Taxing *Alpha*: Labor is the New Capital Gain

Victor Fleischer[1]

What taxpayers report as capital gains is often a form of labor income in disguise. This is especially true at the very top of the income distribution, where a large and rising share of national income is derived from partnership allocations of carried interest and from the sale of founders' stock.

Conventional wisdom holds that effective tax rates decline at the very top of the income distribution because wealthy people have investment income. In fact, investment income is often not the reason. The super-rich are lightly taxed primarily because corporate executives, founders of technology companies, and investment fund managers earn a return on their human capital (labor, ideas, know-how) by reference to the value of a capital asset, thus often transforming labor income into capital gains. This kind of equity-linked compensation—what I call alpha income—accounts for the lion's share of the recent rise of income inequality in the United States.

Recognizing that the capital gains preference is largely a preference for alpha income provides a powerful new argument for abolishing the capital gains preference. The old justifications for the preference are weak. They are even weaker in this new light. Even the last respectable pillar of justification for the capital gains preference—the revenue loss and efficiency cost that occurs when investors are "locked in" to appreciated assets—falls away. Entrepreneurs and fund managers do not control the timing of their capital gains income in the same way that portfolio investors control dispositions of appreciated assets. The capital gains preference should be reduced or eliminated altogether.

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[1] Victor Fleischer is a law professor at the UC-Irvine. The author thanks Lee Alston, Lily Batchelder, Jared Elias, Bill Gentry, Christine Jolls, Ed Kleinbard, Omri Marian, John Morley, Jason Oh, Roberta Romano, Eric Zolt, and participants at workshops at UCLA, UC-Irvine, Indiana-Bloomington, Yale, and the Fifth Annual UCLA/NYU Tax Policy Symposium for comments and suggestions on early drafts of this Article.

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I. INTRODUCTION

Capital gains income is often a form of labor income in disguise. This is especially true at the very top of the income distribution, among the top ten percent of the top one percent. When Mark Zuckerberg sells shares of Facebook, the capital gain he reports on his tax return represents the realized value of the hard work, ideas, and leadership that he has provided to Facebook. It does not represent a return on whatever small financial investment he made with after-tax savings while sitting in a Harvard dorm room.[2]

The same is true on Wall Street, where the blurring of labor income and investment income has become an art form. When Blackstone CEO Stephen Schwarzman receives an allocation of carried interest from a Blackstone private equity fund, the income mostly reflects a return on his labor efforts, ideas, and know-how, not a financial investment. Yet it is taxed at capital gains rates.[3] When Carlyle founder David Rubenstein sells his partnership equity for a capital gain, most of the value he receives is derived from the goodwill of the business—value that has arisen from the labor contributions of Mr. Rubenstein and his colleagues, not from their financial contributions to the firm.[4]

I call this kind of income "*alpha*" income to distinguish it from regular wage income on the one hand and portfolio investment income on the other. I define *alpha* income as a financial return generated from one's human capital, the value of which is derived from the performance of an underlying financial security affected by one's labor efforts (typically, the stock of one's employer). Like wage income, *alpha* income is derived from human capital, not financial capital. Like investment income, however, *alpha* income varies depending on the performance of a financial asset.

Unlike wages, *alpha* income is difficult to measure. *Alpha* is typically observed as an abnormally high return on a financial claim where the excess return reflects the taxpayer's contributions of labor or human capital and not merely a return to risk-bearing or a payment for the use of capital. Think of *alpha* as "sweat equity" for rich people.

Alpha income often has an entrepreneurial element. The founders of Silicon Valley start-ups, for example, typically invest little cash themselves. In-

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[2] Victor Fleischer, *Taxing Founders' Stock*, 59 UCLA L. REV. 60 (2011).

[3] Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 NYU L. REV. 1 (2008); Victor Fleischer, *Taxing Blackstone*, 61 TAX L. REV. 92 (2008).

[4] For a discussion of how David Rubenstein's role in founding Carlyle, see Michael Lewis, The Access Capitalists, THE NEW REPUBLIC, Oct. 17, 1993. For a discussion of Rubenstein's efforts to preserve the favorable tax treatment of carried interest, see Alec MacGillis, The Billionaire's Loophole, THE NEW YORKER, March 14, 2016.

stead, in lieu of high wages, they instead take most of their pay in the form of common stock. If a company succeeds, the value of its common stock increases, sometimes generating very high returns for the founders and early employees.[5]

Alpha income need not be entrepreneurial, however. A CEO who comes in to turn around a distressed company often receives equity compensation that resembles cheap founders' stock. The initial value of the common stock is pushed down close to zero by debt and preferred stock in the capital structure. If the turnaround effort succeeds, the value of the common stock increases, reflecting the efforts of the management team. So long as the CEO's stock was awarded as compensation and not in exchange for an out-of-pocket financial investment, the CEO's income may be properly characterized as *alpha* income even if derived from an old economy or legacy business.

I borrow the term *alpha* from finance, where *alpha* refers to the measure of above-market or excess risk-adjusted return.[6] In finance, *alpha* is distinguished from *beta*, which is the measure of the systematic risk of investing in the capital markets. *Alpha* is most often associated with alternative asset classes, like venture capital funds, oil and gas investments, real estate funds, or "absolute return" hedge funds—asset classes with returns that are not closely correlated with prevailing equity market conditions. In the context of institutional investing, *alpha* represents the value that a successful investment fund manager provides to investors. For purposes of this Article, however, I use the term *alpha* more generically to refer to any return on human capital that where the return is determined by reference to a financial asset affected by one's labor efforts.[7]

Two types of *alpha* income—capital gains from the sale of founders' stock, and partnership income from private investment fund management—together account for much of the most recent increase in top-end income inequality in the United States. Much of the income is legally reported as

[5] As I discuss in more detail below, the stock price of a successful start-up typically reflects the value of entrepreneurial or quasi-monopoly rents associated with advances in technology or business processes.

[6] See, e.g., William Fung et al., *Hedge Funds: Performance, Risk, and Capital Formation*, 63 J. Fin. 1777, 1778 n.3
(Alpha measures the average return accrued over and above compensation for exposure to different sources of systematic risk."). Alpha is a finite resource or positional good tied to human capital; in equilibrium, economic models predict that actively managed investment funds deliver zero risk-adjusted, after-fee returns to investors. See id. at 1780; Jonathan B. Berk & Richard Green, *Mutual Fund Flows and Performance in Rational Markets*, 112 J. Pol. Econ. 1269 (2004).

[7] For example, an allocation of income from a family-owned and -operated business organized as an S Corporation is alpha income. The gain realized from selling the family business is alpha income. A cash salary earned by an employee, whether part of the family or not, is not alpha income.

capital gains income, not ordinary income, and taxed at a lower rate.[8] My data (described in more detail below, and in the appendix) suggests that in recent years as much as half of the long-term capital gains reported by the top 0.1% of households is *alpha* income. Carried interest alone has accounted for as much as 25% of the long-term capital gains reported by the top 0.1% of households.

Recognizing that the capital gains preference is largely a preference for *alpha* income strengthens the already-strong case for eliminating the capital gains preference. (See the table below for a summary of the usual arguments.) Few law professors consider a preference for capital gains to be part of an ideal income tax system. But many still view the lower rate on capital gains to be a necessary concession to the lock-in effect of a realization-based income tax; lock-in is less of a concern for *alpha* income, however, than for portfolio investments.

CAPITAL GAINS ARGUMENTS			
argument	traditional argument	traditional response	response in light of *alpha*
savings/consumption margin	taxing capital gains favors consumption over savings	if so, right solution is to exempt capital income, not just capital gains	*alpha* is a return on labor, not savings; taxing *alpha* does not affect the consumption/savings margin
inflation	capital gains are often inflationary	unfair tax on inflationary gains is more than offset by the unfair benefit of tax deferral	same
individual "double" tax	taxing capital gains is a second tax on income that has already been taxed once as salary	additional income is still income that enhances ability to pay	capital gains tax is often the first and last tax on labor, not a second tax on earned income
entity "double" tax	capital gains = tax on income that has already been taxed once at the corporate level	"double" tax problem would be better addressed by integration of corporate and shareholder taxes	same
risk	rate preference is necessary to compensate investors for risk	income tax only burdens the risk-free portion of portfolio investment returns	tax is an ineffective policy instrument for subsidizing risky labor and entrepreneurship
lock-in	lock-in distorts economic decisions and reduces tax revenue	capital gains preference is justified to revenue-maximizing rate	lock-in problem is mostly limited to portfolio investment, not *alpha* income

[8] See Fleischer, *Founders' Stock*, supra note 2; Fleischer, *Two and Twenty*, supra note 3.

Economists and policy advisors are ambivalent about the capital gains preference, although some view it as a second-best approach to moving our system towards taxing consumption instead of income.[9] In a recent survey of economists who belong to the National Tax Association, for example, just thirty-eight percent indicated support for the preference. Fifty-two percent indicated that the preference encouraged investment and promoted economic growth, suggesting that those economists who do support the capital gains preference do so out of concern for the way that the income tax distorts the savings/consumption margin. Similarly, the concern about the savings/consumption margin is demonstrated by the broad support (sixty-four percent) for greater reliance on consumption taxes. If concern about the savings/consumption margin is indeed the justification for the capital gains preference, a tax break for *alpha* income is misguided. *Alpha* income is a return on labor, not a return on after-tax savings.

By contrast, ninety percent of economists believe that carried interest should be taxed at ordinary income rates. This makes sense. A tax on alpha income is a tax on labor income, not savings, and thus is consistent with a consumption tax approach. (Because *alpha* income is a form of deferred labor income, its value accrues free of tax on the appreciation of pre-realization value or inside build-up, eliminating any temporal distortion of choices between consumption and savings.)

Even lock-in, the last remaining respectable pillar of the capital gains preference, does not categorically justify the capital gains preference for *alpha* income. As with investment income, *alpha* income is taxed only when realized, creating the potential for large behavioral distortions. But entrepreneurs and fund managers often do not control the timing of income in the same way that a portfolio investor controls the timing of asset sales. Concern about lock-in is real and legitimate, but an unlimited across-the-board capital gains preference is not the best way to address the problem.[10]

Contributions to the literature.

1. A new argument for reducing the rate preference.—The primary contribution of this Article is to make a new case for eliminating or reducing the tax preference for capital gains. With few exceptions, the literature justifies the capital gains preference by considering only the behavior of portfolio investors. If I am correct that *alpha* income is a significant source of capital gain, then the

[9] There is a much stronger policy case for moving to a consumption tax baseline which would exempt capital income from tax without singling out long-term capital gains for preferential treatment. I discuss the treatment of alpha income in a consumption tax framework in section x below.

[10] I discuss a possible approach to mitigating lock-in in part x below.

case for the capital gains preference is even weaker than before, and policymakers should reassess the relative costs and benefits of the preference.

2. *Inequality literature.*—I make a descriptive claim, mostly new to the academic literature, that a significant amount of capital gains income at the very top end of the income distribution represents a return on human capital, not financial capital. This claim is important because it changes how we might account for and respond to increasing income inequality, including capital gains policy.[11]

For scholars concerned with inequality, the fact that so much of the recent increase in inequality is attributable to *alpha* income undermines the common explanation that the rich get richer because they have more money. Thomas Piketty, Emmanuel Saez, Gabriel Zucman and other leading economists who study inequality rely extensively on tax data that treats capital gains, capital income, and business income as if it is all income from invested financial capital. In fact, the lion's share of the increase in income inequality in those categories is attributable to the increase in *alpha* income. Differences in human capital, not financial capital, best explain the inequality trend.[12]

A recent paper by Smith, Yagan, Zidar & Zwick makes a similar argument based on data that excludes capital gains. They find that most pass-through business income is a form of labor income, estimating that perhaps 75% of pass-through business income is labor income.[13] This figure, however, excludes realized capital gains. Carried interest, founder stock, and dividend

[11] Compare Thomas Piketty, Capital in the Twenty-First Century; Tax L Rev comments

[12] Relatedly, I make a methodological contribution by emphasizing the importance of institutional detail in analyzing tax data. For example, an important new paper by Emmanuel Saez and Gabriel Zucman estimates changes in wealth inequality by treating all reported taxable investment income, including capital gains income, as if it were financed by capital. If a taxpayer reports $10 of capital gains income in a period where the rate of return is assumed to be 10 percent, then Saez and Zucman infer that there is $100 of wealth producing that income. But if, in fact, the $10 capital gains represents a fund manager's distributive share of carried interest, there is zero wealth standing behind the "investment." My findings below suggest that as much as 50% of capital income is *alpha* income, suggesting that the phenomenon is a critical one and not merely a minor measurement error.

Economists are not alone in paying too little attention to institutional detail. The law review literature rarely makes clear who the investors are or what they invest in. As a result, the literature leaves us more informed in theory than in fact. The 1993 Tax Law Review colloquium on capital gains, for example, brought together the brightest minds in tax, and many of the arguments found in that volume remain sound, insightful, and internally compelling. But necessary facts are missing. The colloquium contained no references to private equity funds, venture capital, hedge funds, founders' stock, or goodwill. It contained just one reference to real estate. Institutional detail can be useful in providing scholars, economists and policymakers with a better understanding of the world as we find it.

[13] Matthew Smith Danny Yagan Owen M. Zidar Eric Zwick

recapitalizations and other forms of alpha income are still treated as investment income in their analysis. This paper, in other words, complements the findings of Smith et al., that emphasize that the rise of inequality is due to the gains of the working rich, not from trust funds. My emphasis here, however, is on that portion of labor income that is taxed at lower capital gains rates.

3. Consumption tax literature.—I make a small but practical contribution to the consumption tax literature, namely that "post-paid" models are superior to "pre-paid" models. In a pre-paid model, wages are taxed as they are received, and investment income is exempt from tax. Because so much *alpha* income is treated as investment income for tax purposes, however, the income (and consumption) of investment fund managers and many executives would escape tax altogether. Value-added taxes or other postpaid models, by contrast, impose taxes directly or indirectly on consumers and thus would tax the consumption of *alpha* earners as well as ordinary wage earners.

4. Entrepreneurship literature.—Finally, I contribute to the growing literature on taxes and entrepreneurship. There is little empirical evidence to support a claim that low taxes increase entrepreneurial entry or entrepreneurial success.[14] Instead, tax breaks for entrepreneurial income are mostly inframarginal—rewarding entrepreneurs for what they would have done anyway.[15]

To be sure, not all *alpha* income goes to the top one percent of the one percent. As Bill Gentry shows in a recent paper, many households have active business income, some of which generates capital gains.[16] Congress has historically demonstrated particular concern about the impact of capital gains taxes on small business. Family-owned businesses provide convenient cover for the ultra-rich, and concern for small business should not be given undue weight. But if Congress chooses to raise the tax rate on capital gains, it may be a necessary concession, as a matter of politics and perhaps of principle, to

[14] See Donald Bruce & Beth Glenn, in this volume; Victor Fleischer, *Job Creationism*, Fordham L. Rev. (2016).

[15] It seems unlikely that Mark Zuckerberg reviewed the tax code before starting Facebook. Cf. The Social Network.

[16] William Gentry, cite.

provide a limited tax shelter for small business.[17] Section 1202 of the current tax code provides a possible conceptual model for small business relief.[18]

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[17] This is not a paper about ideal theory. In an ideal world—with perfect political institutions full of selfless politicians assisted by selfless agents working with perfect information to advance the public interest—I believe the tax system would be simple. The capital gains preference would be repealed, corporate and shareholder-level taxes would be integrated, the realization doctrine would be replaced with a mark-to-market system, and the tax system would not distinguish between labor income and capital income. This Article is not addressed to that ideal world. While I recognize the importance of scholarship that addresses ideal theory, it may be more useful at this point in the scholarly debate to work through potential reforms that more fully account for institutional detail and connect to the legitimate political preferences of voters.

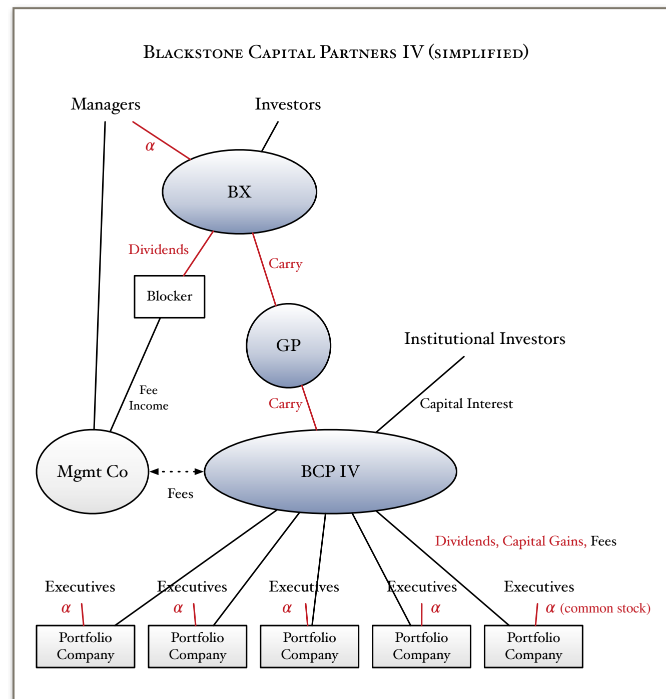
[18] Section 1202 allows investors in "qualified small business stock" to exclude up to $10 million in gains from the sale of stock. See infra part x.

II. LABOR IS THE NEW CAPITAL

A large and increasing portion of capital gains at the very top of the income distribution is *alpha* income. I define *alpha* income as as a financial return generated from one's human capital, the value of which is derived from the performance of an underlying financial security affected by one's labor efforts (typically, the stock price of one's employer). While data limitations make estimates difficult, I estimate that between one-quarter and one-half of all capital gains are derived from sources such as carried interest and founders' stock, not investment income.

A. OVERVIEW: WHAT ALPHA LOOKS LIKE

It may be useful to begin with an example from private equity. Blackstone is a publicly-traded investment management firm with $272 billion in assets under management.[19] Its private equity division raises most of its capital from public pension funds; 37 million retirees—more than half of all U.S. retirees—have a part of their retirement money managed by Blackstone.[20]



To illustrate how labor is transformed into capital gains, consider Blackstone Capital Partners IV, a private equity fund managed by Blackstone. Blackstone raised $6.5 billion in capital for the fund in 2002-03. As of the end of 2014, with most investments exited, the fund reported a net IRR of 37%, with an investment multiple of 2.8x. Over the course of twelve years, the $6.5 billion invested into Fund IV turned into $18.2 billion, generating about $11.7 billion in investment income, almost all in the form of capital gains.

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[19] It is taxed as a partnership, not a C Corporation. See Victor Fleischer, *Taxing Blackstone*, supra note x.

[20] 2014 BX Investor Day at 58.

Of that $11.7 billion in investment gains, only about ten percent was taxed at the preferential rate for individuals. The primary reason is that most of the capital gains were allocated to tax-exempt investors. State pension funds, private pension funds, sovereign wealth funds, and university endowments provide about 80% of the capital for a typical fund. Another 10-15% is made up of taxable corporations, like commercial banks, investment banks, and insurance companies. Corporations, of course, do not enjoy a preferential rate on capital gains, but instead pay tax at the usual corporate rate of 35%. Only about 6% of investment capital is provided by U.S. individuals who might benefit from the capital gains preference, usually through a family office.

FIGURE 2 | BLACKSTONE CAPITAL PARTNERS IV

Investor / Executive	Initial Investment	Net Income	Capital Gains	Tax	% of Tax Paid	Benefit of Preference	Type of Income
Tax-Exempts	$5.2B	$9.36B	$9.36B	0	0	0	Capital Income
C Corps	$0.65B	$1.17B	$1.17B	$0.41B	34%	0	
Family Offices	$0.65B	$1.17B	$1.17B	$0.23B	19%	28%	
Blackstone	$5MM	$3.51B	$2.34B	$0.46B	38%	57%	*Alpha*
CEO & Mgmt	0	$1.17B	$0.58B	$0.12B	10%	15%	
Total	$6.5B	$16.38B	$14.62B	$1.22B	100%	100%	

Where the capital gains preference really matters is for individuals who earn income through their labor efforts. This occurs at two levels. At the bottom of the structure, executives who manage BCP IV's portfolio companies like Kosmos Energy, SunGard, or Merlin Entertainments are largely compensated with stock awards. Although the grant of a stock award gives rise to ordinary income on vesting or at the time of a § 83(b) election, executives typically receive shares at a low price reflecting leverage in the capital structure and the presence of preferred stock. Appreciation in the value of the common stock, when it occurs after vesting, gives rise to capital gains income. The executive team might hold between 5% and 20% of the equity in the portfolio company, depending on the size of the company and its history.

In addition, Blackstone receives "two and twenty" for managing the fund: a one to two percent annual management fee, and a twenty percent carried interest, or share of fund profits.[21] Once the fund clears an eight percent hurdle rate, additional income (known as the catch-up amount) is allocated to

[21] Victor Fleischer, Taxing Blackstone, Tax L. Rev. (2008).

Blackstone until it receives twenty percent of the overall profits in the fund. It then receives twenty percent of income above the catch-up amount.

In this example,[22] 72% of the estimated realized capital gains subject to the capital gains preference represents a return on human capital—and not a return on financial investment.[23]

How representative is this labor-dominated account of capital gains? It is hard to know with precision because gains from carried interest, founder stock, and other forms of *alpha* are not reported separately on tax returns.[24] But as I discuss below, the available data from the IRS Statistics of Income division suggest that the outcomes described above in the Blackstone example are not unusual. Carried interest alone accounts for about ten percent of *all* capital gains and as much as twenty-five percent of capital gains of the top 0.1%. Blackstone's structure represents a common norm at the high end of the income spectrum, not an aberration.[25]

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[22] I assume that all returns to investors are capital gains or qualified dividends, that Blackstone receives half as much in management fees, transaction fees, and monitoring fees as it receives in carry, and that the management teams owned 10% of portfolio company equity, recognizing half as ordinary income and half as capital gains income.

[23] The same result holds true for funds that don't do quite as well. Blackstone formed Capital Partners V in good times, in July 2006, raising a record $21.7 billion in capital. In 2008-09, the financial crisis drove equity prices down. *BCP V* held investments for a longer period than normal. Still, many investments turned around, and as of the time this writing, the fund now reports an IRR, net of fees, of 9 percent, and an investment multiple of 1.5x. Some high-profile investments, like Hilton Hotels and Sea World, turned out better than expected. In the end, over the course of ten years, the $21.7 billion invested into Fund V has turned into $32.6 billion, net of fees, generating about $10.9 billion in capital gains. For BCP V, about 74% of the the realized capital gain subject to the preferential rate is attributable to alpha income, not investment income.

[24] NYT column.

[25] Others have noted the declining number of taxable portfolio investors and the increase of tax-exempt investors. See, e.g., Rosenthal. As the number of taxable portfolio investors declines, the share of capital gains going to taxable alpha earners increases.

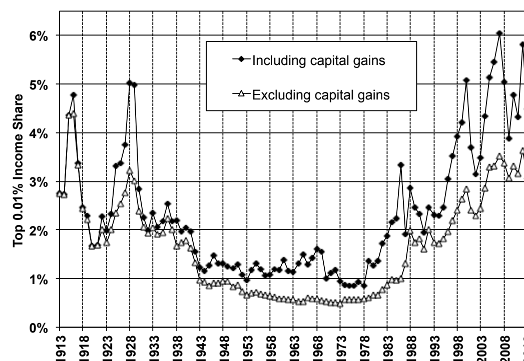
B. Is the Increase in Inequality Attributable to *Alpha* Income?

Tax data does not directly measure *alpha* income. So far as the I.R.S. is concerned, a capital gain is a capital gain; a dividend is a dividend. Nonetheless, one can estimate *alpha* by using proxies for income from founders' stock, carried interest, and private equity dividend recapitalizations. Before turning to my estimates of *alpha*, however, it is useful to first describe in broader terms how *alpha* income is relates to the broader question of income inequality in the United States.

Reinterpreting the Piketty & Saez data.—-

In a landmark paper, economists Thomas Piketty & Emmanuel Saez showed how income inequality in the United States formed a U-shaped curve over time, with inequality decreasing during the Great Depression, staying low after World War II, and then steadily increasing from about 1980 to the present.[26] In *Capital in the Twenty-First Century*, Piketty attributes this rise in inequality to the high rate of return achieved by investors in contrast to the generally low rate of economic growth ($r > g$). While Piketty acknowledges the role of special "super-managers" and executive pay in the United States, he nonetheless assumes that income that is reported in the tax data as capital income is derived from invested capital, not human capital. This assumption is faulty, and it leads Piketty to erroneous conclusions, at least with respect to the United States.

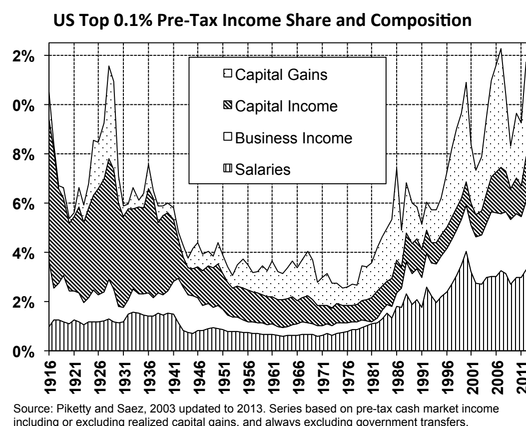
Consider the Piketty & Saez data describing the composition of income at the very top. As they note, the top tenth of the top one percent—about 165,000 households with an income of greater that $1.9 million a year—is largely responsible for shaping the inequality curve upwards. Within this group, the top one percent of the top one percent—16,500 households with income greater than $9.75 million a year—is the group that bends the curve upwards.



[26] Piketty & Saez.

Interpreting the data is challenging because of the way that the I.R.S. Statistics of Income division reports different sources of data. For example, in the SOI data partnership allocations of capital gain are not categorized as "business income" (income from partnerships and S Corporations), but are reported as capital gains. Carried interest, however, represents a return on human capital, not investment capital. Carried interest alone generates about $40 billion a year of long-term capital gains income, or about 10 percent of all reported capital gains, and nearly a quarter of the capital gains at the top.[27] Piketty & Saez are correct in observing the rise of income inequality, but they miss important elements of its cause.

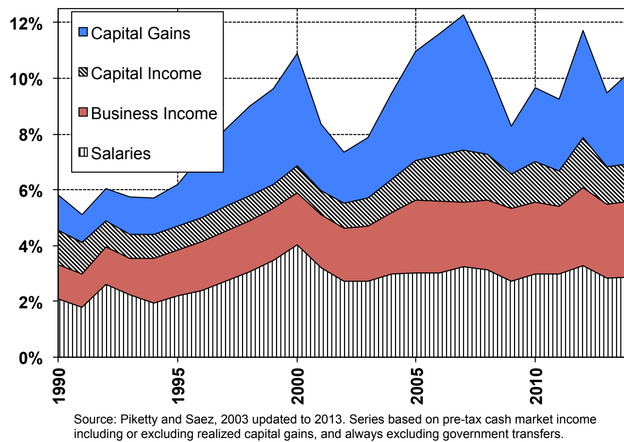
Indeed, the SOI data presentation obscures more than it elucidates. Figure 4, below, describes the sources of income for the the top 0.1% as presented by Piketty & Saez. Each band includes elements of *alpha*. The top band, capital gains, mixes together investment income and *alpha*, such as carried interest, gains from founders' stock, and gains from the sale of partnership interests. The next band, capital income, includes income from interest, dividends, rents and royalties. These dividend amounts include not just normal portfolio dividends, but also carried interest allocations from "dividend recapitalizations" undertaken by private equity funds. The third band, "business income," is a subset of passthrough income—that is, certain income from partnerships (including investment funds) and Subchapter S corporations. The bottom band, salaries, includes not just wages but also the value of equity compensation at the time it is awarded to executives.



[27] NYT estimate.

The rise of income inequality is attributable mostly to *alpha*, not portfolio investment. *Alpha* is mostly taxed at preferential rates, whether from founder stock, sales of partnership equity, or allocations of dividend income from private equity dividend recaps. (*Alpha* from stock awards, the exercise of stock options, and bonus plans is taxed at ordinary rates and is reported in the Piketty & Saez data as "salaries.").

Consider Figure 5, below, which displays the Piketty & Saez data on sources of income for the top 0.1% from 1990 to 2014. During this period, the total share of income in this group increased from 5.8% of all U.S. income to 10.2% of all U.S. income, an increase of 76%. The increase is mostly attributable to capital gains (blue) and passthrough income (red). Capital gains in this group increased from 1.26% of all U.S. income to 3.3% of all U.S income, an increase of 161%. Passthrough income in this group increased from 1.25% of all U.S. income to 2.73% of all U.S. income, an increase of 118%. Together, the two categories increased from 2.5% to 6.03%, or 3.5 percentage points. This represents 80% of the rise in inequality for the top tenth of the top one percent.



The surge of income inequality parallels the expansion of private equity and asset management industries since 2000, reflected in the data as partnership income and capital gains. Capital income (which is mostly portfolio income like interest) increased only modestly, while capital gains more than doubled—a result that would be difficult to understand if capital gains were mostly portfolio income as well.

By contrast, executive salaries have increased only modestly since 1990—less than 0.5 percentage points. The "pay for performance" revolution in executive pay has important implications for corporate governance, and the effect on inequality can be observed in passing in 2000, when stock prices surged during the dot com bubble, inflating the value of both stock options (reported as "salaries") and realized capital gains from the sale of founders' stock. Generally speaking, however, corporate executive pay from stock options and stock awards does *not* account for the rise in inequality.

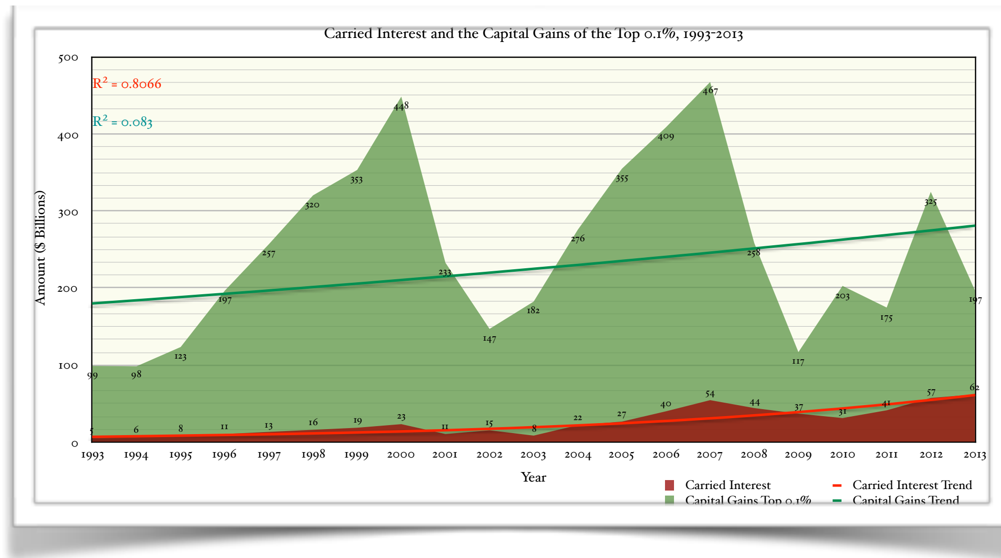
In sum, a closer reading of the SOI data suggests that its failure to distinguish between investment income and *alpha* income has led to two possible mistakes in the economics literature: (1) attributing the rise of inequality in the United States to investment income rather than differences in human capital, and (2) failure to connect inequality to vast increase in assets under management by private equity funds, hedge funds, and other alternative asset classes.

C. Carried Interest and Inequality

Carried interest is like rocket fuel for inequality. At the end of 2014 there were 2,695 private fund advisors in the United States with a total of $6.7 trillion in assets under management. While perhaps only 50,000 taxpayers receive carried interest as part of their compensation, I estimate that those individuals earn about $40 billion annually in carry taxed at long-term capital gains rates, or about $800,000 per individual. (Those individuals receive roughly the same amount of carry taxed at ordinary rates, in addition to six-figure base salaries, putting the majority of fund managers in the top 0.1% of the income distribution.) Moreover, carried interest is not distributed evenly across the industry; founders and top managers receive most of the spoils.

The tax treatment of carried interest is an artifact of partnership tax rules designed with small business in mind. Carried interest is an industry term for the share of partnership profits allocated to the manager of an investment fund as compensation for services rendered. When the fund sells an investment or otherwise earns income, the income is allocated to the partners according to percentages set forth in the partnership agreement. The general partner typically receives a twenty percent profits interest, or carried interest. The general partner is itself owned by the sponsor of the fund, which collects both carried interest and management fees charged to each fund by an affiliate.

Because carried interest is treated as a distributive share of partnership income rather than as compensation, the character of income earned at the partnership level flows through to the individual partners. In venture capital, private equity, real estate, and some hedge funds, the character of income is mostly long-term capital gains, as stock in a portfolio company is usually a capital asset. Some hedge funds, however, trade frequently and generate income taxed at ordinary income, short-term capital gains, or the § 1256 60/40



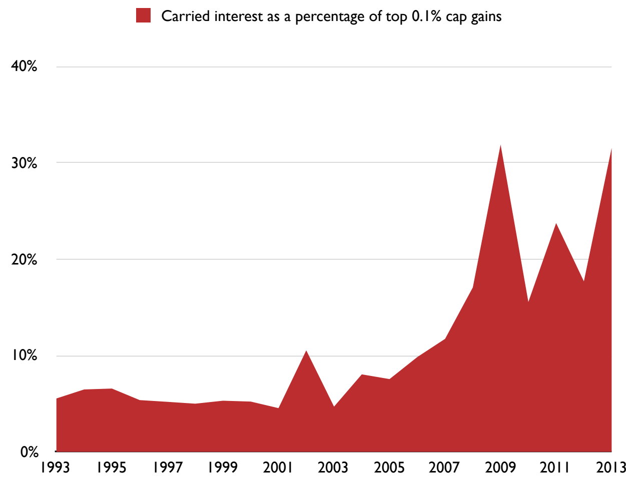
long-term/short-term blended rate for certain derivative instruments.[28] In most years, about half of the income in financial partnerships is classified long-term capital gains or qualified dividends.

1. Carried interest as a rising percentage of top-end capital gains.—

Figure 6 highlights the change in the composition of the capital gains of the top 0.1% as carried interest assumed a prominent role in the economy. As private equity grew in the 2000s, carried interest increased as a percentage of overall capital gains and of the capital gains of the top 0.1%. (I assume that while many recipients of carried interest may make less than $2 million per year, the vast majority of dollars flow to households in the top 0.1%.) By 2013, carried interest accounted for nearly one-third of the capital gains of the top 0.1%.

Carried interest represents a significant and rising percentage of the capital gains at the very top. As shown in Figure 7, the realization of capital gains is sensitive to market timing and to changes in tax rates, with large realiza-

[28] In addition, private equity fund managers often receive large dividend payments in transactions known as dividend recapitalizations or "dividend recaps." In a dividend recap, a private equity fund will raise debt (typically mezzanine or high yield debt) through a portfolio company it acquires. The portfolio company then pays a dividend up to the private equity fund, taking equity off the balance sheet and thereby increasing its leverage ratio further. Such dividends are typically qualified dividends for tax purposes and are taxed at the long-term capital gains rate. For purposes of analysis in this section, I lump together qualified dividends and long-term capital gains.

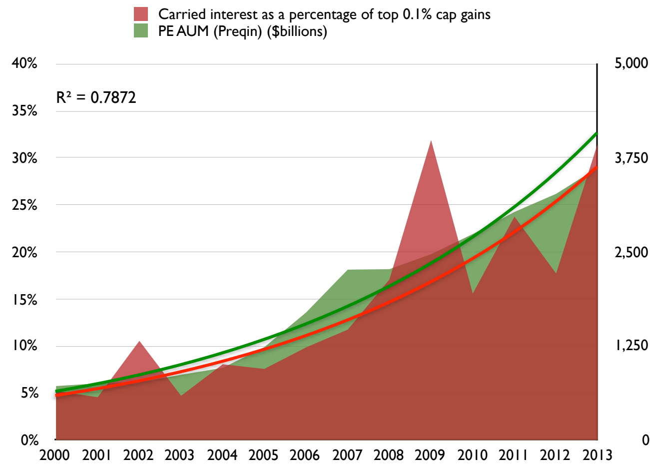


tions in 1997-2000 (the dot com / telecom bubble), 2004-2007 (real estate and private equity boom), and in 2012 (in anticipation of the 2013 tax increase). Capital gains from carried interest displayed less volatility but mirrors the pattern of capital gains generally.

Capital gains from carried interest was fairly modest in the 1990s, rising from about $5 billion in 1993 to a peak of $23 billion in 2000. After a dip from the collapse of the dot com / telecom bubble, capital gains from carried interest rose again to $54 billion in 2007. The total dipped again during the financial crisis, rebounding to new highs of $57 billion in 2012 and $62 billion in 2013. (All figures are inflation-adjusted to 2013 dollars; estimates are limited to financial industry partnerships, and thus exclude carried interest from real estate, oil and gas, mining, or other natural resources activities.)

2. The increase in private equity assets under management.

The increase in carried interest appears to be driven not by increasing investment success, but rather by an increase in assets under management. Figure 8 shows the increase in carried interest as the amount of assets under management (AUM) in private equity increased from about $1 trillion in 2000 to over $3.5 trillion in recent years.

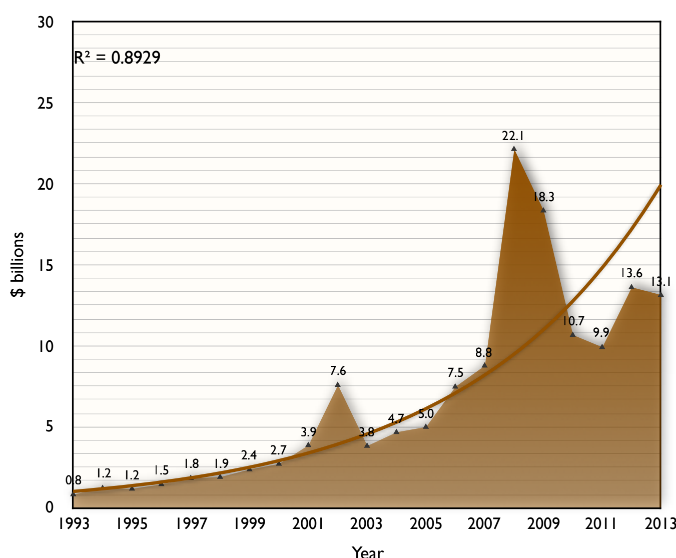


The rate of increase in alternative assets under management seems to have leveled off somewhat, with some institutional investors pulling back from hedge funds and, to a lesser extent, private equity. Still, the industry continues to expand overseas, with significant inflows to the United States as managers repatriate funds from abroad.

3. Private equity dividend recapitalizations.—

Dividends for the top 0.1% surged to $12 billion in 2012. The trend at the top is not driven by portfolio income, however: S&P dividends have generally been rising, but 2012 was unexceptional and roughly the same as 2007 and 2008.

FIGURE 9: GP ALLOCATIONS OF PRIVATE EQUITY DIVIDEND RECAPITALIZATIONS



The trend is instead driven by private equity dividend recapitalizations, which became commonplace in the mid-2000s. In a dividend recap, a private equity-backed company borrows money in the "leveraged loan" market (loans that are syndicated out to other financial institutions) and uses the money to fund a dividend to the private equity fund shareholders. By partially cashing out of the investment early, dividend recaps help keep up the internal rate of return. After a dividend recap, the portfolio company carried a higher debt-to-equity ratio, but the higher risk of failure is offset by the early cash in hand, as well as the tax benefits of higher interest deductions.

As I discussed in the introduction, the majority of capital provided to private equity comes from tax-exempt investors. Thus, when dividends are reported in the tax data, realized dividends mostly represent the portion allocated to the individual fund managers and company management, not to individual portfolio investors in the fund. Figure 9 shows the increase in carried interest allocations of dividends from 1993 to 2013.

4. Cayman Islands hedge fund incentive fees.—

If anything, the full impact of carried interest is not yet reflected in the income tax data. Until 2009, many hedge fund managers organized funds through a Cayman Islands corporation in order to defer the income indefinitely offshore, where it could be reinvested on a pretax basis. Congress passed §457A to treat such deferred income as includible in income beginning in 2009. The legislation allowed existing deferrals to remain deferred offshore, untaxed, until deemed realized no later than end of 2017.[29] Industry observers expect a large amount of income to be repatriated as old structures are unwound. Such income will be taxed as compensation at ordinary rates. Still, it is worth noting that such income is *alpha* income, not investment income.

5. Revenue potential.—

Finally, the carried interest data shows the revenue potential from changing the tax treatment of carried interest, even if one left the capital gains preference otherwise in place. I first suggested taxing carried interest at ordinary rates in 2006. Congress first proposed section 710, which would tax most carried interest at ordinary rates, in 2007. In the decade since, the total amount of carried interest taxed at capital gains rates has grown by more than fifty percent. If one assumes, conservatively, that the growth of carried interest levels off at $50 billion annually, a static estimate would suggest that a twenty percentage point increase in the tax rate would raise $10 billion annually. If one were to add in carried interest from real estate and capital gains from the sale of investment services partnership interests, the tax might raise as much as $15 billion annually, depending on the behavioral response.

My estimates differ substantially from the revenue estimates by the Joint Committee on Taxation and the Treasury Department. I believe the difference in revenue estimates primarily derives from the model the government uses to anticipate behavioral responses to changes in the capital gains tax rate. A recent paper by Treasury authors highlights the highly elastic response of partnership investors. In my view, the use of these elasticity estimates in inappropriate in the context of carried interest; fund managers do not control the timing of realizations in the same way that portfolio investors do. Using a labor model of elasticity would better reflect the reality that fund managers are not portfolio investors.[30] In addition, the government's estimates looked backwards, using historical data from the 1990s to estimate

[29] Pub. L. 110–343, div. C, title VIII, §801(d), Oct. 3, 2008, 122 Stat. 3931 (effective date provision).

[30] It is worth noting that carried interest realizations failed to spike in 2012 in anticipation of the 2013 tax increase, and failed to fall in 2013 in response. It is also worth noting, perhaps, that the government's estimate has declined since 2007 notwithstanding that assets under management have nearly doubled since then.

how much carried interest would be earned going forward, perhaps using the average of 1996-2005 (about $16 billion a year, yielding an estimate of $3.2 billion before adjusting for behavioral response).

D. Founders' Stock

Founders' stock represents the other key way in which labor is the new capital gain. At the very top of the income distribution, a large proportion of gains comes from the sale of stock in a company that was founded by the taxpayer or a relative of the taxpayer. It rarely represents good stock-picking by a portfolio investor.

Distinguishing between portfolio income and *alpha* is not an easy task, even in concept. It is especially challenging when an entrepreneur contributes both labor and capital to a venture, as is often the case. One possible approach is to take the entrepreneur's initial financial investment and impute a high but reasonable rate of return, say, ten percent, reflecting the high cost of capital for risky ventures. To the extent that gains exceed this rate of return, the gains reflect contributions of labor effort, entrepreneurial rents, or monopoly rents, not simple investment gains.

Another approach could be to look at the financial returns achieved by investors who contributed only money and use that figure as a measure of the return to capital. Even in that case, however, it is well understood that some portion of the return in excess of the risk-free rate is financial *alpha* generated by the fund managers who select good companies for investment and help the companies succeed.[31]

In practice, the I.R.S. does not currently provide sufficient information to get useful estimates of the *alpha* income that arises from the sale of founders' stock. At least at a high level of generality, however, the SOI data, when reinforced by journalist accounts and a bit of common sense, show fairly persuasively that a significant portion of what is reported as capital gains represents *alpha* income from the sale of founders' stock.

SOI data. Capital gains are heavily concentrated at the very top of the income distribution, among the top 0.01%. The 16,500 households with more than $10 million in adjusted gross income in 2012 reported $265 billion taxable net capital gains, or about 43% of the total capital gains reported for all taxable returns, or $619 billion. The top 0.01% reported $256 billion in net long-term capital gains, or 42% of the total on taxable returns, $609 billion. The top 0.02-1% reported an additional $69 billion in net long-term capital gains.

1. Estimating founders' stock alpha from SOI data.—

To estimate *alpha,* I first established a baseline rate of return (*beta*) with respect to capital gain transactions beginning in 2011, when it first became

[31] See David Swensen, Pioneering Portfolio Management.

mandatory for brokers to report the stock basis of their customers on Form 1099-B. For transactions where the taxpayer was issued a 1099-B, but no basis was reported on the form, or where the customer did not use a broker, the investment return was considerably higher than for transactions where basis was reported. It is possible that the holding period varies systematically between these two types of transactions—those with basis reported and those without—and that the difference in holding period explains the difference in returns. Importantly, however, transactions where no basis is reported include the sales of employer stock where the taxpayer made a section 83(b) election. The difference between the higher rate of return and the baseline market return this gives a first approximation of *alpha*. I assume that the excess return from these no-basis-reported transactions is divided evenly between investors who do not use a broker for purchasing stock (such as venture capitalists) on the one hand and employees and founders on the other.

It is hard to have a great deal of faith in this estimate, given the many reasons why investors might not have received a Form 1099-B with basis reported. As one can see in Figure 9 above, however, the data fits well with the overall pattern of capital gains realization at the top of the income distribution. The red bar represents long-term capital gain from founders' stock and other equity-linked pay. I can say with some conviction that it is not passive investment income—for which cost basis would normally be reported on Form 1099-B or elsewhere—that is driving the increase in capital gains realizations and the related income inequality. It is either active investment or equity-linked pay, and it seems reasonable to attribute half of the amount to equity-linked pay.

The bottom line is that carried interest and founders' stock together account for a significant amount of the capital gains realizations of the top 0.1% in recent years.

2. The Fortunate 400.— Journalists provide another source of data, or at least anecdata. The Forbes 400 is an annual list of the wealthiest Americans. The data is compiled based largely on public securities filings; it may omit a great deal of private wealth. The estimated wealth of Americans on the list ranges from $1.7 billion to $76 billion, with rankings varying from year to year depending on the stock price of undiversified holdings.[32]

What is clear is that many of the very richest Americans are founders, not investors. To be sure, some of the wealthiest, like the Walton family, inherited the wealth from a previous generation. But a great deal of wealth was generated in the technology boom of the 1990s and more recently, and still rests in the hands of the founders.

[32] http://www.forbes.com/sites/luisakroll/2015/09/29/inside-the-2015-forbes-400-facts-and-figures-about-americas-wealthiest/

Figure 10: Forbes 400 (2015)			
	Name	**Wealth**	**Source**
1	Bill Gates	$76 B	Microsoft
2	Warren Buffett	$62 B	Berkshire Hathaway
3	Larry Ellison	$47.5 B	Oracle
4	Jeff Bezos	$47 B	Amazon.com
5	Charles Koch	$41 B	conglomerate
5	David Koch	$41 B	conglomerate
7	Mark Zuckerberg	$40.3 B	Facebook
8	Michael Bloomberg	$38.6 B	Bloomberg LP
9	Jim Walton	$33.7 B	Wal-Mart
10	Larry Page	$33.3 B	Google

What founders do with their wealth is notoriously difficult to track. Some stock is sold to fund current consumption or to provide diversification. Some is given away—in which case the founders' capital gain in transformed into a charitable deduction, and the charity's transferred capital gain becomes tax-exempt. The remainder is held until death and bequested to heirs with a step up in basis.

It would be too speculative to estimate capital gains income from the wealth estimates in the Forbes 400. It provides an intuition, however, that the source of top incomes may reflect the wealth of founders. IRS data on the "Fortunate 400" indeed suggests that many who make the list of the top 400 AGI do so only once or twice, suggesting that it is the sale of a business that triggers the gains rather than the portfolio income of the wealthy. Whatever the bottom line may turn out to be, it suffices for present purposes to make the point that founders' stock accounts for a significant portion of capital gains at the very top of the income spectrum.

IRS Data: The Fortunate 400

While data on the super-rich is sparse, the IRS sometimes provides statistics on taxpayers with the top 400 adjusted gross income amounts. For the most recent update in 2012, the cutoff for adjusted gross income was $139.6 million, up from $24.4 million in 1992. The top 400 individuals roughly tripled their share of national income over 20 years, from 0.52% to 1.48%.

A significant number of the top 400 are likely the founders of companies. But changes in the composition of income of the the top 400 also suggest that private equity and hedge fund managers now make up a significant part of the very top of the income distribution.

	1992	2012
Salaries & Exec Comp	26%	8%
Interest	7%	4%
Dividends	6%	16%
Capital Gains	36%	57%
Schedule C	5%	1%
Passthrough	17%	13%
	100%	100%
Median Effective Tax Rate	25-30%	10-15%

The decline in the relative proportion of salaries and increase in capital gains suggest that fewer CEOs make the top 400 today. The decline in the effective tax rate supports this conclusion. The data also suggests that a significant portion of the top 400 are fund managers: partnership income for the top 400 peaked at $13 billion during the financial crisis—precisely when some hedge fund managers did extremely well from the "big short."

E. Executive Compensation

Most executive compensation other than carried interest is taxed at ordinary rates. If an executive receives cash, the cash is taxed at ordinary rates when received. If an executive receives a stock award, the value of the award is typically taxed at ordinary rates when the stock is received, unless the stock is restricted by vesting or performance conditions, in which case the award is taxed when those conditions are satisfied. Some executives choose to make an election, known as a § 83(b) election, to recognize the value of a stock award at the time of receipt rather than vesting, in which case the present value is taxed at ordinary rates and future gain or loss is taxed at capi-

tal gains rates. Most stock option awards are taxed at exercise at ordinary rates.[33]

The bulk of executive compensation is performance-based pay where the size of the award is tied to the stock price or other measures of performance, such as sales, or the performance of the stock price relative to industry competitors. Most of this compensation is *alpha* income: compensation for labor efforts where the amount of compensation is tied to the performance of the company. It is often tax at ordinary rates, and not as capital gains, but it is still *alpha* income.

When executives hold on to stock after the initial recognition of income, it is unclear whether to think of any future appreciation in the value of the stock as *alpha* income. In one common scenario, executives who receive stock options will opt for a "cashless hold," selling only as many shares as necessary to fund the exercise price and tax liability associated with the exercise. The remainder of the stock is held in the hopes of further appreciation at capital gains rates. On the one hand, the capital gains that may result look like *alpha* in the sense that the executive will eventually receive income based on his labor efforts. On the other hand, the executive had an opportunity to cash in and reinvest elsewhere, which makes any future appreciation look like investment income. the executive has paid tax at exercise on the spread between the fair market value and exercise price, and so—unlike founders' stock or carried interest—the stock represents an investment of after-tax dollars. For purposes of understanding inequality, it is probably better to think of these gains as *alpha* income rather than portfolio investment income. For purposes of capital gains policy, however, the fact that tax is paid at the time of receipt or vesting means that it is better to think of future appreciation in the value of the stock as similar to portfolio investment income.

E. Partnership Equity & Goodwill

Many founders of private equity and hedge fund management firms have sold partnership equity interests in recent years. The sale of a partnership interest is generally treated as a capital asset. Section 741 and 751 treat certain "hot assets"—assets that would give rise to ordinary income if held, like inventory and receivables—as giving rise to ordinary income when sold. Proposed legislation to change the tax treatment of carried interest would treat carried interest as a hot asset. Under current law, however, the sale of a partnership equity interest in a private equity firm gives rise to capital gain treatment.

The value of these partnerships is a reflection of the future streams of management fees and carried interest earned by the funds—for accounting

[33] Incentive Stock Options (ISOs), which are taxed at capital gains rates, are limited to $x.

purposes, this is mostly reflected as goodwill. The creation of goodwill is *alpha* income to the extent it is captured by the founders and senior managers of the firm.

F. Summary

In sum, increases in *alpha* income account for much of the recent increase in top-end inequality in the United States, and a significant portion of *alpha* is taxed at the long-term capital gains rate. The main sources of such capital gains are from the sale of founders' stock, the sale of partnership equity, and from carried interest.

III. The New Case Against Taxing Capital Gains at Preferential Rates

Traditionally, proponents of the capital gains preference rely on efficiency arguments to justify the preference. First, any tax on capital income further distorts the consumption/savings margin. A lower capital gains rate reduces the distortion. Second, the realization doctrine means that taxpayers can choose when to realize capital gains, and so the revenue-maximizing rate for capital gains may be lower than the optimal rate on labor income. Moreover, the lock-in effect is inefficient, creating an obstacle to the allocation of capital to its highest and best use.

Opponents of the capital gains preference usually point to equity arguments. Someone who makes $100,000 and also has $200,000 in capital gains has a higher ability to pay than someone who makes $100,000 in wage income and has no capital gain. Moreover, someone who makes $100,000 in wage income and also has $200,000 in capital gains has about the same ability to pay as someone who makes $300,000 in capital gains. The capital gains preference, in other words, violates the traditional norms of horizontal and vertical equity.

Congress has traditionally struck a compromise between the two positions, opting for a reduced (but nonzero) rate on capital gains. In recent history, the rates were briefly harmonized following the Tax Reform Act of 1986, at 28%, but soon diverged again.

The rise of *alpha* income should tip the balance for policymakers in the direction of more uniform rates. The efficiency case for the capital gains preference is weaker, and the equity case against the preference is stronger than ever.

A. The Uneasy Case for the Capital Gains Preference

It may be useful to provide a bit more background before turning to the specific arguments. In 1993, the *Tax Law Review* published a colloquium issue on capital gains. In *The Case for a Capital Gains Preference*, Noel Cunningham and Deborah Schenk laid out the strongest case they could, while acknowledging that the argument wasn't all that strong. An ideal income tax would have no preference for capital gains, they argued. The hard question, as they saw it, was whether a preference is desirable assuming an imperfect income tax and a lack of political will to adopt optimal corrections. They concluded that the lock-in effect justified the preference as a second-best alternative, explaining that it is "almost certainly efficient and probably promotes equity." Other scholars were less certain.

Daniel Shaviro made a more forceful defense of the capital gains preference in his contribution, *Uneasiness and Capital Gains*. Professor Shaviro argued that the only difficult question was an empirical one, namely whether the capital gains preference raises revenue over the long term, accounting for both the elasticity of realizations and the planning and gamesmanship incentives a rate preference creates. If a rate cut raises revenue, Professor Shaviro argued, then a preference is obviously justified. "Genuinely revenue-raising rate reduction is nearly always desirable," Professor Shaviro noted, "absent greater external effects than any that seem present here." Other scholars, like Eric Zolt, have similarly explained that non-uniform tax rates may be justified by differences in the mobility of labor versus capital.

The literature has changed little in the quarter-century since the *Tax Law Review* colloquium.[34] Scholars continue to assume that the capital gains preference matters because of its effects on portfolio investors, not its effects on founders, executives, and fund managers. The literature generally assumes that what is reported as capital income is, in fact, a return on capital. Often it is not.[35]

Changing one's perspective from that of a portfolio investor to that of a founder or investment fund manager undermines many of the assumptions that scholars usually make. Because portfolio investors can pick and choose which assets to sell—holding winners and selling losers—scholars assume that the revenue-maximizing rate is considerably lower than the top ordinary income rate. This assumption is more questionable today. Holding on to eq-

[34] The most significant new line of argument has been drawn from the public finance insight that, under certain assumptions, the income tax only burdens the risk-free rate of return. Such a conclusion tends to lead one to prefer a consumption tax as an ideal base. In turn, preferring a consumption tax base might lead to a conclusion that an income tax with a capital gains preference brings one closer to the ideal than an income tax with no capital gains preference. I address this argument in Section C below.

[35] It is not surprising that the tax literature has not yet fully incorporated the transformation of the technology and finance industries that, in turn, have reshaped income inequality in the United States. Recall what was happening in 1993, when the Tax Law Review convened the last major colloquium on capital gains. Marc Andressen introduced Mosaic—soon to become Netscape—ushering in the consumer Internet era. So-called "second generation" mobile phone systems were introduced, and the first person-to-person SMS text message was sent. Finance, too, was just starting to change. There were about 200 venture capital firms, 150 private equity firms, and perhaps 1,000 hedge funds, together managing about $300 billion in alternative assets.

Today, Internet- and mobile-related assets are worth trillions. The Internet bubble inflated, then popped, and it now spits out unicorns and deca-corns. There are over a thousand venture capital firms, over a thousand buyout firms, and eight thousand hedge funds, together managing about $7 trillion in assets. We should not be surprised that the tax literature has not caught up with new face of capital gains.

uity positions (and deferring gains) leaves entrepreneurs and fund managers exposed to firm-specific risk; they are willing to pay a bigger tax bill in order to diversify their returns.

Indeed, taxable portfolio investors are becoming rare. Tax-exempt and tax-indifferent investors now own a majority of portfolio holdings, making the proportion of capital gains earned by tax-sensitive individuals smaller compared to the relatively inelastic *alpha* class.[36]

Alpha also puts the relationship between capital gains and progressivity in a new light. Most people prefer that a tax system be either progressive or flat (proportional), not regressive. Repealing the capital gains preference is essential to avoiding a regressive tax rate structure on labor income. Similarly, even if consumption is taken as the ideal tax base, few would advocate for a regressive rate structure. And yet, under current law, a billionaire entrepreneur can, with adequate estate planning foresight, pass on the entirety of his unconsumed wealth to his heirs with little tax paid at all. This result violates most people's conception of equity with ordinary wage earners.[37][38]

With that background in mind, it may be useful to restate the traditional justifications for the capital gains preference:

(1) the capital gains preference is efficient because capital gains realizations are highly elastic; the rate preference reduces deadweight loss from **asset lock-in** and tax planning, increases revenue, and avoids placing too great an emphasis on symbolic fairness,

(2) the capital gains preference mitigates the **savings/consumption distortion** of the income tax,

(3) a capital gains preference generates **positive externalities** by encouraging risky investments or by fueling entrepreneurship,

(4) a capital gains preference serves as a form of back-door **integration of corporate- and shareholder-level taxes**, and

(5) a capital gains preference is justified because some gains are merely **inflationary gains**.

While each argument provides a plausible case for a capital gains preference, the presence of *alpha* income weakens the case overall.

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[36] Rosenthal tax notes paper.

[37] Fleischer, Fordham L Rev. paper.

[38] It may be true, as Thomas Piketty asserts in Capital, that r > g. But r does not flow to investors alone. It also flows to labor, in the form of alpha.

1. Lock-in

Economic efficiency is the most plausible argument for the rate preference. In order to reduce deadweight loss and increase overall social welfare, it may be efficient to vary tax rates inversely with the elasticity of the activity in question. All taxes cause economic distortions. If one raises taxes on a particular good—avocados, say—where the consumers are highly elastic, consumers may avoid the tax by substituting a lower-taxed replacement—say, hummus. This creates deadweight loss—the government fails to get new revenue from the higher tax, and the consumers buy hummus when they really would have preferred avocados. If, by contrast, demand for avocados is largely price inelastic, few people will substitute hummus to avoid the tax, and the avocado tax is considered efficient.

Taxpayers with appreciated capital assets may prefer, in a world without taxes, to sell the assets and reinvest in other assets. Because capital gains are usually imposed only at realization, however, the tax is imposed only on selling appreciated capital assets (avocados), not holding appreciated capital assets (hummus). The efficiency of taxing capital gains depends on whether the holders of appreciated assets are willing to pay the tax in order to buy assets that they prefer.

Historically, efficiency arguments have carried particular force with respect to capital income. Capital income is more sensitive to tax rates than labor income. Investors often have the ability to defer income or shift the location of investment to avoid paying tax. In an open economy where capital is more mobile than labor, it is generally thought to be more efficient to tax capital at a lower rate than labor income.[39]

To the extent that capital gains are *alpha* income, however, these efficiency arguments lose much of their force. *Alpha* income more closely resembles labor income, not capital income, for efficiency purposes. Portfolio investors can easily choose to hold on to appreciated assets. Investment fund managers, by contrast, want to exit successful portfolio investments as soon as possible to maximize the reported internal rate of return (IRR), the financial metric by which their performance is judged. Furthermore, fund managers are mostly immobile; few are willing to give up U.S. citizenship in order to reduce their tax bill. Moreover, there are few overseas destinations with both a thriving private equity or technology infrastructure and a lower tax burden on executives. (One can legally move a fund to the Cayman Islands, but operating a fund from there would be impractical.)

The phenomenon of *alpha* income also highlights the inefficiency associated with forcing the government to distinguish between labor income and

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[39] Zolt.

capital income. Suppose, for the sake of efficiency, we move to a system where labor income is taxed at 45% and capital income at 0%. If all income is categorized accurately, deadweight loss is reduced because tax causes fewer people to over-consume and under-save. But now assume that some labor income can be mischaracterized as capital income and taxed at a zero rate. Workers who can get a job in the mischaracterized sector will seek work there, creating a new economic distortion. In practice, this means that, on the margins, Harvard Business School graduates might opt for a job in private equity over a job at Facebook. Unless you believe there is a dire shortage of aspiring fund managers, the distortion is likely to be costly. The efficiency costs of these new classification distortions erode the efficiency savings that the preference provides, depending on the rate of mischaracterization. Efficiency, in other words, depends not just on elasticity but also on the government's classification error rate.

Making matters worse, tax lawyers are in the business of maximizing the government's error rate. Tax planning largely involves finding ways to legally tweak the economic activity that clients perform so that it achieves the most advantageous tax treatment. The government is at an intrinsic disadvantage in this game because it must set out its rules—the definitions of different categories of income—in advance. The greater the rate differential, the greater the effort to find gaps and engage in regulatory arbitrage.

All that said, the case remains strong that the capital gains rate should not exceed the revenue-maximizing rate, which government economists estimate at about 28 to 32 percent.[40] The revenue-maximizing rate would be significantly higher, however, if Congress were to treat transfers by gift or bequest as taxable events to the donor.[41] Founders of companies and other holders of appreciated stock often donate stock or hold onto it until death, wiping out income tax liability entirely. The prospect of paying zero income tax on appreciated assets exacerbates the lock-in effect. By treating transfers by gift or bequest as taxable events, the Laffer curve would shift rightwards,

[40] Kamin paper.

[41] See Treasury Estimates on White House Budget Proposal FY 2016 (showing large revenue increase from treating death as a realization event).

and the revenue-maximizing rate would increase, perhaps to about 35 percent. [42][43]

Finally, of course, there are equality as well as efficiency considerations at stake. When the government mischaracterizes certain types of elite labor income as capital gain, it undermines the principle that those with greater ability to pay ought to pay tax at a higher rate.

2. Savings/Consumption margin.

Taxing capital income distorts the savings/consumption margin. Taxing labor income causes a distortion on the labor/leisure margin. If after-tax savings are invested rather than consumed, taxing this capital income causes an additional, second distortion on the savings/consumption margin. All else equal, one distortion is better than two.[44]

Traditionally, scholars have noted that a capital gains preference is a poor policy instrument for increasing the national savings rate. If capital gains are tax-favored, why not interest income, rental income, and other forms of capital income? If the goal is to reduce the after-tax cost of capital, why reduce taxes at the shareholder-level instead of the entity-level? Lowering the rate for capital gains alone draws arbitrary distinctions between different types of capital income and is poorly targeted, having mostly an inframarginal effect on savers.

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[42] There are other options. David Miller, for example, has argued for a mark-to-market regime for publicly-traded assets. I am skeptical, however, of the government's ability to police planning behavior. If publicly-traded stocks are marked-to-market, then surely it would be necessary to mark derivatives to market as well. That would be a good change in the law as well, I think, but even more may be required. For example, it might be necessary to mark-to-market illiquid classes of stock that are not publicly traded. Moreover, some founders would opt to keep a business private on the margins to avoid paying capital gains. Mark-to-market is certainly an idea worth pursuing, but many details need to be worked out.

Another option is Alan Auerbach's proposal for retrospective capital gains taxation. Under this approach, a deferral charge would be added to the tax calculation at the time of disposition. This approach, like mine, would require us to treat the disposition of a capital asset by gift or bequest as a taxable event.

If we assume, for the sake of argument, that disposition of a capital asset by gift or bequest is treated as a taxable event, then the advantage of retrospective capital gains taxation over a uniform rate structure is less obvious. Given the administrative challenges associated with retrospective capital gains tax and the administrative benefits of simply repealing the preference, it seems preferable to just treat income as income.

[43] Add graf on Nordic dual income taxes.

[44] Compare Kaplow with Gamage, Sanchirico.

The presence of *alpha* income weakens the case further. In the case of *alpha* income, there is no distortion of the savings/consumption margin. *Alpha* income is pre-tax labor income, not after-tax savings. The presence of tax on that labor income distorts the taxpayer's choice between labor and leisure; a fund manager facing a 40% tax rate may choose to retire early. But he does not have the option of consuming (or saving) income that he has not yet earned.

The reinvested alpha fallacy. Entrepreneurs sometimes argue that by keeping their "sweat equity" in the business, rather than taking it out, they have effectively reinvested in the business, and taxing the proceeds of such reinvestment at ordinary rates would disadvantage such reinvested alpha compared to one who cashed in early and invested in other assets.

This intuition, which understandable, turns out to be backwards. Assume a world in which all income is taxed at 40%, and there is no capital gains preference. Suppose Goofus and Gallant, entrepreneurs, each own 50% of the common stock of G2-Inc., a C Corporation. G2-Inc. raises money by offering preferred stock to investors, and let us assume that at the end of year 6, each founder's common stock is worth $10 million. A third party offers $10 million for the stock. Goofus takes the money, pays tax of 40%, and reinvests the $6 million in the S&P, earning a 12% annual return. At the end of year 12, he has $12 million. He sells, pays tax of $2.4 million, and has $9.6 million available for consumption.

Gallant declined the offer in year 6. His "reinvested alpha" in G2 also appreciates at 12% annually. At the end of year 12, Gallant sells his stake for $20 million. Gallant pays tax at 40% and has $12 million available for consumption. If anyone is over-taxed here it is Goofus, not Gallant.

Suppose instead a world in which alpha income and wage income were taxed at 40 percent, and portfolio investment income were taxed at a preferential rate of 20 percent. Goofus would pay tax of $1.2 million, not $2.4 million, on his investment gains, and he would have $10.8 million available for consumption.

If there were a zero tax rate on capital gains and a 40% tax rate on *alpha* income, Goofus and Gallant would be taxed equally—at least from a consumption tax perspective. While Goofus pays less tax in absolute dollars ($4 million) compared to Gallant ($8 million), he pays it sooner and has less money to reinvest, make the two amounts equivalent on a present value basis.

To recapitulate, "reinvested alpha" is tax-advantaged because the amounts are reinvested on a pre-tax basis. So long as the tax rate on capital gains is zero or higher, an entrepreneur who reinvests her sweat equity in the business will be better off than one who cashes in, even if alpha income is fully taxed at ordinary rates.

3. Is the capital gains preference a Pigovian subsidy?

The government often lowers tax rates for activities thought to be socially beneficial, and it sometimes increases tax rates for activities thought to be socially harmful. I often find these Pigovian justifications to be unpersuasive as a matter of institutional economics.[45] In practice, the case for Pigovian taxation depends on an assumption of uniform social costs or benefits across different firms or individuals—an assumption that is rarely true.

In recent years, scholars looking for a justification for the capital gains preference have turned to the Pigovian tradition, arguing that taxing capital gains at a low rate or not at all will increase overall welfare by encouraging entrepreneurial entry.

Along similar lines, because our tax system limits taxpayers' ability to use capital losses to offset ordinary income, it is sometimes argued that a preference is necessary to reduce a bias against risk-taking that an income tax would otherwise induce. Professors Cunningham & Schenk explained that it is hardly clear that an income tax discourages risk-taking. After portfolio losses are always available to offset portfolio gains, and leading to the conclusion that the income tax mainly burdens the risk-free rate of return on capital, not the risk premium. To the extent that loss limitations impose a burden on risky returns over safe ones, the definition of a capital asset is not well designed to remedy such a bias.[46]

The strongest case for an entrepreneurial risk subsidy is set forth by Ron Gilson and David Schizer, along with William Gentry's recent paper. Gilson & Schizer describe the entrepreneur's ability to take cheap founders' stock as compensation as a useful tax subsidy for entrepreneurship. Similarly, Gentry argues that the burden of taxation likely causes an undersupply of entrepreneurs.

I remain unpersuaded. Tax is not a good policy instrument for increasing the supply of entrepreneurs. Most of the benefit of the tax subsidy is inframarginal; every founder who succeeds benefits from the capital gains preference, even if they would have started a business in an environment with higher capital gains rates. More to the point, perhaps, tax is not a first-order consideration for most entrepreneurs.

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[45] Vanderbilt law review piece.

[46] Alpha income is more heavily burdened by the income tax than portfolio income; one cannot costlessly scale up labor efforts or costlessly diversify away firm-specific risk. But I find the argument for using the capital gains preference as a tax subsidy for entrepreneurial activity to be weak.

Nor is it clear that we have an undersupply of entrepreneurs generally. There are millions of small business owners, consultants, and independent contractors. Rather, there may be an undersupply of highly-educated, technically-skilled, managerially-talented entrepreneurs with high social and emotional intelligence currently seeking venture capital. Tax is not what constrains the supply. The financial incentive to become an entrepreneur is greater than ever, given the possibility of historically unparalleled financial success. Rather, the supply of such entrepreneurs is constrained by the limited number of people with the leadership experience, technological expertise, finance and accounting skills, and human capital necessary to form a successful start-up. A tax subsidy cannot create human capital where it does not already exist.

If one believes that there is an undersupply of entrepreneurs, then the government should subsidize the creation of human capital through our primary and secondary schools, our universities, and by upgrading our technology infrastructure to enhance productivity.

4. Double Taxation of Corporate Earnings

Defenders of the capital gains preference often argue that it is necessary to reduce the double tax on corporate earnings. Cunningham & Schenk explained that a capital gains preference is a poor second-best alternative to integration. For example, the capital gains preference exacerbates the incentive of corporate managers to retain earnings rather than distribute them. Moreover, if double taxation is the rationale, then the rate preference could be limited to stock in C Corporations.

The analysis is similar in light of *alpha* income. To the extent that *alpha* income is derived from the sale of stock in a C Corporation, and to the extent that shareholders, not employees, bear the burden of the corporate tax, it is correct that the recipients of *alpha* income indirectly bear some of the incidence of the corporate tax. Of course, it is also true that salaried employees bear some of the burden of the corporate tax in the form of reduced wages, which means that ordinary employees of C Corporations are also double-taxed. Yet employees of C Corporations receive no preferential rate on wage income. Why should founders but not employees avoid the burden of the corporate tax, even in a second best world?

Moreover, the assumption that shareholder gains have already been taxed at the corporate level has become, at times, a heroic assumption. The double tax justification fares especially poorly in the technology and pharmaceutical industries. Apple, Google, Facebook, Airbnb and other companies that have generated large gains for founders pay corporate-level tax at a low rate thanks to transfer pricing, cost sharing agreements, and other tax planning techniques.

Furthermore, *alpha* income may be earned without ever paying a corporate-level tax; operating businesses are increasingly organized as partnerships or LLCs.

Eric Toder, Alan Viard, and others have argued persuasively that the future of business tax lies with shareholder-level taxes, not corporate taxes. There is a strong case for reducing the corporate tax, and Congress is inclined to move in that direction. As it does so, the case for using a shareholder-level capital gains preference as a back-door integration method becomes even weaker.

5. Inflation

Advocates for the capital gains preference often point out that part of the increase in the sales price of a capital asset reflects inflation rather than real economic gain. Cunningham & Schenk explained that the benefits of deferral, over time, offset and eventually surpass the burden of inflationary gains. Moreover, because the capital gains preference applies to real gains and not just inflationary gains, "the historically designed capital gains preference is so rough as to provide no justice; in many cases it would exclude real gain and in almost all cases would account for inflation on a purely random basis."[47] [check w Brennan paper]

Inflation is an even weaker justification for a preference for *alpha* income. Because the "investment" in the capital asset is made with pretax dollars in the form of foregone wages, the deferral benefit is larger and more than offsets the inflationary gains.

B. Taxing *Alpha* in a Consumption Tax World

Consumption tax advocates sometimes argue that because capital gains arise from saved income, a capital gains preference is good policy because it brings us closer to the ideal. Cunningham & Schenk noted that a consumption tax ideal provides no reason for favoring the sale of capital assets over other forms of income from savings. Moreover, the preference for capital assets over other assets distorts the allocation of resources.[48]

The phenomenon of *alpha* income further undermines this justification for the capital gains preference. An income tax with a capital gains prefer-

[47] Cunningham & Schenk.

[48] Cunningham & Schenk, supra note x, at 327.

ence resembles a "prepaid" consumption tax, i.e., an income tax with a partial exemption for income from savings. When labor income is mischaracterized as capital income, the consumption it funds goes untaxed. Suppose, in an attempt to approach a consumption tax ideal, we reduced the capital gains rate to zero. Because *alpha* income is taxed as capital gains instead of ordinary income, a founder or fund manager would face no tax at all on their labor income, and their consumption would go entirely untaxed.

By contrast, a postpaid consumption tax, such as a value-added tax, would avoid regressive consumption tax rates based on the source of labor income. It is indeed possible that a progressive, post-paid consumption tax would better satisfy the goal of advancing equality of opportunity.

Eliminating the income tax in favor of a credit-invoice VAT would, in short, mitigate the concerns I raise in this paper. So long as we maintain an income tax, however, and or to the extent that we consider a consumption tax system that relies on labor taxes as a proxy for consumption, the concerns remain valid.

Consider the House GOP Blueprint, A Better Way, that Congress debated in 2017. The Destination-Based Cash Flow Tax, or DBCFT, resembled a subtraction-method VAT. U.S. firms would start with a tax base of U.S. sales, and then would deduct wages and other inputs other than imports. In the absence of a shareholder-level tax on disguised labor income, *alpha* income would go untaxed in many cases, such as for the many technology firms that would be net exporters.

C. Is Uniformity Necessary?

Complete repeal of the preference is not required. As an administrative matter, even with uniform tax rates we could not abolish the complex distinctions between capital assets and non-capital assets. Because taxpayers would remain free, under the realization doctrine, to cherry-pick losers and hold winners, basketing rules would remain necessary to prevent portfolio investors from harvesting capital losses to shelter ordinary income. Taking that complexity as a given, uniformity as such offers little advantage.

Indeed, while I have argued here that the importance of *alpha* income has tipped the cost-benefit analysis in favor of uniform rates, there are other circumstances where the ideal tax rate on capital and ordinary income indeed differ. If Congress decided, in a fit of progressive zeal, to raise ordinary income rates to 70 percent, the efficiency costs associated with the lock-in effect could overwhelm equity concerns, putting the capital gains rate on the wrong side of the Laffer curve. Even absent an increase in the tax rate on ordinary income, the optimal tax rate on capital gains may be lower than 40% if Congress fails to treat dispositions by gift or bequest as taxable events.

Professor Shaviro's basic point from 20 years ago—that the capital gains rate should not exceed the revenue maximizing rate—remains true.

D. Imperfect Political Institutions

The strongest argument for maintaining the capital gains preference, it seems, is not not a normative argument at all, but simply a political argument.

Congress is not a perfect political institution. It works with imperfect information, and the information it has is often provided by lobbyists, think tanks, and others with a political agenda that goes beyond tax policy.

Small business tends to fare well. In part, small business does well because of true political preferences; small business is thought to be important to the fabric of our system of entrepreneurial capitalism. Small business has proven to be an engine of social mobility for generations of immigrants.

But in part, small business has fared well because it provides a cover story for large businesses. Section 1202, for example, provides exemption from capital gains tax for "qualified small business stock." The exemption is limited to C Corporations, however, thereby excluding the vast majority of small business owners. In effect, section 1202 is a tax subsidy for angel investors, venture capitalists, and a few lucky venture-backed entrepreneurs. Similarly, our generous rules for passthrough business taxation are usually publicly justified as helping small business. Yet many finance, real estate, and oil and gas firms that qualify as passthroughs are anything but small.

In my view, an ideal tax code drafted by a Congress with perfect information and no agency costs, acting purely in the public interest would contain no tax subsidies for small business. Once those unrealistic assumptions are relaxed, however, it seems foolish to make perfect the enemy of the good. *Alpha* income makes up a portion of capital gains income, but taxable portfolio investors are still present. There are legitimate concerns about the efficiency costs associated with lock-in, particularly in the context of small, family-owned businesses. Treating disposition by gift or bequest as a taxable event would mitigate but not eliminate the lock-in effect.

To simplify the policy choices somewhat, imagine a trade-off between equity and efficiency. The trade-off changes if the capital gains preference is tied to income. For middle-income taxpayers, abolishing the capital gains preference imposes a potential efficiency cost, especially for small business owners. Imposing a higher tax on small business owners provides more horizontal equity with middle-income wage earners, but Congress does not seem to seek to treat these two groups equally. For top earners, taxing capital gains

also imposes a potential efficiency cost, but it would vastly improve the progressivity of the tax system, reversing the regressively we now observe at the top of the income scale. A more limited capital gains preference may be the optimal second-best solution.

IV. Proposal

A. Repeal (or Reduce) the Capital Gains Preference

Alpha represents a significant portion of capital gains, particularly at the very top of the income distribution, attributable largely to the carried interest of investment fund managers and the sale of stock or partnership equity by founders. To the extent that one wants to use the tax system to address income inequality, the focus should be on raising the tax rate on capital gains, not ordinary income.

[Compare AOC's proposal for 70% tax on wage income.]

To be sure, not all *alpha* income goes to the top one percent of the one percent. As Professor Gentry has shown, many households have active business income, some of which generates capital gains. Congress has historically demonstrated particular concern about the impact of capital gains taxes on small business. Family-owned businesses provide convenient cover for the ultra-rich, and concern for small business should not be given undue weight. But it may be a necessary concession, as a matter of politics if not principle, to provide a more limited tax shelter for small business.[49] Section 1202 of the current tax code provides a possible model for small business relief.[50]

B. Revision of Section 1202

[49] This is not a paper about ideal theory. In an ideal world—with perfect political institutions full of selfless politicians assisted by selfless agents working with perfect information to advance the public interest—I believe the tax system would be simple. The capital gains preference would be repealed, corporate and shareholder-level taxes would be integrated, the realization doctrine would be replaced with a mark-to-market system, and the tax system would not distinguish between labor income and capital income. This Article is not addressed to that ideal world. While I recognize the importance of scholarship that addresses ideal theory, it may be more useful at this point in the scholarly debate to work through potential reforms that more fully account for institutional detail and connect to the legitimate political preferences of voters.

[50] Section 1202 allows investors in "qualified small business stock" to exclude up to $10 million in gains from the sale of stock. See infra part x.

To mitigate the lock-in effect on small business owners, and to provide a politically-necessary subsidy for small business owners, Congress should modify Section 1202. Current section 1202 provides for the exclusion of up to $10 million of gains from the sale of qualified small business stock, limited to Subchapter C corporations. Section 1202 should be amended to allow the exclusion of income from the sale of common stock in a qualified small business, up to a lifetime limit of $2 million per household. The definition of a qualified small business should be expanded to include Subchapter S corporations as well as Subchapter C corporations.

This proposal may be able to garner more political support than a simple repeal of the capital gains preference. The owners of most small businesses have less than $2 million in unrealized appreciation, and those with more than $2 million would still enjoy lower effective tax rates, as the first $2 million of gains would remain exempt. The burden of taxing gains in excess of $2 million would fall only on wealthy or very wealthy taxpayers.

C. Disposition by Gift or Bequest as a Taxable Event

[It is essential that capital gains reform by accompanied by a provision treating disposition of an asset by gift or bequest as a taxable event. As effective tax rates on capital gains rise, tax planning will increase in search of a zero rate.]

D. Mark to Market (Wyden)

[Add discussion of Wyden MTM proposal; David Miller paper.]

E. Wealth Tax

{Compare repeal of LTCG preference with wealth tax as approach to taxing alpha income. Very difficult to value unrealized labor income.]

V. Conclusion

Eliminating or reducing the capital gains preference is good tax policy, as measure by the traditional norms of equity, efficiency, and administrability. As a practical matter, however, Democrats are likely to view the question largely in terms of recent trends relating to income inequality, while Republicans may view the question in terms of job creationism.

If addressing inequality is the goal, then repealing the capital gains preference is far preferable than increasing the top ordinary income rate. The rich earn much of their income from *alpha*, and *alpha* is usually taxed as capital gains. The policy priorities of the Democratic party in recent years suggests that this is news to them. Raising the top ordinary income rate affects the top 2% of taxpayers, but not the top 0.1%. Indeed, by stirring up broader resentment towards high tax rates, raising the top ordinary income rate arguably benefits the top 0.1%, who might be happy to pay a higher tax on ordinary income if that is the cost of preserving a low tax rate on their much larger capital gains.

Capital gains policy is just one small part of the inequality debate. The tax system did not cause inequality. It cannot fix inequality— unless we were to impose confiscatory tax rates that would stifle economic growth. What the tax system can and should do is treat people fairly, with average tax rates rising with income. The tax system fails spectacularly at the very top end, where capital gains are concentrated.

Republicans may be unlikely to be persuaded by this analysis. For some Republicans, taxing capital gains at low rates remains core Republican ideology, more a matter of faith than reason. For other Republicans, however, there is a strong desire to reduce the corporate tax, and openness to raising shareholder-level taxes, and even adopting a mark-to-market system, as the means to an end.

And for all but the most strident true believers, there is a recognition that ideological preferences may have to bend to fit the reality of revenue targets. Unlike the Trump campaign plan or the House Blueprint, the Big Six framework for tax reform does not reduce the tax rate on capital gains and dividends. It is possible that as policymakers focus on reducing firm-level taxes, increasing the tax rate on capital gains may become a viable political option.

Appendix A: (to come — below are some notes, which I will expand on in the next draft)

Estimating Carried Interest

1. Method 1: SOI Data.

The statistics of Income Division of the I.R.S. produces estimates of partnership income based on tax return data. Table 13pa05 breaks down partnership income by industry, type of income, and by distribution to type of partner (corporations, partnerships, tax-exempt partner, general partner, limited partner, etc.

In recent years, private investments funds almost always organize the general partner of the fund as a partnership itself.

Within the finance industry, allocations to partnership general partners in 2013 amounted to $92 billion of which approximately 47%, or $43.7 billion, was taxed at long-term capital gains rates.

Total long-term capital gains rates for all taxpayers in 2013 was $483 billion. Carried interest thus accounts for about 9% of all capital gains in 2013. Assuming, for simplicity, that fund managers in the top 0.1% of income earners (>$1.9 million) earned the all of the carried interest, the carried interest accounts for about 24% of capital gains at the top.

[add in individual gp]

2. Method 2: Count from the top

Four large firms (Apollo, Blackstone, KKR, Carlyle) accrued approximately $6 billion per year in LTCG from carried interest during 2012-2014. Those firms have about $500 billion in assets under management, or about 25% of the $2 trillion in US private equity AUM, leading to an estimate of $24 billion in carry taxed at LTCG rates. (This estimate assumes that the returns of the largest firms are reasonable proxies for the returns of smaller firms. Data from Preqin shows that this assumption is generally true.)

One would then have to add in additional amounts for venture capital and for hedge funds (esp. activist and certain long-only funds). To provide a rough estimate, assume that venture capital and hedge funds generate another $6 billion in LTCG carry, for a total of $30 billion per year.

3. Method 3: CalPERS Data

CalPERS estimated that it paid $700 million in carried interest to private equity fund managers in fiscal year 2014-15 on $4.1 billion of realized gains. (The estimate did not include any carry paid to managers who did not report carry data, so it is low.) CalPERS allocates about $30 billion of its program to private equity, or about 1.5% of all US PE AUM. If CalPERS is representative, then the total carry earned is about $47 billion a year, with about 3/4 of that amount, or $35 billion a year, taxed at LTCG.

Adding in venture capital and hedge funds (about 25% together) generates an estimate of $47 billion per year.