Pragmatic Case for Taxing an Equity Fund Manager's Profit Share as Compensation, A

Mark P. Gergen
Berkeley Law

Follow this and additional works at: https://scholarship.law.berkeley.edu/facpubs
Part of the Law Commons

Recommended Citation
Pragmatic Case for Taxing an Equity Fund Manager's Profit Share as Compensation, A, 87 Tax Mag. 139 (2009)
A Pragmatic Case for Taxing an Equity Fund Manager’s Profit Share As Compensation

By Mark P. Gergen

Mark P. Gergen discusses taxing a private equity fund manager’s profit share as compensation.

This article responds to a challenge David Weisbach has put to proponents of taxing a private equity fund manager’s profit share as compensation. In a spirited defense of the status quo, Weisbach objects to arguments for change that rely on the analogy of a fund manager’s profit share to a compensatory stock option and contingent compensation. His objection to reasoning by analogy in the tax area is more general. The general objection grounds on the premise that principles and concepts of tax law are of secondary relevance in resolving issues of tax policy. To put it baldly, the premise is that when deciding how to tax transaction x a policymaker should care about existing tax law rules that apply to transaction y only insofar as the y rules might alter the response of taxpayers within the intended field of the x rules in undesirable ways. This perspective disregards arguments of fairness or horizontal equity. In this essay I respond to the specifics of Weisbach’s defense of the status quo while accepting his normative premises, taking up the challenge to make a case for proposed Code Sec. 710 that does not depend on argument by analogy or about the unfairness of taxing fund managers at lower rates than working people. I hope to persuade you that proposed Code Sec. 710 stands up pretty well from this perspective.

The immediate question is how to tax a private equity fund manager’s profit share when the profits apparently are a return for time, effort, expertise, and knowledge the manager provides to a fund. Under current law a manager’s profit share is taxed as capital gain if this is the character of the income to a fund, which typically it is. Proposed Code Sec. 710 taxes a manager’s profit share as compensation subject to ordinary rates and to self-employment taxes except insofar as the profits represent a reasonable return on capital invested by a manager in a fund. This is similar to an approach to taxing a service partner in a capital intensive partnership that I advocated over 15 years ago.

The gist of the pragmatic argument against trying to tax a fund manager’s profit share as compensation is that the effort will complicate tax law while raising little or no revenue because people can easily design around the new rule. I believe this argument rests on unrealistic assumptions about the salience of tax considerations to contract design in the private equity market and about the flexibility of contract design. But this is no more than a hunch based on past behavior in the area and in related areas. What I do in this article is to use a simple model to identify the least intrusive ways people might restructure a fund to minimize the impact of Code Sec. 710 while preserving a fund’s basic economic structure. The analysis shows that it is difficult for people to dodge most of the brunt of Code Sec. 710 without fundamentally changing a fund’s economic structure. The analysis also suggests a few ways in which Code Sec. 710 can be strengthened. And it clarifies the key tradeoffs and unknowns facing policymakers in this area. I will address the questions of how to treat

Mark P. Gergen is a Professor at Berkeley Law School, University of California.
equity investors, how to define a reasonable return on a fund manager's invested capital, how to handle revaluations of a manager's invested capital, how to handle investor debt-financing of a manager's invested capital and how to deal with a hybrid financial structure in which the limited partnership interest is a mix of debt and equity. I do not address questions about the scope of Code Sec. 710, nor do I address strategies to avoid Code Sec. 710 that involve restructuring a fund as a corporation.

**Tax Consequences to Investors**

I begin with the question of the appropriate tax consequences to fund investors of treating a manager's profit share as compensation. The issue is fairly straightforward and it encapsulates the key trade-offs and unknowns facing policymakers in choosing whether and how to tax a fund manager's profit share as compensation.

A recent article by Chris Sanchirico assumes investors will include a manager's profit share in their income and have an equal expense item. Sanchirico shows that under current law this expense probably is deductible against other income. If this is true, then the tax cost to the manager of taxing profits as compensation (the difference between the ordinary tax rate and the capital gains rate) will equal the tax benefit to individual investors (who will concurrently have income taxed at the capital gains rate and an equal deduction against income that would otherwise be taxed at the ordinary tax rate). This reduces the revenue gained by Code Sec. 710, though significant revenue still is gained. Even under Sanchirico's assumptions, revenue is gained when investors are tax exempt, otherwise tax indifferent or corporations (which do not benefit from the capital gains preference). Over half of the capital invested in private equity funds is from such tax clienteles. And some revenue still is gained when investors are individuals insofar as a manager's profit share is subject to the self-employment tax.

Code Sec. 710 tries to finesse this issue. It provides that a manager's profit share is taxed as compensation. The investors do not include the profit share in income and they have no corresponding expense. The point I take from Weisbach is that the tax law rules governing the treatment of investment advice and management fees in other contexts are of only secondary relevance in deciding how the implicit fee paid by the investors to the manager should be treated in this context. These rules are relevant only to the extent they are likely to induce people to respond to Code Sec. 710 in undesirable ways.

The immediate concern is that people may redesign a transaction to have a fund pay the manager an explicit fee as contingent compensation in lieu of a profit share. The investors would be allocated the manager's profit share and a corresponding expense item. This design around is cheap and easy for it is a simple matter of drafting and bookkeeping when profits are distributed. The design around presents only a smidge more difficulty when profits are undistributed. Basically it requires that a fund pay a manager compensation in cash the manager reconverts to the fund as invested capital. Cash need not change hands for the manager can commit to a "compensation reinvestment plan" akin to a dividend reinvestment plan. The design around does not change the economics of a fund. It only changes the formal description of the payment to the manager.

Policymakers can respond to the availability of a cheap and easy design around in essentially three ways:

1. Submit by rewriting Code Sec. 710 to replicate the results under the design around however a transaction is structure, i.e., provide that investors will include the manager's profit share in income and have an offsetting expense item even if the parties do not formally arrange matters this way.
2. Keep Code Sec. 710 as it is and do nothing to prevent a cheap and easy design around.
3. Keep Code Sec. 710 as it is and add a rule making it costly and hard to design around the rule, e.g., provide by regulation that compensation paid to a manager that is contingent on partnership profits will be treated as an allocation of those profits however the payment is formally characterized.

Option 3 will raise the most revenue and cause the greatest changes in behavior in the private equity market. For example, funds that cater to individual investors may avoid the rule in Option 3 by making the manager an employee without a partnership interest. This alters contract design, which may result in inefficiencies in a manager's performance or in investor monitoring of a manager's performance that do not exist under the existing contract design. Or the additional tax burden on private equity funds with partner-managers may push some individual investors who would have invested in private equity
funds under Options 2 and 3 to invest their capital elsewhere. Combining these effects, it is theoretically possible that the private equity market will segment between funds that cater to individual investors (which will use an inefficient contract design because of the tax savings) and funds that cater to other investors (which have no tax incentive to alter contract design). This last possibility is more theoretical than real because equity markets do not cleanly organize around tax clienteles.

Option 1 raises the least revenue and will cause the least change in contract design and capital flow. One way to think about Option 1 is that it shields individual investors from the impact of Code Sec. 710. This assumes fund managers pass the cost of Code Sec. 710 through to investors by demanding a greater share of returns and that individual investors offset this reduction in returns with the tax benefit of having concurrent capital gain and an ordinary deduction. Whoever reaps the tax benefit to individual investors it should reduce the overall impact of Code Sec. 710 on the flow of talent and capital to the private equity market. Option 1 also saves people the expense of rewriting contracts to secure the tax benefit.

Some will think Option 2 objectionable on legalistic grounds for it elevates form over substance. Some will think it objectionable on fairness grounds for it makes Code Sec. 710 a trap for the unwary. A private equity fund with individual investors that does not exploit the design around is leaving money on the table under Option 2. These sorts of objections need not concern me here for I have accepted Weisbach’s normative premises. Option 2 would be attractive to a policymaker who was concerned about the potential effects of Option 3 on contract design and the flow of talent and capital to the private equity market and unhappy with the revenue foregone under Option 1. The existence of a design around in Option 2 serves like a safety valve. The hope is that funds will take advantage of the cheap and easy design around rather than forego otherwise profitable opportunities or alter contract design in costly ways.

Which is the best option largely turns on the elasticity of contract design in the private equity market. There is a great deal of evidence that contract design is fairly inelastic or “sticky” in markets like the private equity market. This is to be expected. The contracts that define the respective rights and obligations of fund managers and investors are complex but by necessity must be fairly standardized across the market. There are significant costs to changing terms in complex standardized contracts that are borne by the first mover while the corresponding benefits from a successful innovation in contract design are reaped by everyone. The inelasticity or stickiness of contract design favors Options 2 or 3. Option 3 is preferable to Option 2 if contract design is only somewhat inelastic and we are not concerned with the effect of Code Sec. 710 on the flow of managerial talent and capital to private equity. Option 3 requires a much more significant redesign of a fund’s contract with a manager to give individual investors a tax benefit offsetting the tax cost of Code Sec. 710 to the manager.

Option 3 is open to the objection that a strengthened Code Sec. 710 will exacerbate the reduction of the flow of managerial talent and capital to private equity by reducing after-tax yields compared to other activities and investments. Perhaps Code Sec. 710 will have this effect. But this is very different from the objection that Code Sec. 710 will increase complexity and create contractual inefficiencies without raising revenue. In the summer of 2007 it may have been possible to argue with a straight face that private equity was the locomotive pulling the millenial economy and that Congress should do nothing that might slow this engine down. Even then this argument was no more special pleading for the industry. In winter 2008 it looks like the private equity engine was overheated, especially in the leveraged buyout segment of the market. Revenue must be gotten from somewhere. There is no a priori reason to think that returns to labor and capital in the private equity market are a particularly socially harmful place to get it.

**The Financial Structure of Private Equity**

The substitution of explicit contingent compensation for a profit share is only one of several possible responses to Code Sec. 710 that would tend to reduce the revenue raised by Code Sec. 710 while potentially creating contractual inefficiencies. Before examining other possible responses it is useful to look at the financial structure of a private equity fund. A simple binomial model highlights a key characteristic of private equity funds that static models tend to elide—their risk.

Assume $x$ is invested for $n$ years with an expected return of $r$ that may vary by plus or minus $v$ each year. In the best case scenario, the investment will have an unbroken series of good years in which it...
142

Table 1

<table>
<thead>
<tr>
<th>Probability</th>
<th>0.78%</th>
<th>5.47%</th>
<th>16.41%</th>
<th>27.34%</th>
<th>27.34%</th>
<th>16.41%</th>
<th>5.47%</th>
<th>0.78%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Terminal value</td>
<td>$358.32</td>
<td>$298.60</td>
<td>$248.83</td>
<td>$207.36</td>
<td>$172.80</td>
<td>$144.00</td>
<td>$120.00</td>
<td>$100.00</td>
</tr>
</tbody>
</table>

Table 2

<table>
<thead>
<tr>
<th>Probability</th>
<th>0.78%</th>
<th>5.47%</th>
<th>16.41%</th>
<th>27.34%</th>
<th>27.34%</th>
<th>16.41%</th>
<th>5.47%</th>
<th>0.78%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Terminal value (excluding fee)</td>
<td>$314.78</td>
<td>$262.31</td>
<td>$218.60</td>
<td>$182.16</td>
<td>$151.80</td>
<td>$126.50</td>
<td>$105.42</td>
<td>$87.85</td>
</tr>
<tr>
<td>LP priority return</td>
<td>$167.10</td>
<td>$167.10</td>
<td>$167.10</td>
<td>$167.10</td>
<td>$151.80</td>
<td>$126.50</td>
<td>$105.42</td>
<td>$87.85</td>
</tr>
<tr>
<td>GM makeup</td>
<td>$13.92</td>
<td>$13.92</td>
<td>$13.92</td>
<td>$13.92</td>
<td>$0.00</td>
<td>$0.00</td>
<td>$0.00</td>
<td>$0.00</td>
</tr>
<tr>
<td>LP surplus</td>
<td>$107.01</td>
<td>$65.04</td>
<td>$30.06</td>
<td>$0.92</td>
<td>$0.00</td>
<td>$0.00</td>
<td>$0.00</td>
<td>$0.00</td>
</tr>
<tr>
<td>GM surplus</td>
<td>$26.75</td>
<td>$16.26</td>
<td>$7.52</td>
<td>$0.23</td>
<td>$0.00</td>
<td>$0.00</td>
<td>$0.00</td>
<td>$0.00</td>
</tr>
<tr>
<td>LPs receive</td>
<td>$274.11</td>
<td>$232.14</td>
<td>$197.16</td>
<td>$168.01</td>
<td>$151.80</td>
<td>$126.50</td>
<td>$105.42</td>
<td>$87.85</td>
</tr>
<tr>
<td>GM receives</td>
<td>$40.67</td>
<td>$30.18</td>
<td>$21.44</td>
<td>$14.15</td>
<td>$10.54</td>
<td>$8.79</td>
<td>$7.02</td>
<td>$5.47</td>
</tr>
</tbody>
</table>

Table 2 shows the payoffs to the manager (“GM”) and the investors (“LPs”) under the stated assumptions given a typical fund structure across the range of possible outcomes. The GM receives a 20-percent profit share after the LPs receive a return of their investment plus an eight-percent hurdle rate. This I assume throughout that the LPs invest $97.50 and the GM invests $2.50 unless otherwise stated.

The GM also receives an annual fee equal to two percent of the invested capital. This conforms to the proverbial two-and-20 fee arrangement. Guaranteed fees tend to be a bit lower in reality, particularly in the later years of a fund. I assume sufficient invested capital is set aside ($12.15 in the example) by the fund to pay the GM’s fee assuming a risk-free and tax-free rate of return of five percent. This is why the terminal values in Table 2 do not match the terminal values in Table 1. I establish a reserve so I can retain the binomial model. I will use five percent as a discount rate throughout in determining present values.

The variables r and v (the base expected rate of return and the possible variance each period) are specified to make the fund a very attractive investment while having roughly two-thirds of the GM’s compensation consist of the fee and one-third consist of the profits interest, both on an expected value basis. One study finds this ratio to be typical historically. The investment is a fairly good one from an LP’s perspective assuming a five-percent risk-free rate of return. An LP’s expected rate of return is 7.51 percent. Some of the premium would be compensation for bearing risk. The rest of the premium is value created by the GM’s efforts and knowledge. On these assumptions the GM captures slightly over half of the premium. Increasing the volatility of the return (i.e., increasing v) increases the GM’s share without changing the aggregate expected return. This is as one would expect given the option-like character of a GM’s profit share. I will flag situations in which a conclusion depends on a fund’s risk (which is a
function of \( v \), the expected profitability of the fund (which is a function of the difference between \( r \) and the risk free rate of return), or the division of profits between the GM and the LPs.

**A Comparison of the Tax Burden on a GM Under Current Law and Proposed Code Sec. 710**

Currently a GM's profit share is taxed at capital gains rates if a fund realizes capital gains on its investment in the project companies. This typically will be the case. It usually is assumed a GM pays tax at ordinary rates on the fee. This is not necessarily true. While it is true that a guaranteed payment under Code Sec. 707(c) is ordinary income to the recipient, under current tax law it is possible to structure a guarantee so that an amount that would be paid on a guarantee instead is paid out of partnership income in lieu of the guarantee if there is available income.\(^8\) Under this arrangement the GM's fee is capital gains if the fund has capital gains income in the relevant year. A successful buyout fund is likely to have capital gains income in the form of dividends throughout its life. A successful venture capital fund is likely to have capital gains income in the fund's later years. A fund also could invest sums set aside to pay the fee, or funds not yet invested in start-up companies, to yield capital gains. I am aware of no data on the extent to which funds actually exploit this legally low-risk\(^9\) and low-cost\(^10\) opportunity in structuring the fee or on how often funds that do exploit this opportunity have capital gains income to convert the fee.

Proposed Code Sec. 710 taxes as “ordinary income for the performance of services” a partner's distributive share of income on an “investment services partnership interest.”\(^11\) Gain on the disposition of an interest also is so treated\(^12\) as is gain is recognized by the partnership on a distribution of appreciated property “with respect to” an interest.\(^13\) In the typical private equity fund a GM will contribute a small percentage of the fund's capital. One study reports the norm is one percent. Other reports suggest GMs invest a higher percentage of capital in a range of one to five percent. Code Sec. 710 preserves the character of the part of a GM's distributive share that is a return on the GM's invested capital. Under an important prophylactic rule a GM's return on capital cannot exceed the return of other partners who do not provide capital.\(^14\)

Table 3 shows the calculation of the tax on the GM's distributive share of profits under proposed Code Sec. 710, assuming the GM's return on invested capital equals the LP's actual return on capital in the particular outcome. Recall the GM invests $2.50 or 2.5 percent of total fund capital. The GM's stated return on invested capital includes recovery of this investment. All other assumptions remain as stated above. Note that the higher rate of return to the LP in the better outcomes enables a GM to shield more profits from being taxed as compensation but that the fraction of a GM's profit share shielded from being taxed as compensation decreases.

Table 4 shows the after-tax return to the GM under current law and Code Sec. 710 across the range of possible outcomes. It assumes a 15-percent capital gains rate and a 35-percent ordinary rate and holds all other assumptions constant.

Table 4 illustrates that the bite of Code Sec. 710 is felt only when a fund is successful because the GM shares in profits only after the LPs recover their investment plus the hurdle rate. While Code Sec. 710 bites slightly harder in proportionate terms the more successful a fund turns out to be, this effect is blunted by crediting the GM with a return on its invested capital (which is taxed as capital gain) equal to the LPs' return on invested capital. Generally, decreasing

---

**Table 3**

<table>
<thead>
<tr>
<th>Probability</th>
<th>0.78%</th>
<th>5.47%</th>
<th>16.41%</th>
<th>27.34%</th>
<th>27.34%</th>
<th>16.41%</th>
<th>5.47%</th>
<th>0.78%</th>
</tr>
</thead>
<tbody>
<tr>
<td>LP's rate of return</td>
<td>15.9%</td>
<td>13.2%</td>
<td>10.6%</td>
<td>8.1%</td>
<td>6.5%</td>
<td>3.8%</td>
<td>1.1%</td>
<td>-1.5%</td>
</tr>
<tr>
<td>GM's return on invested capital</td>
<td>$7.03</td>
<td>$5.95</td>
<td>$5.06</td>
<td>$4.31</td>
<td>$4.06</td>
<td>$3.18</td>
<td>$2.30</td>
<td>$1.42</td>
</tr>
<tr>
<td>GM's compensation</td>
<td>$33.64</td>
<td>$24.23</td>
<td>$16.38</td>
<td>$9.84</td>
<td>$0.00</td>
<td>$0.00</td>
<td>$0.00</td>
<td>$0.00</td>
</tr>
</tbody>
</table>

**Table 4**

<table>
<thead>
<tr>
<th>Probability</th>
<th>0.78%</th>
<th>5.47%</th>
<th>16.41%</th>
<th>27.34%</th>
<th>27.34%</th>
<th>16.41%</th>
<th>5.47%</th>
<th>0.78%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-tax</td>
<td>$40.67</td>
<td>$30.18</td>
<td>$21.44</td>
<td>$14.15</td>
<td>$0.00</td>
<td>$0.00</td>
<td>$0.00</td>
<td>$0.00</td>
</tr>
<tr>
<td>After-tax now</td>
<td>$34.95</td>
<td>$26.03</td>
<td>$18.59</td>
<td>$12.40</td>
<td>$0.38</td>
<td>$0.38</td>
<td>$0.38</td>
<td>$0.38</td>
</tr>
<tr>
<td>After-tax § 710</td>
<td>$28.22</td>
<td>$21.18</td>
<td>$15.32</td>
<td>$10.43</td>
<td>$0.38</td>
<td>$0.38</td>
<td>$0.38</td>
<td>$0.38</td>
</tr>
</tbody>
</table>
the GM's capital contribution increases the impact of Code Sec. 710 while increasing the risk of the fund (v in the model) increases the impact of Code Sec. 710. The positive after-tax return to the GM in the outcomes in which the profit share does not payout is a product of the capital loss on the GM's invested capital.

As noted earlier, on average a GM earns two-thirds of its compensation from the fee and one-third from the profits interest. If the fee is treated as a guaranteed payment, then Code Sec. 710 will not alter its tax treatment. As a consequence, if one looks at the GM's total return on an expected value basis, then the impact of Code Sec. 710 is relatively modest. The variables in the model were specified to replicate a two-thirds/one-third ratio between the fee and the profits interest on an expected value basis. Code Sec. 710 decreases the after-tax expected value of the GM's total interest (the fee plus the profit share) in present dollars from $13.44 to $12.45.

This brings me to the single greatest unknown about the fiscal impact of Code Sec. 710. As explained earlier, there is a good chance under current law that a GM's fee can be structured so it is taxed as capital gain if a fund has capital gain income in a year. I do not know how often funds are structured to exploit this tax opportunity and how often funds that do exploit it have capital gain income to convert a GM's fee. If funds often do convert a GM's fee into capital gain, then Code Sec. 710 will have a much more significant impact both in the revenue it raises and in the increase in the tax burden on private equity.

Code Sec. 710 generally will prevent conversion of the fee into capital gains. A simple example illustrates why. Assume the GM invests $2.50, the LPs invest $97.50, and the fund has $5 capital gain income in year one. The GM is given a $2 priority on the capital gain income in lieu of a fee. The remaining $3 is allocated to the LPs. The LPs return on capital is 3.1 percent. The GM will treat eight cents of its return as capital gain, then Code Sec. 710 will have a much more significant impact both in the revenue it raises and in the increase in the tax burden on private equity.

Minor Design Issues

The discussion of Code Sec. 710 at the 2008 Chicago Tax Conference focused on two issues. Both are a product of the decision to preserve capital gain treatment of a GM's profit share insofar as profits represent a reasonable return on the GM's invested capital: (1) defining what is a "reasonable return" on a GM's invested capital, particularly when there are multiple classes of investors who have returns with different time and risk structures; and 2) whether and how a GM's invested capital should be adjusted to include a GM's share of book gain on revaluation events that do not involve either realization or recognition of the book gain. A general theme of this part is that these are technical issues that do not seriously threaten the effort to tax a GM's profit share as compensation.

Identifying a Reasonable Return on a GM's Invested Capital

The logic behind the approach taken in Code Sec. 710 is that any return a GM receives in excess of the return the LPs receive on their capital is identified as a return received by the GM in return for providing services to the fund. The tactic of inferring an unknown amount from a known amount in an arm's-length exchange is a familiar one in tax law. The pattern of returns in Table 3 points up one objection to employing this tactic in this context. The deemed amount paid for a GM's services varies widely from zero in half of the outcomes to $40.67 in the best outcome. A much closer approximation of what the LPs were willing to pay for the GM's services is the expected value of the profits interest, which is $9.35 in year seven and $6.65 in present value (using a five-percent discount rate). This is the small kernel of truth in the argument that much of a GM's return is for risk-taking and for accepted deferred returns, and so is analogous to capital gains. Because of the difficulty of valuing a GM's profits interest, and the certainty that taxpayers will report aggressively low values under a rule taxing an interest on receipt, no one seriously proposes trying to measure compensation by the value of the interest received.

The worry is that when there are multiple classes of LPs with returns that have different time and risk structures, it will become difficult to identify whether the actual return received by a GM who invests significant capital is a return on capital or a return on a profits interest received in exchange for labor. This problem is easy to solve technically. It boils down to a choice between a strong or a weak formal rule. Under a strong formal rule the benchmark would be the lowest return to capital to date received by any
class of LP interests. Under a weak formal rule the benchmark would be the highest return to capital to date received by any class of LP interests. Both rules are easy to understand and to apply. Private equity funds already collect the relevant information and make similar calculations in allocating profits between the GM and LPs to give the LPs priority on profits until the hurdle rate is achieved.

Private equity funds generally have only one class of equity interests so this problem does not arise. If the problem does arise, then it most likely will be presented by funds that issue low-risk LP interests akin to preferred stock and high-risk LP interests akin to common stock or options. If we assume a bifurcated LP structure along these lines, then it turns out there is little difference on an expected value basis between the weak rule and the strong rule, which Tables 5 and 6 illustrate. I assume the LP interest is broken into two classes, defined as LP1 and LP2. LP1 invests $85 in capital and receives a priority return of eight percent plus five percent of total LP profits in excess of the priority return. LP2 invests $12.50 in capital and receives the balance of LP profits. LP1 resembles high interest debt with an equity kicker. LP2 resembles common stock or an option. The two classes have similar expected returns.

Table 5 shows the payouts to LP1 and LP2 across the different outcomes and the rate of return to each. It also shows the “blended” rate of return for purposes of comparison. The blended rate is what the benchmark rate would have been had there been a single class of LP interests.

Under the weak formal rule the higher rate of return is used to calculate the GM’s return on invested capital, which is taxed as capital gain. Under the strong formal rule the lower rate of return is used. Under the weak formal rule, this rate will be higher than the rate that would have applied with a single class of LP interests. Under the strong formal rule this rate will be lower. The change in the GM’s deemed return on invested capital alters the GM’s tax burden, but the effect is pronounced only in low probability outcomes in which a fund is extremely profitable. Table 6 illustrates. It shows the after-tax value of GM’s profits interest in each outcome assuming a single class of LP interests, a bifurcated LP structure under a weak rule, and a bifurcated LP structure under a strong rule.

The difference is trivial on an expected value basis. The expected present value of the GM’s profit interest is $4.93 in the first case, $4.89 in the second and $5.14 in the third. There are two reasons for this. The more important reason is that neither class of LP interests in a bifurcated structure has a significantly higher yield than a unitary LP interest when a fund’s return is only marginally better than the hurdle rate, which are the most likely outcomes in which a manager’s profit interest pays out. The other reason is that in highly profitable outcomes the return on the common stock or option-like LP interest remains a fraction (albeit a smaller fraction) of the GM’s return on invested capital.

The point to be taken away from this is that the problem of multiple classes of LP interests is solvable. Either of two administrable formal rules is likely to have tolerable effects on people’s behavior. The weak rule gives people some incentive to use multi class LP structures, and loses some revenue, but these effects are small. The strong rule is unlikely to create a significant disincentive to using multi class LP structures. The weak rule is preferable to the strong if there is a real worry about a strong rule hindering experimentation with novel capital structures. The strong rule is preferable to the weak if there is a real worry about a weak rule encouraging people to manipulate capital structure to minimize tax.

Table 5

<table>
<thead>
<tr>
<th>Probability</th>
<th>0.78%</th>
<th>5.47%</th>
<th>16.41%</th>
<th>27.34%</th>
<th>27.34%</th>
<th>16.41%</th>
<th>5.47%</th>
<th>0.78%</th>
</tr>
</thead>
<tbody>
<tr>
<td>LP1 return</td>
<td>$152.10</td>
<td>$150.00</td>
<td>$148.25</td>
<td>$146.79</td>
<td>$145.98</td>
<td>$126.50</td>
<td>$105.42</td>
<td>$87.85</td>
</tr>
<tr>
<td>LP1 rate</td>
<td>8.7%</td>
<td>8.5%</td>
<td>8.3%</td>
<td>8.1%</td>
<td>8.0%</td>
<td>5.8%</td>
<td>3.1%</td>
<td>0.5%</td>
</tr>
<tr>
<td>LP2 return</td>
<td>$122.01</td>
<td>$82.14</td>
<td>$48.91</td>
<td>$21.22</td>
<td>$5.82</td>
<td>$0.00</td>
<td>$0.00</td>
<td>$0.00</td>
</tr>
<tr>
<td>LP2 rate</td>
<td>38.5%</td>
<td>30.9%</td>
<td>21.5%</td>
<td>10.3%</td>
<td>-100.0%</td>
<td>-100.0%</td>
<td>-100.0%</td>
<td>-100.0%</td>
</tr>
<tr>
<td>“Blended” rate</td>
<td>15.9%</td>
<td>13.2%</td>
<td>10.6%</td>
<td>8.1%</td>
<td>6.5%</td>
<td>3.8%</td>
<td>1.1%</td>
<td>-1.5%</td>
</tr>
</tbody>
</table>

Table 6

<table>
<thead>
<tr>
<th>Probability</th>
<th>0.78%</th>
<th>5.47%</th>
<th>16.41%</th>
<th>27.34%</th>
<th>27.34%</th>
<th>16.41%</th>
<th>5.47%</th>
<th>0.78%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single LP</td>
<td>$28.22</td>
<td>$21.18</td>
<td>$15.32</td>
<td>$10.43</td>
<td>$0.38</td>
<td>$0.38</td>
<td>$0.38</td>
<td>$0.38</td>
</tr>
<tr>
<td>Bi-LP weak rule</td>
<td>$31.69</td>
<td>$23.28</td>
<td>$16.26</td>
<td>$10.44</td>
<td>$0.38</td>
<td>$0.38</td>
<td>$0.38</td>
<td>$0.38</td>
</tr>
<tr>
<td>Bi-LP strong rule</td>
<td>$27.71</td>
<td>$20.87</td>
<td>$15.18</td>
<td>$10.42</td>
<td>$0.38</td>
<td>$0.38</td>
<td>$0.38</td>
<td>$0.38</td>
</tr>
</tbody>
</table>

TAXES—THE TAX MAGAZINE®
Revaluations
The issue of revaluations raises the questions of whether and how to adjust a manager's invested capital when a fund has book gains that are not realized or recognized for tax purposes. The discussion at the conference focused on the case in which a fund's assets increase in value and new capital is contributed. The Code Sec. 704(b) regulations permit revaluation of a partnership's assets in this situation and the allocation of book gain to the existing partners. This prompts questions about the book and tax consequences of a revaluation to the manager. The question is more general. For example, a similar question arises if funds merge. And the question arises in any non-pro rata contribution or distribution. Thus, a fund can trigger an elective revaluation by paying a GM cash that the GM reconverts.

Existing partnership rules supply an elegant way to handle revaluations that suffers from being dauntingly complicated. The solution is to tag a manager with book gain equal to the tax gain that would have been allocated to the manager had the fund sold its assets at fair market value and liquidated at the time of the transaction triggering the revaluation ("the hypothetical sale"). This book gain (assuming it does not disappear before a realization and recognition event) is eventually taxed to the manager in whatever character the gain would have had to the manager in the hypothetical sale. The manager's invested capital is increased by the amount of the manager's book gain in the hypothetical sale. The restated invested capital is used to determine the extent to which future profits allocations (excluding the profit booked in the hypothetical sale) represent a return to invested capital taxed as capital gain.

This is best illustrated with a stripped down example. The GM invests $5 and the LPs invest $95 in an asset worth $100. After two years the asset is worth $200 when an event justifying a revaluation occurs. The asset is booked up to $200 by the fund. Profits are split $80 to the LPs and $20 to the GM. Of the GM's $20 book gain, $4.21 is tagged as a return on invested capital that will eventually be taxed as capital gain.20 $15.79 is tagged to eventually be taxed as compensation. The GM's invested capital is increased from $5 to $25.

My experience in teaching Code Sec. 704(c), which is where this approach to handling built-in gain and loss is best articulated, is that even stripped down examples like the above tax the patience of diligent students. Making these sorts of calculations to tag a manager of a private equity fund with compensatory built in gain for later recognition is vastly more complicated. A GM's share of overall book gain on an asset revaluation could range from zero to 20 percent, depending on how much the overall gain surpasses the hurdle rate. Each of a fund's investments would have to be separately valued. It is not clear how a GM's share of the overall book gain should be spread across a mix of gain and loss assets. And so on.

Notwithstanding this complexity, a revaluation can be attractive to a GM because an increase in a GM's invested capital increases the amount of future gain that is taxed as capital gain. While the effect is quite slight when low yields recur, it becomes significant when high yields recur. For example, if a fund realizes a 10-percent yield over consecutive years, then a revaluation after the first year converts only 3.21 percent of the GM's second year return from compensation into capital gains. This is hardly worth the headaches of a revaluation. But this number increases to 6.21 percent at 20-percent consecutive returns and to nine percent at 30-percent consecutive returns. If a fund doubles in value twice, then revaluing after the first doubling converts almost one-quarter of the GM's total return from compensation into capital gains. A GM of a fund that has a wildly profitable run of years may clamor for revaluation. Revaluation becomes even more attractive if it can be done retroactively.

A simple way to temper the incentive to revalue is to permit a revaluation to increase a GM's invested capital only if the GM recognizes the book gain for tax purposes. The loss of the tax benefit of deferral generally swamps the benefit of converting a fraction of an uncertain future gain from ordinary income into capital gain. This solution has an attractive symmetry for in most other contexts investments that yield capital gain are made with already taxed wealth.

LP Financing of GM Invested Capital
Noel Cunningham and Mitchell Engler have argued that treating the LPs as having loaned the GM sufficient funds to purchase the GM's profits interest produces attractive results as a matter of tax policy.20 Interest is imputed on the implicit loan as compensation to the GM under Code Sec. 7872 either at the applicable federal rate or at whatever other rate is thought appropriate. Cunningham and Engler also propose to allow the GM to deduct the imputed interest as an expense but treat the interest as invest-
ment interest. The underlying idea is that the interest expense should be used to shield the GM from capital gain income. This is roughly similar to giving the GM a basis in its profits interest equal to the amount of imputed compensation and allowing the GM to offset this basis against its share of profits as the profits are earned or to recover the basis as a loss if the fund winds up not repaying the GM's capital.

The Cunningham-Engler proposal is similar to a possible design around Code Sec. 710. In this design, the LPs reduce their invested capital in a fund and instead use the withheld capital to make a non-recourse loan to the GM. The loan is secured by the GM's interest in the fund. The GM invests the capital in the fund. The effect is to shift invested capital from the LPs to the GM. Most analyses assume a loan of sufficient amount to shift the ratio of GM-to-LP invested capital to 20/80, which is sufficient to ensure that any profits a GM receives will be treated as a return on capital. The GM also receives an additional allocation of profits to pay off the principal amount of the loan. This is a wash from the perspective of both parties from both tax and economic purposes.

A curious feature of proposed Code Sec. 710 is that it prevents this design around by disregarding GM invested capital when it is funded by a loan from an LP (or a related party). This is curious because Cunningham and Engler are right. Imputing interest on a hypothetical loan produces after-tax results that on an expected value basis are fairly close to the results under Code Sec. 710 if the interest is treated as an investment interest expense (or, even better, if it is capitalized in the GM's profit interest). I can think of no good policy reason for this decision apart from uncertainty over the tax treatment of the stated or imputed interest.

**A Possible Achilles Heel: A Hybrid of LP Equity and Debt**

In his defense of the status quo, Weisbach analogizes the financial structure of a fund to situations in which (1) an individual manages an investment made with borrowed funds (I will call this "the investing on margin analogy"), and (2) a fund sponsor (a.k.a., the GM) raises funds by issuing debt rather than equity (I will call this "the LP-as-lender analogy").

Weisbach uses the investing on margin analogy to make a rhetorical point. His point is that a taxpayer who actively manages an investment made with borrowed funds gets to treat a positive return as capital gain, even though a significant part of the return is attributable to the taxpayer's expenditure of time and effort. The analogy reminds us that tax law does not cleanly distinguish between returns to labor and returns to capital, particularly when it comes to risk-taking that involves working with borrowed capital.

The investing on margin analogy bears on the practicality of taxing a GM's profit share as compensation only if investing on margin is a practical substitute for the fund structure. The two arrangements are very dissimilar economically, making them poor substitutes. An investment in a private equity fund is locked in for five to ten years come what may. An investment on margin is subject to an automatic margin calls if the investment declines in value, exposing the lender to a risk the investment (which is collateral) will be insufficient to repay the loan. A GM bears no risk of loss beyond its capital contribution (which often is as small as one percent of capital) and reaps only one-fifth of the gain on the investment made with the LPs' money. An investor on margin bears the risk of any loss on the investment and reaps all of the gain. The investor is obligated to pay interest on margin financing come what may. Investors in a fund are compensated for the use of their capital by receiving a preferred return. And so on.

The LP-as-lender analogy is more interesting from a practical perspective. This is how Weisbach describes the alternative arrangement:

Suppose that instead of using limited partnership interests, the sponsors issued debt. The debt could have terms similar to the limited partnership interests: it would be nonrecourse debt with a fixed rate of interest of 8 percent and an equity kicker of 80 percent of all profits above 10 percent. If this security would not qualify as debt, it would be relatively easy to structure a similar security or combination of payoffs that would.

Distinguishing between debt and equity interests in an enterprise is a vexed problem in tax law. Still it is possible to say with a high degree of confidence that a typical LP interest in a private equity fund will be treated for tax purposes as equity even if the interest is labeled as debt. A typical LP interest has many of the attributes of equity and few of the attributes of debt. The equity-like attributes include the fact that the interest is in a thinly capitalized high-risk venture, the fact that the LP has no recourse other than against venture assets, the fact that the interest is paid...
only out of available income, and the fact that the LP shares in gain.

Weisbach knows this. While he does not develop the point, I assume what he has in mind is restructuring an LP interest as a mix of debt and equity that in tandem will match the payoffs under the typical fund structure in a way that qualifies the debt instrument as debt for tax purposes. This is fairly easy to do. A part and perhaps all of an LP's priority rights under the hurdle structure could be repackage as the payments on a discounted debt instrument. If this done with the entire payment stream, then "LP debt" would pay an amount equal to total LP capital (the sum raised from issuing LP debt plus LP equity) plus the hurdle rate. LP equity would have the right to 80 percent of profits once LP debt was paid and the GM make up was satisfied. So long as LP debt and LP equity is in the same hands, this structure has the exact same risks and cash flows as the current fund structure. Structuring part of the LP interest as debt might give the LPs additional legal rights, particularly in the event of a nominal default. But I imagine there are ways to work around this that would not imperil classification of the interest as debt. For example, the LP debt could be held by a trust to prevent individual investors from opportunistically asserting legal rights.

This structure reduces the LPs' invested equity, which has the effect of increasing the LPs' return on equity when a fund is very successful. This allows the GM to treat more profits as a "reasonable return" on its invested capital. The relative prices set on the LP loan and the LP equity determines how much of the GM's profit interest is satisfied. Assume as above that the GM contributes $2.50 and the LPs contribute $97.50. To take an extreme example, pricing the LP debt at $97.25 and the LP equity at 25 cents effectively shields all of the GM's profits from being taxed as compensation in most outcomes in which a GM receives profits.23

This is the potential Achilles heel of Code Sec. 710. It is ironic that the drafters wrote Code Sec. 710 to close the door to an unproblematic substitute (LP financing of a GM's invested capital) while leaving the door open to a much more problematic substitute. Though it is possible that the drafters foresaw this issue and left it to be dealt with by regulations defining a reasonable return on a GM's invested capital. Happily, there is a solution. A strong rule would aggregate LP-debt and LP-equity if it is held by the same hands (or by related hands) for purposes of determining an LP's invested capital and the return to capital.

Whether the strong rule will work depends on how much a fund is able to raise in an arm's-length transaction by issuing a security with cash flows that match an LP's priority rights that will be treated as debt for tax purposes. The key is to raise as much capital as possible through debt, lowering the price of equity, and increasing the rate of return on equity in profitable outcomes, which in turn increases the benchmark rate the GM will use in determining its return on invested capital. The model illustrates the basic dynamics and suggests there is reason for hope. Recall that the expected present value of the GM's profits interest is $6.65 pre-tax. After-tax the expected present value is $5.92 under current law and $4.93 under Code Sec. 710. Splitting the LP interest into debt with rights that match the priority right and equity actually reduces the after-tax expected value of the GM's profits interest if the debt-equity ratio is less than 92-to-8 (the $8 includes both GM and LP equity capital). While this may seem counter-intuitive, it is a consequence of treating none of the GM's return as a reasonable return on capital in outcomes in which the GM receives a profit payout not matched by the payout to LP-equity. A debt-equity ratio greater than 92-to-8 increases the expected after-tax value of the GM's profits interest so that this value is higher than it would be with pure LP equity. For example, a debt-equity ratio of 96-to-4 increases the expected after tax-value of the GM's profit interest from $4.93 to $5.37, or by over eight percent, eliminating almost half of the tax burden imposed by Code Sec. 710.

I do not know what price a typical LP priority right would bring in an arm's-length transaction sold separately from the LP right to surplus profits. Under the assumed payout structure the LP priority right could command a fairly high price. The expected present value of the LP priority right is $108.21 while the expected present value of the LP right to surplus profits is $6.81. This is because I assumed an average return significantly higher than a normal return and that the LP investors almost always recovered almost all of their invested capital. I expect few funds offer such rewards with so little risk. Increasing the risk-reward ratio of an investment in a fund (i.e., decreasing r and increasing v) decreases the value of the LP priority right in relationship to the LP right to surplus profits. In the current economic environment, I think we can be confident that funds will not respond to Code Sec. 710 by raising capital by repacking LP priority rights as debt sold separately from the LP right to surplus profits. In any event, even if a fund was expected to
offer supra-normal returns, it would be odd if the fund responded to this be raising capital in a way that implicitly underpriced equity relative to debt. The success of a hybrid capital turns on equity being under-priced so that it will yield a sufficiently high return to mask the GM’s profits from being taxed as compensation in the most profitable outcomes.

This does suggest that it is important to the success of Code Sec. 710 that LP debt and equity be aggregated when it is in the same hands (or related hands) for purposes of determining a reasonable return on a GM’s invested capital. When LP debt and equity is in the same (or related) hands there are no economic constraints on pricing debt high in relation to equity. The IRS could try to discourage funds from under-pricing equity on an ex post ad hoc basis by enforcing a rule that disregards returns on under-priced equity. But this presents problems similar to trying to tax a GM on the expected value of a profits interest on receipt of the interest. People can be expected to price equity relative to debt aggressively to shield as much of a GM’s profits as possible from being taxed as compensation. The IRS will find itself contesting valuation on a case-by-case basis facing a taxpayer who has the upper hand in resources and information.

Conclusion

The pragmatic argument against Code Sec. 710 is that it will complicate tax law without raising revenue because people can easily plan around the rule. I have shown in this article that there are good reasons to think this is not true, particularly if teeth are put in Code Sec. 710. Many of the problems that have been raised, such as identifying a reasonable return on a GM’s invested capital when there are multiple classes of LP interests and handling revaluations, are technical in nature and solvable. There is concern that people will respond to Code Sec. 710 by restating a GM’s profit share as compensation. This would provide individual LPs an offsetting tax benefit equal to the GM’s tax burden, reducing the revenue gain from the statute. But this response can be tempered by a rule that treats a GM’s contingent compensation as a profit allocation. Another concern is that a LP interest will be disaggregated into debt and equity with a low value being assigned to the equity and a high value assigned to the debt. Low-balling the value of equity would increase the return on equity when a fund is successful, and allow a GM to characterize a larger share of its profits as a reasonable return on its invested capital. As a guard against this debt and equity should be aggregated when it comes from the same pockets or related pockets for purposes of determining what is a “reasonable return” on a GM’s invested capital.

This article also highlights an important unknown about the impact of Code Sec. 710. Under current law it is possible to structure a GM’s fee so that the fee is capital gain if a fund has capital gain income in the year the fee is paid. I know of no data on how often funds take advantage of this. If funds often do take advantage of this, then Code Sec. 710 will have a much greater impact for a side-product of Code Sec. 710 is that it makes it virtually impossible to convert a fee into capital gain.

ENDNOTES

2 Mark P. Gergen, Reforming Subchapter K: Compensating Service Partners, 48 TAX L. REV. 1 (1992). A major difference is that I proposed treating the other partners as having an expense equal to the service partner’s income. Code Sec. 710 does not do this. The approach taken by Code Sec. 710 is defensible in the context of private equity funds because it avoids the situation in which individual investors get the tax benefit of concurrent capital gain income and an ordinary deduction.
4 If the change was costly, then it would also be relevant whether a fund’s infra marginal investors were individuals benefiting from the change or other types of investors, which were indifferent to it.
5 Most of this is taken from Andrew Metrick and Ayako Yasuda, The Economics of Private Equity Funds (Sept. 8, 2008), Swedish Institute for Financial Research Conference on The Economics of the Private Equity Market, Available at SSRN: http://ssrn.com/abstract=596334. This is consistent with Weisbach’s description. See 94 VA. L. REV., at 720–26.
6 The expected value of the fee is $11.57 and the expected value of the GM’s profit interest is $6.65.
7 Metrick and Yasuda, supra note 5.
9 While this is permissible under Code Sec. 707(c) the government could argue that the GM has ordinary income on receipt of the interest because it falls outside the safe harbor of Rev. Proc. 93-27, 1993-2 CB 343 or that the profits are compensation under Code Sec. 707(a)(2)(A). For a discussion of the legal issues, see Gregg D Polsky, Private Equity Management Fee Conversions (Nov. 4, 2008). SSRN: http://ssrn.com/abstract=1295443.
10 The qualification is because there is a cost to LPs who are not tax-indifferent in forgoing the deduction for a Code Sec. 707(c) payment.
11 Proposed Code Sec. 710(a). An investment services partnership interest is an interest held by a person who provides a “substantial quantity” of certain enumerated services “with respect to the assets of the partnership in the conduct of the trade or business of providing such services.” Proposed Code Sec. 710(c)(1). Enumerated services include:

149

March 2009

HeinOnline -- 87 Tax Mag. 149 2009
(A) Advising as to the advisability of investing in, purchasing, or selling any specified asset. Managing, acquiring, or disposing of any specified asset. Arranging financing with respect to acquiring specified assets. Any activity in support of any service described in subparagraphs (A) through (C).

Specified assets are securities, real estate, commodities and options or derivative contracts with respect to securities, real estate and commodities. The general line drawn here is between managing assets and creating or developing assets. The legislation will cover a partner who receives an interest in a real estate development partnership for services that include a "substantial quantity" of work advising the partnership on the acquisition or sale of real estate, managing real estate or arranging financing. It will not cover a partner who oversaw construction or development of real estate so long as the partner does not also provide a "substantial quantity" of enumerated services. Your guess is as good as mine as to whether this will apply to a service partner in an oil and gas venture. It clearly will not cover a service partner in an R&D partnership, i.e., the "brains" in the classic "money-brains" partnership. Nor will it cover a service partner, such as an actor, in a creative enterprise, such as a film deal. Intellectual property is not among the specified assets and creative activities are not among the enumerated services. This sort of line-drawing invites innumerable quibbles. For example, a manager in a "troll fund," which invests in "manages" and sells patents, will not be covered because patents are not among the specified assets.

12 Proposed Code Sec. 710(b).
13 Proposed Code Sec. 710(b)(4). It is not clear what this means. The most likely solution is to treat the partner as having compensation equal to the amount of compensation the partner would have had if the partnership had sold its assets for their fair market value immediately prior to the sale or liquidation. This handling of a sale follows Code Sec. 751(a). This handling of a liquidating distribution follows Code Sec. 737. The Code Sec. 704(c) regulations preserve the attribute of booked built-in gain as compensation through various events in the life-cycle of a partnership.

14 The rule prohibits allocating to a service partner "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." Data on this could cast light on other issues of interest. If funds that predictably yield recurring capital gains do not exploit this opportunity, then it would be interesting to know why. A possible reason is that the tax cost to individual investors offsets the tax benefit to managers. This would tend to suggest that funds will respond to Code Sec. 710 by restructuring profits that are taxed as compensation to be stated as compensation to provide individual investors the tax benefit described in Section 1. Similarly, if funds tend not to exploit this opportunity when they have a large number of individual investors, then it would suggest that the private equity market might respond to Code Sec. 710 by segmenting between funds that cater to individual investors and funds that cater to other investors. On the other hand, if funds that now predominantly serve nonindividual investors do not exploit this opportunity, then it would suggest that people are likely to try to design around Code Sec. 710, but it also increases the revenue gain from Code Sec. 710 in a sector that is difficult to design around.

16 There was a suggestion at the conference that difficulties also arise when there are multiple classes of service partners who invest different amounts of capital in proportion to the value of the services they contribute. This is not a problem for an approximation of the value of the services contributed by each service partner may be inferred by comparing the return of each service partner to the return of a partner who contributed significant capital and no services.

17 See, e.g., T.C. Davis, SCI, 62-2 ustc ¶9509, 370 US 65 (1962) (inferring value to taxpayer of inducing spouse to relinquish inchoate marital rights from the value of property relinquished in the exchange). It is easy in principle to devise an LP class that would shield all of a GM's profits under the weak rule. An LP class that tracks the GM's capital contribution and profit allocation does the trick. But no fund would sell such an interest unless it was a sham for it to be buttressed by an anti-abuse rule that bars a sufficient deterrent, then the weak rule can make up.

18 It is easy in principle to devise an LP class that would shield all of a GM's profits under the weak rule. An LP class that tracks the GM's capital contribution and profit allocation does the trick. But no fund would sell such an interest unless it was a sham for it to be buttressed by an anti-abuse rule that bars a sufficient deterrent, then the weak rule can make up.

19 There was a suggestion at the conference that difficulties also arise when there are multiple classes of service partners who invest different amounts of capital in proportion to the value of the services they contribute. This is not a problem for an approximation of the value of the services contributed by each service partner may be inferred by comparing the return of each service partner to the return of a partner who contributed significant capital and no services.

17 See, e.g., T.C. Davis, SCI, 62-2 ustc ¶9509, 370 US 65 (1962) (inferring value to taxpayer of inducing spouse to relinquish inchoate marital rights from the value of property relinquished in the exchange). It is easy in principle to devise an LP class that would shield all of a GM's profits under the weak rule. An LP class that tracks the GM's capital contribution and profit allocation does the trick. But no fund would sell such an interest unless it was a sham for it to be buttressed by an anti-abuse rule that bars a sufficient deterrent, then the weak rule can make up.

The discounted present value of this is $6.57, using a five-percent discount rate. Subtracting the present value of the annual 31 cent tax charge ($1.77) yields $4.80 on an expected value basis. This is slightly less than the expected value of a profits interest under Code Sec. 710 ($4.89).

21 This can be shown with the model. Keep all of the assumptions stated above but add a loan of $17.50 from the LPs to the GM to bring the GM's invested capital up to $20. This is sufficient to shield all profits from being taxed as compensation as the GM's return on invested capital will never exceed the LPs' return. At a rate of five percent, annual imputed interest is 88 cents and the GM's tax cost is 31 cents per year. The GM capitalizes a total of $6.13 interest. In year seven the GM has a basis of $8.63 in its profit share. Profits in excess of this are taxed as capital gain. Lesser profit yields a capital loss. This leaves the GM with the following amounts after-tax in year seven:

<table>
<thead>
<tr>
<th>Probability</th>
<th>Amount</th>
<th>Probability</th>
<th>Amount</th>
<th>Probability</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.78</td>
<td>$35.86</td>
<td>0.47</td>
<td>$19.51</td>
<td>0.27</td>
<td>$12.91</td>
</tr>
<tr>
<td>0.47</td>
<td>$26.95</td>
<td>0.16</td>
<td>$12.91</td>
<td>0.03</td>
<td>$1.29</td>
</tr>
<tr>
<td>0.16</td>
<td>$27.34</td>
<td>0.04</td>
<td>$12.91</td>
<td>0.00</td>
<td>$1.29</td>
</tr>
<tr>
<td>0.04</td>
<td>$1.29</td>
<td>0.00</td>
<td>$1.29</td>
<td>0.00</td>
<td>$1.29</td>
</tr>
</tbody>
</table>

A GM's profits are still taxed as compensation in outcomes in which the GM earns 100 percent of the profits under the profit makeup and outcomes in which the LPs' "excess profits" (i.e., profits over and above the LPs' hurdle rate and the GMs' make up) do not provide a sufficient rate of return to LP equity to treat the GM's profit share as a reasonable return on equity.