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CLOSING THE CARRIED INTEREST LOOPHOLE AND THE IMPACTS ON VENTURE CAPITAL

I. INTRODUCTION

Rooted in the classic Robin Hood tale of taking money from the rich and giving it to the poor, the debate over carried interest has started to mature and catch the attention of politicians and members of the public. Put simply, carried interest is a compensation vehicle in the private equity industry that allows the general partner (GP) of a fund to take a portion of partnership profits regardless of the size of its own contributions.[1] The largest criticism of carried interest is the benefit of being potentially taxed at a long-term capital gains rate, as opposed to an ordinary income tax rate.[2] This issue has attracted the attention of both sides of the aisle, as Democrats and Republicans alike have offered solutions. Even President Trump has expressed interest in eliminating the benefit.[3] While the subject of carried interest has been a topic of interest at the federal level,[4] the states have likewise attempted to find ways to closing this so-called loophole, which is what this Comment will analyze.

Specifically, the focus of this Comment is Illinois Senate Bill 1719 (the Illinois Bill), which was passed by the Illinois Senate in July of 2017 and has been on Session Sine Die during the drafting of this Comment.[5] Additionally, during the drafting of this Comment, the Il-

1. This is in comparison to investments made in a person's individual capacity, an investment strategy that exceeds the scope of this Comment, and the Illinois legislation that is the subject of this Comment.

2. Judith Lewis Mernit, *How the Carried-Interest Loophole Makes the Super-Rich Super-Richer*, MOYERS (June 23, 2016), http://billmoyers.com/story/carried-interest-loophole-makes-super-rich-super-richer/. To note, long-term capital gains refer to the favorable tax rates between 0% and 20% that apply to certain types of qualifying income, as opposed to an individual's ordinary federal income tax rates that apply to income from wages, interest, and rent. Evan Tarver, *What Is the Difference Between Income Tax and Capital Gains Tax?*, INVESTOPEDIA, https://www.investopedia.com/ask/answers/052015/what-difference-between-income-tax-and-capital-gains-tax.asp (last updated Apr. 19, 2019). Moreover, for carried interest to be taxed at the applicable long-term capital gains rate, the underlying profits must come from investments that are held for a minimum of three years. *See* discussion and sources cited *infra* note 24.

3. *See* JIM NUNNS ET AL., TAX POLICY CTR., AN ANALYSIS OF DONALD TRUMP'S TAX PLAN 2 (2015); Katy Osborn, *This Is the Tax Loophole Obama, Bush, and Trump All Want to Close*, MONEY (Sept. 16, 2015), http://money.com/money/4036087/tax-loophole-carried-interest/.

4. *See, e.g.*, Carried Interest Fairness Act of 2017, H.R. 2295, 115th Cong. (2017).

5. S.B. 1719, 100th Gen. Assemb., Reg. Sess. (Ill. 2017). In the legislative process, a bill being placed in Sine Die occurs when a particular congress ends. At such time, any legislation that has

linois House of Representatives considered corollary legislation, Illinois House Bill 4293, which has likewise been placed on Session Sine Die.[6] Despite its Sine Die status, the Illinois Senate Bill's primary advocate, Senator Daniel Biss, has signaled a continued interest in pursuing this attack on carried interest. In particular, Senator Biss made the Illinois carried interest tax a core part of his 2018 Illinois Governorship campaign.[7]

Critics of the design of carried interest and its tax advantages rely on the narrative of a tax loophole that exists only to help the rich get richer, while the middle class suffers as a result.[8] By focusing on the partners of large private equity firms, the profit figures appear to justify these commentators' conclusions.[9] In particular, the CEO of Blackstone Group earned just under $800 million from the private equity firm in 2015 alone.[10] However, there is an important distinction to keep in mind between private equity firms and venture capital firms. Venture capital firms play a critical role in the early-stage development of start-ups.[11] Particularly, the companies targeted by venture capital firms are associated with a high risk of failure, have smaller revenue figures, and show signs of potentially high growth.[12] Conversely, private equity firms invest significantly greater sums of money in companies that carry much less risk due to their maturity.[13] For example, in 2016, private equity firms' deals totaled $649 billion[14] while venture capital firms' deals totaled just $71.8 billion.[15] Differen-

yet to be passed will likely be placed on Sine Die adjournment, which effectively means that particular congress has permanently ended consideration of those bills. Mark Strand & Tim Lang, *What is a Sine Die Adjournment?*, CONG. INST. (Jan. 5, 2015), https://www.conginst.org/2015/01/05/what-is-a-sine-die-adjournment/.

6. H.B. 4293, 100th Gen. Assemb. (Ill. 2018) (designated Session Sine Die on Jan. 8, 2019).

7. *Candidate Q&A: Daniel Biss, Democratic Candidate for Illinois Governor*, QUAD-CITIES ONLINE (Mar. 1, 2018), https://qconline.com/news/elections/candidate-q-a-daniel-biss-democratic-candidate-for-illinois-governor/article_0e5d78fb-cace-536b-a80a-4bf7035e1b2f.html.

8. *See* Osborn, *supra* note 3.

9. Ben Protess & Michael Corkery, *Just How Much Do the Top Private Equity Earners Make?*, N.Y. TIMES (Dec. 10, 2016), https://www.nytimes.com/2016/12/10/business/dealbook/just-how-much-do-the-top-private-equity-earners-make.html.

10. *Id.*

11. *What Is the Difference Between Private Equity and Venture Capital?*, INVESTOPEDIA, http://www.investopedia.com/ask/answers/020415/what-difference-between-private-equity-and-venture-capital.asp (last updated Apr. 15, 2019) [hereinafter *What Is the Difference*].

12. *Id.*; *see also generally* Bob Zider, *How Venture Capital Works*, HARV. BUS. REV., Nov.–Dec. 1998, at 131.

13. *See What is the Difference*, *supra* note 11.

14. *2016 Annual U.S. PE Breakdown*, PITCHBOOK (Seattle, Wash.), Jan. 19, 2017, at 5.

15. *3Q 2017 Venture Monitor*, PITCHBOOK (Seattle, Wash.), Oct. 9, 2017, at 4. These figures can potentially lead to a number of different conclusions; however, it is important to note that private equity investments tend to be significantly larger compared to venture capital investments, especially in the earlier stages of venture capital funding. Given the difference in size of

tiating between these two types of private funding sources is significant to the analysis of this Comment because the risk appetite of venture capital firms is by default higher than private equity firms in order to accommodate the increased risk that a venture capital investment will prove unprofitable.

This Comment argues that targeting the carried interest tax scheme of the private equity industry will cripple venture capital firms' investment behavior, which could result in burdens—to venture capital firms, their investors, start-ups, and state economies to name a few—that outweigh benefits of targeting carried interest. In 2017, the Illinois Senate passed the first bill of its kind in the State, which seeks to impose a 20% "privilege tax" on GPs of private funds who receive carried interest from their fund's investments.[16] Around the same time, U.S. Representative Sander Levin introduced federal legislation aimed at carried interest, which could expose a GP's income from carried interest to ordinary income tax rates instead of potentially long-term capital gains tax rates.[17] Similar to these and other proposals, the proposed 20% privilege tax[18] in Illinois is a redistribution scheme that would ultimately cripple a flow of capital to emerging businesses and will result in greater harms than benefits.

Further, this Comment will address the likelihood of venture capital firms either leaving their current place of business for states that have a more investor-friendly legislature or adjusting their compensation structures to offset the decrease in gains they will incur due to additional taxes on carried interest. A measure like the Illinois privilege tax will not merely decrease the profits earned by GPs of venture cap-

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the average deal, it can logically be inferred that an investor committing significantly greater sums of money in fewer deals would expect the investment to carry less risk of failure compared to venture capital. For example, private equity funds may only invest in a single company, so when analyzing the overall performance of the fund, the single company can make or break the fund's profits. In contrast, a venture capital fund that invests in multiple companies will likely account for the potential failure of some of those companies by virtue of the nature of the companies' maturities. *See generally Private Equity vs. Venture Capital: What's the Difference?*, INVESTOPEDIA, https://www.investopedia.com/ask/answers/020415/what-difference-between-private-equity-and-venture-capital.asp (last updated Apr. 15, 2019).

16. *See* Ill. S.B. 1719, 100th Gen. Assemb., Reg. Sess. (Ill. 2017).

17. *See* Carried Interest Fairness Act of 2017, H.R. 2295, 115th Cong. (2017). This proposed legislation marks the most recent attempt by Representative Levin to tackle carried interest. *See* Samuel Olchyk & Chaim Gordon, *Carried Interest Legislation Introduced in Congress*, LEXOLOGY (May 19, 2017), https://www.lexology.com/library/detail.aspx?g=a17f9e42-842f-43a6-bb15-d58f2ad5cefa. For a further discussion of U.S. Congressional attempts to pass a measure targeting tax treatment of carry, see *infra* notes 49–51 and accompanying text.

18. As used in this Comment, the term "privilege tax" refers to a tax that is not designed as a revenue raising measure, but instead a tax on a group of persons based on a perceived privilege the particular group of persons enjoys.

ital funds; it will also likely result in the tightening of the partners' investment decision-making, thus crippling economic growth by restricting a start-up company's access to capital.

Part II begins by providing an overview of the history and mechanics of carried interest and concludes with a discussion of how certain proposed legislation intends to eliminate the favorable tax treatment of carry.[19] Part III will cover a range of the likely effects of Illinois's attempt to impose greater taxation on venture capital firms and the consequences from imposing additional taxation of carry at the national level. Part IV will cover a set of potential responses from Illinois's venture capital community as an attempt to mitigate the effects of the bill or escape it entirely.

II. Background

This Section will begin with the history of carried interest and an explanation of this complex topic. Then, it will explain the roots of carried interest and provide an illustration of how GPs earn carry. Finally, this Section will provide an explanation of how carried interest is currently taxed and how recently proposed legislation will attempt to tackle carried interest tax advantages.

A. Carried Interest History and Explanation

The term "carried interest" can be traced back hundreds of years to merchants in the Mediterranean who would carry cargo belonging to others and earn 20% of the profits on the cargo for their services.[20] In today's context, venture capital firms derive some of their compensation from the profits of their investments, like the Mediterranean merchants, for carrying the risk of the investment.[21]

Carry is a contractual right that entitles GPs of private funds to a profits interest in the fund partnership, which is typically set at 20% of the profits generated by the fund.[22] Thus, for tax purposes, the income GPs recognize by receiving carry is treated as a share of the underly-

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19. "Tax treatment of carry" may also be referred to as "taxation of carried interest;" as such, the two terms should be interpreted the same throughout this Comment.

20. Andrew Romans, *The Term Carried Interest Goes Back to the Medieval Merchants in Genoa, Pisa, Florence, and Venice*, Rubicon Venture Capital (May 18, 2014), http://rubicon.vc/the-term-carried-interest-goes-back-to-the-medieval-merchants-in-genoa-pisa-florence-and-venice/.

21. *Id.*

22. *What Is Carried Interest, and How Should It Be Taxed?*, *in* The Tax Policy Center Briefing Book: A Citizen's Guide to the Tax System and Tax Policy (Frank Sammartino et al. eds.) (ebook), http://www.taxpolicycenter.org/briefing-book/what-carried-interest-and-how-should-it-be-taxed (last visited Apr. 13, 2019).

ing income or gain recognized by the fund.[23] As a result, GPs are able to earn carry that is treated not as ordinary income, but as long-term capital gains, provided the fund sells qualifying assets that have been held for a three-year period.[24] Assuming the GPs' income is taxed at the highest tax bracket, the resulting long-term capital gain from the carry is likely taxed at 23.8%.[25] Carry is used as a compensation structure for the GPs of private investment funds, regardless of the size of the GPs' contributions.[26] In addition to receiving a fixed percentage of fund profits, GPs also receive annual fees for the management of the investment fund, which are equal to a small percentage of the fund's committed capital.[27] These annual fees are commonly known as management fees and a 2% fee is typical.[28] However, unlike carry, these management fees are taxed at ordinary income tax rates.[29] Taken together, the industry term for a 2% management fee and the 20% carried interest compensation structure is known as "two and twenty."[30]

To illustrate fund operations and carried interest, the following example explains a simple fund formation and distribution resulting in carry. The hypothetical Private Investment Fund, L.P. (PIF) raises a $10,000,000 fund and the fund investors (limited partners, or LPs) do not require specified returns (known as "hurdle")[31] on their invest-

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23. Douglas A. Kahn & Jeffrey H, Kahn, *The Fallacious Objections to the Tax Treatment of Carried Interest*, 20 FL. TAX REV. 319, 326 (2017).

24. 26 U.S.C. § 1061(d)(1)(A) (2012 & Supp. V 2018); Matthew Frankel, *Long-Term Capital Gains Tax Rates in 2017*, MOTLEY FOOL (Dec. 11, 2016, 6:47 AM), https://www.fool.com/retirement/2016/12/11/long-term-capital-gains-tax-rates-in-2017.aspx; Matthew Goldstein, *Senate, Like House, Opts to Keep Tax Break for Rich that Trump Vowed to End*, N.Y. TIMES (Nov. 17, 2017), https://www.nytimes.com/2017/11/17/business/republican-tax-plan-carried-interest.html. Notwithstanding the long-term capital gains treatment, the taxation on a GP's ordinary income would be based on an individual's taxable income, which taxes respective marginal income tax brackets at rates that range between 10% and 37%. 26 U.S.C. § 1(j) (Supp. V 2018).

25. *See* Goldstein, *supra* note 24. In addition to long-term capital gains, the Internal Revenue Code's Net Investment Income Tax imposes an additional 3.8% surcharge to the net investment income of taxpayers who have income in excess of the statutory threshold. *See* 26 U.S.C. § 1411(a)(1) (2012).

26. James Chen, *Carried Interest*, INVESTOPEDIA, http://www.investopedia.com/terms/c/carriedinterest.asp (last updated Feb. 11, 2019).

27. Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 9 (2008).

28. *Id.* at 8.

29. *Id.* at 9–10. Rightfully so, management fees are the primary fee paid by limited partners to cover the venture capital firm's administrative overhead and salaries for partners and non-partners, and will generally exist as a fixed amount regardless of how the fund performs. *Id.*

30. *Id.* at 1.

31. This rate of return is otherwise known as a hurdle rate, which reflects a defined amount that must be distributed back to the limited partners before any of the GPs are able to receive allocations from the sale of assets. Craig Hart, *Hurdle Rates for PE/VC Funds: An Overview*, VC EXPERTS, https://www.vcexperts.com/buzz_articles/189 (last visited Oct. 15, 2017).

ments. In the fund's agreement, the GP of PIF will be entitled to 20% carried interest for managing the partnership and 2% management fees. Assuming PIF operates for ten years, this will result in $2,000,000 in management fees that are paid annually ($200,000 per year), which is taxed to the GP as ordinary income and leaves the original fund with $8,000,000 of investable capital. In this hypothetical, PIF makes a single $2,000,000 investment every year, exhausts all $8,000,000 from the fund by Year Four, and sells all its investments for $15,000,000 in Year Ten.[32]

By Year Ten, the LPs will have paid $2,000,000 in total management fees to the GPs who will recognize the management fees as ordinary income, which is forever out of the LPs' hands and is not factored into the fund's profits. After selling the investments, the fund is left with only $5,000,000 in profits, of which the GP takes 20% ($1,000,000) and the LPs take 80% ($4,000,000). So, over ten years, the fund managed to generate a 50% total return on all contributed capital,[33] and because each of PIF's investments were held for over three years, the GP's $1,000,000 will be taxed at the favorable long-term capital gains rate, assuming that all of PIF's underlying investments were in capital assets.[34] Ignoring the layers of complexities of the partnership structure, possible re-investable capital, and daily fund operations, the above example provides a simple explanation of the process of receiving carried interest and how management fees impact profits.

Further, it should be noted that there are other valuable considerations about calculating how and when carried interest is determined.[35] First, there are two primary methods of calculating a fund's carry: net profits or gross profits.[36] Under the net profits approach, the fund's expenses are subtracted from the fund's profits before LPs' and GPs' carry is divided, allowing for a pro rata split of the expenses.[37] Alter-

32. Depending on the company, some experts estimate that average holding periods of these companies could be anywhere between six and eight years. Hans Swildens & Eric Yee, *The Venture Capital Risk and Return Matrix*, INDUSTRY VENTURES (Feb. 7, 2017), http://www.industryventures.com/2017/02/07/the-venture-capital-risk-and-return-matrix/.

33. While the fund would return 50% of every dollar invested, the return on the capital that PIF actually used for investing would be 87.5% as only $8 million of the $10 million was invested in start-ups.

34. *See* 26 U.S.C. § 1222(1) (2012 & Supp. V 2018). However, if the investments were held for less than the three-year period, the resulting distributions would not qualify for the favorable long-term capital gains treatment. *See* 26 U.S.C. § 1061(d)(1)(A) (2012 & Supp. V 2018).

35. Robert D. Starin, *Taxation of Carried Interest*, LEXISNEXIS (Apr. 12, 2017), https://www.lexisnexis.com/lexis-practice-advisor/the-journal/b/lpa/archive/2017/04/12/taxation-of-carried-interest.aspx.

36. *Id.*

37. *Id.* According to the above example, if the expenses of PIF totaled $100,000, then to calculate the carry for each party would mean that the $100,000 in expenses would be subtracted from

natively, under the gross profits approach, the carry is calculated before factoring in expenses because the carry is strictly based on gain.[38] Second, after determining how carried interest is calculated, there are two methods for determining when carry is calculated.[39] The first, dubbed the "European Model," requires all of the LPs' capital contributions to be returned before the GPs may participate in the profits.[40] The second, known as the "deal-by-deal" model, allows profits and carry to be calculated after each distribution from an investment.[41] Under the deal-by-deal model, GPs are generally able to collect more profit through carry, but standard provisions, called "clawback" provisions, exist in a limited partnership agreement to account for this. These provisions prevent the GPs from deriving more benefits than they would otherwise receive under a European Model.[42]

B. Taxing Carry and the Legislative Attempts to Imposing Additional Taxes

Currently, when a venture capital firm establishes a new fund, it typically opts to treat the fund as a partnership for tax purposes. Partnerships are a type of pass-through entity that allow profits to flow through to partners in accordance with the partnership agreement.[43] Assuming a two and twenty model, the GPs will then be entitled to a 20% profits interest upon the establishment of the partnership, allowing the GPs to only be taxed when the partnership realizes gains.[44] These partnerships, managed by their GPs, make decisions to invest in particular start-ups in return for equity and will offer investment man-

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the $1,000,000 profit to leave $900,000 for the LPs and GPs to split based on their carried interests. So, the LPs would take 80% of the $900,000 ($720,000 in carry) and the GPs would take 20% ($180,000 in carry). The expenses to factor in would be the management fees that go towards paying the salaries of the firm's staff and keeping the lights on, as well as expenses related to legal, accounting, and other similar expenses. Asher Bearman, *How VC Funds Work – Expenses and Management Fees*, VENTURE ALLEY (Jan. 12, 2011) https://www.theventurealley.com/2011/01/how-vc-funds-work-expenses-and-management-fees/.

38. *See* Starin, *supra* note 35. Referring back to the PIF example, if PIF has $2,000,000 in management fees and $5,000,000 profit, the carry will be calculated first to give the GPs their 20% ($1,000,000), and the LPs will be forced to bear the expenses, meaning their 80% ($4,000,000) will actually be reduced by the $2,000,000 in fund expenses, leaving them with $2,000,000 at the end of the day.

39. *See* Starin, *supra* note 35.

40. *Id.*

41. *Id.*

42. *Id.*

43. Alan D. Viard, *The Taxation of Carried Interest: Understanding the Issues*, 61 NAT'L TAX J. 447, 447 (2008).

44. Note, *Taxing Partnership Profits Interests: The Carried Interest Problem*, 124 HARV. L. REV. 1773, 1777–78 (2011).

agement services to the company in order to increase the start-up's value.[45] Therefore, because the partnership has an interest in a given portfolio company, the partners will be taxed on the partnership's share of the income from the sale of the equity interest in a portfolio company, initial public offering (IPO), or sale of the interest through a secondary offering.[46] Accordingly, under Sections 1(h) and 702(b) of the Internal Revenue Code, as partnership profits pass to the firms' partners, assuming the fund's underlying assets are capital assets that are held for at least three years, their income will be subject to long-term capital gains rates between 0% and 20%[47] plus an additional 3.8% tax in many cases.[48]

Recently, taxation in the United States has been a topic of significant attention. In 2017, Representative Levin of the U.S. House of Representatives introduced the Carried Interest Fairness Act of 2017,[49] which would treat GPs' carried interest as ordinary income for income tax purposes instead of income that is potentially eligible for long-term capital gains rates.[50] While the several attempts by Representative Levin appear to have failed to be advanced in the legislative process, another bill, dubbed the Carried Interest Fairness Act of 2019, was reintroduced by Senator Tammy Baldwin and Representative Bill Pascrell in March of 2019 to revive Representative Levin's previous attempts at taxing carried interest.[51]

The effect of this legislation would only allow profits that GPs receive in proportion to their invested capital in the fund to be taxed at long-term capital gains rates (provided that the fund's underlying income is long-term capital gain).[52] The crux of this legislation depends on whether the partnership qualifies as an "investment partnership." An investment partnership is defined as any partnership in which, at the end of two consecutive calendar quarters, substantially all of the partnership assets are specified assets and less than 75% of the part-

45. *See* Viard, *supra* note 43, at 446.

46. *Id.* at 447.

47. 26 U.S.C. § 1(h) (2012 & Supp. V 2018).

48. *See* 26 U.S.C. § 1411(a)(1) (2012).

49. An identical bill was proposed by Representative Levin in 2015 and 2012, which failed to gain traction in both years. *Rep. Levin Takes Another Shot at Carried Interests*, KPMG 1, https://home.kpmg.com/content/dam/kpmg/pdf/2016/04/rep-levin-takes-another-shot-at-carried-interest.pdf (last visited Mar. 15, 2019).

50. *See* Olchyk & Gordon, *supra* note 17.

51. Carried Interest Fairness Act of 2019, H.R. 1735, 116th Cong. (2019); Jessica Smith, *Democratic Lawmakers Move to Close 'Horrible Loophole' in Tax Code*, YAHOO! FIN. (Mar. 13, 2019), https://finance.yahoo.com/news/sen-tammy-baldwin-moves-to-close-horrible-loophole-in-tax-code-190339287.html.

52. *Id.*

nership capital is attributable to qualified capital interests constituting property held in connection with the owner's business or trade.[53]

Despite the numerous attempts of Representative Levin and any support his bills targeting carry may have, the GOP tax bill passed at the end of 2017 will likely hurt the chances of passing another major tax bill in the near future. In December of 2017, Congress passed the Tax Cuts and Jobs Act,[54] which is heralded as one of the most significant tax overhauls in decades.[55] While the overhaul had impacts on many areas of the tax code, the legislation was relatively silent on the subject of carried interest.[56] Rather than rely on the federal government to act on the matter, several states have attempted to take a stance against private fund managers to tax carry at the state level at rates closer to ordinary income rates.

In particular, New York Governor Andrew Cuomo proposed legislation—not long after the passage of the GOP tax bill—that would impose a tax on fund managers equal to 17% of GPs' carry.[57] However, this New York proposal would only take effect if Connecticut, New Jersey, Massachusetts, and Pennsylvania also enact legislation targeting carried interest.[58] Similarly, in 2018, New Jersey passed a bill that would impose a 17% tax on GPs' carry, the effect of which being conditional on the passage of similar legislation in neighboring states.[59] Rhode Island also proposed a 19% tax on GPs' carry that

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53. *See Rep. Levin Takes Another Shot at Carried Interests*, *supra* note 49; *see also* 35 Ill. Comp. Stat. § 5/1501(a) (11.5) (2012 & Supp. 2018) (defining "investment partnership").

54. Tax Cuts and Jobs Act, Pub. L. 115-97, 131 Stat. 2054 (2017) (codified at 26 U.S.C. § 1 *et seq.*).

55. *Trump Hails 'Largest Tax Cut' in US History*, BBC NEWS (Dec. 20, 2017), http://www.bbc.com/news/world-us-canada-42429424.

56. Sahil Kapur et al., *How the Carried Interest Break Survived the Tax Bill*, BLOOMBERG (Dec. 22, 2017, 3:00 AM), https://www.bloomberg.com/news/articles/2017-12-22/cohn-mnuchin-split-helped-break-trump-s-carried-interest-pledge. The only change that affects the appeal of carry is the addition of a three-year holding period before many private fund managers are able to have their carry treated as long-term capital gains. *See* 26 U.S.C. § 1061 (2012 & Supp. V 2018).

57. *States Continue to Propose Tax on Carried Interest – Recent Activity in New Jersey, New York, Rhode Island and Illinois*, PWC (Jan. 29, 2018), https://www.pwc.com/us/en/state-local-tax/newsletters/salt-insights/assets/pwc-recent-carried-interest-proposals-in-nj-ny-ri-and-il.pdf.

58. *States Continue to Propose Tax on Carried Interest*, *supra* note 57; *see also* FY 2019 New York State Executive Budget: Revenue, Article VII Legislation, H.R.J. Res 12674-01-8 (M), 203d Leg., Reg. Sess. (N.Y. 2019).

59. *States Continue to Propose Tax on Carried Interest*, *supra* note 57; *see also* 2018 N.J. Sess. Law Serv. Ch. 45 (Assemb. B. 3088) (West) (codified as amended at N.J. Stat. Ann. § 54:10A-6.4 (West 2018)).

would take effect upon the enactment of federal legislation with identical effects.[60]

C. Illinois's Answer to the Carried Interest Debate

In 2017, the Illinois Senate passed Senate Bill 1719 (the Illinois Bill) in an attempt to impose additional taxation on GPs' carried interest.[61] The bill specifically targets the profits earned by investment partnerships and S corporations[62] that conduct investment management services.[63] This tax would add a surcharge of 20% to the GPs' carry in a given taxable year, as opposed to the profits that would be earned from each individual deal.[64] Accordingly, GPs of Illinois funds applying a "two and twenty" scheme with $10 million in profits in one year would traditionally pay GPs 20% on that $10 million, equal to $2 million. Under the Illinois Bill, however, the $2 million allocated to the GP would be reduced by 20%, leaving the GP with $1.6 million. The 20% surcharge essentially means that once the LPs' capital contributions are all returned, the GPs' carry in that taxable year will be subject to a 20% tax prior to any distributions.[65]

The Illinois Bill is unique compared to the Northeast states' proposed bills because Illinois would not require the passage of similar legislation in neighboring states before taking effect.[66] Further, compared to other states' attempts, the Illinois Bill was passed in the Illinois Senate in May of 2017, and the companion bill in the Illinois House, House Bill 4293, which have both since been placed on Session

60. *States Continue to Propose Tax on Carried Interest*, *supra* note 57; *see also* S.B. 2072, 2018 Gen. Assemb., Reg. Sess. (R.I. 2018). While this Rhode Island bill effectively died in committee, it should still stand to highlight how state legislatures have expressed interest in acting to impose additional tax on carried interest.

61. *See* S.B. 1719, 100th Gen. Assemb., Reg. Sess. (Ill. 2017).

62. In contrast to traditional C corporations, close corporations, or LLCs that seek pass-through tax treatment akin to partnerships will first elect for the entity to be treated as a corporation, and then make an S corporation election under Internal Revenue Code § 1362(a) for such tax treatment, provided that on the day such election is made all shareholders consent to such election. *See* 26 U.S.C. § 1362(a) (2012). For the purpose of this Comment, such shareholders would include the partners of private funds seeking long-term capital gain treatment of the distributions they receive from the S corporation.

63. *See* Ill. S.B. 1719.

64. *Id.*

65. Under the example in Section II.A, in Year Ten when PIF realized a gain of $300,000, that gain would be subjected to a surcharge of $200,000 to cover this tax, and then the carry would be split between the partners on the remaining $100,000. So, the GPs will instead receive $20,000 in carry (assuming a net-profits approach), which will be taxed at the long-term capital gains rate of each respective GP. This legislature would ultimately place additional burdens on the LPs whose gains are cut when the aggregate fund profits are taxed.

66. *See* Ill. S.B. 1719.

Sine Die.[67] The future of carried interest is unclear at any level—federal or state—and the debate is far from over.

III. Analysis

Legislation aimed at closing this "carried-interest loophole" will create burdens to venture capital firms that exceed any benefits of greater tax revenue that might come from the new tax schemes. Section A analyzes how a "privilege tax" is an inadequate solution to the issue of generating tax revenue from these investment transactions and discusses the likely consequences that arise when these firms' partners have to foot a greater tax burden. Section B discusses how imposing greater taxation on venture capital firm partners alters their investment decision-making, thus crippling start-up companies' access to capital. Section C argues that, in an economic climate with historically low interest rates and fewer sources of returns, the additional tax will work to eliminate sources of greater returns that do not currently exist in the public market. Finally, subsection D posits how the cost of additional taxation on carry will likely fall back on the start-up companies, as venture capitalists' business models change to adjust for the new taxation schemes.

A. Flaws in Illinois's Privilege Tax

The Illinois Bill's primary weapon targeting carry is a privilege tax that would impose a 20% tax on carry before the profits reach the hands of the GPs.[68] However, the traditional rule of thumb is that a GP typically only commits approximately 1% of the total capital that will be invested in a fund.[69] Put simply, if a fund were to raise $100 million, the presumption would be that the GP only committed $1,000,000. Therefore, in attempting to capture greater tax revenue from a group that is supposedly unjustly enriched by carry, the Illinois Bill would only penalize the GPs who receive 20% of the fund's profits and ignore the parties receiving the other 80%. This means that, of the $1.1 billion of venture capital invested in 2015,[70] and assuming a 20% return on the investment, Illinois would only generate $8.8 mil-

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67. H.B. 4293, 100th Gen. Assemb., Reg. Sess. (Ill. 2018) (designated Session Sine Die on Jan. 8, 2019) (H.B. 4293 was the companion bill to Illinois Senate Bill 1719).

68. *See* S.B. 1719, 100th Gen. Assemb., Reg. Sess. (Ill. 2017).

69. Allen Latta, *LP Corner: Thoughts on GP Commitment*, AllenLatta (May 13, 2017), http://www.allenlatta.com/allens-blog/lp-corner-thoughts-on-gp-commitment.

70. Amina Elahi, *How Venture Capital Investments Stacked Up in Illinois in 2015*, Chi. Trib. (Jan. 15, 2016, 10:00 AM), http://www.chicagotribune.com/bluesky/originals/ct-venture-capital-illinois-2015-bsi-20160115-story.html. For a point of clarification, this $1.1 billion figure refers to venture capital funding in Illinois *companies*, not necessarily funds invested by Illinois funds.

lion in tax liability coming from GPs.[71] This type of taxation would then amount to an effective tax rate of approximately 39% on GPs after accounting for long-term capital gain taxes.[72] At those rates, Illinois is just pushing GPs and business out of the State for the sake of making artificial income parity.

TABLE 1. 2015 Total Venture Capital Investment of $1.1 Billion with a 20% Return

Total Return	$1,320,000,000.00		
Total Profit	$220,000,000.00		
Groups	**Contributions**	**Carry**	**Post-Fee Profit**[73]
LPs (99%)	$1,089,000,000.00	$176,000,000.00	$176,000,000.00
GPs (1%)	$11,000,000.00	$44,000,000.00	$35,200,000.00
Post-Capital Gains Profits[74]	**0%**	**15%**	**23.8%**
LPs (99%)	$176,000,000.00	$149,600,000.00	$134,112,000.00
GPs (1%)	$35,200,000.00	$29,920,000.00	$26,822,400.00
Percentage of Profits Retained Post Capital Gains[75]			
LPs (99%)	100%	85%	76%
GPs (1%)	80%	68%	61%

However, for the sake of the hypothetical, the $1.1 billion figure will be used from a hypothetical Illinois funds' perspective. *Id.*

71. A flat 20% return on $1.1 billion results in $220 million in profits, which—based on a 20%/80% split for carry—leaves GPs with $44 million in profits subject to the proposed 20% privilege tax under the Illinois Bill.

72. See *infra* note 75 for an explanation of how GPs are potentially subjected to a 39% effective tax rate as outlined in Table 1.

73. This "Post-Fee Profit" highlights the amount of profit LPs and GPs take after the Illinois privilege tax is applied. To note, because the privilege tax only applies to the GPs, the LPs' "Post-Fee Profit" is unchanged from the carry they already take, while the GPs lose 20% of their carry to the privilege tax.

74. For the sake of simplicity, the "Post-Capital Gains Profits" only looks at the amount of profit LPs and GPs take after federal income tax rates are applied. While the hypotheticals used in this Comment assume that the parties are high-income earners and are thus taxed at the highest applicable federal income tax rates, the 0% and 15% rates are also displayed for informative purposes. Most importantly, though, is the 23.8% rate, which reflects the rate most likely to apply to these hypothetical individuals comprising both the LPs and GPs.

75. Under this "Percentage of Profits Retained Post Capital Gains" portion of Table 1, the percentages displayed represent the percentage of profits LPs and GPs actually take after accounting for the figures in the "Post-Capital Gains Profits" section directly above. For example, LPs at the 23.8% capital gains bracket have Post-Capital Gains Profits of $134,112,000.00, which equates to approximately 76% of the original $176,000,000.00 "Post-Fee Profit." Assuming the income in the hypothetical as set out in Table 1 is the only income LPs or GPs receive in a given year, one could also read this portion of Table 1 as identifying the effective tax rate of either group. In particular, assuming the GPs in this hypothetical fall under the 23.8% rate and do not

Assuming GPs are on average only committing 1% of the fund's total capital, Illinois would be ignoring the group that receives a much bigger cut of the pie. Such a move begs the question of why the State should devote its resources to punishing certain groups and incidentally making tax revenue, when maximizing tax revenue should be the primary goal. Further, considering that the average holding period[76] of a venture capital investment is approximately eight years,[77] GPs have a lot of time to move these funds to neighboring states, thus avoiding the privilege tax to the extent possible.[78]

Specifically, as this Comment focuses on the likely effects of the Illinois Bill, an important consideration is the venture capital industry's geographic distribution. California is certainly the industry's giant, making up over 50% of the industry's investment total in the first three months of 2018.[79] However, the Midwest, and Chicago specifically, has been the hometown of "unicorns"[80] like Groupon and GrubHub. It is also the home of the nationally prominent 1871 incubator[81] and one of the number-one university accelerators, the University of Chicago New Venture Challenge.[82] Thus, the Illinois plan

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receive income from any other sources, it could be said their effective tax rate would amount to approximately 39% (the difference between the 61% retained profits and 100% retained profits, which would assume no Illinois privilege tax at all).

76. The term "holding period" refers to the period of time between an investor's asset purchase and the sale of the asset. Julia Kagan, *Holding Period*, INVESTOPEDIA, https://www.investopedia.com/terms/h/holdingperiod.asp (last updated Apr. 21, 2019).

77. *See* Swildens & Yee, *supra* note 31.

78. I say "to the extent possible" because if it took GPs long enough to move the fund to a neighboring state, such that there were liquidations in the pre-move period that are subject to the privilege tax, the fund may still be on the hook for the 20% privilege tax but not for any that occur after the move to the neighboring state. *See* 35 Ill. Comp. Stat. § 5/201(a) (2012 & Supp. 2018) (establishing that taxes are imposed on parties that earn or receive income in or as a resident of Illinois).

79. Andrew Soergel, *4 States Control 80 Percent of Venture Capital Dollars*, U.S. NEWS & WORLD REP., (May 10, 2018, 5:55 PM), https://www.usnews.com/news/best-states/articles/2018-05-10/4-states-control-80-percent-of-venture-capital-dollars.

80. The term "unicorn" is the moniker given to start-up companies that reach a valuation of $1 billion, which is a milestone that is estimated to be attained by only approximately 0.07% of start-ups. James Chen, *Unicorn*, INVESTOPEDIA, https://www.investopedia.com/terms/u/unicorn.asp (last updated Dec. 21, 2017).

81. 1871 is ranked as the number one university-affiliated technology hub. Mick Swasko, *1871 Celebrates Five Years as the Center of Chicago's Tech Ecosystem*, 1871 (May 2, 2017), https://1871.com/press-releases/1871-celebrates-five-years-center-chicagos-tech-ecosystem/. Incubators play an important role in the venture capital environment by providing work spaces and other resources that assist early-stage start-ups in their development and growth. Jeffrey K. Cassin, *Could an Incubator or Accelerator Benefit Your Startup?*, SCARINCI HOLLENBECK (Feb. 17, 2017), https://scarincihollenbeck.com/law-firm-insights/business-law/incubator-or-accelator-mentorship-programs/.

82. Yael Hochberg et al., *2017 Accelerator Rankings*, SEED ACCELERATOR RANKINGS PROJECT (2017), http://seedrankings.com/pdf/sarp_2017_accelerator_rankings.pdf. In contrast to an

defeats the purpose of favorable long-term capital gains in venture capital and could undercut Illinois's venture capital industry. Staying mindful of investors' interests to maintain diverse portfolios, Illinois's plan only adds to the argument against committing capital to the risky venture capital environment.

B. The Illinois Solution's Disincentivizing Consequences

By creating greater barriers to venture capital funds' ability to profit off their investment services, the Illinois Bill, and others of its kind, undermine the high-risk, high-reward incentive structure that exists in venture capital. It helps to first understand that venture capital investments are among some of the riskiest investments that can be made, and only 15%–20% of venture capital investments deliver positive returns.[83] Further, when venture capital firms elect to invest in a company, the money that is invested is generally tied up for an average of eight years.[84] Put simply, for venture capital firms to have sufficient incentive to invest capital into start-ups, the potential returns need to be commensurate with the risk of tying up large sums of capital for nearly a decade in the high-risk ventures.

By having to forfeit 20% of carry from Illinois's proposed privilege tax, in addition to the amount that will be lost from capital gains taxes, the Illinois Bill could push investors away from venture capital if there are alternatives like the public market that can deliver a higher after-tax, "risk-adjusted" return.[85] For the GPs who are looking for the

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incubator, accelerators are typically structured as formal training programs intended for early-stage start-ups with more defined growth than counterparts participating in incubators, and typically offer equity funding in the companies as well. *See* Cassin, *supra* note 81.

83. Kenneth Freeman, *Exploring Risk-Reward Tradeoffs in Venture Capital Investment Opportunities*, Fin. Poise (Oct. 30, 2017), https://www.financialpoise.com/exploring-tradeoffs-in-venture-capital-investment-opportunities/.

84. *See* Kagan, *supra* note 76.

85. The term "risk-adjusted" as it relates to investment returns is a measurement of an investment's true return when factoring in how much risk is involved with the particular investment. *See* James Chen, *Risk-Adjusted Return*, Investopedia, https://www.investopedia.com/terms/r/riskadjustedreturn.asp (last updated Dec. 20, 2018). For example, without factoring risk into an investment's return profile, if Fund A returns 7% on its venture capital investments and Fund B returns 7% on its investments in publicly-traded stocks, one could infer the two funds are equally successful in investing. However, as noted throughout this Comment, venture capital investments are inherently riskier than investments in the public market. So comparatively, Fund A's 7% return is actually less successful than Fund B's 7% return because Fund A's risk-adjusted return should produce higher returns than the alternative of what can be achieved in the "safer" public market. While this example comparing Fund A and Fund B glosses over many of the mechanics behind what "risk-adjusted returns" actually means, the important takeaway is that riskier investments should outperform safer investments. One method of measuring risk-adjusted returns is through a fund's "alpha," which is discussed later in this Comment. *See infra* notes 96–106 and accompanying text.

fruits from high-risk investing, the additional layer of taxation on top of the long-term capital gains tax brings GPs' effective tax rate closer to ordinary income tax rates.[86] At that point, if these profits are taxed at close to ordinary income tax rates, GPs are better off seeking returns in the public market or holding on to their money instead of investing altogether.

Instead, as one commentator has demonstrated, governments could capture more revenue from investment activity by adjusting marginal tax rates to push individuals to invest more in order to avoid higher marginal tax rates.[87] However, this commentator's theory of igniting greater investment activity would require effective tax rates that are lower than marginal tax rates. In light of the 2017 GOP tax bill, assuming venture capital GPs are high-income earners,[88] the marginal tax brackets for these individuals were reduced to 32%, 35%, and 37%, down from 33%, 35%, and 39.6%, respectively.[89] Thus, as outlined above, these high-income GPs would be subject to similar, if not greater, tax rates for their role in venture capital.[90]

While existing GPs would surely be deprived of the incentive to stay in the venture capital market, this effect would also have consequences on the would-be GPs seeking to form new funds. When investors evaluate a venture capital firm's performance, the go-to benchmark is individual fund distributions to paid-in capital (DPI), which accounts for the ratio of all distributions made to investors, divided by the amount of capital that investors contributed.[91] This measurement is potentially subject to material impacts by the Illinois Bill because as GPs lose 20% of their carry to the privilege tax, the likely result of GPs adjusting the fund's compensation structure away from two and twenty would burden the existing benchmarks.

86. *See* Swildens & Yee, *supra* note 31.

87. Mike Kimel, *How Tax Rates Affect Investment and Consumption – A Look at the Data*, Bus. Insider (Jan. 23, 2011, 2:56 PM), www.businessinsider.com/how-tax-rates-affect-investment-and-consumption-a-look-at-the-data-2011-1.

88. "High-income earner" being defined as single taxpayers earning at least $157,500. Amy Fontinelle, *How the GOP Tax Bill Affects You*, Investopedia, https://www.investopedia.com/taxes/how-gop-tax-bill-affects-you/ (last updated Apr. 11, 2019).

89. *Id.*

90. *See* Swildens & Yee, *supra* note 31. The 20% privilege tax plus the 23.8% rate amounts to an effective tax rate that is greater than ordinary income tax rates. *See also supra* Table 1.

91. Éléonore Jarry-Ferron, *Venture Capital 101: Making Sense of VC Returns*, Brightspark Ventures: Brightspark Blog (Jan. 31, 2017), http://blog.brightspark.com/venture-capital-101-making-sense-of-vc-returns. For example, if a fund has a 1.0x (1.0 times) DPI, that would mean the fund has effectively broken-even by generating returns equal to the amount of capital paid into the fund.

With average fund lifespans between eight and twelve years[92] and timelines for breaking-even to achieve a 1.0x DPI averaging approximately 8.47 years,[93] GPs have thin margins for error to make money in this business. The Illinois Bill would then hack away 20% of GPs' profits earned by fund investments, crippling the incentive to establish new venture capital firms or the ability of current players to remain competitive. The effect of impairing GPs' ability to stay competitive in such a challenging market could potentially stop individuals from attempting to enter. To adjust for the difference, GPs would have to make an additional 25% on every dollar on their investments to be in the same position if the Illinois Bill was not in effect.[94] As a result, the venture capital market is undercut from less total financing in emerging markets for companies that might otherwise prove to be profitable.

C. Interest Rates, Alpha, and Venture Capital

Core to fiscal policy and how interest rates affect individual investing behavior is that when interest rates are low, individuals are incentivized to invest their money to generate higher returns than most savings accounts can generate.[95] In the world of finance, professionals measure investment performance by the investment's "alpha," or the excess return of an investment relative to the return of a benchmark index.[96] For example, the illustration in section A that assumes an annual 7% return in the Standard & Poor's 500 index (S&P 500) would represent the benchmark used to gauge the performance of an investment. Without devoting too much discussion into the fine mechanics of measuring alpha, the concept of investment performance relative to appropriate benchmarks is sufficient for this analysis.

92. Allen Wagner, *The Venture Capital Lifecycle*, PitchBook (May 14, 2014), https://pitchbook.com/news/articles/the-venture-capital-lifecycle.

93. Michael Roth, *What GPs Need to Know About the Private Equity J-Curve (and Why LPs Care)*, Cobalt (Jan. 25, 2017), https://www.cobaltgp.com/what-gps-need-to-know-about-the-private-equity-j-curve/.

94. In the PIF hypothetical, if the GP were to pay Illinois's proposed privilege tax, the GP would be left with $800,000, as opposed to $1,000,000, or 16% of the $5,000,000 total profit. So because $1,000,000 is 25% higher than $800,000, for the GP to get back to $1,000,000 in carry, the fund will have to earn $6,250,000, or approximately 103.13% (2.03x DPI) on investable capital.

95. Kira Brecht, *4 Ways Rising Interest Rates Will Affect Your Investments*, U.S. News & World Rep. (Oct. 9, 2015, 9:00 AM), https://money.usnews.com/money/personal-finance/mutual-funds/articles/2015/10/09/4-ways-rising-interest-rates-will-affect-your-investments.

96. James Chen, *Alpha*, Investopedia, https://www.investopedia.com/terms/a/alpha.asp (last updated Feb. 18, 2019).

Additionally, interest rates in the United States[97] have only started growing since the period of historic lows that marked the all-time low of 0.25% in late 2008.[98] In particular, when considering the entire investing ecosystem, interest rates play a critical role in investors' decisions of where their money is best suited to grow.[99] In theory, the complicated relationship between investors' risk appetite and interest rates is such that when interest rates are low, investors can place more capital in risky investments because the returns are much greater than traditional investment strategies.[100] The logic then follows that as interest rates climb, investors have less incentive to place capital in risky investments (e.g., venture capital) because they can now generate safer returns through other investment vehicles.[101]

Therefore, with interest rates at historic lows, the goal of stimulating the economy by encouraging individuals to invest would not flow to the venture capital industry if the returns are not as good as other available public markets.[102] Additionally, the movement towards rising interest rates in the near-term could potentially cast difficulty on the venture capital industry as other investment vehicles also provide

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97. Technically, the term "interest rate" as used in U.S. economic discussions is directly related to the "Federal Funds Rate," which is a rate set by the Federal Reserve's Federal Open Market Committee (FOMC). James Chen, *Federal Funds Rate*, INVESTOPEDIA, https://www.investopedia.com/terms/f/federalfundsrate.asp (last updated Apr. 18, 2019). The Federal Funds Rate affects the U.S. economy by setting a rate for inter-bank lending on an overnight basis to maintain reserve requirements that are established by the Federal Reserve. *Id.* As the Federal Funds Rate increases, the U.S. money supply decreases and leads to higher interest rates, resulting in less overall investment spending. *Id.*; *see also* Jesse Neugarten, *Do Lower Interest Rates Increase Investment Spending?*, INVESTOPEDIA, https://www.investopedia.com/ask/answers/101315/do-lower-interest-rates-increase-investment-spending.asp (last updated Mar. 14, 2019).

98. Kimberly Amadeo, *Fed Funds Rate History with Its Highs, Lows and Chart with Major Events: Why the Fed Changes Rates*, BALANCE, https://www.thebalance.com/fed-funds-rate-history-highs-lows-3306135 (last updated Mar. 15, 2019). During the drafting of this Comment, the U.S. interest rate was between 1.25% and 1.5%, which is a rate that is so low that the last time interest rates were at that level was in the 1960s. Kimberly Amadeo, *Current Federal Reserve Interest Rates and Why They Change: Why the Fed Funds Rate Rose to 2.5 Percent*, BALANCE, https://www.thebalance.com/current-federal-reserve-interest-rates-3305694 (last updated Jan. 15, 2019); *see also Federal Funds Rate – 62 Year Historical Chart*, MACROTRENDS, http://www.macrotrends.net/2015/fed-funds-rate-historical-chart (last visited Feb. 5, 2018).

99. *See* Neugarten, *supra* note 97.

100. Matthew Johnston, *Fed Raising Rates Affects Startup Funding*, INVESTOPEDIA (June 30, 2015, 7:45 AM), https://www.investopedia.com/articles/personal-finance/063015/fed-raising-rates-affects-startup-funding.asp [https://web.archive.org/web/20171103135426/http://www.investopedia.com/articles/personal-finance/063015/fed-raising-rates-affects-startup-funding.asp].

101. This view of investing patterns as they relate to interest rates is in itself a topic suitable for PhD dissertations, but is merely simplified in this Comment to demonstrate how economic and fiscal policies have implications that bleed into almost any conceivable investment-related medium.

102. Elian D. Alvarez, *Interest Rates and Venture Capital*, HACKERNOON (Oct. 2, 2017), https://hackernoon.com/interest-rates-and-venture-capital-390429a83903.

investors with safer returns over time. Thus, by imposing a privilege tax that cuts profits, the taxing scheme would play a role in keeping the venture capital industry from taking advantage of stimulating policies that exist with low interest rates and help fuel the industry's growth.[103] As the economy shifts towards tightening policies from higher interest rates, it makes little sense to pursue a tax that bullies an industry that is highly exposed to risk as other public investment sources become more profitable.

Additionally, if GPs change the two and twenty model enough to the detriment of LPs, it would make more sense for an individual LP to invest her capital commitments in the public market instead. Particularly, given the S&P 500[104] average annual return of 7%,[105] LPs in the 23.8% long-term capital gains bracket could achieve the same results within three years and reinvest their profits over the same eight-year holding period.[106]

TABLE 2. 7% Average Return for the S&P 500

LP Investment	$1,089,000,000.00		
Years After Investment	**Year 1**	**Year 2**	**Year 3**
Return on Investment	$1,165,230,000.00	$1,246,796,100.00	$1,334,071,827.00
Percent Return	**7.00%**	**14.49%**	**22.50%**
Profit	$76,230,000.00	$157,796,100.00	$245,071,827.00
Profits After Long-Term Capital Gains of 23.8%	**$58,087,260.00**	**$120,240,628.20**	**$186,744,732.17**

103. *Id.*

104. The Standard & Poor's 500 Index is a collection of stocks that represents the most common benchmark of success in the U.S. stock market. Will Kenton & Chris Murphy, *S&P 500 Index – Standard & Poor's 500 Index Definition*, INVESTOPEDIA, https://www.investopedia.com/terms/s/sp500.asp (last updated Apr. 19, 2019).

105. J.B. Maverick, *What Is the Average Annual Return for the S&P 500*, INVESTOPEDIA, https://www.investopedia.com/ask/answers/042415/what-average-annual-return-sp-500.asp (last updated Mar. 13, 2019).

106. Taking the figures from Table 1, these LPs would hypothetically contribute $1.089 billion to the fund and have $134.112 million in profits after the fund had sold all of its investments. *See supra* Table 1. In the alternative, LPs could experience significantly greater returns through the public market instead. *See infra* Table 2.

D. Who Really Pays When Venture Capitalists Pay More

Not only would the 20% tax cut away at GPs' ability to demonstrate real value to remain competitive in the industry, but these same GPs would also be forced to adjust their investment decision-making to the detriment of start-up companies. As fund managers deploy capital in their investing activities, the threat of additional taxation potentially skews a GP's risk appetite away from early-stage financing[107] and towards more mature rounds where a company has demonstrated viable business operations.[108] Knowing that 20% of their profits will be taken by the government, the GP of PIF has more incentive to invest in companies that are more likely to produce returns and give the GP a greater chance of making money, as opposed to longer-shots with more frequent patterns of failure.[109]

To adjust for a lack of supply of venture capital financing, early-stage companies could then turn to angel investors[110] to carry their business forward. The benefit for angels is that they do not have to deal with the same hurdles that the Illinois Bill would present to investing partnerships and S corporations because their investments are made in their individual capacities. However, in the third quarter of 2017, the global seed and angel deal volume only contributed to approximately 3.6% of the total deal volume in venture capital.[111] In

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107. In venture capital, investment types are broken down into different categories depending on a company's maturity, typically starting with "seed" and "pre-seed" funding, followed by Series A, B, C, and beyond, which designate the types being offered in that particular round of financing. Nathan Reiff, *Series A, B, C Funding: How it Works*, INVESTOPEDIA, https://www.investopedia.com/articles/personal-finance/102015/series-b-c-funding-what-it-all-means-and-how-it-works.asp (last updated Feb. 8, 2019). The seed rounds and Series A can be characterized as early-stage financing where companies are in the infant stages of business, thus carrying the highest risk for failure. Alisha Arora, *What Does Series-A, Series-B, Series-C Funding Mean in Startups*, STARTUP FREAK, http://www.startupfreak.com/what-does-series-a-series-b-series-c-funding-mean-in-startups/ (last visited Feb. 5, 2018).

108. The loss-rate, or failure of an investment to return the original allocation, of later-stage investments drops to 30%, compared to the typical early-stage loss-rate of 65%. *See* Swildens & Yee, *supra* note 31.

109. In addition to later-stage companies having a significantly lower loss-rate, the investments in later-stage companies have shorter holding periods, which despite lower returns, could provide more opportunities to invest in more companies to make up for the difference in returns. *See id.*

110. Angel investors are individual people who invest capital into companies in smaller rounds before venture capitalists enter to help jumpstart a company's business development. *How Do Angel Investors Differ from Venture Capitalists*, ROCKIES VENTURE CLUB, https://www.rockiesventureclub.org/colorado-capital-conference/how-do-angel-investors-differ-from-venture-capitalists/? (last visited Mar. 15, 2019).

111. Jason D. Rowley, *Q3 2017 Global Report: VC Deal and Dollar Volume Projected to Reach Post-Dot Com Highs*, CRUNCHBASE NEWS (Oct. 3, 2017), https://news.crunchbase.com/news/q3-2017-global-report-vc-deal-dollar-volume-projected-reach-post-dot-com-highs/.

addition to a relatively small total amount of financing coming from angel investors, these investors do not have the luxury of managing institutional investors' funds, so the ability to invest is limited to the funds in their own personal accounts. Put simply, given this viable source of funding, the angel investing market is not large enough to carry the total early-stage deal volume.[112]

In addition to reducing potential funding that early-stage companies could receive, the lasting impact could result in these companies creating fewer jobs to generate tax revenue. Between 1979 and 2013, one study found that venture capital-backed start-ups that successfully reached their IPO reflected approximately $4.3 trillion in total market capitalization value[113] and contributed 38% of the employees of all these companies.[114] While it is not entirely clear how much venture capital funding played a role in the companies' ability to scale and reach an IPO, venture capital certainly played a role in the entire scheme and assisted in the creation of large revenues and jobs.[115] In this same period, over 2,600 venture-capital-backed companies had IPOs,[116] and if each one of these companies had only 10 employees, the tax revenue from company profits and employee salaries could exceed $500 million looking forward.[117]

Further, the Illinois venture capital industry led the Midwest by investing approximately $1.34 billion in 2015, and by offering the highest percentage of successful exits for investments in the 10 years preceding 2015.[118] Given the success that start-ups have experienced

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112. *See id.* In Q3 2017, total early-stage deal volume was at approximately $23.07 billion against total seed and angel deal volume of $2.16 billion.

113. Market capitalization refers to the total market value of all of a company's shares outstanding in the market that are available for trading, thus providing for a rough value of the company's value. James Chen, *Market Capitalization*, INVESTOPEDIA, https://www.investopedia.com/terms/m/marketcapitalization.asp (last updated Dec. 10, 2018).

114. Ilya A. Strebulaev & Will Gornall, *How Much Does Venture Capital Drive the U.S. Economy?*, STAN. GRADUATE SCH. BUS. (2015), https://www.gsb.stanford.edu/insights/how-much-does-venture-capital-drive-us-economy. This study focused its findings on venture capital-backed companies that ultimately were successful to reach an IPO, such as Apple, Starbucks, and Tesla for example, which is an especially successful exit scenario for start-ups. *Id.*

115. *Id.*

116. *Id.*

117. In one study, the average developer in an early-stage start-up made an annual salary of $110,000. Ben West, *Startup Employees Don't Earn More*, 80,000 HOURS (Oct. 7, 2015), https://80000hours.org/2015/10/startup-salaries-and-equity-compensation/. Based on 2018 federal income tax brackets for a single-individual, this results in approximately $20,689.50 of potential tax revenue per employee, or $537,927,000 of annual tax revenue given the assumption of 2,600 companies with only 10 employees.

118. *2017 Midwest Startup and Venture Capital Market Analysis*, HYDE PARK ANGELS 9–16 (Aug. 2017), http://hydeparkangels.com/wp-content/uploads/2017/08/2017-Midwest-Startup-and-Venture-Capital-Analysis.pdf. Specifically, exits by multiple on invested capital was on average

in the Midwest, and Chicago specifically, it makes little sense to establish tax systems that divest the industry of the incentive to continue making progress to benefit the overall economy. In sum, Chicago has earned its status as the Midwest's dominant hub of venture capital and innovation, a title, and more importantly a growing industry, that would be compromised by the penalizing nature of the Illinois Bill.

Not only does this privilege tax undercut the risk-reward matrix for the industry, but it would play a role in compromising the goal of the Illinois Growth and Innovation Fund (ILGIF).[119] The ILGIF is a program originally started in 2002 that allows the Treasurer to devote up to 1% of the State's investment portfolio into Illinois venture capital firms that actively invest in technology businesses.[120] Where the Treasury has devoted a significant amount of capital to contribute to the growth of the State's economy and to the creation of nearly 6,300 jobs since the launch of the first Technology Development Account (TDA I) in 2005, the privilege tax would then send the community mixed signals of the State's support of the industry.[121]

Considering the number of benefits that Illinois's venture capital industry brings to investors, start-ups, and even the State's economy, Illinois's penalty tax should be viewed as an overly burdensome measure that ignores how the private funds industry helps the State more than it hurts the State. Whether its investors who have alternatives to investing in the public market that promote job growth—and generate income tax revenue as a result—or the start-ups that will lose opportunities to have a funded business, it is clear that with measures like Illinois's privilege tax, nobody wins.

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higher than any other major venture capital markets, where 81% of successful exits were between 3x and 10x the total invested capital. *Id.*

119. In 2016, the Illinois treasury launched their second Illinois Growth and Innovation Fund (TDA II), which allocated over $200 million of Illinois's investment portfolio that is to be invested in Illinois venture capital funds to promote economic growth, specifically for technology businesses. Meg Graham, *Illinois to Invest $220M in Venture Funds Focused on Tech Startups*, CHI. TRIB. (Jan. 26, 2016, 12:56 PM), http://www.chicagotribune.com/bluesky/originals/ct-frerichs-tech-venture-funds-bsi-20160126-story.html.

120. ILL. GROWTH & INNOVATION FUND, https://www.ilgif.com/ (last visited Feb. 5, 2018).

121. *Technology Development Account I*, ILL. GROWTH & INNOVATION FUND, https://www.ilgif.com/ilgifimpact/ (last visited Feb. 5, 2018). Since the inception of the ILGIF in 2002, the TDA I fund was allotted $74 million, followed by the TDA II fund that was allotted $222 million in 2011, which now precedes the State's plan to allocate up to 5% of the State's investment portfolio, or over $700 million, for a subsequent fund. *See* ILL. GROWTH & INNOVATION FUND, *supra* note 120.

IV. Impact

The venture capital community is likely to respond to the threat from Illinois's proposed privilege tax. This Section will discuss possible responses by the GPs of venture capital funds that would mitigate the Illinois Bill's effects or circumvent it entirely. It is important to note that the following scenarios are speculative—it is impossible to predict with certainty how venture capital firms would respond to the new legislation. Considering possible responses helps to highlight the flaws in effectuating such a wide-impacting tax scheme. The first possible scenario examines the adjustment venture capital firms could make to their fee structures to maximize their returns to mitigate the effects of the Illinois Bill. The second possible scenario assesses what amount of venture capital money could potentially be leaving Illinois in the event the Illinois Bill is enacted.

A. Venture Capital Firms Rethink Two and Twenty

A potential response from the Illinois venture capital industry could be these firms changing the "two and twenty" compensation model. Two and twenty is a creature of contract, meaning firms can adjust the compensation structure to match their needs or incentivize LPs to invest in a given fund.[122] For the rest of this subsection, two different fee structures will be evaluated. The first scenario assumes 1% management fees and 30% carried interest, where LPs pay less for the venture capital firm to keep the lights on and the fund operating in exchange for giving up a larger cut of profits from the fund's performance. The second scenario will assume 3% management fees and 10% carried interest to reflect an opposite objective of the first scenario. In both of these scenarios, the benchmark will be the hypothetical PIF mentioned above with one single GP.[123] I will calculate the sum of the GP's likely tax liability after ten years, assuming the GP's only income is the management fees and carry.

1. Lower Management Fees and More Carry

Returning to the hypothetical PIF, where the sole GP raises a $10 million fund and has returned $15 million (a $5 million profit) by Year Ten, assume the arrangement is changed so that the GP will only take

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122. In 2014, Bain Capital raised their 11th fund at $7.3 billion, and provided LPs with two fee options, where the fees were either 0.5% management fees and 30% carried interest, or 1.5% management fees and 20% carried interest. Arleen Jacobius, *Bain Capital Closes 11th Fund at $7.3 Billion*, Pensions & Inv. (Apr. 17, 2014, 3:55 PM), http://www.pionline.com/article/20140417/ONLINE/140419858/bain-capital-closes-11th-fund-at-73-billion.

123. *See* hypothetical discussed *supra* Section II.A.

1% in management fees in return for 30% carry from the $10 million fund. Also, assuming the same investment activity and results in Year Ten, the GP would have only taken $1 million over the ten years and PIF will have $5 million in profits to be divided according to the fund's carry provision.

In a world where Illinois is permitted to take 20% from the GP's profits, the GP will take 30% ($1.5 million), which will be reduced by the Illinois privilege tax, leaving the GP with $1.2 million and the LPs will take 70% ($3.5 million). Over the life of this fund, the GP will have made $1 million taxable at ordinary income rates, and $1.2 million of income that is likely taxed as long-term capital gains, and the LPs will have made $3.5 million, the taxing of which will depend on who the investor is. Under this approach, the GP's annual $100,000 management fees[124] and subsequent $1.2 million carry interest will result in approximately $768,495 total tax liability after ten years, assuming PIF is the GP's only source of income.

TABLE 3. GP Tax on 1% Management Fees and 30% Carry (One and Thirty)

Management Fees	$100,000 per year
Annual Tax **Sum of Tax After Ten Years**	$18,289.50[125] **$182,895.00**
Illinois 20% Privilege Tax	$300,000.00
Carry After Privilege Tax	**$1,200,000.00**
23.8% Long-Term Capital Gains	$285,600.00
GP's Total Tax Liability	**$768,495.00**

Now, this scenario would likely be embraced by LPs given that the 70% carry and savings from paying $1 million less in management fees would actually put the LPs in a better economic position had the Illinois Bill never challenged the GP's profits. Additionally, because the GP only takes a 1% management fee, the GP would have $9 million

124. Because the hypothetical GP's only income comes from management fees, this would put the GP in the 24% tax bracket according to the new GOP tax bill. 26 U.S.C. § 1(j)(2)(C) (Supp. V 2018).

125. As used in this Section, the calculation for "Annual Tax" and "Sum of Tax After Ten Years" refers to a hypothetical GP that comprises a single person that is taxed at the applicable marginal income tax rates as they exist during the drafting of this Comment. Moreover, these figures assume the same rates will apply for the entire ten-year duration of these hypotheticals.

of investable capital to generate the $15 million in Year Ten, which means PIF would need to return approximately 66.67% on the investable $9 million, compared to the 87.5%.[126] Thus, there is a greater cushion for the GP if one of the investments does not happen to be more successful.

However, the GP's annual $100,000 needs to cover items like salary, rent, and other annual expenses, making the end-result much less positive until the carry comes in. Even if this fund were to be scaled to the size of an average fund,[127] the result would likely be the same to adjust for expectations to invest capital in more companies and accrue more expenses to accommodate the larger fund. A fee structure like this, while favorable to LPs in general to maintain their expectations for receiving carry from their alternative asset investment, could continue to dilute the available talent of GPs willing to work in Illinois venture capital at a discount for anticipated returns from the fund.

2. Higher Management Fees and Less Carry

Again, using the hypothetical PIF and assuming that the GP takes 3% in management fees in return for 10% carry from the $10 million fund and that the same mechanics apply, the fund will generate $3 million in management fees and produce $15 million in Year Ten. After Illinois takes a 20% cut of the GP's profits, or $100,000, the GP will be left with $400,000.

In this scenario, the GP will make $3 million that is taxed as ordinary income, and $400,000 that is taxed as long-term capital gains. So, the GP of PIF's annual $300,000 in management fees and $400,000 carry would result in approximately $1,002,088 total tax liability after the ten-year period. Meanwhile, the LPs of PIF will receive their 90%, or $4.5 million, that will be taxed at their respective income tax rates.

126. *See* hypothetical discussed *supra* Section II.A.

127. *See 2017 PE & VC Fundraising Report*, PitchBook (Seattle, Wash.), Mar. 1, 2018, at 9 [hereinafter *2017 PE & VC Fundraising Report*] (providing an estimate for the average size of venture capital funds in 2017 to be $170 million).

TABLE 4. GP Tax on 3% Management Fees and 10% Carry (Three and Ten)

Management Fees	$300,000 per year
Annual Tax **Sum of Tax After Ten Years**	$80,688.83[128] **$806,888.30**
Illinois 20% Privilege Tax	$100,000.00
Carry	**$400,000.00**
23.8% Long-Term Capital Gains	$95,200.00
GP's Total Tax Liability	**$1,002,088.30**

The annual take-home with management fees that large would be considerably more than the one and thirty fee structure, and it would offer more upside to LPs' profits from carry, provided the fund is successful. Further, even though Illinois is still able to capture some revenue money from the fund's profits, there is a significant difference in tax revenue from the ordinary income tax compared to the one and twenty scenario that is going to the federal government instead.

A scenario like this would likely incentivize would-be venture capitalists to stay in the industry; however, this arrangement could make obtaining LP funds more difficult without a proven track record of success.[129] Additionally, the GP in this scenario only has $7 million investable capital because $3 million will be lost to management fees, so the GP would have to return approximately 114.26% to generate $15 million in Year Ten, compared to 87.5%.[130]

In light of this wrinkle in a "three and ten" fee structure, there could be an opportunity for firms to negotiate with LPs to allow for recycling the fund's distributions until the committed capital has been returned to the fund, at which point management fees would be low-

128. *See* discussion *supra* note 125.

129. One sample of data from 2009 regarding management fees of venture capital firms found that the average management fee percentage was approximately 2.25%. Kate Litvak, *Venture Capital Limited Partnership Agreements: Understanding Compensation Arrangements*, 76 U. CHI. L. REV. 161, 174 (2009). Further, even an increase from 2% to 2.5% would be met with heavy negotiation to carry out. *Id.* at 181. Another survey conducted in 2013 found that only 10% of venture capital firms charged management fees that were higher than 2.5% of committed capital. Joanna Glasner, *Most VCs Don't Have 2 Percent Fee*, PE HUB NETWORK (Dec. 9, 2013), https://www.pehub.com/2013/12/most-vcs-dont-have-2-percent-fee/. The takeaway from these two different studies lends little support to the practicality of PIF's ability to charge a 3% management fee; however, Illinois's willingness to pass Senate Bill 1719 could change the way funds are structured in the future.

130. *See* hypothetical discussed *supra* note Section II.A.

ered.[131] The advantage to this method would allow for the fund to reuse capital, which mitigates the lowered DPI from capital calls for management fees, thereby enhancing the fund's return profile.[132]

Moreover, instead of reusing capital from an exit to invest in more companies, GPs could waive their management fees for a given period in return for taking more from the exit of a company. This method could potentially face scrutiny by the IRS, however, depending on how the waiver is structured—whether as a management fee waiver or as GPs taking an interest in future profits—and how the capital is used.[133] If the fund were to waive its management fees in exchange for using profits as compensation instead, then the GPs would ideally realize only long-term capital gains for the period, but the IRS's characterization and resulting tax treatment is not clear.

In the wake of attempting to limit private funds from manipulating compensation arrangements, the IRS has proposed a regulation that will limit funds' ability to waive management fees and treat compensation as long-term capital gains.[134] Essentially, the IRS' goal with the proposed regulation is to identify arrangements that are treated as disguised payments for services under Internal Revenue Code Section 707(a)(2)(A).[135] According to the regulation, if the interests and waivers are not subject to "significant entrepreneurial risks," then it is likely the IRS would characterize the transaction as one that is subject to ordinary tax rates.[136] Further, the proposed regulation provides the necessary elements for when arrangements are disguised payments of services:

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131. "Recycling" returns would mean the capital from a distribution after selling an asset can either be retained by the fund or used to make new investments. Kader Crawford, *Fund Managers and Recycling of Capital*, TRIANGLE FUNDS (Nov. 17, 2014), https://trianglefunds.com/private-investment-fund-managers-recycling-capital/.

132. Johnny Brennan, *Recycling in Venture Capital*, JOHNNYBRENNAN.IO (Oct. 17, 2016), http://johnnybrennan.io/recycling-in-venture-capital/.

133. As provided in Section 707 of the Internal Revenue Code, there are three alternatives to determine what a payment from a partnership to a partner can be: (1) a payment of a partner's distributable share, (2) guaranteed payment to a partner under Section 707(c), or (3) a payment to a partner not in their partner capacity under Section 707(a). *See* William M. Funk, *Carried Interests and Tax Treatment of Fee Waivers: An Attempt at Reform in the Proposed Regulations*, 18 BUS. ENTITIES, no. 4, 2016, at 14, 16 (citing 26 U.S.C. § 707 (2012)).

134. Jonathan Williamson, *Management Fee Waivers: Potentials and Pitfalls for Fund Advisors*, COHEN & CO (Nov. 7, 2017), https://www.cohencpa.com/insights/articles/management-fee-waivers-potentials-and-pitfalls; *see also* Funk, *supra* note 133; *see also* Prop. Treas. Reg. § 1.707-2, 80 Fed. Reg. 43,652 (Aug. 19, 2015).

135. *See* Prop. Treas. Reg. § 1.707-2, 80 Fed. Reg. at 43,652.

136. *See* Williamson, *supra* note 134 (quoting Prop. Treas. Reg. § 1.707-2, 80 Fed. Reg. at 43,653).

> (b) *Elements necessary to characterize arrangements as disguised payments for services*— (1) In general. An arrangement will be treated as a disguised payment for services if—
>
> (i) A person (service provider), either in a partner capacity or in anticipation of becoming a partner, performs services (directly or through its delegate) to or for the benefit of a partnership;
>
> (ii) There is a related direct or indirect allocation and distribution to such service provider; and
>
> (iii) The performance of such services and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a person acting other than in that person's capacity as a partner.[137]

To successfully waive management fees in a year and receive distributions from exits subject to long-term capital gains rates, GPs would need "sufficient entrepreneurial risk" and compliance with the proposed regulation so that the payment will not be a disguised payment for services.[138] While this particular regulation is not in effect, it should serve as notice for the venture capital industry of the IRS's interest in targeting the re-characterization of management fees to obtain more favorable tax treatment.

B. *Encouragement for Venture Capital to Leave Illinois*

As Illinois presses to impose a greater tax on private funding at the state level, one potential response from venture capital firms could be leaving the Land of Lincoln to conduct business from neighboring states. While determining what level of departure would result if this bill was enacted in Illinois is something better suited for the economists, private equity professionals have already made threats to leave.[139] If even 10% of Illinois's venture capital industry leaves the state, the result would be a total industry size of $1.206 billion, or a total loss of $134 million. That level of potential $134 million loss begins to approach the average size of venture capital funds raised in

137. *See* Prop. Treas. Reg. § 1.707-2, 80 Fed. Reg. 43,652. Also the proposed regulation would impose timing requirements on the effect of the determination and inclusion, which are all determined based on the facts and circumstances. *See id.*

138. Whether a distribution carries significant entrepreneurial risk to the fact of payment and the amount is ultimately "based on the likelihood that the service provider will 'receive an allocation regardless of the overall success of the business operation.'" *See* Funk, *supra* note 133. Without diving into great detail about this proposed regulation and the administrative hurdles GPs would need to jump in order to satisfy the requirements, it will be sufficient to understand some of the threats GPs face to effectively re-characterize their income.

139. Lynne Marek, *Governor Candidate Biss Is a Traitor, Say Private-Equity Investors*, CRAIN'S CHI. BUS. (June 17, 2017), http://www.chicagobusiness.com/article/20170617/ISSUE01/170619894/governor-candidate-biss-is-a-traitor-say-private-equity-investors.

2016.[140] Therefore, this would mean that the Illinois Bill could, by itself, result in the departure of enough venture capital money from the state that an entirely new fund could be raised in Illinois. A $134 million loss would not only result in less tax revenue via the privilege tax, but it would also mean less tax revenue from venture capital firms' management fees that are taxed as ordinary income.[141]

The next step in this scenario would then turn on answering the question of where venture capital firms would relocate. In this case, there is no shortage of places where the firms could relocate and keep a strong presence in the Midwest. States like Michigan, Ohio, Missouri, Minnesota, Wisconsin, and Indiana have all been home to a significant number of companies that have successfully raised venture capital financings between 2015 and 2017.[142] In addition to the neighboring states being home to budding venture capital industries, their location in the Midwest would also mitigate the risk that relocation would displace access to the Illinois entrepreneurial network. Further, these states to-date do not have any outstanding proposals to impose a tax on GPs, unlike Illinois, nor does there appear to be interest in such legislation either, which only adds to the viability of such a move working to the benefit of GPs.

While speculating on the departure of venture capital firms may be viewed as conjecture to some, crippling the ability of individuals to make a profitable business for themselves and other entrepreneurs would force the hand of those who are passionate about staying in this industry.

V. Conclusion

Illinois Senate Bill 1719 is an overly disincentivizing proposal that will likely restrict the ability of venture capitalists to provide financing to start-ups and to stimulate both local micro-economies and broad macro-economies. When it comes to promoting an industry that cre-

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140. In 2016, 353 funds were successfully raised with a total amount of capital raised of $51.1 billion, which would make the average fund size across all of these closings approximately $145 million. *2017 PE & VC Fundraising Report*, *supra* note 127, at 8. It is worth noting, however, that while the average fund size was approximately $145 million, five funds in total raised over $1 billion alone, or $9.5 billion together, which represents approximately 18.59% of total venture capital fundraising for the year, and significantly distorts the $145 million average fund size figure. *2016 Year in Review: Top 5 VC Deals, Exits & Funds*, PitchBook (Dec. 23, 2016), https://pitchbook.com/news/articles/2016-year-in-review-top-5-vc-deals-exits-funds.

141. *See* Fleischer, *supra* note 27, at 9–10.

142. Jason Rowley, *Here Are the Best Startup Cities in the Midwest*, TechCrunch, https://techcrunch.com/2017/08/02/here-are-the-best-startup-cities-in-the-midwest/ (last visited Mar. 15, 2019).

ates jobs and pushes innovation forward, Illinois's proposed privilege tax will stunt these objectives and unjustly punish the start-up industry that already suffers from the difficulty of becoming profitable businesses. Given the valuable investment management services venture capital firms provide to portfolio companies and LPs, taking a cut off the top of profits robs their ability to invest more capital into progressive industries and provide profitable investment options for institutional investors. Moreover, Chicago's position as the Midwest's leader in venture capital would be compromised from such a tax scheme. This scheme would only push GPs away from the city when deciding on the best region to call home and make a difference in the lives of aspiring local entrepreneurs.

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