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THE SHIELD OF "UNINTENDED CONSEQUENCES": ANALYZING VENTURE CAPITAL'S DEFENSE AGAINST INCREASED CARRIED INTEREST TAXATION

I. INTRODUCTION

Congress is considering two bills to treat carried interest, popular with private equity firms for its low tax rate, as just another form of general income for tax purposes. [1] As the debate over increasing taxation to 35%[2] on profits for general partners of private equity firms and from multi-billion dollar leveraged buyouts continues, other industries are becoming concerned.[3] The issue of taxation on carried interest is even more complex than the headlines suggest. This is *not* only about buyout firms. In fact, politicians like Senator Charles Schumer have refused to support tax legislation that applies only to private equity[4] and even the National Association of Realtors has stepped forward.[5] Venture capitalists also rely on carried interest,[6] and increased taxation would be a blow to their profitability.

Other businesses are justifiably worried that congressional action will lead to "unintended consequences,"[7] and both investors in start-ups and

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1. H.R. 2834, 110th Cong. (2007); S. 1624, 110th Cong. (2007). Carried interest is a unique form of return on investment used by investment fund managers. Instead of being paid salaries, fund managers actively invest client's money and receive payment for their management services with a percentage of the profits (interest) received on those investments.

2. *The Taxation of Carried Interest: Hearing Before the S. Comm. on Finance*, 110th Cong. 15 (July 11, 2007) (testimony of Peter R. Orszag, Director of the Congressional Budget Office), *available at* http://www.senate.gov/~finance/hearings/testimony/2007test/071107testpo.pdf [hereinafter Orszag Testimony] ("[O]rdinary income for high-income taxpayers is typically subject to a 35 percent marginal income tax rate and . . . [l]ong-term capital gains for such taxpayers are typically subject to a 15 percent tax rate.").

3. Jessica Holzer, *Realtors Take Aim at Private Equity Tax Hike Plan*, THE HILL, Aug. 3, 2007; Kevin Drawbaugh, *Business Group Backs Carried Interest Tax Break*, REUTERS, Sept. 4, 2007; *Minority Group Joins Fight Over Carried Interest*, N.Y. TIMES, Sept. 5, 2007; Energy master limited partnerships invest in and manage gas pipelines, which are capital intensive. *See* David Givens, *Gas Processors Report: Is The Carry Going to Get You?*, Aug. 15, 2007, *available at* 2007 WLNR 16173143.

4. Raymond Hernandez & Stephen Labaton, *In Opposing Tax Plan, Schumer Breaks With Party*, N.Y. TIMES, July 30, 2007, at A1.

5. Realtors are protesting tax increases on limited partnerships that rely on carried interest and that commonly invest in real estate. Holzer, *supra* note 3 ("The fact of the matter is that real estate is more broadly affected. It is a major stakeholder in this issue.") (quoting Steve Renna, senior vice president and counsel to the Real Estate Roundtable).

6. *See* Marco V. Masotti, *Private Equity Funds: Current Terms and Trends*, 1617 PLI/CORP 213 (2007). When venture capital funds invest in a company, they are given part ownership of the enterprise, which is called a profits interest (an interest in the profits). The fund receives returns on the investment when it realizes profits, but the portion of the return that the general partner takes for himself is carried interest.

7. Press Release, Nat'l Venture Capital Ass'n, National Venture Capital Association Statement on Carried Interest Bill (June 22, 2007), http://www.nvca.org/pdf/carriedinterestbillstatement.pdf.

sellers in the real estate market alike may find that the market may shift substantially if Congress decides to increase taxation of carried interest. This note argues that a tax increase on carried interest is a good idea, and private equity managers should be paying the same taxes that middle America does.[8] The "unintended consequences"[9] of increasing carried interest taxation are not as significant as 2007's lobbying has made it seem, and many industries that may be affected by carried interest taxation are reasonable targets.[10] Furthermore, proposed legislation will not increase taxes on all carried interest.[11] Venture capital firms should be especially concerned because the strength and nature of venture capital business indicates that they should be more than a mere unintended target.

The debate on carried interest also necessarily focuses on the underlying policy reasons for tax incentives in investment.[12] Closing tax loopholes is commonplace and market economies are structured to respond to changing taxation naturally.[13] There is money to be made in investment[14] and Congress should not believe the arguments made against increased taxation. Venture capitalists argue that they are unique in the carried interest debate and that they should be spared higher taxation for the sake of the American economy,[15] but ranking Senate members in Washington are not easily convinced[16] and there are many reasons to place venture capital in the same tax bracket as middle America.

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8. The average American worker pays the general income tax, which can be as high as 35%. Press Release, Citizens for Tax Justice, Myths and Facts About Private Equity Fund Managers – and the Tax Loophole They Enjoy (July 2007).

9. *See* Press Release, Nat'l Venture Capital Ass'n, *supra* note 7.

10. For discussion, see Part V.C.

11. Entrepreneurs who do not provide investment services and carried interest proportionate to personal investment will not be taxed. H.R. 2834, 110th Cong. (2007).

12. *See* Victor Fleischer, *The Missing Preferred Return*, 31 J. CORP. L. 77 (Fall 2005).

13. *See* Michael S. Knoll, *The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of Taxing Profit Interests as Ordinary Income* (Univ. of Pa. Law Sch. Inst. for Law & Econ., Research Paper No. 07-20, 2007) (arguing that firms using carried interest have a variety of choices including shifting the tax burden if the carried interest loophole is closed).

14. Actual profit figures are unavailable because partnerships do not provide annual reports and investments paid out in carried interest are not taxed until realized, which is upon sale of a portfolio company.

15. GLOBAL INSIGHT, VENTURE IMPACT: THE ECONOMIC IMPORTANCE OF VENTURE CAPITAL BACKED COMPANIES TO THE U.S. ECONOMY 5 (4th ed. 2007), http://www.nvca.org/pdf/NVCA_VentureCapital07.pdf ("Venture capital backed companies outperformed their non-ventured counterparts in job creation and revenue growth.").

16. Press Release, Sen. Max Baucus, Chairman of the Senate Committee on Finance, Carried Interest, Part 1: Opening Statement of Sen. Max Baucus (D-Mont.) (July 11, 2007), *available at* http://www.senate.gov/~finance/hearings/statements/071107mb.pdf ("The United States economy is strong and dynamic. Our entrepreneurship creates new jobs. We do not want to stifle the mother of invention. On the other hand, we wish to ensure fair treatment under the tax code."); *see also* Press Release, Sen. Chuck Grassley, Ranking Member of the S. Comm. on Finance, Statement of Sen. Chuck Grassley, Hearing, Carried Interest, Part 1 (July 11, 2007), *available at* http://www.senate.gov/~finance/hearings/statements/071107cg.pdf ("We can't allow the carried

To understand why the proposed carried interest taxation is reasonable, it is necessary to look at why capital gains taxation exists. Venture capitalists believe that their returns on investment are distinct from other common issues of carried interest compensation. However, the reality of an efficient market and underlying policy issues suggest that venture capital should not be treated differently. Part II of this note provides a survey of the venture capital industry, including its recent growth and role in the American investment marketplace and explains how the industry will be affected by increased taxation. It also examines the nature of risk-taking (an issue to be addressed further in Part V.A) and profitability in the venture capital industry. Part III provides an introduction to carried interest and the lower capital gains taxation rate. It explains which industries commonly structure their businesses to take advantage of lower taxation and the difference between the proposed bills on carried interest. Part IV gives a survey of recent tax reform that affected venture capital.

Part V addresses the arguments made by venture capitalists against increased taxation. Part V.A addresses the effects of changing the cost/benefit equation established in the industry, which includes the risk-taking nature of the industry, the need for providing incentives to fund managers, and the likelihood that opportunities in the global investment landscape will encourage an exodus of American venture capital firms and managers. Part V.B provides justifications for altering the present definition of carried interest and treating it as income from services rendered as opposed to capital gain. Finally, Part V.C addresses the effects of shifting the tax burden, how other industries and investors will be affected, and how the policy reasons behind proposed legislation indicate that the venture capital industry is not an unintended casualty.

II. SURVEY OF THE VENTURE CAPITAL INDUSTRY

Venture capital funds invest in companies that have not had a public offering of stock.[17] Those companies market themselves to venture capitalists to attract investments when they need a significant capital outlay to expand their businesses.[18] In return for providing money,[19] venture capitalists are given equity in the business, and often a negotiated number of director seats so that the venture capital fund has a say in the

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interest tail to wag the capital gains dog . . . I wouldn't call it a no-brainer that all those [carried interest] profits should be taxed as a return on investment rather than a return on labor.").

17. Masotti, *supra* note 6, at 215.

18. *Id.* at 215–16.

19. Venture capitalists typically provide between $10 million and $15 million in return for an ownership position. *See* Dwayne Moyers & Crystal Detamore-Rodman, *Pursing Venture Capital: Determine Whether You're a Good Candidate For Institutional VC Funding*, ENTREPRENEUR.COM, June 20, 2007, http://www.entrepreneur.com/money/financing/venturecapital/article180654.html.

management of the start-up.[20] As such, venture capital funds do not simply provide cash to start-up companies; they also provide market expertise and constant, active management to help the business succeed and maximize its value.[21] The goal of a venture capital fund is to invest in a private company and to expand the business until it can be sold for a profit to another company, or until the venture company can issue stock in an initial public offering (IPO).[22] Arguably, an IPO is the best end-result for a venture investment because the private market for sale of a company is much smaller than the market for shares of a corporation. Therefore, a venture capital firm will be able to get the greatest dollar amount offered for its prior equity investment.

Companies are divided into "stages" that help define how early in their business development they are prior to going public.[23] Venture capital firms use stages as an investment strategy to diversify the group of companies they invest in and to consider what type of management assistance each company will need. Furthermore, staging investments and investing with other venture capital funds helps to limit the risk exposure of a fund.[24] Venture capitalists do not solely invest in companies that are months away from going public. In fact, less than half of the money invested in the second quarter of 2007 was invested in "later stage" companies.[25] During that period, $221 million was invested in startup/seed companies, $1.388 billion was invested in early-stage companies, $2.377 billion was invested in expansion companies and $3.142 billion was invested in later stage companies.[26] In total, "[v]enture capitalists invested $7.1 billion in 977 deals in the second quarter of 2007 — the highest level of deals reported in a quarter since Q3 2001."[27] Those figures indicate that venture capitalists can look forward to recording carried interest figures when their investments are sold or go public.

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20. "*Carried Interest": Hearing Before the S. Comm. on Finance*, 110th Cong. at 5 (July 11, 2007) (testimony of Kate D. Mitchell, Managing Director of Scale Venture Partners), *available at* http://www.senate.gov/~finance/hearings/testimony/2007test/071107testkm.pdf [hereinafter Mitchell Testimony].

21. *Id.*

22. Moyers, *supra* note 19 (if the company can neither go public or be acquired, there is little opportunity for sufficient profit which would entice a venture capital fund to invest millions of dollars).

23. Robert P. Bartlett, III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 52–53 (2006).

24. *Id.* at 42.

25. NAT'L VENTURE CAPITAL ASS'N, MONEYTREE REPORT: Q2 2007 US RESULTS at 4 (2007), *available at* https://www.pwcmoneytree.com/MTPublic/ns/moneytree/filesource/exhibits/2Q07MoneyTree_Report.pdf ("later stage" companies are predicted to be the companies closest to an IPO).

26. *Id.*

27. *Id.*

Venture capital investments appear risky because only 20% of venture-backed companies "achieve realizable and meaningful gains."[28] Of the remaining 80%, half "lose some or all of the invested money,"[29] and half "generate a modest profit."[30] To hedge their bets, "a venture fund might make investments in ten or fifteen portfolio companies."[31] Because multiple investments are required to spread the risk, venture capital funds will require investors to commit to investment prior to selecting their portfolio companies.[32] Partners who invest money do not expect to see returns immediately; due to the nature of investing in companies, investments are usually for a period of five to ten years, at which time the company will hopefully go public.[33] The final realized profit on an investment is the money raised from the IPO or sale.

III. CARRIED INTEREST AND ITS USE IN PARTNERSHIPS

Venture capital funds, buyout funds, hedge funds and "similar alternative investment vehicles"[34] (each is a type of "private equity" fund) choose to structure their businesses as partnerships to avoid the corporate tax rate as well as other burdensome corporate regulations.[35] In a partnership, profits pass through to the individual partners and the government taxes each individual partner instead of the entity as a whole.[36] The partnership structure gives businesspeople the flexibility to distribute profits in a more tax-efficient manner by allowing each partner to be taxed solely on his own investment.[37] Private equity funds take advantage of that efficiency by structuring the partnership to separate the profits of the investors from those of management.[38] Each investor becomes a limited partner and the general partner is a separate management entity.[39] Investors provide the vast majority of capital, while the general partner manages the

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28. Mitchell Testimony, *supra* note 20, at 7.

29. *Id.*

30. *Id.*

31. Fleischer, *supra* note 12, at 87.

32. Knoll, *supra* note 13, at 2.

33. Mitchell Testimony, *supra* note 20, at 7.

34. STAFF OF THE JOINT COMM. ON TAXATION, 110TH CONG., PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS AND RELATED ISSUES, PART I, at 2 (Sept. 4, 2007) [hereinafter JOINT COMM. ON TAXATION REPORT, PART I].

35. Orszag Testimony, *supra* note 2, at 5–6 ("[N]oncorporate forms of conducting business . . . were created in part to avoid the potential distortions associated with corporate taxation.").

36. *Testimony of Treasury Assistant Secretary for Tax Policy Eric Solomon Before the Senate Committee on Finance*, 110th Cong. 2 (July 11, 2007), *available at* http://www.senate.gov/~finance/hearings/testimony/2007test/071107testes.pdf [hereinafter Solomon Testimony].

37. *Id.*

38. Even though a manager's return is taxed the same as a limited partner's, his carried interest is contingent and is never proportionate to his own investment. *See id*.

39. JOINT COMM. ON TAXATION REPORT, PART I, *supra* note 34, at 3.

fund, provides expertise in deciding what investments to make and consults the companies it chooses in order to maximize the value of the investment.[40]

In a typical private equity fund, the general partner's compensation is "two and twenty."[41] For its services, the general partner receives a 2% management fee and 20% of the profits.[42] More successful and well-known private equity funds can and do charge more.[43] The management fee covers "ongoing operational expenses of the manager, such as rent, salary and other overhead items."[44] However, the real incentive for the manager is the profits,[45] because successful management nets the general partner one-fifth of every dollar earned on the limited partner's capital. "Carried interest" is a term that describes the general partner's interest in the profits of the investment.[46] Although 20% of profits may seem high when the general partner provides little or no capital, there is no shortage of willing investors,[47] which suggests that 20% is a fair market rate. Investors prefer carried interest over a larger, flat management fee because it is economically efficient; it provides incentives for the general partner and, in turn, protects the investors from disinterested management who would otherwise collect a flat fee and have no incentive to actively monitor the investment.[48] Furthermore, venture capitalists prefer carried interest specifically because tax legislation treats it as a return on investment.[49] Returns on capital investments receive beneficial taxation compared to general income, though there are exceptions.[50]

If capital investments are made for a period longer than one year, they are taxed at a lower capital gains rate instead of the general income rate.[51]

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40. Mitchell Testimony, *supra* note 20, at 5 (Limited partners in venture capital funds are usually "institutional investors such as pension funds, universities and endowments, and private foundations [that] typically provide between 95 to 99 percent of the capital for the fund").

41. Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds* (Legal Studies Research Paper Series, Working Paper No. 06-27, 2007).

42. The management fee is typically 2% of the fund's assets, not the profits. JOINT COMM. ON TAXATION REPORT, PART I, *supra* note 34, at 3.

43. Masotti, *supra* note 6, at 223 ("a general partner with a strong track record may receive a carried interest percentage of as high as 25% to 30%").

44. *Id.* at 227.

45. Joseph W. Bartlett, *Why Plan to Change Carry Tax is Misguided*, VENTURE CAPITAL J., Aug. 2007, at 31.

46. Masotti, *supra* note 6, at 223.

47. Fundraising for venture funds increased every year from 2002 ($3.8 Billion) to 2006 ($30.9 Billion), and "[t]he level of dollars raised by the firms suggests a continued demand by institutional investors for quality venture capital investment opportunities." Press Release, Nat'l Venture Capital Ass'n, Venture Capital Fundraising Activity Healthy and Prudent in Second Quarter of 2007 (July 16, 2007), http://www.nvca.org/pdf/Q207VCFundraisingfinal.pdf (quoting Mark Heesen, president of the NVCA).

48. *See* Fleischer, *supra* note 41, at 5.

49. *See* Knoll, *supra* note 13, at 4.

50. Capital investments made for less than one year do not qualify for the capital gains rate. *See id*.

51. Knoll, *supra* note 13, at 4.

The lower capital gains rate encourages long-term investments, which are essential to economic growth.[52] Limited partners' returns on investment in private equity funds are typically subject to the capital gains rate,[53] but general partners also manage to receive the same treatment because their carried interest is profit from the capital investment made by the limited partners. Although it is not the general partners' money, tax law treats the carried interest substantively as the same form of investment return. The benefit to the general partner is significant: Tax on payment for management is the 15% capital gains rate and not the 35% income tax.[54] As a result, managers of successful private equity funds earn millions of dollars more than the average American, but are taxed at a far lower rate.[55]

Congressional response to the inherent tax inequalities in carried interest tax treatment initially occurred as the result of a working paper by Professor Victor Fleischer of the University of Illinois College of Law that addressed the carried interest tax loophole and the inherent inequalities it creates.[56] After Professor Fleischer posted a draft of his paper online, Senate staff contacted him to testify in a closed-door briefing.[57] Soon after his statements before select members of Congress,[58] both the House and Senate drafted laws to close the tax loopholes Professor Fleischer addressed. However, the two bills have substantially different features. While the Senate bill solely addresses a tax loophole for publicly traded partnerships that often also use carried interest, [59] the House bill addresses partnerships that go public as well as taxation of managers using carried interest.[60]

The House bill, H.R. 2834, addresses taxation of investment managers that do not provide their own capital to a partnership. The bill treats partnership profit interests as ordinary income if they involve "a substantial quantity" of investment services including:

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52. *See Testimony of ACCF President Mark Bloomfield Before the Committee on Ways and Means of the U.S. House of Representatives*, 105th Cong. (March 19, 1997), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=105_house_hearings&docid=f:4861 6. pdf.

53. Knoll, *supra* note 13, at 4.

54. Solomon Testimony, *supra* note 36, at 3 (compensation for services is usually taxed at ordinary income rates).

55. *See* Fleischer, *supra* note 41, at 3 ("Almost nine times as many Wall Street managers earned over $100 million as public company CEOs; many of these top-earners on Wall Street are fund managers. And they pay tax on much of that income at a 15% rate, while the much-maligned public company CEOs, if nothing else, pay tax at a 35% rate on most of their income.").

56. Fleischer, *supra* note 41, at 6–7.

57. Jerry Crimmins, *He Finds His Sudden 'Fame' a Bit Taxing*, CHI. DAILY L. BULL., July 20, 2007, at 3.

58. *Id.*

59. S. 1624, 110th Cong. (2007).

60. H.R. 2834, 110th Cong. (2007). This note focuses solely on the debate over carried interest taxation as it affects management of private partnerships, not tax loopholes that prevent the corporate tax rate from applying to certain publicly traded partnerships.

> (A) Advising the partnership as to the value of any specified asset.
> (B) Advising the partnership as to the advisability of investing in, purchasing, or selling any specified asset.
> (C) Managing, acquiring, or disposing of any specified asset.
> (D) Arranging financing with respect to acquiring specified assets.
> (E) Any activity in support of any service described in subparagraphs (A) through (D).[61]

"Specified assets" include 1) securities, 2) real estate, 3) commodities, and 4) any options or derivatives with respect to the three.[62]

The bill avoids increasing taxation on capital investments to encourage general partners to invest their own money in the partnership, because partners are only taxed at the higher income rate if their portion of the profits does not result from a proportionate share of personal capital investment.[63] Limited partners maintain the capital gains rate, but general partners are taxed at the higher income rate for any profits received solely as a result of management of a limited partner's funds.[64] Therefore, general partners are taxed at 15% if they made a proportionate capital investment to the other partners, but those who wish to receive compensation for their management services cannot take advantage of the tax loophole by receiving a carried interest instead of a management fee.[65]

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61. *Id.*
62. *Id.*
63. If—

> (i) a portion of an investment services partnership interest is acquired on account of a contribution of invested capital, and
>
> (ii) the partnership makes a reasonable allocation of partnership items between the portion of the distributive share that is with respect to invested capital and the portion of such distributive share that is not with respect to invested capital,
>
> then subsection (a) shall not apply to the portion of the distributive share that is with respect to invested capital. An allocation will not be treated as reasonable for purposes of this subparagraph if such allocation would result in the partnership allocating a greater portion of income to invested capital than any other partner not providing services would have been allocated with respect to the same amount of invested capital.

Id. (subsection (a) provides that generally, carried interest will be treated as general income).

64. *See id.*
65. *See* Press Release, Nat'l Venture Capital Ass'n, *supra* note 7. To provide some examples, in situation 1, the general partner is compensated with a 2% management fee and a 20% carried interest, but the limited partners provide all of the capital. Prior to H.R. 2834, the management fee would be taxed at the 35% ordinary income rate and the carried interest to the general partner would be taxed at the 15% capital gains rate. Subsequent to H.R. 2834, they would both be taxed at the 35% ordinary income rate. In situation 2, the general partner receives the same compensation, but he provides 10% of the capital invested. Prior to H.R. 2834, the management fee would be taxed at 35%, but the carried interest would be taxed at 15%. Subsequent to H.R. 2834, the management fee would still be taxed at 35%. However, because the general partner provided 10% of the capital but received 20% of the profits, one-half of his carried interest would be taxed at the 15% capital gains rate because it was the proportionate profits to his investment.

Private equity firms ominously argue that the result of H.R. 2834 will not simply be an increased tax burden for them. Their complaints fail to recognize that there will be some positive effects on the market, however. First, tax revenues will initially increase as the result of the carried interest loophole closing.[66] Second, taxation of investing will become more efficient as long-term capital investment continues to be encouraged, without allowing managers with limited personal capital risk to reap a disproportionate share of the profits.[67] Finally, general partners will be encouraged to invest their own money if they want to maximize their own profits, thereby increasing their own risk and in turn protecting investors to a greater extent by aligning the interests of the investors and the managers.[68]

IV. RECENT HISTORY OF TAXATION REFORM

There is a long history of taxation reform and its effects on venture capital, though some of the most important tax changes have occurred within the last forty years. "Prior to 1979, pension funds were severely limited by" the "Employee Retirement Income Security Act's (ERISA) 'prudent man' rule."[69] Pension funds represented one of the largest groups of institutional investors,[70] who were and are to this day responsible for a substantial portion of investment capital in the American economy.[71] To expand investment opportunities, the prudent man rule was changed to allow managers of pension funds to invest a maximum of 10% of their fund's capital in higher-risk investment opportunities, including venture capital funds.[72] The influx of capital increased "annual new contributions to venture capital funds from $100–200 [million] during the 1970s to in excess of $4 billion by the end of the 1980s."[73] However, the Tax Reform Act of 1986 quickly cut into that increase in capital investment when it removed

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The remaining one-half would be taxed at 35% because it was profits paid directly as a result of the general managers services, not capital.

66. Knoll, *supra* note 13, at 10–12 ("[P]rivate equity funds raised more than $200 billion in 2000 and 2006, but less than that in all other years . . . [a]ssuming $200 billion is invested each year in private equity funds, the additional tax collected would amount to between $2.6 billion and $4.2 billion a year.").

67. AVIVA ARON-DINE, CTR. ON BUDGET & POLICY PRIORITIES, AN ANALYSIS OF THE "CARRIED INTEREST" CONTROVERSY 2 (rev. Aug. 1, 2007), *available at* http://www.cbpp.org/7-31-07tax.htm ("Generally speaking, a tax system is more efficient when it treats like activities alike: rather than having tax rates determine how people allocate their resources, it is better for the tax system to create a level playing field.").

68. General partners will receive the same return on investment as limited partners, so their interests will be more aligned. *See* Fleischer, *supra* note 12, at 94–95.

69. Paul A. Gompers, *The Rise and Fall of Venture Capital*, 13 BUS. & ECON. HIST. 1, 2 (1994).

70. *See id.* at 13 (by 1988, pension funds were the largest investors in venture capital).

71. JOINT COMM. ON TAXATION REPORT, PART I, *supra* note 34, at 19.

72. Gompers, *supra* note 69, at 2.

73. *Id.*

the lower capital gains rate and taxed capital gains as ordinary income.[74] One swift legislative move thus destroyed the main tax incentive to long-term investment: "[V]enture-capital investment fell from roughly $4 billion in 1987 to under $1.4 billion" in 1991 because of the increased taxation.[75] Twenty-two years after the precipitous drop, Congress passed the Jobs and Growth Tax Relief and Reconciliation Act of 2003.[76] The act lowered the capital gains rate to 15%, and later bills extended capital gains tax protection through 2010.[77] Investing in the second quarter of 2007 was the highest since 2001.[78] Clearly, taxation reform has historically had a dramatic effect on venture capital.

However, the present proposed legislation has a much more limited scope than previous tax changes. Unlike the limitations on investment made by the "prudent man" rule, taxation on carried interest will only directly affect general partners, not investors.[79] Limited partners in venture capital funds are still taxed at the capital gains rate because they do not use carried interest.[80] The legislation proposed is also dissimilar to a change in the capital gains rate: Increased taxation of capital gains affects all investors in venture capital funds, but taxation of carried interest only directly affects venture capital managers' profits.[81] While capital gains taxation may make investment overall less profitable, only a tiny fraction of investors today who would normally be affected by broad capital gains taxation use carried interest.[82] Venture capitalists are concerned by congressional attempts to increase tax on carried for one reason: profit. However, their justifications for maintaining the tax loophole are not quite as simple.

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74. Steve Lohr, *Venture Capital: Looking For Stars*, N.Y. TIMES, Dec. 24, 1992 (the Reagan administration intended to simplify the tax system by treating capital gains and general income the same).

75. *Id.*

76. Press Release, The White House, President Signs Jobs and Growth Tax Relief and Reconciliation Act of 2003 (May 28, 2003), *available at* http://www.whitehouse.gov/news/releases/2003/05/20030528-9.html ("The benefits of the Jobs and Growth Act will also go to investors. The top capital gains tax rate will be reduced by 25 percent, which will encourage more investment and risk-taking, and that will help in job creation.").

77. Tax Increase Prevention and Reconciliation Act of 2005 § 102, H.R. 4297, 109th Cong. (2006).

78. NAT'L VENTURE CAPITAL ASS'N, *supra* note 25, at 1.

79. *See* Gompers, *supra* note 69, at 12 (noting that "capital gains taxation has a [relatively] small impact on the amount of money flowing into the venture capital industry" because the majority "of the money flowing into new funds is from tax-exempt sources").

80. Carried interest is a form of return solely when there is no capital contribution by the manager. *See* JOINT COMM. ON TAXATION REPORT, PART I, *supra* note 34, at 3.

81. Presently, every partner's return is treated as capital gain, but congressional legislation would only affect those partners that did not provide a proportionate capital investment. *See* H.R. 2834 § 710(c)(1), 110th Cong. (2007).

82. Capital gains taxation would apply to the 95% of investment from limited partners (assuming they are not tax-exempt), but carried interest taxation would only affect the remaining 5% from general partners. *See* Mitchell Testimony, *supra* note 20, at 5.

V. THE VENTURE CAPITAL INDUSTRY'S RESPONSE

Venture capital funds believe that carried interest should not be taxed as general income for three main reasons. First, the investment market has already established a cost-benefit balance that will be upset by increased taxation.[83] Second, venture capitalists have built equity in their portfolio companies by providing unique management services and therefore, their profit should be treated as profit resulting from a capital gain.[84] Finally, taxing carried interest will have "unintended consequences,"[85] affecting a variety of industries that use carried interest, people that invest in those industries, and the American economy as a whole.[86] This note addresses each of these arguments against carried interest taxation in turn.

A. CHANGING THE COST/BENEFIT EQUATION

To defend the present cost/benefit equation, venture capitalists highlight the economics of venture capital and the other opportunities available for investment. First, they believe venture capitalists will not enter the market if profits are decreased.[87] Second, tax benefits should exist for industries such as venture capital that take significant business risk.[88] Third, carried interest is a necessary incentive to managers that protects investors and encourages intelligent investing.[89] Fourth, without the beneficial tax treatment of carried interest, managers will leave the venture capital industry for greener pastures.[90] Finally, venture capital firms will be forced to transfer their business to foreign countries with better tax structures for investing in start-ups.[91] However, deeper review suggests the market will quickly adapt to taxation of carried interest and venture capitalists' concerns are taken to an extreme.

1. Decreasing Profits

A direct effect of increased taxation will be to decrease the after-tax returns that managers receive from investment in portfolio companies. By decreasing profitability, a number of venture capitalists could be forced out of the market, or at least discouraged from entering it.[92] However,

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83. *Id.* at 14 ("Our limited partners . . . must be assured that their costs of investing in venture funds will not increase because the balance of partnership income is suddenly thrown off kilter.").

84. Venture capitalists refer to the ownership rights created by management services as "sweat equity." *See Id.* at 6.

85. *See* Press Release, Nat'l Venture Capital Ass'n, *supra* note 7.

86. *See* discussion *infra* Part V.C.

87. *See* Mitchell Testimony, *supra* note 20, at 13 ("[W]e are still a small and fragile industry.").

88. JOINT COMM. ON TAXATION REPORT, PART I, *supra* note 34, at 56.

89. *Id.* at 59.

90. Bartlett, *supra* note 45.

91. *Id.*

92. *See* Mitchell Testimony, *supra* note 20, at 13.

investment at levels not seen since 2001[93] indicates that the venture capital industry can withstand a shift of the cost-benefit equation.

Venture capitalists aim to portray themselves as both powerful and responsible for the success of the American economy, but also weak and barely profitable to the point at which applying the ordinary income tax would force them to close up shop.[94] In between 1991 and 2004, only about 35% of U.S. venture funds generated carried interest and therefore, few funds were profitable.[95] However, 11% generated $50 million or more, with eight firms earning over $500 million in carried interest.[96] At first glance, those numbers indicate that the majority of venture capital firms cannot afford increased taxation. However, 11% were making enough money to be extremely profitable even if there were increased taxation, and if 35% of firms generated carried interest, then 65% of venture firms during that same period would not have been affected at all by a higher taxation rate. Furthermore, as funds mature the amount of carried interest rises dramatically.[97] Therefore, many of those same funds can expect greater returns than the above figures even suggest.

Of the 11,686 companies first funded[98] between 1991 and 2000, only 18% are known to have failed, and 47% were acquired, went public, or are going public.[99] Considering the goal of venture capitalists is sale or an IPO, and public offerings typically provide exponential returns to investment,[100] those figures imply strong returns on investment. Furthermore, performance indices show there are positive returns on average for venture capital funds' investment outlook.[101] Profits that are realized in one year are equal to 18.1% of capital invested; in ten years (the highest point) they are 21%, and in five years (the lowest point) they are 2.7%.[102] The one-year outlook is almost double that of the S&P 500 and the ten-year investment outlook is more than triple that of the S&P 500.[103] In terms of present value to venture capital managers, each $100 invested is worth $8.98 of carried interest and

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93. NAT'L VENTURE CAPITAL ASS'N, *supra* note 25, at 5.

94. Mitchell Testimony, *supra* note 20, at 2–4 (noting that venture capital is a founder and builder of the American economy, but it is "still a cottage industry" that is "small and fragile").

95. JOINT COMM. ON TAXATION REPORT, PART I, *supra* note 34, at 23.

96. *Id.*

97. *Id.*

98. That is, invested in by venture capital firms.

99. GLOBAL INSIGHT, *supra* note 15, at 11.

100. John H. Cochrane, The Risk and Return of Venture Capital 1–2 (Mar. 19, 2004) (unpublished manuscript, *available at* http://faculty.chicagogsb.edu/john.cochrane/research/Papers/ venture.pdf).

101. Press Release, Nat'l Venture Capital Ass'n, Venture Capital Out Performance Holds Steady in Period Ending Q1 2007 (Aug. 2, 2007), *available at* http://www.nvca.org/pdf/Q107VCPerformanceFINAL.pdf.

102. *Id.*

103. *Id.* The Standard & Poor 500 ("S&P 500") is an index of U.S. equities that is commonly used as a measuring stick for investments. Standard & Poor's 500 Index (S&P 500), http://www.investopedia.com/terms/s/sp500.asp (last visited Apr. 14, 2008).

$14.80 in management fees.[104] It is no surprise that managers want to prevent carried interest legislation when the venture capital industry is earning such astonishing profits.

Near-record figures indicate two things: First, venture capital remains an extremely attractive form of investment and therefore, it is safe to infer that there is no shortage of profits for limited partners.[105] Second, venture capitalists have increasing amounts of capital invested and because management fees rise proportionately with capital invested and carried interest increases proportionately with capital invested when investments are profitable, there is no shortage of profits for general partners.[106] Venture capitalists' arguments today against increased taxation are no different from those made in the past, and they are entirely self-serving: "While venture capitalists may argue vehemently for decreases in the capital gains rate, the ones who would benefit most from such a reduction are the venture capitalists themselves."[107]

2. Encouraging Risk-Takers

A key component to the cost-benefit equation is the level of risk that venture capitalists take on when helping fledging entrepreneurs develop their businesses. With higher risks come the possibility of greater costs and lower benefits. However, while encouraging risk takers is an important way to stimulate economic growth,[108] risk also benefits the risk-taker. Risk occurs in all markets; attorneys on contingency, doctors, professional athletes, and many other professions accept risk and pay general income rates[109] because the market automatically rewards risk-takers.[110] Not only does the market automatically reward risk, "[t]he progressive income tax itself defrays risk: it takes a larger share of the gains when things turn out well, a smaller share when things turn out poorly, and it allows a deduction for losses."[111]

Lower taxes are not necessary to encourage risk-takers like venture capitalists. The purpose of the capital gains rate is not to encourage risk-

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104. JOINT COMM. ON TAXATION REPORT, PART I, *supra* note 34, at 21–22.

105. Limited partners would not invest in funds that did not provide attractive returns on investment.

106. Assuming an efficient market in which investors will only invest when returns are likely, then high investment figures indicate that proportionate carried interest figures are increasing as well.

107. Gompers, *supra* note 69, at 23.

108. *See* Maria Giduskova & Borja Larrain, *International Risk-Taking, Volatility, and Consumption Growth* (Fed. Reserve Bank of Boston, Working Paper No. 06-17, 2006).

109. Press Release, Sen. Max Baucus, *supra* note 16.

110. *Testimony Concerning The Tax Treatment of Compensation Paid to Hedge, Private Equity and Venture Capital Fund Managers*, 110th Cong. 4 (July 11, 2007) (statement of Darryll K. Jones, Professor of Law, Stetson University School of Law), *available at* http://www.senate.gov/~finance/hearings/testimony/2007test/073107testdj.pdf.

111. ARON-DINE, *supra* note 67, at 8.

taking; it is to encourage investment in capital assets.[112] Therefore, the "risk rationale for capital gains treatment does not apply."[113] Risk-taking is also not always a beneficial goal because it can "encourage fund managers to receive more compensation in the form of risky equity rather than cash salary, which in turn may distort the operation of the venture capital markets."[114]

Venture capitalists actually assume much less risk than it appears. Venture capitalists claim they "invest significant portions of [their] personal savings," yet admit that institutional investors provide "between 95 to 99 [%] of the capital."[115] Those investors accept the vast majority of risk simply by having the most capital to lose. A manager does not accept risk by acquiring "an ownership interest in the enterprise betting that his upside will provide an ample economic reward."[116] The real risk is in the possibility of loss, not of gain, and managers do not truly have downside risk.[117] Venture capitalists may believe they should be rewarded for their risk-taking, but the "home run mentality"[118] for taking on risky ventures exists because they have the luxury of placing the burden of risk squarely on the limited partners.

The real risk that occurs for managers is possible damage to their reputations.[119] Because investors in a venture capital fund are typically passive, they evaluate managers prior to investing based on the managers' investment track records before and during their investments.[120] Managers thus have a strong incentive to maintain a good reputation if they wish to attract investors in the future. For that reason, reputation plays a key role in ensuring competence of management and protecting against opportunism,[121] not carried interest. Venture capitalists believe that risk should be encouraged, but their argument fails most of all because the proposed legislation does not remove risk from the equation; it will still encourage

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112. JOINT COMM. ON TAXATION REPORT, PART I, *supra* note 34, at 56.

113. *Id.*

114. Fleischer, *supra* note 12, at 79. For discussion of the inefficiency of carried interest, see *supra* Part V.B.3.

115. Mitchell Testimony, *supra* note 20, at 5.

116. Solomon Testimony, *supra* note 36, at 7.

117. William R. Peterson, *The Role of Consumer Preference Development in Incremental Innovation: How Diamond Multimedia Helped Create the IPod*, 85 TEX. L. REV. 1553, 1575 (2007); Press Release, Citizens for Tax Justice, *supra* note 8.

118. Peterson, *supra* note 117, at 1575 (quoting Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 UCLA L. REV. 1737, 1765 (1994)). The home run mentality is the willingness of venture capitalists to invest in more high-risk and high-reward companies because they do not typically invest their own money, and therefore do not have as strong a disincentive to take risks as a normal investor would.

119. Christopher Gulinello, *Venture Capital Funds, Organizational Law, and Passive Investors*, 70 ALB. L. REV. 303, 345 (2006).

120. *Id.* at 314.

121. *Id.* at 343.

actual risk because it will "continue to treat as capital gains the portion of the income attributable to a capital investment."[122]

3. Providing Incentives

Carried interest is an important part of the cost-benefit equation because it creates strong incentives for venture capitalists to actively manage portfolio companies and maximize the potential of each investment. One commentator suggests, "[t]he future health of venture capital depends upon measures that will align the incentives of venture capital investors . . . , venture capitalists, and entrepreneurs who seek money to finance their projects."[123] Venture capitalists consider the incentive aspect of carried interest a necessary characteristic of investing that would be damaged by increased taxation. However, incentives still exist if taxation increases because even profits taxed 35% are better than none.

Additionally, venture capitalists refuse to use the same incentives commonly found in other investment forms, but they could easily do so, thus weakening their argument that low carried interest taxation is their only incentive.[124] The majority of venture capital funds do not provide the basic incentive structure that other private equity funds use.[125] Throughout the private equity industry, managers' rights to profits from investments are typically limited until the investors have recouped their money.[126] The most common method is a "hurdle rate,"[127] whereby proceeds of an investment are first distributed to the investors to recover their initial investments, then a set rate of return must be surpassed before the carried interest and remaining profits distributions include the general partner.[128] Once the general partner meets the set rate of return, he may also be allowed to "catch up" so that he receives the full 20% of carried interest based on the entire investment and not solely on the returns after passing the hurdle.[129] The hurdle rate discourages lazy management by preventing managers from enjoying the benefits of investment returns when the investment has had limited success. By refusing to use a hurdle rate, venture capitalists "reward both superior and mediocre performance."[130]

A capital gains rate is not necessary to provide incentives for managers of venture capital. The attraction of profits itself is an incentive; profits are simply taxed more if carried interest is treated as general income. Greater profits do not occur solely due to the lower taxation rate; instead it merely

122. ARON-DINE, *supra* note 67, at 6.
123. Gompers, *supra* note 69, at 2.
124. Fleischer, *supra* note 12, at 78.
125. *Id.* at 86.
126. *Id.* at 78.
127. *Id.* at 84.
128. Masotti, *supra* note 6, at 222.
129. Fleischer, *supra* note 12, at 84.
130. *Id.* at 86.

"motivate[s] the current structure of compensation received by fund managers".[131] Venture capitalists use carried interest because it is highly profitable, not because an incentive would not exist otherwise. Managers are merely paid more handsomely for their work than they will be if legislation is passed.

4. Leaving the Venture Capital Industry

Venture capitalists also believe that the threat of lower profits will encourage managers to leave the industry entirely.[132] Managers work in venture capital because carried interest is the most efficient form of compensation.[133] If venture capital returns in the form of carried interest are taxed at a higher rate, some managers will be tempted to accept higher paying jobs elsewhere. However, that issue is more of a concern for venture capitalists than it should be for Congress. Creating tax incentives to artificially keep venture capitalists in the industry will only distort the job market, just as it may distort managers' investment decisions.[134] Market efficiencies will put the most capable people in the jobs where they will be the most productive.[135] The government does not pay people to work in investment banks, so it should not tax those same workers less to encourage them to work in venture capital. Instead, the proposed legislation taxes workers according to the services they provide, not the industry in which they work.[136]

5. Moving Offshore

As the threat of increased carried interest taxation looms, venture capitalists portend a flight of their businesses out of the United States to countries where they will be more profitable.[137] Some politicians also believe that increased taxation "could lead to an exodus of jobs and companies from New York, and even from the country."[138] Much of venture capitalists' anxiety is the result of increasing competition from foreign markets. One indicator, "the ability of the U.S. market to attract listings of

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131. DONALD J. MARPLES, CONG. RESEARCH SERV., RS22717, TAXATION OF PRIVATE EQUITY AND HEDGE FUND PARTNERSHIPS: CHARACTERIZATION OF CARRIED INTEREST 2 (Sept. 7, 2007).
132. *See* Bartlett, *supra* note 45 (noting that carried interest is the sole incentive for managers to invest in "emerging growth companies").
133. *See* Fleischer, *supra* note 41, at 2.
134. *See* Fleischer, *supra* note 12, at 79.
135. ARON-DINE, *supra* note 67, at 8–9.
136. H.R. 2834, 110th Cong. (2007).
137. *See* Bartlett, *supra* note 45.
138. Hernandez, *supra* note 4.

foreign companies engaging in initial public offerings,"[139] suggests that there is "a decline in the U.S. competitive position."[140]

While decreased competitiveness is a real concern for venture capitalists, it is unlikely that they will consider exiting the American market. In actuality, only the larger venture capital firms with more resources are capable of significantly increasing their foreign investment, let alone moving their businesses entirely.[141] Furthermore, the United States still provides "superior returns" and "adequate deal flow" which will convince venture capitalists to remain.[142] "[U.S.] venture funds formed between 1983 and 1998 show consistently better returns than European funds that commenced operations during the same period"[143] and carried interest treatment is unlikely to substantially change the two markets' disparity.

A popular offshore location for venture capitalists that do decide to work offshore is the United Kingdom.[144] Discussion of increasing taxation on carried interest has occurred recently in the United Kingdom, though Parliament is unlikely to pass legislation similar to H.R. 2834 or S. 1624 and therefore, funds may be tempted to move abroad.[145] In Europe, there are at least thirteen different countries that treat carried interest as capital gain.[146] However, funds are not going to leave the United States simply because offshore jurisdictions "extend the welcome mat."[147] Venture capital firms will still incur U.S. taxes if they invest in companies based in the United States, and they can "rarely perform [management] services from abroad."[148]

Even if the tax benefits abroad are greater than in the United States, "[v]enture capitalism has done much better in America than Britain, although the incentive from carried interest is bigger in the latter. The industry's success clearly depends on other things than tax."[149] Therefore, it

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139. COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT 29 (2006), *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.

140. *Id.* at x.

141. *See* DELOITTE TOUCHE TOHMATSU, GLOBAL TRENDS IN VENTURE CAPITAL: 2007 SURVEY 11 (2007), *available at* http://www.deloitte.com/dtt/cda/doc/content/dtt_tmt_globaltrendsVC_2007.pdf.

142. *Id.* at 13.

143. Catarina Dantas Machado Rosa & Kristiina Raade, *Profitability of Venture Capital Investment in Europe and the United States* 18 (European Comm'n, Economic Paper No. 245, 2006), *available at* http://ec.europa.eu/economy_finance/publications/economic_papers/2006/ecp245en.pdf.

144. Bartlett, *supra* note 45.

145. *Id.*

146. MARPLES, *supra* note 131, at 3.

147. Bartlett, *supra* note 45.

148. ARON-DINE, *supra* note 67, at 12 (quoting Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*).

149. *Carried Away: One Tax Break for Private Equity is Unfair—But Don't Blame the Buy-out Barons*, ECONOMIST, June 9, 2007, at 13 [hereinafter *Carried Away*].

would be a poor tax strategy to offer beneficial tax rates simply because of a fear of losing venture capital business. A race to the bottom mentality does not work with regulation, and it will not work with taxes.[150]

B. DEFINING CARRIED INTEREST AS CAPITAL GAIN

As is evident from the previous section, there are practical market reasons for taxing venture capitalists the same as other private equity. In addition, carried interest should be taxed as general income if Congress views carried interest as conceptually different from capital gain. Venture capitalists make different arguments in their attempts to define carried interest as capital gain. First, they are paid by their investors for their knowledge and experience, intangibles shared with the very entrepreneurs who create a start-up and who are handsomely compensated for their own non-capital investments.[151] Portfolio companies are valued above book value for those very intangibles that the venture capitalists provide, and for which they should be compensated.[152] Second, venture capitalists' contribution should be defined in terms of providing a type of capital by building "sweat equity" in their investments and therefore, profits are based on a capital investment.[153] Finally, treating the services venture capitalists provide as capital is an efficient way to encourage investment.[154] These arguments attempt to prove that policy requires carried interest be treated as capital gain. However, they dance around one main fact: Management is simply a service provided to investors. Services are generally taxed as ordinary income, not capital gain.[155] Managers are paid for the advice they provide and by the resulting increase in the sale price of a portfolio company.[156]

1. Compensation for Non-Capital Investments

Venture capitalists believe that the carried interest they receive should be treated as capital gain because they add tangible value to a portfolio

150. COMM. ON CAPITAL MKTS. REGULATION, *supra* note 139, at 59.

151. Mitchell Testimony, *supra* note 20, at 5 ("This nurturing takes the form of money and strategic management, including intangible guidance and goodwill—all equally important to the company's ultimate success."); *see also id.* at 11 (discussing how entrepreneurs invest intangibles such as ideas and labor).

152. *See* Denise Caruso, *When Balance Sheets Collide With the New Economy*, N.Y. TIMES, Sept. 9, 2007, § 3, at 34.

153. Sweat equity is ownership of an entity that a person earns by investing his time and effort into building the business. *See* Mitchell Testimony, *supra* note 20, at 9 ("As venture investors, we assert that it is appropriate to reward investors of sweat equity with the same long-term capital gain tax benefits that investors of financial equity receive.").

154. *See id.* at 12 ("If sweat equity or intangibles are not recognized as having long term value associated with them, then venture capitalists may as well be passive investors.").

155. *See* Orszag Testimony, *supra* note 2, at 9–10.

156. Mitchell Testimony, *supra* note 20, at 6 ("entrepreneurs actively seek out venture investors who can add value to their companies").

company and the returns they receive in carried interest are based on that appreciation.[157] Although management services are typically treated as labor for tax purposes, venture capitalists believe the value they add to an investment is a form of intangible capital, not labor.[158] Entrepreneurs and investors employ venture capitalists and pay them with carried interest because they provide skill, knowledge and experience.[159] Venture capitalists are unlike normal investors who solely provide money because management is a form of "human capital."[160]

When an entrepreneur eventually sells his business, his profit is subject to capital gains tax treatment.[161] The entrepreneur has essentially made a long term investment in his company, and tax legislation does not differentiate between the value added to the company based on the entrepreneur's financial investment and the intellectual property or human capital he invests.[162] However, the proposed tax legislation will treat the human capital provided by venture capitalists and the capital provided by entrepreneurs very differently.[163] Venture capitalists are jealous of the relative proposed tax treatment entrepreneurs will receive and rightfully so; the human capital venture capitalists provide is significant. Before venture capitalists step in, the entrepreneur's company is an "original business plan" that is "essentially illiquid and worthless" until venture capitalists apply an "experienced hand."[164] Venture capitalists are instrumental in maximizing returns on entrepreneurship by providing both funding and expertise to a start-up.[165] Yet they will not benefit from the lower capital gains tax if the proposed tax legislation is passed.

Market valuation of companies supports the argument that venture capitalists can provide intangible capital.[166] Venture capitalists bid on potential investments based on the intangibles of an entrepreneur's ideas[167]

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157. Venture capitalists profit when they are paid for their equity in the company, so their efforts to make the company successful, and therefore to add to the value of their investment, is ultimately done to increase the sale price of a portfolio company. *See id.* at 5 (intangible guidance is "equally important to the company's ultimate success").

158. *See* Press Release, Nat'l Venture Capital Ass'n, NVCA Board Members Meet in Washington to Discuss Stifling Effects of Carried Interest Tax Bill on Start-Up Companies and Innovation: Venture Capitalists Continue to Urge Members of Congress Not to Harm Emerging Entrepreneur Community (Sept. 18, 2007).

159. *See* Solomon Testimony, *supra* note 36, at 7 ("The common theme in all these instances is . . . [contribution of] skill and knowledge . . . .").

160. Masotti, *supra* note 6, at 219.

161. Solomon Testimony, *supra* note 36, at 6.

162. *See* Press Release, Sen. Chuck Grassley, *supra* note 16.

163. H.R. 2834 taxes investment services as general income, but entrepreneurs' labor is not an investment service. *See* H.R. 2834 § 710(c)(1), 110th Cong. (2007).

164. GLOBAL INSIGHT, *supra* note 15, at 8–10.

165. *Id.* at 9.

166. *See* Caruso, *supra* note 152.

167. Burnham's Beat, Carried Interest Debate Cont.: The Death of Sweat Equity?, June 25, 2007, http://billburnham.blogs.com/burnhamsbeat/2007/06/carried-interes.html.

and those same companies are commonly valued over asset value simply because of intangibles like those that venture capitalists provide.[168] However, while carried interest may be a return on human capital, market valuation of portfolio companies alone does not explain why carried interest is a return on capital instead of labor. Venture capitalists must show that the human capital they provide, in the form of management, should not be treated as services just like other investment advice.

2. Redefining Services as Sweat Equity

Venture capitalists will attempt to define their contributions as necessary to avoid increased taxation. If they contribute capital to start-ups, then carried interest is capital gain. However, if venture capitalists provide services, then carried interest is general income. The problem venture capitalists face when trying to define carried interest as capital gain is that they provide very little capital; limited partners provide the lion's share of money.[169] Furthermore, if venture capitalists were approached for financial investment, then they would simply be providing high-risk credit and not the unique hands-on management they claim.[170] Yet venture capitalists cannot admit to simply providing services without seeming to agree that carried interest is general income. Therefore, venture capitalists are forced to define carried interest between the two poles.

Venture capitalists claim the result of their investment is sweat equity[171] to avoid this dilemma; their services are theoretically converted into equity by being an intangible capital investment.[172] Although limited partners provide most of the money, the profits on venture capital include more than what the limited partners would have received if they had made similar investments elsewhere.[173] Venture capitalists do indeed add something intangible, but it exits in the form of capital. They believe this justifies treating carried interest as a return on capital investment.[174] Venture capitalists often use partnerships because "the appeal of the partnership form is its convenience as a method of pooling together labor and capital," but pooling is not unique to partnerships that use carried interest.[175] Returns on various forms of investment are often taxed as general income even

168. *See* Caruso, *supra* note 152.
169. Mitchell Testimony, *supra* note 20, at 5.
170. *Id.* at 12.
171. *Id.* at 9.
172. *See* Press Release, Nat'l Venture Capital Ass'n, *supra* note 158.
173. The reputation, knowledge, and goodwill is a valuable contribution provided by venture capitalists that is absent in simple hands-off stock ownership. *See* Mitchell Testimony, *supra* note 20, at 6.
174. *See* Press Release, Nat'l Venture Capital Ass'n, *supra* note 158 ("This type of intangible investment . . . is what Congress intended for capital gains treatment.").
175. Fleischer, *supra* note 41, at 25–26.

when "blurring"[176] the line between labor and capital.[177] Other business arrangements that pool together labor and capital only treat them as pure capital gain if there is a true entrepreneurial risk.[178] Furthermore, the present proposed legislation is clearly intended to address both those situations when services are provided without any real financial investment, and when both services *and* capital investment are involved.[179]

Venture capitalists define the services they provide equivocally to take advantage of tax benefits. They claim venture capital is inherently about creating capital investment because they take an active part in entrepreneurship by both investing in start-ups and actually being involved in business decisions while on the board of directors.[180] However, while the capital gains rate exists to promote investment by increasing access to capital,[181] it is not intended to benefit every person generally involved in investment.[182] Tax legislation simply would have no way to differentiate between mere investors that are essentially granted board positions by virtue of the size of their investments (like major stockholders in corporations), and investors that somehow provide some type of valuable management. The purpose of a lower capital gains rate is to encourage capital formation by taxing direct investors at a lower rate, not the venture capitalists who manage direct investment[183] and merely provide services to the investors. The present legislation does not propose to remove the capital gains rate entirely[184] because there are still accepted benefits to capital formation.[185] Taxing venture capitalists is not inconsistent with that policy because the portion of their equity return resulting from capital investment is still treated as such.[186]

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176. MARPLES, *supra* note 131, at 4.

177. Solomon Testimony, *supra* note 36, at 6–7.

178. *Id.* at 7.

179. *See* H.R. 2834 § 710(c)(1), 110th Cong. (2007).

180. *See* Mitchell Testimony, *supra* note 20, at 12 (capital gains tax policy was enacted to encourage entrepreneurship and Congress intended for it to apply to both the entrepreneur and the venture capitalist).

181. Stephen Moore & John Silvia, *The ABCs of the Capital Gains Tax* (CATO Inst., Policy Analysis No. 242, 1995), *available at* http://www.cato.org/pub_display.php?pub_id=1101&full=1.

182. *See Carried Away*, *supra* note 149 (capital gains treatment was "originally intended to reward small-business owners and entrepreneurs").

183. Orszag Testimony, *supra* note 2, at 16.

184. S. 1624, 110th Cong. (2007); H.R. 2834 § 710(c)(1), 110th Cong. (2007).

185. Increasing access to capital dampens business cycles and decreases macroeconomic volatility, even if it raises the assumption of risks by investors systematically. Orszag Testimony, *supra* note 2, at 2.

186. Only returns that are due to investment services without a proportionate capital investment are taxed as general income. H.R. 2834 § 710(c)(1), 110th Cong. (2007).

3. Efficiency

Capital gains taxation exists because making long-term capital investments inexpensive is an efficient way to encourage activity in the investment market.[187] Venture capitalists believe that if encouraging long-term capital investment is a policy goal, then the services they provide to long-term capital investors should be as well.[188] After all, it would be unreasonable to expect lay investors to spend the time and energy that venture capitalists do in choosing investment opportunities and helping them grow.[189] Defining carried interest as a capital gain might encourage more venture capital investment because potential venture capitalists would be attracted by the industry's lower taxation, but it would have other, negative efficiency consequences.

Carried interest is used in place of salary and other typical types of payment for labor, so taxing carried interest at a lower rate than "other forms of compensation . . . [can lead] to distortions in employment, organizational form and compensation decisions."[190] While other service industries base decisions on taxation for labor, venture capitalists structure their business as partnerships and use carried interest specifically because of tax incentives for capital investment.[191] Taxing carried interest less than general income "violates the principles of both horizontal and vertical equity;" people who earn the same amounts pay different taxes merely because of the "form of the income" they receive and people who are paid more do not necessarily pay more taxes.[192] If workers and investors structure their activities in certain forms solely based on tax reasons, then it is inefficient for the market because it creates "deadweight loss" by distorting investment behavior.[193]

Applying the lower capital gains rate to carried interest is "widely considered to be inconsistent with basic federal income tax principles"[194] including limiting costs on the market in the form of externalities.[195] Control of externalities is crucial to an efficient economy.[196] Venture capital creates positive externalities such as innovation,[197] but carried interest

187. *See* Orszag Testimony, *supra* note 2, at 15–16.
188. *See* Mitchell Testimony, *supra* note 20, at 12.
189. *Id.* at 6 (venture capitalists themselves do not have the ability to divide their time between more than five to seven director seats).
190. MARPLES, *supra* note 131, at 3–4.
191. Solomon Testimony, *supra* note 36, at 1.
192. MARPLES, *supra* note 131, at 3–4.
193. Fleischer, *supra* note 41, at 19.
194. Knoll, *supra* note 13, at 4.
195. *See* Peterson, *supra* note 117, at 1569–1570.
196. *See* Knoll, *supra* note 13, at 4–5 (an "all-parties perspective" is necessary when considering consequences of tax policy); *see also* Peterson, *supra* note 117, at 1569 (externalities create market failures).
197. Peterson, *supra* note 117, at 1559.

creates negative externalities in the form of market distortion.[198] It is the job of the government to subsidize the positive externalities while taxing the negative ones.[199] The proposed legislation creates a consistent and efficient tax policy by treating carried interest as general income, but applying the capital gains rate if venture capitalists invest their own capital.

C. THE UNINTENDED CONSEQUENCES OF SHIFTING THE TAX BURDEN

Carried interest is a "common feature of partnerships" outside of the private equity industry.[200] These partnerships may unwittingly be subjected to higher taxation if Congress passes the new legislation. Venture capitalists point out a bevy of "unintended consequences"[201] that they believe will occur as a result of an increase in taxation on carried interest. First, increasing taxation will merely shift the burden to investors who will have to pay higher fees for investment management,[202] and to the relatively poor investors.[203] Second, increasing taxation will hurt small business, which relies on money from venture capital,[204] and pensioners, whom the federal government should protect from increased taxation.[205] Finally, venture capital investment creates jobs and sparks innovation essential to the American economy, and therefore the economy will be harmed by a lack of venture capital investment if higher taxation occurs.[206]

1. Shifting the Tax Burden

Increasing taxation on carried interest will place a heavier burden on general partners, but the shift is likely to be temporary.[207] "A shift of the tax burden away from limited partners and towards general partners will likely lead limited partners to pay more (before tax) to general partners to compensate for the shift in tax burden."[208] The increased tax burden will probably change the way both venture capitalists and investors act in the market.[209] If the cost of venture capital investment rises, then investors will

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198. *See* Fleischer, *supra* note 12, at 79.
199. Peterson, *supra* note 117, at 1569.
200. Orszag Testimony, *supra* note 2, at 11.
201. *See* Press Release, Nat'l Venture Capital Ass'n, *supra* note 7.
202. Knoll, *supra* note 13, at 6.
203. Because capital-intensive investors are wealthy by definition, and those investors that earn equity through services will not be able to benefit from the capital gains rate.
204. *See* Mitchell Testimony, *supra* note 20, at 4 (venture capital creates "new companies that quite simply would not exist if this capital were not available").
205. *See* Ryan J. Donmoyer & Alison Fitzgerald, *Pension Fund Group Drops Opposition to Tax Change*, INT'L HERALD TRIB., Sept. 6, 2007, http://www.iht.com/articles/2007/09/05/bloomberg/bxpension.php.
206. Mitchell Testimony, *supra* note 20, at 2.
207. Knoll, *supra* note 13, at 6.
208. *Id.*
209. *Id.* at 7.

be discouraged from entering the market. General partners may also raise management fees, or request a larger share of the profits from the limited partners.[210] Furthermore, venture capitalists may require more equity from portfolio companies in return for their investments.

Though decreasing venture capital investment will directly affect the total capital available to start-ups, it will not be an unforeseen consequence of taxation like venture capitalists suggest. Shifting the tax burden commonly affects market strategies.[211] By making certain forms of investment activity more or less expensive, taxation creates efficient behavior.[212] The ability to shift taxation for that very purpose is the driving force behind tax policy.[213] If taxation of carried interest increases, there will be fewer instances when the rate meant specifically for capital investments is applied to services. Presently, taxation controls the market; venture capitalists even select a business structure based almost entirely on tax benefits.[214] If carried interest is taxed as general income, venture capitalists will act efficiently by investing solely where opportunities are profitable on their merits.[215] Furthermore, although the tax burden may shift back to limited partners, congressmen have already said that carried interest taxation is about policy decisions and closing loopholes, not about raising tax revenues.[216]

A result of increased carried interest taxation will also be to foreclose use of the capital gains rate by anyone other than capital investors. Somewhat ironically, venture capitalists decry increased taxation because only the capital-intensive investors will benefit.[217] By preventing non-capital investors from enjoying the benefits of the capital gains tax rate, the burden is shifted away from the rich to investors that cannot or do not provide tangible capital. Investors are the ones that have the wealth, while managers provide the real work in the form of sweat equity.[218] Therefore, carried interest taxation "ends up penalizing labor by reserving beneficial

210. Solomon Testimony, *supra* note 36, at 8 ("This rule is likely to affect the economic deal between the service partner and investors.").

211. Rebecca S. Rudnick, *Enforcing the Fundamental Premises of Partnership Taxation*, 22 HOFSTRA L. REV. 229, 305–08 (1993).

212. *See* Robert J. Peroni, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455, 486 (1999) (eliminating tax benefits can encourage efficient use of capital).

213. JOINT ECONOMIC COMM. OF THE U.S. CONG., THE INEFFICIENCY OF TARGETED TAX POLICIES (Apr. 1997), *available at* http://www.house.gov/jec/fiscal/tx-grwth/targets.htm [hereinafter JOINT ECONOMIC COMM. REPORT].

214. Solomon Testimony, *supra* note 36, at 1.

215. *See* JOINT ECONOMIC COMM. REPORT, *supra* note 213 (efficient tax policies "allocate resources to their most highly valued uses").

216. Press Release, Sen. Chuck Grassley, *supra* note 16.

217. Mitchell Testimony, *supra* note 20, at 9 (claiming that increasing taxation on carried interest is the equivalent of subsidizing the wealthy).

218. *Id.*

tax treatment only for the providers of capital."[219] However, there are two problems with such claims: first, labor is commonly taxed as general income[220] and it is solely the carried interest loophole that would be closed; second, tax encourages capital formation because it benefits everyone indirectly,[221] whereas the rich would otherwise be encouraged to keep their capital out of the marketplace, harming the economy.

2. Hurting the People Using and Investing In Venture Capital

A great deal of political capital will be required to pass carried interest taxation because it may negatively affect a variety of groups including pensioners,[222] small business owners,[223] real estate owners,[224] and minority businesspeople.[225] Pensioners are paying close attention to the carried interest debate because it could result in venture capitalists shifting greater costs to the investors. The remaining groups are concerned that increased taxation will increase the cost of capital to their businesses. However, many of the concerns expressed are relatively unfounded.

Real estate investment represented only 13% of partnership income distributed in 2004, compared with 63% for securities partnerships,[226] and it is only those partnerships that provide investment services that will be taxed.[227] Ironically, minority and women investors attacking carried interest taxation are receiving funding from the private equity industry, which makes their claims seem disingenuous.[228] Similarly, President Bush has also jumped into the debate claiming that small businesses must be protected.[229] Such support for trickle-down legislation fails because a low capital gains rate and therefore, also taxation on carried interest, has "modest effects" on "capital formation and economic activity."[230]

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219. Burnham's Beat, *supra* note 167.

220. *See* JOINT COMM. ON TAXATION REPORT, PART I, *supra* note 34, at 52–53 (arguing that if compensation is based on services, then it should be treated as ordinary income).

221. Lower taxes stimulate economic growth. *See* JOINT ECONOMIC COMM. REPORT, *supra* note 213.

222. *See* Press Release, Citizens for Tax Justice, *supra* note 8 ("The private equity industry has tried to create the impression that public employee pensions will be damaged by this reform.").

223. Kevin Drawbaugh, *Business Group Backs Carried Interest Tax Break*, REUTERS, Sept. 4, 2007.

224. Holzer, *supra* note 3.

225. *Minority Group Joins Fight Over Carried Interest*, N.Y. TIMES DEALBOOK, Sept. 5, 2007, http://dealbook.blogs.nytimes.com/2007/09/05/minority-group-joins-fight-over-carried-interest/ [hereinafter *Minority Group Joins Fight*].

226. DR. JOHN RUTLEDGE, U.S. CHAMBER OF COMMERCE, ANALYSIS OF THE IMPACT OF INCREASING CARRIED INTEREST TAX RATES ON THE U.S. ECONOMY (Sept. 2007), *available at* http://www.uschamber.com/NR/rdonlyres/espkx2nh7rnh2oeohbh253lo5guaaiucqfd4erqpaqgnvmeoron6zhpt4fcx3thuqpjtqvu6pgxb4fvw3ottf52n6sa/07carriedinterest_study.pdf.

227. H.R. 2834 § 710(c)(1), 110th Cong. (2007).

228. *Minority Group Joins Fight*, *supra* note 225.

229. Drawbaugh, *supra* note 3.

230. Orszag Testimony, *supra* note 2, at 16.

Pensioners are not as concerned by carried interest taxation as venture capitalists claim. Regular investors could be hurt if general partners pass costs onto them, but the cost per investor should be minimal because it will be spread throughout entire pension funds that typically diversify their holdings.[231] The quality of investment management should also not be affected by increased taxation.[232] Even pension funds have agreed that "[t]he argument that this is about the interest of retired public employees is ludicrous."[233] Pensioners are unlikely to be significantly hurt by shifting costs because if the market had the flexibility to allow managers to charge greater fees, then they would have already done so.[234]

3. Venture Capital's Place in the American Economy

Some view venture capital as the life-blood of the American economy because it creates jobs and sparks innovation.[235] "Venture capital is the only industry in the proposed carried interest legislation that creates new companies, industries and technologies."[236] Increased taxation could result in decreased investment, which would slow small business growth and lead to a weaker economy.[237]

"[T]here is considerable evidence that countries with better financial markets, like the United States, enjoy more rapid economic growth, which creates more new jobs nationwide."[238] Financial markets can easily be weakened when the costs of investing are too high because investors will put their money wherever it is cheapest to invest. "Weaker U.S. capital markets mean higher costs of capital for U.S. companies, reduced asset values, fewer jobs, and less economic activity across the entire country."[239] However, while carried interest taxation will affect after-tax profitability for venture capital managers, it will not directly affect total capital invested. As long as venture capital is still profitable relative to other investment options, entrepreneurs will still have a source of investment. The American economy will be hurt if entrepreneurship is stifled, but venture capital investing will exist as long as investors are willing to provide money.

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231. Stephen Labaton & Jenny Anderson, *Pension Effect From Tax Plan Is Called Slight*, N.Y. TIMES, Sept. 7, 2007, at C1.

232. Press Release, Citizens for Tax Justice, *supra* note 8.

233. ARON-DINE, *supra* note 67, at 12 (quoting Alison Fitzgerald, *"Buyout Firms" Tax Rise Wouldn't Hurt Workers, Pension Funds Say*, BLOOMBERG NEWS, July 11, 2007).

234. JOINT COMM. ON TAXATION REPORT, PART I, *supra* note 34, at 58.

235. GLOBAL INSIGHT, *supra* note 15, at 5 ("the nation's venture capital backed companies employed over 10.4 million American workers in high-quality jobs and generated $2.3 trillion in revenue in 2006.").

236. Press Release, Nat'l Venture Capital Ass'n, *supra* note 158.

237. RUTLEDGE, *supra* note 226.

238. COMM. ON CAPITAL MKTS. REGULATION, *supra* note 139, at ix.

239. *Id.* at 23.

Changing the tax treatment of managers is simply unlikely to have a significant effect on entrepreneurship overall.

VI. CONCLUSION

Venture capitalists fail to provide convincing arguments against carried interest taxation because tax legislation on carried interest has been proposed for practical policy reasons. Venture capitalists help to nurture small businesses in America that might fail without additional funding and management expertise. However, while present capital gains taxation may provide indirect benefits to the American economy, it also benefits venture capitalists in a way that creates tax inequalities. The market provides strong evidence that venture capitalists are able to withstand an increase in taxation and they are unlikely to avoid the industry or more their business to another country. Even with greater taxes, they will have significant incentives to actively manage their portfolio companies and take investment risks.

Increased taxation of carried interest is also appropriate because venture capitalists are providing a service, even if they add tangible value to the companies they invest in. Regardless of how to define the contribution that venture capitalists provide, it is essentially different from capital investment. The market will be more efficient if the carried interest loophole is closed and investors based their decisions purely on the merit of their options and not the tax benefits.

The proposed legislation is far more carefully crafted than its drafters are given credit for: It treats capital gains income different only in the unique instance that it is the result of investment services without a proportionate personal investment.[240] Alternative tax legislation that has been proposed by venture capitalists and other industries that attack increased carried interest taxation are simply misguided. The same groups lobbying against the present legislation will be even more displeased if taxes are raised on the top 1% of income earners, or if the capital gains tax is raised.[241]

Small business owners, minorities, pensioners, and everyone outside of the private equity industry should be pleased with H.R. 2834 because the present tax system is stacked against them. It is unreasonable to avoid an increase in tax for venture capitalists simply because the costs of investment may shift to investors or entrepreneurs in the market. The American economy is strong because taxation creates a relatively level playing field, not because Congress provides incentives for investment management. Although venture capital plays a vital role in nurturing promising U.S.

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240. H.R. 2834 § 710(c)(1), 110th Cong. (2007).
241. *See* Hernandez, *supra* note 4.

businesses, the industry will survive when venture capitalists pay taxes the same way as the average American.

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