TAXING PRIVATE EQUITY CARRIED INTEREST USING AN INCENTIVE STOCK OPTION ANALOGY

Rarely does an idea that germinates in a law review article catch the attention of Congress. Even more rarely does such an idea inspire policy statements by presidential candidates. Recently, however, an idea that originated in Professor Victor Fleischer’s forthcoming article, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, has done both. The issue to which it relates is the taxation of the so-called “carried interest” that private equity professionals earn from their funds’ investments.

Private equity funds are in the business of buying and selling companies. They make money when they sell their holdings at a profit or, less frequently, when their holdings pay dividends. Fund managers are paid in part with a share of the fund’s profits — a share called carried interest, or simply “carry.” It has long been the law that when profits flow through to the managers, the managers pay tax on the profits as if they had sold the stock or received the dividend for their own accounts. That is, if the fund recognizes long-term capital gains, the managers recognize long-term capital gains and pay a 15% tax; likewise, if the fund recognizes qualified dividends, the managers recognize qualified dividend income and pay a 15% tax. These tax rates contrast with the marginal tax rate that workers pay on their salaries, which can be as high as 35%, plus 1.45% for Medicare, and up to 6.2% more for Social Security.

Recent scholarship challenges this discrepancy, and legislative proposals seek to change it. Led by Professor Fleischer, tax scholars, not

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2 See Andrew Ross Sorkin, *A Professor’s Word on a Buyout Tax Battle*, N.Y. TIMES DEALBOOK, Oct. 3, 2007, at 8 (describing how Professor Fleischer’s idea progressed from “a draft of a paper” about “the arcane intricacies” of “an unglamorous topic” to “front-page news” that has been “the subject of hearings on Capitol Hill and the focus of a proposed bill”).
6 Id. § 3101(a).
former policymakers,\(^8\) legislators,\(^9\) and even some business executives\(^{10}\) have argued that carried interest is, in substance, compensation for labor and should be taxed as such. They have accordingly called for tax law reforms that would, at least in some instances, raise the rate of tax that private equity partners pay on their carried interest. Opponents — principally private equity partners and those who represent them — argue that these reforms would create inequity, encourage investors to expatriate their capital, or otherwise harm the economy.\(^{11}\) The issue has even become a talking point for 2008 presidential hopefuls.\(^{12}\) No politically viable resolution of the issue has yet emerged, however. This Note seeks to offer one — one that is both moderate and rooted in existing tax code paradigms.

Part I describes the tax statutes and regulatory pronouncements applicable to carried interest. Through comparisons with other forms of incentive compensation — specifically, stock and stock options — it explains why the tax treatment of carried interest is peculiar and highly favorable to taxpayers, and it concludes that the form of incentive compensation that is most similar to carried interest from both an economic and a tax perspective is an incentive stock option (ISO).

Part II examines ISOs in greater detail and suggests that some of the features of ISO taxation that differ from pure capital gains treatment might also be useful to bridge the gap between the sides of the carried interest debate. Part III then explores the various scholarly and legislative positions in that debate and proposes an intermediate approach.

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\(^8\) See, e.g., Jenny Anderson, Scrutiny on Tax Rates that Fund Managers Pay, N.Y. TIMES, June 13, 2007, at C3 (discussing comments made by former Treasury Secretary Robert Rubin).


\(^10\) See, e.g., Stephen Labaton & Jenny Anderson, Pension Effect from Tax Plan Is Called Slight, N.Y. TIMES, Sept. 7, 2007, at C1 (reporting pro-reform remarks by Leo Hindery, Jr., who was formerly a telecommunications executive and is now a private equity fund manager).

\(^11\) Id. Of course, the incentive to expatriate would disappear if foreign governments also raised the tax rates on private equity profits, as the United Kingdom has recently suggested it might do. See U.K. Tax Loopholes To Close, INT’L HERALD TRIB., Oct. 10, 2007, at 11.

to taxing carried interest. This approach is less taxpayer-friendly than the current regime, yet less aggressive and more in tune with existing and accepted forms of compensation — and therefore perhaps more politically palatable — than many proposals that have been advanced.

I. ECONOMICS AND TAXATION OF EQUITY COMPENSATION

A. Private Equity Funds and the Compensation of Their Managers

Private equity funds are typically organized either as partnerships or as limited liability companies that are taxed as partnerships so that they can avoid the entity-level tax that C corporations must pay.13 The general partner or partners — the fund’s investment professionals or a partnership or LLC that they form — manage the fund’s business and make the investment decisions. The limited partners — endowments, pension funds, wealthy individuals, and the like — supply most of the capital for the fund to invest.

The general partners are compensated in two ways. First, regardless of the fund’s performance, they receive an annual management fee, which they use to pay ordinary expenses such as office rent, staff salaries, and their own compensation. The management fee is typically paid as a percentage of the limited partners’ capital commitments to the fund, and 2% is common.14 Thus, for example, the general partners of the Texas Pacific Group’s $14-billion TPG Partners V fund15 will receive $280 million in management fees during each year of the fund’s life.16 These fees are taxed as ordinary income just as any employee’s salary would be.17 Second, general partners receive a portion of any profits that the fund returns to its investors. It is this share of the fund’s profits that has placed the most successful fund managers among the richest of the nation’s rich. For example, suppose that Texas Pacific’s fund operates for seven years, that the committed capital is entirely invested in equal portions over the first three years, that the fund returns a modest 10% per year, and that the fund realizes

13 Jack S. Levin, Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions ¶ 1001.3, at 10-9 (2007); see also id. ¶ 1001.1—2, at 10-3 to 10-9 (discussing the tax implications of the choice of entity in the context of private equity fund formation).
14 Id. ¶ 1004, at 10-13; Fleischer, supra note 1, at 5.
16 This example makes the simplifying assumption that the management fee remains constant throughout the fund’s lifetime. It is not uncommon, however, for the management fee to decline in the fund’s later years of existence, after most of its capital has been invested. See Levin, supra note 13, ¶ 1004, at 10-14.
17 Id. ¶ 1004, at 10-15; Fleischer, supra note 1, at 7.
its profits in equal portions over the last three years. If the general partners receive the industry-standard 20% carried interest18 and the partnership reimburses the limited partners for all of the management fees before any carried interest is distributed,19 the general partners will earn about $2.5 billion more.20 The taxation of these outsized profits has become the subject of the recent debate.

B. Carried Interest as Common Stock

1. Economic Equivalence. — Carried interest is an ownership share in the profits generated by the fund. In this sense, carried interest in a partnership is economically analogous to common stock in a corporation that is financed by common stock and participating preferred stock having a 1x liquidity preference.21 Upon liquidation, a preferred stockholder is entitled both to receive its liquidity preference and to participate ratably with the common stockholders in any additional distributions, and an owner of common stock will receive a ratable share of the distributions after the preferred stockholders’ liquidity preference is paid. Analogously, a limited partner’s interest in a private equity partnership entitles the limited partner both to receive back its capital contribution and to participate ratably with the general partners who hold carried interest in any profits of the partnership, and an owner of carried interest will receive a ratable share of the partnership’s distributions after the capital contributions are repaid.

2. Tax Comparison. — If a manager of a corporation is compensated with stock, he must pay tax on that stock. Under § 83(a) of the Internal Revenue Code, a person who receives property in connection with the performance of services recognizes the fair market value of

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18 LEVIN, supra note 13, ¶ 1002.1, at 10-10; Fleischer, supra note 1, at 5.
19 See LEVIN, supra note 13, ¶ 1003.2, at 10-12 (defining “net profits” as “realized profit less realized losses and expenses, including management fees” (emphasis omitted)).
20 This sum grows dramatically as the fund’s rate of return increases. In this example, a 15% rate of return would give the general partners $3.8 billion in carried interest, and a 20% rate of return would give the general partners $5.4 billion. The most successful private equity funds have historically achieved these higher rates of return. For example, the Blackstone Group’s private equity funds have averaged a 22.8% annual rate of return. Blackstone Group L.P., Securities Registration Statement (Form S-1), at 5 (Mar. 22, 2007).
21 Participating preferred stock, also known as “double-dip preferred stock” or a “preferred-common unit,” is stock that entitles its holder both to a liquidation preference, as with garden-variety preferred stock, and to participate in any further appreciation as if the stock had been converted to common stock. For comparisons of participating preferred stock with other forms of preferred stock, see LEVIN, supra note 13, ¶ 203, at 2-25 to 2-27; Jesse M. Fried & Mira Ganor, Agency Costs of Venture Capitalist Control in Startups, 81 N.Y.U. L. REV. 967, 982 n.36 (2006); Ronald J. Gilson & David M. Schizer, Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock, 116 HARV. L. REV. 874, 894, 906–07 (2003); Timothy J. Harris, Modeling the Conversion Decisions of Preferred Stock, 58 BUS. LAW. 587, 587–91 (2003); and D. Gordon Smith, The Exit Structure of Venture Capital, 53 UCLA L. REV. 315, 339 (2005).
that property, reduced by any amount he paid for it, as ordinary income. Not surprisingly, stock is considered property within the meaning of § 83(a).\(^{22}\) Even if the stock is subject to vesting — that is, if the manager forfeits the stock if his employment ends within a certain period of time — he must pay tax on the value of the stock when the vesting period lapses.\(^{23}\)

If carried interest in a partnership is economically analogous to common stock in a corporation, then one would expect a partner who receives carried interest in consideration for his services, like a manager who receives stock, to recognize ordinary income equal to the value of the carried interest. And indeed, nothing in § 83 or in the accompanying regulations indicates that the two should be treated any differently. Nevertheless, the IRS treats carried interest much more favorably.

The IRS has given guidance on carried interest in Revenue Procedures 93-27\(^{24}\) and 2001-43.\(^{25}\) Revenue Procedure 93-27 begins by distinguishing between interests in partnership capital and interests in partnership profits. It defines a capital interest as “an interest that would give the holder a share of the proceeds if the partnership’s assets were sold at fair market value and then . . . distributed in a complete liquidation of the partnership,” and it defines a profits interest as any other type of interest.\(^{26}\) It then specifies that, in most cases, a general partner’s receipt of a profits interest results in no immediate tax.\(^{27}\) Revenue Procedure 2001-43 clarifies that, in most circumstances, the same rules apply if the profits interest is unvested when the general partner receives it.\(^{28}\)

These interpretations tax the receipt of a profits interest by reference to its liquidation value, in contrast to § 83(a), which taxes the re-

\(^{22}\) Treas. Reg. § 1.83-3(e) (as amended in 2005).

\(^{23}\) I.R.C. § 83(a) (2000). Alternatively, the manager can elect to recognize the value of the unvested stock in the year he receives it. Id. § 83(b). A so-called 83(b) election might be used if the value of the unvested stock is very small when granted, as in the case of an early-stage startup company, but has the potential to rise substantially.

\(^{24}\) 1993-2 C.B. 343.


\(^{26}\) Rev. Proc. 93-27 § 2, 1993-2 C.B. at 343. The determination whether the holder would receive a share of the liquidation proceeds is made at the time that the partner receives the interest. Id. § 2.01.

\(^{27}\) Id. § 4, 1993-2 C.B. at 344; see also LEVIN, supra note 13, ¶ 1006, at 10-18 (describing the rule of Rev. Proc. 93-27 as “taxpayer-favorable”).

\(^{28}\) See Rev. Proc. 2001-43 § 3, 2001-2 C.B. at 191 (“[W]here a partnership grants a profits interest . . . in a transaction meeting the requirements of this revenue procedure and Rev. Proc. 93-27, the Internal Revenue Service will not treat the grant of the interest or the event that causes the interest to become substantially vested . . . as a taxable event . . . .”). Regulations proposed in 2005 would have applied § 83(a) to partnership interests generally but would have continued to allow partners to receive profits interests without incurring tax. See Prop. Treas. Reg. § 1.83-3(e), (l), 70 Fed. Reg. 29,675, 29,680–81 (May 24, 2005); I.R.S. Notice 2005-43, 2005-1 C.B. 1221.
ceipt of property in general by reference to its fair market value. The implications of these differing approaches can be striking. The carried interest of Texas Pacific’s new fund, although difficult to value precisely, unquestionably has a fair market value of many millions of dollars.²⁹ But if the partnership were liquidated when the general partners receive their carried interest — that is, at the moment the partnership is formed — the holders of carried interest would receive none of the proceeds; the limited partners would simply receive back their capital contributions in full. Therefore, carried interest is a profits interest within the meaning of Revenue Procedures 93-27 and 2001-43, and a general partner who receives carried interest pays no immediate tax. The tax code thus conceptualizes carried interest and common stock in vastly different ways.

C. Carried Interest as a Stock Option

1. Economic Equivalence. — As the previous section establishes, a grant of carried interest is economically similar to a grant of common stock, but the two are treated very differently by the tax system. There is, however, a form of ownership-based compensation that is economically similar to carried interest but is more closely analogous from a tax perspective: the stock option. A stock option is a right for the option holder to purchase shares of stock at a fixed price, known as the “strike price.”³⁰ If the value of the stock underlying the option rises above the strike price, the option holder can recognize a gain equal to the excess; if the value of the underlying stock falls below the strike price, the option holder recognizes no gain and no loss.

A general partner who holds a 20% carried interest in a private equity fund has the same economic outlook as a holder of an option with a strike price of zero on 20% of the common stock of a corporation that is otherwise capitalized with participating preferred stock. If the private equity fund returns profits in excess of the general partner’s cost of acquiring the carried interest — in other words, the general partner’s strike price — which is zero, then the general partner recognizes a gain equal to 20% of these profits. And if the private equity fund loses money, the general partner recognizes neither gain nor loss on his carried interest.³¹

²⁹ Cf. Gilson & Schizer, supra note 21, at 907 n.108 (“Just ask a new partner at Cravath, Swaine & Moore whether making partner, and gaining the continued right to use the firm’s reputation and assets, affects her net worth.”).
³¹ See Fleischer, supra note 1, at 1 (“If the fund does badly . . . the manager can walk away.”).
Thus, carried interest is economically equivalent to both a grant of common stock and a grant of an option with a strike price of zero.\textsuperscript{32} To be sure, the latter forms of compensation are not ordinarily considered interchangeable. Although publicly traded corporations frequently compensate their employees with grants of common stock, they do not generally issue options with a strike price of zero. Instead, when they issue options, they do so “at the money,” that is, at a strike price equal to the fair market value of the underlying stock at the time the option is granted. But in the unique case of private partnerships, common stock and stock options are in fact interchangeable, because the factors discouraging publicly traded corporations from issuing “in the money” options — options having a strike price below the fair market value of the underlying stock at the time of the grant — do not apply to most partnerships.

First, as a historical matter, in-the-money options received unfavorable accounting treatment until recently. Under rules in effect until mid-2005, a corporation that issued at-the-money options did not record any associated expense on its income statement, whereas a corporation that issued in-the-money options was required to record expenses, both on the date of grant and possibly in future accounting periods.\textsuperscript{33} Private equity partnerships, however, are typically evaluated based on their internal rates of return on capital rather than on net income reported in accordance with accounting rules,\textsuperscript{34} so they are generally less concerned, or perhaps not at all concerned, with the appearance of their income statements.

Second, according to a limit imposed by § 162(m) of the Code, public corporations cannot deduct executive compensation in excess of $1 million unless it is “performance-based.” In-the-money stock options are not considered performance-based compensation,\textsuperscript{35} whereas at-the-money stock options qualify as performance-based compensation in nearly every circumstance of real-world import, and their costs are

\begin{itemize}
\item \textsuperscript{32} See Walker, supra note 30, at §69 n.29 (“[R]estricted stock . . . is analogous to an option with zero exercise price.”).
\item \textsuperscript{33} See M.P. Narayanan et al., The Economic Impact of Backdating of Executive Stock Options, 105 Mich. L. Rev. 1597, 1622–23 (2007); Walker, supra note 30, at §68–69.
\item \textsuperscript{34} See Symposium, Business Bankruptcy Panel: The Brave New World of Finance, 23 Emory Bankr. Dev. J. 549, 571 (2007) (“[P]rivate equity firms are . . . judged by the internal rate of return that their firms generate.”); see also Steven E. Hurdle, Jr., Comment, A Blow to Public Investing: Reforming the System of Private Equity Fund Disclosures, 53 UCLA L. Rev. 239, 254 n.101 (2005) (referring to internal rate of return as “essentially a measure of fund self-performance”).
\item \textsuperscript{35} See LEVIN, supra note 13, ¶ 908.5.1, at 9-39 (“If the stock option . . . is in-the-money at all at grant, none of the compensation attributable to such grant satisfies the performance-based-compensation exception, even with respect to post-grant appreciation.” (emphases added)); Narayanan et al., supra note 33, at 1620.
\end{itemize}
therefore deductible in their entirety.\textsuperscript{36} Section 162(m) therefore discourages publicly traded corporations from using in-the-money stock options. Section 162(m) applies only to corporations, however, and therefore does not impose a restriction on partnerships.

Third, a service provider who receives an in-the-money stock option risks a penalty tax assessed on certain deferred compensation arrangements by § 409A of the Code.\textsuperscript{37} Partnerships again enjoy an advantage because the § 409A tax does not apply to partnership profits interests.\textsuperscript{38}

In summary, the principal tax and accounting considerations that disincline corporations to issue in-the-money stock options do not present the same complications to private equity partnerships that desire to compensate their general partners with carried interest. Thus, just as it is legitimate to conceptualize carried interest as a grant of stock, it is equally legitimate to conceptualize carried interest as a grant of a stock option having a strike price of zero.

2. Tax Comparison. — The tax treatment of stock options is more similar to that of carried interest than is the tax treatment of stock itself. Like the receipt of carried interest, the receipt of most stock options does not result in an immediate tax because, according to § 83(e), the usual rule of § 83 does not apply to “the transfer of an option without a readily ascertainable fair market value.”\textsuperscript{39} Nearly all stock options issued as compensation meet this definition because the stock options that corporations issue to their employees are not traded on public markets.\textsuperscript{40} Although the receipt of a compensatory stock option ordinarily results in no tax, an option holder sometimes pays a tax when he exercises the option and receives the underlying stock. The applicable rules depend on whether the option is a nonqualified stock option or, instead, an ISO within the meaning of § 422 of the Code.

When a holder exercises a nonqualified stock option — defined as a stock option that is not an ISO — he receives stock, which is property within the meaning of § 83(a). The exemption provided by § 83(e) does not apply to this stock, and as a result, he recognizes ordinary income to the extent that the fair market value of the stock he receives


\textsuperscript{37} LEVIN, supra note 13, ¶ 602.6.2(1), at 6–54.

\textsuperscript{38} See I.R.S. Notice 2005-1 § IV.A, 2005-1 C.B. 274, 279 (“[T]axpayers may treat an issuance of a profits interest in connection with the performance of services that is properly treated . . . as not resulting in inclusion of income . . . at the time of issuance, as also not resulting in the deferral of compensation.”); LEVIN, supra note 13, ¶ 602.5(2), at 6-49.

\textsuperscript{39} I.R.C. § 83(e)(3) (2000).

\textsuperscript{40} See Treas. Reg. § 1.83-7(b) (as amended in 2004).
exceeds the strike price. If he holds onto the stock, any appreciation he subsequently realizes is capital gain.

If this tax upon exercise were the sole consequence of exercising a nonqualified stock option, then the case for taxing carried interest as ordinary income would be very strong indeed: carried interest is economically equivalent to an option with a strike price of zero; one who exercises an option with a strike price of zero and immediately sells the underlying stock recognizes ordinary income equal to the value of the stock; therefore, one who receives carried interest should equivalently recognize ordinary income. But this story is incomplete because when an option holder exercises a nonqualified stock option and recognizes ordinary income, the corporation that issued the option receives an ordinary deduction in the same amount under §83(h) of the Code. Thus, under the simplifying assumption that a corporation and an executive pay tax at the same rate, the exercise of a nonqualified stock option does not increase the government’s tax revenues. Rather, it merely shifts a tax liability from the corporation to the option holder. From the perspective of the Treasury, then, nonqualified stock options are a mechanism for tax shifting, not a mechanism for tax generation: what the IRS takes away with one hand, it gives with the other.

This reality makes nonqualified stock options a tax-efficient form of compensation, but it also makes the nonqualified stock option analogy inapt for partnerships. Partnerships do not pay an entity-level tax, and limited partners in private equity funds are often tax-exempt. As a result, the §83(h) deduction provides no benefit, or at best a reduced benefit, in the context of private equity. Treating carried interest as a nonqualified stock option, therefore, would not equate carried interest with more familiar forms of compensation because nonqualified stock options increase taxes in the private equity context, whereas in the corporate context they merely shift taxes in most cases.

ISOs provide a more apt analogy. ISOs and nonqualified options give their holders the same economic rights and payout possibilities but are governed by different tax rules. When a holder exercises an ISO, he recognizes no income on the excess of the fair market value over the strike price, and he recognizes capital gain on any subsequent realized appreciation of the stock. The issuer receives no deduction.43

42 This simplifying assumption is often a correct one. Under current law, the highest marginal rate for both individual and corporate tax payers is 35%.
43 I.R.C. §421(a); see also Walker, supra note 41, at 738 (“ISOs should be particularly appealing to effectively tax-exempt companies.”). The excess of the fair market value over the strike price is an item of adjustment for the purposes of the alternative minimum tax (AMT). I.R.C. §56(b)(3). In light of the widespread and nearly uniform distaste for the AMT, see, e.g., Gabriel
In these crucial respects, an ISO with a strike price of zero is the corporate world’s closest analogy to carried interest in terms of both economics and taxation. Neither an immediately exercised ISO with a strike price of zero nor carried interest subjects the holder to tax, both result in capital gains on sale proceeds in excess of the strike price, and neither gives a deduction to the entity that issued it. ISOs, however, are subject to several important limitations that prevent them from being used to provide managers and other employees with pure, limitless capital gains. These limitations, discussed in the next Part, may suggest analogous ways in which the Code can curtail the pure, limitless capital gains that carried interest now bestows.

II. ISO LIMITATIONS AS POSSIBLE INSPIRATIONS FOR REFORM

Although carried interest finds its closest conceptual analog in ISOs with a strike price of zero, the analogy initially appears to be of limited usefulness because of several limitations on the use of ISOs as devices for compensation. This Part discusses the three principal limitations and considers whether they have implications for the carried interest debate. It concludes that, just as ISOs cannot be issued for less than fair market value, carried interest should not be issued for less than its estimated or imputed fair market value. If it is, the amount by which the carried interest is in the money when it is granted should be recognized or recaptured as ordinary income.

A. Fair Market Value

A stock option with a strike price of zero cannot be an ISO. For a stock option to qualify as an ISO, the strike price cannot be lower than the fair market value of the underlying stock. Thus, to preserve the analogy to ISOs, carried interest should not be issued for less than its fair market value. Under this proposal, distributions of carried interest would constitute ordinary income to the general partners until the amount of carried interest distributed, in the aggregate, reached the est...
timated fair market value of the carried interest; thereafter, distributions would constitute capital gains.

Although the concept of fair market value is difficult to apply to carried interest because carried interest does not trade on public markets, this valuation problem is no more serious than the problem of ascribing a fair market value to the stock of a privately held, early-stage startup corporation issuing ISOs. Corporations that do not have publicly traded stock may estimate the value of their stock in good faith, and option holders of early-stage startups generally have no risk of imputed income if the common stock is valued at no less than 10% of the corporation’s preferred stock. From this principle, one can propose a moderating reform proposal for carried interest. In the private equity context, one might analogously suggest that a good-faith estimate of the fair market value of each unit of carried interest should be no less than 10%, or perhaps 20%, of the capital committed for each unit of capital interest.

**B. Annual Maximum**

Under current law, there is no limit on the amount of carried interest that can qualify for the long-term capital gains rate. In contrast, the use of ISOs is not limitless: the portion of a stock option that becomes exercisable in any calendar year cannot be an ISO to the extent that the underlying stock was worth more than $100,000 at the time the option was granted. The ISO-like features of carried interest could be similarly limited, for example, by capping the amount of carried interest that each general partner, or the general partner group as a whole, could receive as long-term capital gain, with any excess constituting ordinary income. A limit of $100,000 would be nonsensically

46 Id. § 422(c)(1).

47 See Fleischer, supra note 1, at 29 ("[T]he rule of thumb among Silicon Valley practitioners is that... the common stock should be valued at least at one-tenth the value of the preferred stock to reflect the option value of the common stock."). The example illustrated in LEVIN, supra note 13, ¶ 203.2, at 2-27, suggests a financing structure consisting of participating preferred stock and common stock, in which each share of common stock is valued at 6% of the issue price per common share equivalent of the preferred stock. Even assuming that this structure poses no § 83(a) risk, the participating preferred stock in this structure will likely be entitled to a preferred dividend, which a private equity limited partner would not receive. Moreover, common stock in an early-stage startup is probably a riskier investment than a profits interest in a private equity fund. Therefore, 10% or 20% is perhaps a more appropriate approximation for the purposes of this Note’s proposal. For factors affecting the risk that income will be imputed to the common stockholders under § 83(a), see id. ¶ 203.1, at 2-27.

48 The precise percentage chosen is less important than the method of imposing the tax. Indeed, even if Congress were to adopt a method such as the one proposed here, it would not need to decide the appropriate percentage to use. Rather, it could direct the IRS to promulgate implementing regulations.

49 I.R.C. § 422(d).
low given the size and scale of modern-day private equity funds and investments, but some reasonable compromise might be reached. However, this type of reform is probably undesirable. First, it would invite gamesmanship. If the limit were imposed on an annual basis, as is the ISO limit, then fund managers might seek to time their realizations to minimize their taxes, and these types of decisions would benefit nobody but the managers themselves. Second, this type of reform would appear to penalize successful fund managers disproportionately. Because a higher tax rate would be imposed only on carried interest distributions exceeding a threshold amount, a wildly successful fund manager would pay a higher tax rate on his carried interest than would a mediocre fund manager. Given that private equity investing is a war for the highest returns, the tax system should seek to avoid tilting the playing field by subsidizing less successful investors.

C. Extended Holding Period

A third distinctive feature of ISOs is that an ISO holder, to obtain the favorable ISO tax treatment, must comply with holding period requirements that are more onerous than the one-year holding period that generally triggers the lower long-term capital gains rate. Specifically, an ISO holder may not dispose of shares received from the exercise of an ISO within two years of receiving the option or within one year of exercising it. If he makes a “disqualifying disposition” that does not comply with these requirements, then the ISO is retroactively treated as a nonqualified option.

There seems to be little need to use the concept of an extended holding period in the context of private equity partnerships. ISOs, which can be granted only to employees and only in relatively small amounts, are designed at least in part to allow corporations to attract and retain employees. An extended holding period requirement reinforces this goal. Carried interest, in contrast, is not a mechanism of retaining private equity partners, whose continued involvement is already ensured by management rights, their own capital investment in the fund, and other contractual mechanisms. Moreover, under current law, carried interest distributed in the first year of a partnership would be a short-term capital gain and therefore taxed at ordinary income rates. No principled reason seems to support extending that treatment to the second year of a partnership but not beyond. In any event, be-

50 Id. § 422(a)(1).
cause it is rare for private equity partnerships to become profitable enough to distribute carried interest within their first two years of existence, this type of restriction would be of little consequence.

D. The Proposal

The previous three sections conclude that if carried interest is to be treated as an ISO, it must have a strike price no less than its fair market value. Fair market value must be estimated by comparing the economic rights of the carried interest with the economic rights of the capital partners — in the same way that a startup corporation’s common stock is valued by comparing its economic rights with those of its capital investors. General partners would not pay this estimated fair market value to the partnership when the partnership is formed and they receive their carried interest. Instead, they would be treated as having received a nonrecourse loan from the partnership that is forgiven — and therefore recaptured as ordinary income — to the extent that they receive distributions of profits.

Returning to the example of the Texas Pacific Group’s fund from Part I, the framework proposed here would treat Texas Pacific’s limited partners as having purchased participating preferred units for $175 million each, for a total of $14 billion in capital commitments. Assuming that each common unit is valued at 20% of the value of each preferred unit, the general partners would therefore be treated as having received 20 common units for $35 million each, for a total of $700 million. Thus, the first $700 million of carried interest should be treated as ordinary income and the next $1.8 billion as a capital gain. Assuming that Texas Pacific’s general partners pay a constant 35% rate of tax on their ordinary income, this proposal would result in an

53 See Senate Hearing I, supra note 9, at 8 (testimony of Kate D. Mitchell).
54 The precise method for conducting this valuation — the appropriate ratio of the value of the capital interests to the value of the carried interest — would involve an empirical analysis, the particulars of which are beyond the scope of this Note. Congress and the IRS can implement the valuation method in a variety of ways, such as through a Revenue Procedure.
55 The loan described here would not bear interest, and § 7872 of the Code would impute a market rate of interest to such a loan. To avoid such a complication, legislation or regulations implementing this proposal could make the conceptually straightforward assumption that interest is paid in kind at a market rate.
57 If the partnership is dissolved before the loan is repaid in its entirety, the cancellation of the remaining nonrecourse indebtedness does not result in any income to the general partners. See Rev. Rul. 92-53.
average tax rate of about 20% on the carried interest. The average tax rate would vary directly with the valuation ratio and inversely with the fund’s rate of return.

III. COMPETING REFORM PROPOSALS

Legislators have put forth two proposals to amend the tax law in response to the perceived undertaxation of private equity partnerships. The most prominent such bill, introduced in June 2007, is known as the Baucus-Grassley Bill for its sponsoring senators. This bill appears to be less a serious, intellectually justifiable reform proposal than a political maneuver. Its structure and the reasons it should be rejected are discussed in section A.1. The second proposal, advanced in Professor Fleischer’s forthcoming article and embodied in another bill introduced in June 2007, is a far more viable solution. Section A.2 takes up this proposal, along with the responses it has generated. Section B then explores why this Note’s reform proposal may be preferable to any of the solutions advanced thus far.

A. The Legislative and Scholarly Landscape

1. The Baucus-Grassley Bill. — Perhaps surprisingly, the Baucus-Grassley Bill would not alter Revenue Procedure 93-27, impose a higher rate of tax on carried interest, or otherwise change the tax landscape from the perspective of most private equity funds. Rather, it would create an exception to an exception to an exception, ultimately imposing an entity-level tax on all private equity profits, but only for private equity partnerships traded on a public securities market.

As discussed above, the general rule for partnerships, and for LLCs that have elected to be taxed as partnerships, is that they pay no entity-level tax, and their income, as well as the character of that income as either capital or ordinary, flows through to their owners. According to the publicly traded partnership exception of §7704 of the Code, however, a partnership is taxed as if it were a corporation if its interests are readily tradable on a securities market. A publicly traded

58 The Treasury would have a slight time value advantage because it would collect tax at a higher rate on earlier distributions and at a lower rate on later distributions.
60 See H.R. 2834, 110th Cong. (2007).
61 See S. 1624. A nearly identical bill was introduced in the House of Representatives one week after the Baucus-Grassley Bill was introduced in the Senate. See H.R. 2785, 110th Cong. (2007).
62 I.R.C. § 7704(a)-(b) (2000). One prominent justification for an entity-level tax on publicly traded partnerships is that the liquidity associated with public markets is considered one of the hallmarks and benefits of organization as a corporation. See Michael S. Knoll, Commentary, Of Fruit and Trees: The Relationship Between Income and Wealth Taxes, 53 TAX L. REV. 187, 592 & n.23 (2000); Herwig J. Schlunk, I Come Not To Praise the Corporate Income Tax, but To Save It,
investment partnership, however, would not be subject to the publicly traded partnership tax because § 7704 does not impose an entity-level tax on a publicly traded partnership if 90% of its income is in the form of certain types of passive income, such as interest, dividends, and capital gains from sales of securities. Private equity funds ordinarily satisfy this income requirement. If enacted, the Baucus-Grassley Bill would make the passive income exception unavailable to publicly traded partnerships that receive carried interest.

As a matter of tax system design, it is not clear why targeting publicly traded private equity partnerships — a category to which most private equity partnerships do not belong — is desirable. Indeed, the bill is best understood not as a product of reasoned legislative deliberation but as a political reaction to perceived excesses of successful private equity fund managers, particularly Blackstone Group cofounder Stephen Schwarzman, whose extravagant spending habits and windfall profit from Blackstone’s June 2007 IPO caught the attention of even the most casual of business news readers.

For this reason, even Professor Fleischer, the leading proponent of the movement to tax carried interest as ordinary income, views the Baucus-Grassley Bill as a “rifleshot approach” to taxing carried interest that is politically viable precisely because of its exceedingly narrow scope. But this viability comes at a social cost. By disadvantaging publicly traded private equity partnerships relative to their privately held counterparts, the Baucus-Grassley Bill might have the effect of keeping these partnerships off the public markets, which would deprive many investors of a potentially lucrative investment opportunity in much the same way that other forms of regulation deprive


64 See Fleischer, supra note 62, at 5 (observing that “the change would only apply to a sliver of the industry”).


66 Fleischer, supra note 62, at 4–5.

67 See Ryan J. Donmoyer, Blackstone Says Senate Bill To Cost It $525 Million, BLOOMBERG.COM, Aug. 24, 2007, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ark4Wm9IFSRI (quoting Professor Fleischer as saying that “there is ‘some truth’ to Blackstone’s argument that the tax change” contemplated by the Baucus-Grassley Bill “would discourage initial public offerings by private-equity firms”).
public-market investors of potentially desirable investment opportuni-
ties, but without the accompanying motivation of investor protection.

Professor Fleischer concedes that the bill could be viewed as a justi-
tifiable response to “regulatory gamesmanship” that converts returns
from labor into returns from capital investment. However, that argu-
ment rests on the not-so-tacit assumption that carried interest gener-
ally should be treated as compensation for services rather than as a re-
turn on investment capital. But if the ultimate underlying concern is
that carried interest is taxed in a manner that improperly favors tax-
PAYERS, then the solution should be to tax carried interest in a way that
does not improperly favor taxpayers.

2. The Fleischer/House Proposal. — Professor Fleischer’s proposal,
incorporated into House Bill 2834 and the Temporary Tax Relief Act
of 2007, would tax all carried interest as ordinary income. The logic
behind the proposal is both simple and enticing. In essence, the argu-
ment is that private equity general partners provide investment man-
agement services to their partnerships, they receive carried interest as
compensation for those services, and compensation for services ren-
dered, like any other form of salary, should be taxed as ordinary in-
come, not converted into capital gain merely because it is labeled as a
share of profits rather than an outright cash payment.

68 Other such forms of regulation include the investor accreditation requirement for private
placements conducted under SEC Regulation D, see Stephen J. Choi, Company Registration: To-
ward a Status-Based Antifraud Regime, 64 U. CHI. L. REV. 567, 644–45 (1997); John L. Orcutt,
Improving the Efficiency of the Angel Finance Market: A Proposal To Expand the Intermediary
Role of Finders in the Private Capital Raising Setting, 37 ARIZ. ST. L.J. 861, 933 (2005); David V.
Snyder, Private Lawmaking, 64 OHIO ST. L.J. 371, 432 (2003), and the plethora of securities laws
and SEC regulations imposed upon many investment management companies, see Non-U.S. Pub-
lic Offerings by Private Equity Funds — A New Chapter in Fundraising, PRIVATE EQUITY
NEWSLETTER (Kirkland & Ellis LLP, Chicago, Ill.), May 25, 2006, at 1, available at http://
(citing these laws and regulations, which cause “buyout groups [to] encounter difficulties raising
capital from the U.S. public markets,” as one reason that Kohlberg Kravis Roberts & Co. chose to
raise public capital on the Euronext market rather than on domestic public markets).


71 See Fleischer, supra note 1, at 1–2, 42–43, 49–50. This line of reasoning was explored in the
early 1990s following a series of conflicting court decisions, see Laura E. Cunningham, Taxing
Partnership Interests Exchanged for Services, 47 TAX L. REV. 247 (1991); Mark P. Gergen, Re-
forming Subchapter K: Compensating Service Partners, 48 TAX L. REV. 69 (1992); Henry Or-
dower, Taxing Service Partners To Achieve Horizontal Equity, 46 TAX LAW. 19 (1992); Leo L.
Schmolka, Taxing Partnership Interests Exchanged for Services: Let Diamond/Campbell Quietly
Die, 47 TAX L. REV. 287 (1991), but the discussion at that time was primarily confined to aca-
demic circles and did not have the policy salience or public prominence of the contemporary pri-
ivate equity debate, see Senate Hearing I, supra note 9, at 1 (statement of Sen. Chuck Grassley)
(“While this issue is not new to the tax law, it has received heightened attention from the prolifera-
tion of private equity and hedge funds structured as partnerships.”); Fleischer, supra note 1, at 12
(“The debate sometimes ha[d] the air of an academic parlor game.”).
In arriving at this proposal, Professor Fleischer considers but ultimately rejects several alternatives. One such alternative would be to apply § 83(a) literally and require general partners to appraise the fair market value of their carried interest. Professor Fleischer concludes that this “forced valuation” approach is undesirable because it “is easily gamed” and, in light of the speculative nature of private equity partnerships, “will tend to understate” the potential future value of carried interest.\(^\text{72}\) Another alternative, the “cost-of-capital approach,” conceptualizes carried interest as if it were an interest-free loan from the limited partners to the general partners and to impute interest on this loan, at a fair market rate, as ordinary income to the general partners each year. He dismisses this approach as complex and difficult to administer.\(^\text{73}\) As a final alternative, he considers an approach that would allow taxpayers to elect between different methods of taxation.\(^\text{74}\) Ultimately, he endorses what later became the House bill — taxing all carried interest as ordinary income — chiefly because of its relative simplicity.\(^\text{75}\)

Policy-based criticisms of the House proposal are manifold. Venture capital funds, which invest in early-stage companies and therefore contribute to job-creation — in contrast to buyout funds, which ordinarily invest in more established businesses and therefore generally do not create jobs, at least not directly\(^\text{76}\) — argue that their investing activities are crucial to the United States’s global economic dominance and will be threatened by increased taxation.\(^\text{77}\) Similarly, real estate

\(^\text{72}\) Fleischer, supra note 1, at 43–44.

\(^\text{73}\) See id. at 44–46 & n.144; see also House Hearing, supra note 7, at 17–18 (statement of Peter R. Orszag) (outlining this approach and discussing some of its benefits and drawbacks).

\(^\text{74}\) Fleischer, supra note 1, at 46–47.

\(^\text{75}\) Id. at 49; see also id. at 50 (advocating a “baseline rule” according to which “allocations of income that are disproportionate to the amount of capital a partner has invested in a fund [are] treated as ordinary income”).

\(^\text{76}\) Buyout funds may create jobs if buyout-sponsored businesses are more efficiently managed and therefore grow faster than businesses sponsored through other means. See Carried Interest, Part II: Hearing Before the S. Comm. on Finance, 110th Cong. 4 (2007) [hereinafter Senate Hearing II] (statement of Bruce Rosenblum), available at http://finance.senate.gov/sitepages/hearing073107.htm. But this effect is indirect in any event, and it is doubtful that buyout-sponsored job creation can compare favorably to the job creation wrought by companies, such as Apple, eBay, FedEx, and Google, that were financed by venture capital from their inception.

\(^\text{77}\) See, e.g., House Hearing, supra note 7, at 9–11 (statement of Jonathan Silver); Senate Hearing I, supra note 9, at 12–14 (statement of Kate D. Mitchell); see also JOINT ECON. COMM., RESEARCH REPORT NO. 110-14, CARRIED INTERESTS, TAXATION, AND ENTREPRENEURSHIP 3 (2007), available at http://www.house.gov/jec/Research%20Reports/2007/tr110-14.pdf (concluding that “[t]axing carried interests as ordinary income” would “likely result” in a “reduction in entrepreneurial activities and “could deter business investment and slow economic growth”). If Congress wanted to treat carried interest in venture capital funds differently from carried interest in buyout and other private equity funds, it could impose the higher tax only on gains from investments made in corporations that have an established trade or business. Cf. I.R.C. § 355(b)(2)(A)–(B) (2000) (defining “active conduct of a trade or business” to include a requirement
developers, who are often compensated by a carried interest in a real estate partnership, warn that economic development revitalization will decelerate if they have fewer profits to reinvest in their businesses.\textsuperscript{78} Some private equity investors warn that increasing the tax on carried interest will cause economically beneficial investments to be forgone in light of tax-motivated considerations.\textsuperscript{79} Finally, some observers suggest that increasing private equity investors’ tax bills may unsettle the widely accepted economic compromise that limited partners, many of which are public employee pension funds, strike with general partners and that at least part of the economic incidence of the tax increase will ultimately fall on the workers who contribute to and depend on these funds for their retirement income.\textsuperscript{80}

Many arguments on the other side, however, are persuasive. For example, at least some pension fund managers reject the idea that the incidence of higher taxes will fall on limited partners and their beneficiaries. Instead, they perceive the demand for private equity investment opportunities, as well as the market for investment opportunities more generally, to be elastic.\textsuperscript{81} Some critics, including some venture capitalists, dismiss venture capitalists’ objections as self-serving.\textsuperscript{82} Others simply criticize the current tax law as unfair.\textsuperscript{83}

This Note does not adopt any of these positions, but it does not wholly reject any of them, either. A moderate solution is necessary precisely because all of the concerns presented to the House and Senate are persuasive and meritorious. In contrast to all of these proposals, this Note’s approach would both address the supposed loophole of Revenue Procedure 93-27 that the House proposal’s proponents deride and maintain the core economic incentives that its detractors prize.
B. Why ISO Equivalence Is a Superior Approach

As discussed in Part II, this Note proposes an approach that would assign a fair market value to carried interest when it is granted but would impose a tax on that value only when general partners actually receive their distributive share of carried interest, at which point any carried interest exceeding that fair market value would be a capital gain. This section discusses why, along several axes, this proposal is superior to, or at least no worse than, competing reform proposals.

1. Coordination with Existing Tax Concepts. — As discussed previously, partnership profits interests are a species sui generis under current tax law, treated under the wholly regulatory cloth of Revenue Procedures 93-27 and 2001-43. These regulations not only seem to conflict with both the text and logic of § 83(a), but also bear the reduced democratic legitimacy that is often associated with administrative regulation vis-à-vis legislation, particularly when it relates to the government’s taxing power. The House proposal fares only slightly better in this regard. Although it would accomplish its goal through legislation, it would not change the status quo’s treatment of carried interest as a sui generis form of compensation, seemingly untethered to the logic of § 83. This Note’s proposal, in contrast, derives its inspiration from an existing, recognized, and accepted form of compensation, one that finds its basis in the Code itself.

2. Distributive Justice. — One feature of the House proposal, which is either a virtue or a vice depending on one’s point of view, is that it would tax carried interest most aggressively and therefore would be most redistributive. The distributive justice argument is appealing — particularly in light of the growing income disparities between the highest-earning and lowest-earning taxpayers — but it is ultimately irreconcilable with other portions of the tax code, most notably those relating to dividends. Since 2003, individual taxpayers have paid the lower long-term capital gains rate when they receive so-called “qualified dividends,” a category that includes dividends from domestic corporations. Americans who hold dividend-paying stocks are overwhelmingly among the wealthiest, and as a result, the benefit


85 For congressional testimony concerning the income disparity, see, for example, House Hearing, supra note 7 (statement of Leonard E. Burman); and id. (statement of Jason Furman). For a more anecdotal and populist account, see Roger Lowenstein, The Inequality Conundrum, N.Y. TIMES, June 10, 2007, § 6, at 11.

of this reduced tax inures almost entirely to high-income taxpayers.\textsuperscript{87} Many of these taxpayers receive dividends from the companies that they manage, and it would be difficult to justify the preferential treatment they would receive if private equity fund managers’ carried interest were taxed as ordinary income.

Professor Fleischer observes that taxing carried interest as capital gains “allows some of the richest workers in the country to pay tax on their labor income at a low effective rate.”\textsuperscript{88} Although this statement is undoubtedly true in the context of private equity, it is also true outside that context. For example, Steve Ballmer, Microsoft’s chief executive, receives the vast majority of his income from Microsoft in the form of dividends and gains from sales of Microsoft stock rather than from salary or bonus. He pays a 15\% rate of tax on these dividends and gains, even though their source — Microsoft’s profit — is intimately connected with the value and effectiveness of his “labor” and is the product of his “sweat equity.”\textsuperscript{89} If the aim of new legislation is to redistribute income from the rich to the poor — or, equivalently, to redistribute tax burdens from the poor to the rich — focusing on one narrow form of income that is earned by a relatively small number of taxpayers seems like a strategy that is both low-impact and hard to square with other principles embodied in the tax code that tend to favor wealthy taxpayers in more significant ways.\textsuperscript{90} In other words, distributive justice is not a sufficiently weighty normative goal to justify a change from systematically inconsistent undertaxation to systematically inconsistent overtaxation.\textsuperscript{91}

\begin{thebibliography}{99}
\bibitem{Fleischer} Fleischer, supra note 1, at 2–3.
\bibitem{HouseHearing} See \textit{House Hearing}, supra note 7 (statement of C. Eugene Steuerle) (remarking that “the distinction” between labor income and capital income “is arbitrary for the business owner” and that “it is often difficult to separate capital from labor income”).
\bibitem{id} See \textit{id.} (statement of Jack S. Levin) (warning Congress not to “enact[] punitive tax legislation based on vignettes” but rather to conduct “careful macro-economic analysis”); \textit{cf. id.} at 18–19 (statement of Peter R. Orszag) (remarking, as a general matter, that “[a] lower tax rate on capital gains and dividends than on other forms of income creates opportunities for tax avoidance and complicates the tax system” and that “[a]s the tax rate differential increases, the distinctions among different types of income assume greater importance”).
\end{thebibliography}
3. Harshness and Arbitrariness. — This Note’s proposal would defer tax on carried interest until the general partner realizes carried interest and would never impute income to general partners. This approach is consistent with the Code’s prevailing realization-based approach to taxation.\(^\text{92}\) In contrast, some of the alternative proposals, most notably the cost-of-capital approach, would impute income to general partners every year.\(^\text{93}\)

Tax reform should seek to avoid this harsh consequence. In a multibillion-dollar private equity fund, several million dollars of income would be imputed to the general partners every year. It would be burdensome if general partners were taxed on several million dollars of imputed income when their realizations and profits, if any, were years away. General partners might seek to avoid this result by negotiating for tax gross-up distributions from limited partners, a purely tax-motivated complexity.

To be sure, this Note’s proposal has elements of what Professor Fleischer calls “forced valuation” because it assigns a prospective value to a carried interest at the moment the partnership is formed. In this regard, it is susceptible to gaming and systematic undervaluation and has elements of arbitrariness. But gaming can be controlled with clear regulations, and the approach proposed here is no more susceptible to gaming than is § 83 in the context of stock issuances by startup corporations. Problems of systematic undervaluation can also be mitigated by allowing the IRS, as it builds expertise in administering this new regime, to maintain some regulatory control over the method of valuation. Finally, arbitrariness can be minimized by making use of concepts that are already employed with other forms of compensation, and in any event, any conceivable solution will be less arbitrary than Revenue Procedure 93-27’s choice of zero as the value assigned to carried interest.

4. Administrability. — This Note’s proposal would undoubtedly entail more administration than would the House proposal. It would require private equity funds to estimate the option value of their general partners’ carried interest, determine whether gains are short-term or long-term, and keep track of the cumulative amount of carried interest distributed. The House proposal, in contrast, would apply one rate of tax to all distributions and therefore would require a minimal amount of administration.

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\(^\text{93}\) Fleischer, supra note 1, at 31–32.
Yet simplicity need not be pursued at all costs, and the added complexity of this Note’s proposal would not be unduly burdensome. Quite apart from how carried interest is taxed, private equity funds must comply with a multitude of regulations that may apply to the companies in their portfolio in addition to tax and securities laws at the fund level. Moreover, they already must perform various accounting and tax services for their limited partners. For example, a private equity fund must determine whether its gains are short-term or long-term so that it can provide reports to its taxable domestic investors, and it also must determine and report its unrelated business taxable income to its tax-exempt investors. Furthermore, determining the amount of capital that is distributed as carried interest is often a complicated task that requires legal and accounting expertise. Private equity firms have savvy advisors to guide them through this thicket.\textsuperscript{94} In short, the administrative burden that this Note’s proposal would create is likely to be minimal compared with what current law requires.

**CONCLUSION**

This Note proposes a new approach for taxing the profits interests that private equity fund managers receive as compensation for successful investments. It argues that private equity partnerships are economically analogous to corporations whose capital structures consist of participating preferred stock and common stock, and it demonstrates that, among the forms of equity-based compensatory awards, incentive stock options offer the most useful analogy to carried interest, in terms of both economic rights and tax consequences.

The recipient of an ISO pays no tax on the option value when he receives it or when he exercises it, but he pays a tax when he sells the underlying stock. This Note proposes to assign an option value to a carried interest at the time it is granted, and to impose a tax on that value only when carried interest is realized. Upon realization, carried interest would be taxed as ordinary income to the extent of the estimated option value, and any excess would be taxed as capital gain.

This approach is superior to several other possible reforms. It is consistent with a realization-based approach to taxation, it bears resemblance to familiar forms of management incentive compensation, and it does not distort § 83’s policies and legitimacy. Perhaps most importantly, it is a moderate solution that seeks to incorporate and reflect the sound policy concerns emanating from all corners of the business community, the academy, Capitol Hill, and the campaign trail.

\textsuperscript{94} For example, the Blackstone Group spends more than $50 million annually for the near-exclusive services of several dozen attorneys. Amy Kolz, *Market Makers*, AM. LAW., Nov. 2006, at 88, 90.