (as compared to their receipt of cash), requiring them to negotiate for tax distributions from the fund so that they have at least enough cash to pay their taxes.

The partnership structure, unlike the corporate structure, permits this type of flexibility. It allows different types of items of income to be shared in varying ratios and permits different partners to receive distributions in varying ratios over the term of the fund. This flexible structure is a key component in achieving the appropriate economic incentives to match the entrepreneurial risks taken by the parties.

[100] Reg. § 1.704-1(b)(2).

[101] Reg. § 1.704-1(b)(3).

[102] Within the past 10 years, all 50 states have enacted limited liability company statutes. This has resulted in increased use of the LLC form of business organization for operating companies as it offers both limited liability and flow-through taxation. Although this will result in the venture capital fund being treated as engaged in a trade or business for at least some provisions of the Code (*see, e.g.*, Code Section 875), it is unclear, whether a venture capital fund's management fee would be treated as a Code Section 162 business expense if one or more of the venture capital fund's portfolio companies were organized as LLCs.

[103] *Moller v. U.S.*, 721 F2d 810 (1983), *cert. denied*, 467 U.S. 1251 (1984); *Whipple v. Commissioner*, 373 U.S. 193 (1963).

[104] Code Section 56(b)(1)(a)(i).

Appendix C: Economic Risk Inherent in Carried Interest Structures

I. General Categories of Risk

There are many types of risk undertaken by venture capitalists, some of which significantly differentiate them from other service providers.

A. Risk of Time and Effort (Opportunity Cost). Venture capitalists take risks that are identical to the risks taken by any entrepreneur. They invest their capital and their time in the development of new technology and new businesses, in the hope that their investment will pay off. Often it does not. In exchange, they often give up lucrative careers that provide more stable, guaranteed compensation (like investment banking, consulting, and law).

There is also an important reputational risk to joining a venture capital firm. Given that the best returns are limited to the top 10% to 25% of the funds, there is a high mortality rate for venture firms themselves. Venture capitalists leave stable jobs and spend productive years trying to establish a venture career but can often find that they might not get funded again in the future by their investors. It is difficult to regain a stable job track after a failed venture.

B. Risk Associated with Invested Financial Capital. Though most of the capital comes from outside investors (as is the case with most entrepreneurial ventures), venture capitalists also typically invest a significant amount of their personal net worth in the companies. The amount of capital invested typically represents a significant portion of the venture capitalist's personal net worth. This investment is inextricably linked to the receipt of carried interest since it is generally required both by the investors and under United States tax rules in order to be treated as a "partner." This distinguishes carried interest from a mere option.

The percentage of personal net worth invested in their own funds is significant in analyzing the financial risk undertaken by venture capitalists. For example, assume that the return on a venture capitalist's financial commitment—calculated in the same manner as that of an institutional investor in the fund—continues to be taxed as an item of flow-through partnership income (as the Rangel Bill provides). This return, however, does not necessarily reflect the return that rationally would be required by an investor on his or her financial investment. The "financial return" that venture capitalists would require on their financial commitments should be quite different—much higher—than institutional investors would require. This is because institutional investors typically invest 3% to 10% of their investable assets across the high-risk alternative asset class. Venture capitalists, on the other hand, are more likely to invest a substantial part of their personal net worth in their funds (and without even diversification across the high-risk asset class). Carried interest is a mechanism to deliver the greater financial return that is required by such an investor.

C. Financial Risk Associated with Clawback/Valuation. If the carried interest has previously been received in the form of portfolio company stock, there is a risk that stock will decrease in value before it is or can be sold by the general partner or the venture capitalists. Under almost all agreements, the clawback cannot be satisfied with that depreciated stock. Instead, the venture capitalists have to make up the difference out of their own personal assets. Clawback provisions have become very actively discussed since, post-2000, there were a number of funds and general partners who found themselves in the position of owing a clawback. Investors have continued to insist on these provisions as they serve to align venture capitalists with their interests over the life of the fund.

This risk generally can be reduced by delaying the receipt of carried interest payments to minimize the likelihood of a clawback. Most general partners do not receive any carried interest from their fund until the investors have received a 100% return of their capital contributions to the fund (or, in the most conservative case, the capital commitments to the fund). Though this reduces the risk of a "clawback" obligation, it does not eliminate the risk. Furthermore, the delay of carried interest does not defer or otherwise reduce the tax liability—the venture capitalists still have to pay tax on their shares of profits even if, at such time, they receive no distributions of proceeds.

Delaying receipt of carried interest for such a long time period also makes it more difficult to compete in the market with other types of businesses for talented professionals. The tax rate differential has been one incentive for new venture capitalists to view the delay in receipt of carried interest (often seven years) as worthwhile.

D. Financial Risk Related to Annual Taxation of Cumulative Economic Arrangement. Because the venture capitalists are partners—owners of the fund through the general partners—they have to pay tax on an annual basis, reflecting their economic entitlements to a share of the profits of the fund, including carried interest. Carried interest, however, is calculated on a cumulative basis, so the venture capitalists' actual economic entitlement will not be determinable until the end of the life of the fund.

This can cause tax anomalies resulting in the venture capitalists paying more in tax than they should have—which is a real economic risk of loss. For example, if the carried interest totals $20 million in the early years of the fund, the GP will pay tax on that amount in the years that it was realized by the fund but years before carried interest distribution would have been made. Later losses might result in the overall carried interest equaling only $5 million. (Losses often occur later in the life of the fund after all attempts to make a portfolio company profitable ultimately have failed.) This would result in the venture capitalists paying tax on $20 million even if the venture capitalists are only entitled, ultimately, to $5 million. Although they will receive $15 million in losses, those losses might not be deductible by the venture capitalists because they can only be carried forward to offset capital gains but cannot be carried back.

II. Practical Illustrations of Venture Capital Risk

The following stories illustrate the often overlooked volatile risk profile of the venture capital industry and establish the practical reality of the entrepreneurial risk taken on by a venture capitalist.

Shortly after the Internet bubble burst in the early part of this century, some partners in venture capital firms that focused on information technology found that their real economic losses were quite significant.[105]

Client A. Client A was a nuclear physicist who had worked for a large corporation for many years and who had subsequently started his own, very successful company. After he sold that company, Client A started his own venture capital firm with some like-minded colleagues and formed a $200 million fund to invest in other start-up companies focused on similar technologies. Over several years, the fund called $100 million from its investors, using a portion, during the pre-bubble era, to invest into about 10 companies and the rest to pay expenses, including an annual management fee to Client A's firm equal to 2% of commitments ($4 million per year). The fee was used for the majority of the fund's operating expenses and all of the expenses to run his firm—including office space, computers, insurance, salaries, and payroll taxes for his staff, partners, and himself. As was typical, he and his partners would be entitled to 20% of the fund's cumulative net profits over its 10-year life.

Before the bubble burst, two of the 10 companies went public, resulting in the fund's receiving stock worth $200 million. Because the original investment in these two companies was $20 million, this represented a net gain of $180 million, and with expenses to date of another $20 million, a $160 million cumulative net profit for the fund to date. The fund's limited partners

[105] All identifying information and figures have been blended, simplified and/or changed to maintain client confidentiality.

required that the first $100 million of stock be distributed to the investors. Twenty percent of the remaining $100 million of stock was distributed to the venture capitalists, or $20 million (even though the venture capitalists would ultimately be entitled to $32 million—20% of cumulative net profit of $160 million—if the rest of the portfolio achieved no further gain or loss).

After that big win, the venture capitalists called the remaining capital of $100 million from its investors and used that to invest in companies and pay expenses. Then the bubble burst. It became clear that the rest of the portfolio was going to be a wash-out. The companies failed. Ultimately, the entire $160 million of prior net profit was going to be offset by losses and expenses so that—on a cumulative basis—the fund was going to have a zero net profit.

Now, here was the interesting part. The venture capital fund had a cumulative net profit of $0. This meant that—since 20% of $0 = $0—the venture capitalists were entitled to no carried interest, so they'd have to return the $20 million of stock they had received. But because the venture capitalists were subject to a "lock-up," they had been unable to sell the $20 million of stock and it was now valueless. They were staring down the barrel of a $20 million obligation but had never received the corresponding benefit. It wasn't spent on cars, houses, or private jets. It wasn't sitting in the bank. It had vanished with the risk that is the essence of the venture capital industry.

Client B. Client B worked at a larger venture firm that invested in companies across the information technology and life sciences technology industries. Client B's partners included scientists, engineers, medical doctors, and other technologically savvy professionals. When the technology bubble burst, their situation was a little different. Using the same set of figures as above for convenience, Client B's fund had actually sold securities, rather than distributing them in kind. Client B's group of venture capitalists had received their carried interest of $20 million in cash. But they had paid tax on $36 million—they had paid $7.2 million in US federal income tax at the then-capital gains rate of 20%.[106] Far from deferring taxation, Client B's venture capitalists actually paid tax on $16 million of income in advance of receiving the associated cash. But that was not Client B's biggest concern. Rather, Client B's venture capitalists had an obligation of $20 million but had only received $12.8 million after taxes. Although not as severe as Client A's case, Client B and his partners still had to come up with $7.2 million out of thin air.[107]

Client C. Client C had been an MIT whiz kid who had built up the company he founded with venture capital backing. After 11 years, he sold it to a large Washington-based company. In the late '90s, he was courted by a number of venture capital funds to help build other such companies. He had agreed to join a venture capital firm whose most recent fund (Fund X) had been formed two years earlier. Client C was impressed by the performance of that fund's portfolio of companies. When they brought him on board, Client C was granted 10% of the carried interest of the Fund X general partner. Client C recognized compensation income when he received his share of the carried interest since Client C was treated as having received a capital interest equal to his pro rata share of the unrealized appreciation inherent in the Fund X portfolio of companies. Because the carried interest was subject to vesting, Client C made an election under Code Section 83(b) and paid tax on that value at ordinary income rates. Fund X's value then plummeted after the bubble burst, and Client C received no distributions of carried interest.

These stories illustrate that:

106 Even though the general partner was only entitled to $32 million (20% of the $160 million cumulative net gain), its partners could not deduct the $20 million of expenses. The expenses were Section 212 expenses rather than Section 162 expenses because, like most venture capital funds, its activities are treated as "investing" which are not considered a trade or business. Code Section 212. Since the venture capitalists were subject to the alternative minimum tax, the expenses were not deductible. Code Section 56.

107 Those familiar with venture capital fund arrangements will note that venture capitalists often are limited in their obligation to return overdistributions of carried interest equal to their total carried interest distributions ($20 million here) less an amount equal to their associated tax liability ($7.2 million here) so that the VCs liability would exactly equal the available assets of $12.8 million. This was not the case with Client B. Even if it were, however, the government still likely wins (even if the financial investors do not). Although Client B will be allocated losses equal to the previously allocated gains, those losses will be capital in nature and therefore only deductible against Client B's future capital gains, if any.

- Venture capital is a risky business. Venture capitalists themselves are at real entrepreneurial risk of loss, and their fortunes rise and fall with the companies that they help to build.[108]
- A venture capitalist's carried interest is not like an option received by the employee of a corporation, and it is nothing like an annual discretionary bonus received by an investment banker. Rather, the venture capitalist's carried interest is very similar to the stock received by the founder of a start-up company. The venture capitalist, corporate founder, and sole proprietor each invests intangible assets, time, energy, and money in the hope of building value in his or her business. Corporate founders receive capital gain tax treatment when they sell their businesses.
- It is far too simplistic to assert that a venture capitalist's carried interest is the "single most tax-efficient form of compensation available without limitation to highly-paid executives."[109]
- Tax gamesmanship is not the driving force behind the venture capital structure. As partners, venture capitalists are subject to a complex set of partnership tax rules with a long history of thought behind them. Under these rules, it is inaccurate to say that carried interest is currently subject to tax at 15% or that it is a non-taxable profits interest.
- It is nearly impossible to ascertain the value of a carried interest at the inception of a venture capital fund, and any non-zero value would, in effect, be a tax on unrealized human labor, which may or may not ultimately result in any carried interest distributions. ◎

[108] Conventional wisdom has it that for every ten portfolio companies in which a venture capital fund invests, 5 to 6 will fail, 2 to 3 will make a modest return (or at least recoup its cost), and 1 to 2 will be large enough winners to allow the fund as a whole to outperform the public markets. *Venture Impact: The Economic Importance of Venture Capital Backed Companies to the U.S. Economy* (Global Insight, Inc., Waltham, MA) 2007, at 10-11.

[109] Fleischer, *supra* note 4, at 2.

The Federal Role

Continued from page 5

Priuses aren't going to get us there at any scale that matters, unless we get to a broader rate of diffusion of hybridization of the fleet as a whole.

I think most of us are pretty sober about the impact of prices over consumer behavior. I'm a big believer in public education and technology advancement, and outreach, particularly with the younger generation; but the response we're seeing in consumer behavior is probably a combination of price and awareness – and I'll let other people speak to the likelihood that it's mostly price.

I know a lot of people who struggle to make ends meet and are going to go to the cheapest pump on a given day. That they would pay a premium on E85 would be a stretch.

And so, pushing the technology down the cost curve, using the government balance sheet appropriately to accelerate change and augment financing scenarios, whether it's for efficiency or new technology, I think is better than banking on buzz.

What role do standards play, in terms of getting consumers to adopt this?

AK: They're very important; the market doesn't operate at great levels of foresight. And so, standards and codes to raise the bar on minimum levels of technology utilization, I view as quite important and in need of far greater uniformity across the country.

Not everybody is in agreement with me on that, but Secretary Bodman is. People have noticed we have taken a very strong stand maintaining very healthy clips to the rate of turn on codes and standards – things like appliance codes, working with states on building codes. So, that's an area of renewed emphasis.

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