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Private investment fund managers take a share of the profits of the partnership as the equity portion of their compensation. The tax rules for compensating service partners create a planning opportunity for managers who receive the industry standard "two and twenty" (a two percent management fee and twenty percent profits interest). Compensation is routinely deferred and converted from ordinary income into long-term capital gain. After all is said and done, this quirk in the tax law allows some of the very richest workers in the country to pay tax on their labor income at a very low rate. Changes in the investment world - the growth of private equity funds and hedge funds, the adoption of portable alpha strategies by tax-exempt and tax-indifferent institutional investors, the preference for capital gains, and aggressive tax planning - require reconsideration of the partnership profits puzzle. In this Article, I offer a targeted reform proposal.

The equity compensation of fund managers raises issues of both timing and character. As far as timing is concerned, everyone recognizes that a profits interest in a partnership has economic value. The tax rules -including regulations recently proposed by the Treasury Department - allow taxpayers to count only the liquidation value of the partnership interest and ignore its option value. Because the liquidation value of a profits interest is zero, the granting of a profits interest is not treated as a taxable event. Commentators accept this status quo because of concerns about administrative convenience, a reluctance to taxing endowment, and comparisons to the tax code's generous treatment of equity compensation in the context of sole proprietorships and corporations. None of these concerns holds up well in the context of private investment funds.

I propose that, under certain circumstances, investment partnerships with more than \$25 million in capital under management be required to use a "cost-of-capital" approach. The general partner (GP) would be allocated an annual cost-of-capital charge (e.g. 6% of the 20% profits interest times the total capital under management) as ordinary income. The limited partners (LPs) would be allocated the corresponding deduction (or would capitalize the expense, as appropriate). This approach allows the tax treatment to more closely reflect the economics of the arrangement: in the typical fund, the GP effectively receives a non-recourse, interest-free compensatory loan of 20% of the capital in the fund, but the foregone interest is not taxed currently as ordinary income, as it would be under section 7872.

This cost-of-capital approach to timing also provides a reasonable compromise on the character issue. As when an entrepreneur takes a below market salary and pours her efforts back into the business as "sweat equity," the appreciation in the value of a private equity fund reflects a mix of labor income and investment income. A cost-of-capital approach disaggregates these two elements, allowing service partners to receive the same capital gains preference that they would receive on other investments, but no more.