Recasting Carried Interest: An Examination of Recent Tax Reform Proposals

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INTRODUCTION

"The nature of investment vehicles is changing right before our eyes, and the tax code must keep up with the times . . . ."[1] In the spring of 2007, Senator Baucus's observation resonated with congressional skepticism toward the favorable tax treatment of private equity, venture capital, and hedge fund general partners—"money managers"—who purportedly exploit a "tax loophole the size of a Mack truck."[2] Congress has proposed to more than double the income tax on carried interest—the payout that fund managers receive when their investments are profitable—to prevent fund managers from receiving a purported windfall.[3] Tax scholars and politicians have cited the preferential tax treatment of carried interest as a significant legal loophole because carried interest superficially resembles the ordinary compensation that school teachers and corporate executives receive.[4] And while school teachers and corporate executives pay income taxes equaling as much as thirty-five percent of their incomes, a private equity general partner's carried interest is currently taxed at a low capital gains rate of fifteen percent,[5] allowing him to withhold a significant portion of his lucrative

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1. News Release, Senate Comm. on Fin., Baucus-Grassley Bill Addresses Publicly Traded Partnerships 1 (June 14, 2007), *available at* http://finance.senate.gov/press/Gpress/2007/prg061407d.pdf [hereinafter Committee on Finance News Release].

2. Jenny Anderson, *For Private Investment, The Party Isn't Over*, N.Y. TIMES, Oct. 10, 2007, at C1; *see* Chris William Sanchirico, *The Tax Advantage to Paying Private Equity Fund Managers with Profit Shares: What Is It? Why Is It Bad?*, 75 U. CHI. L. REV. 1071, 1073 n.4 (2008) (citing to several newspaper articles on the subject of carried interest).

3. *See* H.R. 2834, 110th Cong. (2007); S. 1624, 110th Cong. (2007). Throughout this Note, "general partner" denotes the entity, and "fund manager" denotes the individual working for the general partner.

4. *See, e.g.*, Kevin Drawbaugh, *Hillary Clinton Slams Private Equity Tax Loophole*, REUTERS, *available at* http://www.reuters.com/article/politicsNews/idUSN1339356720070713 (In a presidential campaign statement, Hillary Clinton said: "It offends our values as a nation when an investment manager making $50 million can pay a lower tax rate on her earned income than a teacher making $50,000 pays on her income."); Press Release, U.S. Rep. Sander Levin, Levin and Democrats Introduce Legislation to End Carried Interest Tax Advantage (June 22, 2007), *available at* http://www.house.gov/apps/list/press/mi12_levin/PR062207.shtml ("These investment managers are being paid to provide a service to their limited partners and fairness requires they be taxed at the rates applicable to service income just as any other American worker.").

5. *See* 26 U.S.C.A. § 1(a)–(e) (2002 & Supp. 2008) (providing the individual income tax

profits from the federal government. But since this congressional scrutiny arose after a period of unprecedented success in the buyout industry,[6] it is unclear whether fund managers are truly engaging in "tax arbitrage,"[7] or whether they are simply easy targets because of their wealth.[8] Since last year's congressional debate,[9] the financial landscape has changed dramatically. But the issue remains relevant; the Obama administration has reignited the debate by proposing to raise the tax on carried interest as part of its budget plan.[10]

This Note assesses whether carried interest, a fund manager's profits interest, should be taxed at ordinary income rates or maintain its current low capital gains tax rate. The recent economic downturn has demonstrated the extent to which carried interest payments are not guaranteed, as private equity firms have suffered tremendous

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rates and cost of living adjustments for 2009); 26 U.S.C.A. §1 (h)(C) (2002 & Supp. 2008) (providing the capital gains tax rate for 2009); Rev. Proc. 2008-66, 2008-45 I.R.B. 1107. As a matter of tax policy, the lower tax rate on capital gains is believed to stimulate investment and contribute to economic growth. As John F. Kennedy noted in 1963, "[t]he tax on capital gains directly affects investment decisions, the mobility and flow of risk capital . . . the ease or difficulty experienced by new ventures in obtaining capital, and thereby the strength and potential for growth in the economy." *A Capital Gains Primer*, WALL ST. J., Oct. 15, 2007, at A22, *available at* http://online.wsj.com/article/SB119240927948858793.html; *cf.* AVIVA ARON-DINE, AN ANALYSIS OF THE "CARRIED INTEREST" CONTROVERSY 10 (2007) (arguing that right of deferral is a much stronger benefit than the lower tax rate), *available at* http://www.cbpp.org/7-31-07tax.pdf.

6. A few years ago, private equity firms experienced tremendous success. The availability of cheap credit provided fund managers with greater leverage for their deals. Nine out of ten of the largest company buyouts occurred between 2006 and 2007 alone. Robert J. Samuelson, *The Private Equity Boom*, WASH. POST, Mar. 15, 2007, at A19, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2007/03/14/AR2007031402177.html. And for the past two decades, these firms have seen average annual returns of 13.2%, whereas S&P 500 stocks have only averaged 9.7%. *Id.*; *see also* Nelson D. Schwartz, *Wall Street's Man of the Moment*, FORTUNE, Mar. 5, 2007, at 74, *available at* http://money.cnn.com/magazines/fortune/fortune_archive/2007/03/05/8401261/.

7. *See* Joann M. Weiner, *Saving Private Equity*, 117 TAX NOTES 309, 312 (2007). Eugene Steuerle, a former Treasury deputy assistant secretary for tax analysis, notes that fund managers have an incentive to characterize portions of their incomes as capital gains to take advantage of the preferential tax treatment accorded to capital gains versus ordinary income. *Id.*

8. Analysts noted that the top twenty-five fund managers make more money in one year than the CEOs of all of the S&P 500 companies combined. Weiner, *supra* note 7, at 316. On the 2007 Forbes 400 list of the wealthiest Americans, twenty fund managers are new additions to the list, each with a net worth of at least $1.3 billion. *Id*. at 311–12; *see The World's Richest People*, FORBES, Mar. 8, 2007, http://www.forbes.com/2007/03/06/billionaires-new-richest_07billionaires_cz_lk_af_0308billieintro.html.

9. *See*, *e.g.*, N.Y. STATE BAR ASS'N TAX SECTION, REPORT ON PROPOSED CARRIED INTEREST AND FEE DEFERRAL LEGISLATION 17 n.53 (2008) (collecting articles documenting the debate); Jenny Anderson & Andrew Ross Sorkin, *Congress Weighs End to Tax Break for Hedge Funds*, N.Y. TIMES, June 21, 2007, at A1.

10. *See* Ryan J. Donmoyer & Gillian Wee, *Buyout, Hedge Funds Must Reorganize to Avoid Taxes, Lawyers Say*, BLOOMBERG, Dec. 23, 2008, http://www.bloomberg.com/apps/news?pid=20601103&sid=a1nrn_IYRqwE&refer=news; Thomas Heath, *Investors Bristle at Obama Budget*, WASH. POST, Feb. 27, 2009 at A08; Andrew Ross Sorkin, *Putting a Bull's-Eye on a Tax Loophole*, N.Y. TIMES, March 9, 2009, at B1.

losses resulting from diminished returns. The Senate's proposal to tax all publicly traded investment partnerships as corporations aptly targets tax-advantaged publicly traded partnerships, such as Blackstone and Fortress, that have used their "passive income" to achieve unintended tax advantages.[11] In contrast, the House's broad proposal to recast carried interest from capital gains into ordinary compensation is overly punitive and misguided.[12] The responsibilities undertaken and capital contributed by many investment partnerships that utilize the carried interest fee structure embody the types of capital risks that the current legal regime taxes at a preferential rate.[13]

Part I examines the tax benefits associated with using a partnership structure, and how private equity and venture capital general partners are able to achieve substantial tax savings. Part II addresses the arguments for and against taxing carried interest at ordinary income rates. Part III examines the unintended tax benefits achieved by publicly traded partnerships such as Blackstone. This Note concludes that attempts to frame carried interest tax policy as an "either/or" proposition are ill-conceived, and the proper legislative approach to taxing carried interest must recognize that it embodies both ordinary income and capital gain.

I. BACKGROUND: THE TAX BENEFITS OF CARRIED INTEREST AND THE PARTNERSHIP STRUCTURE

Private equity funds and hedge funds, commonly referred to as "alternative investment vehicles," have become popular among many institutional investors, such as universities, pension funds, and wealthy individuals.[14] Despite their success in

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11. The Blackstone Group LP (http://www.blackstone.com/) and Fortress Investment Group LLC (http://www.fortressinv.com/) are two previously private investment partnerships that subsequently took their firms public. The ease with which both firms recategorized significant portions of income by shifting it through blocker entities illustrates how treating carried interest as a capital gain, which consequently qualifies it as "passive income" under the publicly traded partnership statute, is problematic. *See* Victor Fleischer, *Taxing Blackstone*, 61 TAX L. REV. 89 (2008); Lee A. Sheppard, *Blackstone Proves Carried Interests Can Be Valued*, 115 TAX NOTES 1236, 1239–40 (2007); Susan Beck, *The Transformers*, AM. LAW., Nov. 2007, at 94, 96.

12. To a large extent, the debate in Congress seems to be more focused on raising federal revenues than achieving fairness in the tax code. *See* Sarah Lueck, *Two Tax Proposals Target Wealthy Fund Managers*, WALL ST. J., Oct. 25, 2007, at A12, *available at* http://online.wsj.com/article/SB119328131658070972.html (supporting an income tax increase on private equity and hedge fund managers, whose tax increase in carried interest would raise an estimated $25.6 billion in revenue over ten years).

13. Many venture capitalist general partners have contended that the manner in which they earn their carried interest differs from the manner in which private equity and hedge fund general partners earn their carried interest because they undertake more capital risks. *See, e.g.*, *Carried Interest Part I: Hearing Before the S. Comm. on Finance*, 110th Cong. (2007), *available at* http://finance.senate.gov/sitepages/hearing071107.htm [hereinafter *Carried Interest Part I*] (statement of Kate D. Mitchell, Managing Director, Scale Venture Partners).

14. *See* MARK JICKLING & DONALD J. MARPLES, CRS REPORT FOR CONGRESS: TAXATION OF HEDGE FUND AND PRIVATE EQUITY MANAGERS 2 (2007), *available at* http://assets.opencrs.com/rpts/RS22689_20070705.pdf; JOINT COMM. ON TAXATION, PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS AND

generating significant investment returns[15] for their investors, their commensurate success in generating astronomically high profits for themselves has drawn public scrutiny. Their astonishingly high net worths have prompted some to liken fund managers such as Henry Kravis and Stephen Schwartzman[16] to the robber barons of the Gilded Age.[17] While the level of public attention to the issue of carried interest taxation has declined since the onset of the economic slowdown of 2008, the debate that began in 2007 will likely be revived under Barack Obama's administration.[18]

Using the partnership structure, fund managers have been able to reap the benefits of the lower capital gains tax rate of fifteen percent on their carried interest, a significant source of their profits, while essentially performing services that some have argued are substantially similar to those performed by entities that are taxed at higher corporate tax rates.[19] Certain fund managers who have taken their management partnerships public have achieved further tax savings by structuring the initial public offering (IPO) to avoid disadvantageous high corporate tax rates[20] and double taxation.[21] This Part discusses the tax benefits accorded to a fund manager whose entity operates as a partnership and utilizes a carried interest fee structure. A partner receives many tax benefits at the outset when the partnership is formed and throughout the ongoing business of the fund partnership. Since the general partners' relationship with the limited partners is created by private contract, the general partners have the flexibility to devise terms that are favorable to them by recharacterizing fees in a tax-friendly way.

RELATED ISSUES, PART I, at 2 (2007), *available at* http://www.house.gov/jct/x-41-07.pdf [hereinafter PRESENT LAW AND ANALYSIS PART I].

15. *See* Weiner, *supra* note 7, at 309 (discussing the high rate of return for private equity investors); Andrew Ross Sorkin, *Of Private Equity, Politics and Income Taxes*, N.Y. TIMES, Mar. 11, 2007, § 3, at 37, *available at* http://www.nytimes.com/2007/03/11/business/yourmoney/11deal.html.

16. Henry Kravis, the co-founder of the firm Kohlberg Kravis & Roberts Co., and Steve Schwarzman, the head of the private equity firm Blackstone, have been vilified by the media, as many believe that they both exemplify excessive wealth and lavish lifestyles made possible by the lower capital gains taxes that they pay on a majority of their incomes. *See, e.g.*, *Raging Bull: Steve Schwarzman Declares the Dawn of a New Golden Age for Private Equity*, ECONOMIST, Nov. 8, 2008, at 84.

17. Richard Rubin & Clea Benson, *Private Equity Firms: A Matter of Some Interest*, CQ WKLY., July 16, 2007, at 2104.

18. *See* Donmoyer & Wee, *supra* note 10.

19. The top corporate tax rate is thirty-five percent, and this tax rate applies to private equity and venture capital general partners. *See, e.g.*, William L. Watts, *Rep. Rangel Proposes AMT Repeal, Corporate Tax-Rate Cut*, MARKETWATCH, Oct. 25, 2007, http://www.marketwatch.com/news/story/rep-rangel-proposes-amt-repeal/story.aspx?guid=%7BC865D786%2D4883%2D454F%2DA2A3%2D0E19F70AB094%7D&dist=msr_8.

20. Blackstone and Fortress executed high profile initial public stock offerings. Through creative lawyering and tax planning, the firms were able to simultaneously avoid paying the higher corporate tax rate and avoid regulation under the Investment Company Act. *See* Beck, *supra* note 11, at 110.

21. "Double taxation" refers to the imposition of two taxes on corporate profits—once to the corporation when the profits are earned and once to the shareholders when the earnings are distributed as dividends. BLACK'S LAW DICTIONARY 1500 (8th ed. 2004).

A. Carried Interest and the Current Fee Structure

A carried interest is "a right to receive a percentage of fund profits without an obligation to contribute a corresponding share of the financial capital of the fund."[22] The term originated with the idea that the investors "carry" the investment by contributing most of the capital and by bearing the burden of a failed investment by not being able to seek recourse through the fund manager's personal assets.[23] Carried interest is currently taxed at the capital gains rate of fifteen percent rather than the ordinary income rate of thirty-five percent[24] because of the risk that the fund managers assume when they invest capital in uncertain markets.[25]

The carried interest is identified as each fund manager's "profits interest," or future interest in the profits of the partnership.[26] A fund manager is not taxed upon receiving his or her right to a portion of the profits derived from the sale of a portfolio company or other investment.[27] Rather, a carried interest is taxed when individual fund managers realize it,[28] and the Internal Revenue Code ("the Code") treats the income as a capital gain rather than an ordinary income distribution.[29]

The Code identifies a capital gain when a capital asset,[30] such as a stock or bond, is sold at a price higher than the asset's basis.[31] If a fund manager holds a capital asset for

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22. ARON-DINE, *supra* note 5, at 4; *see also* PRESENT LAW AND ANALYSIS PART I, *supra* note 14, at 2.

23. *See* Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 4 (2008). In the early 1980s it was simple for the investors to provide fund managers with a nonrecourse loan equivalent to twenty percent of the contributed capital and bear "the cost of capital" by not charging interest on the loan. *Id.* at 21; *see* JACK S. LEVIN, STRUCTURING VENTURE CAPITAL, PRIVATE EQUITY, AND ENTREPRENEURIAL TRANSACTIONS ¶ 1002.4, at 10-10 (2002) (noting how partnerships previously allocated eighty percent of the profit in accordance with the amount of capital contributed, "without offset for losses on unsuccessful deals and fund expenses (including management fees)"); Nöel B. Cunningham & Mitchell L. Engler, *The Carried Interest Controversy: Let's Not Get Carried Away*, 61 TAX L. REV. 121, 128 n.41 (2008) (discussing how a fund's investors bear the losses when the investments decrease in value). As discussed later on in this Note, the interest-free arrangement would no longer be feasible under I.R.C. § 7872 (2006).

24. The top marginal income tax rate is currently thirty-five percent. I.R.C. § 1(i)(2) (2006).

25. The investment risk has traditionally been likened to an "entrepreneurial risk." *See* David A. Weisbach, *Professor Says Carried Interest Legislation Is Misguided*, 116 TAX NOTES 505, 508 (2007).

26. Upon the formation of a partnership, the partners' interests in the partnership are subdivided into capital interests and profits interests. *See* discussion *infra* Part I.B.

27. *See* Weisbach, *supra* note 25, at 506.

28. A realization event is a transaction that converts noncash assets into cash assets and "substantially changes a taxpayer's economic position so that income tax may be imposed or a tax allowance granted." BLACK'S LAW DICTIONARY 1292 (8th ed. 2004).

29. Many have noted that fund managers enjoy two tax benefits with their carried interest: timing, whereby the partner is not required to recognize income upon its receipt of a profits interest, and character, whereby the partner's share of investment proceeds is taxed at the lower capital gains rate when its share of partnership capital gain is attributed to it. *See, e.g.*, *Carried Interest Part I*, *supra* note 13 (statement of Peter R. Orszag, Director, Cong. Budget Office, at 7–11).

30. *See* I.RC. § 1221(a) (2006).

31. *See* Kathy Krawczyk & Lorraine Wright, *Dividends and Capital Gains Planning After*

one year or less, the Code deems the gain a short-term capital gain and taxes it at ordinary income rates.[32] However, if the fund manager holds the capital asset for longer than one year and sells it for a profit, the profit is a long-term capital gain and is taxed at a lower rate of fifteen percent.[33] The fund managers of private equity and venture capital funds are able to keep a significant portion of their incomes because many of their portfolio company holdings are held over a period of several years, qualifying their carried interests for long-term capital gains treatment.[34] As a capital gain, the carried interest not only has the benefit of a lower tax rate than that of ordinary income, but it also has the benefit of deferral since it is not taxed until it is realized.[35]

Ordinary income, on the other hand, consists of "any gain from the sale or exchange of property" which is neither classified as a capital asset nor classified as property in accordance with § 1231(b) of the Internal Revenue Code.[36] Individuals have a strong incentive to classify income that the Code would ordinarily tax as ordinary income as capital gains because of the difference between the two tax rates.[37] The statutory definition of a capital asset provides a series of exceptions, which enables all property that does not fall into one of the enumerated statutory categories to qualify as capital.[38]

While the carried interest amount earned by private equity general partners is substantial, typically amounting to twenty percent of the fund's profits, it is never guaranteed.[39] Many partnership agreements subject the carried interest to a "hurdle rate," which requires the general partners to return the limited partners' capital contribution plus a certain percentage of the fund's profits before the general partners are entitled to their percentage.[40] Moreover, carried interest distributions are often subject to a clawback provision, whereby a partner in receipt of fund profits after the sale of a portfolio company must subsequently give back a portion of a profit earned if

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the 2003 Tax Act, CPA J., Oct. 2004, at 36, 36, *available at* http://www.nysscpa.org/cpajournal/2004/1004/essentials/p36.htm.

32. *See* I.R.C. § 1222 (1) (2006).

33. *See id.*

34. Jack Levin notes that under the industry standard, each fund has a ten to twelve year life. *See* LEVIN, *supra* note 23, ¶ 1005, at 10–13.

35. *See Carried Interest Part I*, *supra* note 13 (statement of Peter R. Orszag, Director, Cong. Budget Office, at 8–9). The benefit of deferral has been significant for hedge fund managers, who can accumulate tax-free investment returns over an extended period of time by holding their profits in foreign-chartered funds. *See* JICKLING & MARPLES, *supra* note 14, at 3. However, a recent revision to I.R.C. § 457A put an end to this by preventing offshore hedge fund managers from deferring fee income for services performed after 2008. *See* Emergency Economic Stabilization Act of 2008, tit. VIII, § 801, Pub. L. No. 110-343, 122 Stat. 3929 (2008) (to be codified at I.R.C. § 457A).

36. I.R.C. § 64 (2006).

37. *See* Timothy R. Koski, *A New Twist to the Substitute-for-Ordinary Income Doctrine: Third Circuit Adopts "Family Resemblance" Test to Characterize Sale of Lottery Proceeds as Ordinary Income*, 83 N.D. L. REV. 27, 28 (2007).

38. *See* I.R.C. § 1221(a)(1)-(8) (2006).

39. Andrew Kirkpatrick, Note, *The Shield of "Unintended Consequences": Analyzing Venture Capital's Defense Against Increased Carried Interest Taxation*, 2 BROOK. J. CORP. FIN. & COM. L. 483, 488 (2008).

40. *See* Fleischer, *supra* note 23, at 24. Eight percent is a fairly common hurdle rate. *See* Victor Fleischer, *The Missing Preferred Return*, 31 J. CORP. L. 77, 78 (2005) [hereinafter Fleischer, *The Missing Preferred Return*].

the overall profit goal was not achieved.[41] In recent months, the economic downturn has stirred anxiety in hedge fund investors, who have responded to low investment returns by requesting redemptions on their capital.[42] The effect of the influx of the redemption requests forced many funds to sell many assets, which consequently lowered the profits.

In addition to providing for a carried interest, the general partners charge the limited partners a management fee equivalent to approximately two percent of the assets under management regardless of whether the underlying investments are profitable.[43] This amount is taxed at the ordinary income rate of thirty-five percent.[44] Since the partners are able to set the terms of their compensation by contract, the fees that the general partners charge the limited partners are somewhat amorphous. Fund managers often convert their management fees into carried interest in the form of a "fee waiver" whereby they increase their distributive share in the fund's gains rather than charging a management fee.[45] For instance, a general partner could decrease its management fee to one percent and increase its carried interest to 26.7% in a $1 billion investment fund that originally had a two percent management fee and twenty percent carried interest.[46] Whereas the general partner would have originally owed $11.5 million in taxes, by recharacterizing a portion of its management fee into carried interest, the general partner reduces the amount it owes in taxes by $2 million.[47]

B. Tax Benefits of Partnership Structure–Formation

The relationship between fund managers and their investors is usually structured as a limited partnership or limited liability company under state law.[48] As the fund's

41. *See* Fleischer, *The Missing Preferred Return*, *supra* note 40, at 85. As Fleischer discusses in his article, if a limited partner invests $100 in a ten-year private equity fund, and the contract provides for an eight percent hurdle rate that is compounded annually, the limited partner must receive $216 before the general partner can take any carried interest. If the fund's combination of profits and losses yields an overall five percent return, the general partner would receive one percent of the return as carried interest. *Id.*

42. *See Hedge Funds Anxious as Redemption Deadline Looms*, *N.Y. Times*' DealBook Blog, http://dealbook.blogs.nytimes.com/2008/11/14/hedge-funds-anxious-as-redemption-deadline-looms/?scp=1&sq=Hedge%20Funds%20Anxious%20as%20Redemption%20Deadline%20Looms&st=cse (Nov. 14, 2008, 7:24 EST).

43. *See* Fleischer, *supra* note 23, at 3.

44. *See* Fleischer, *The Missing Preferred Return*, *supra* note 40, at 109.

45. *See* Sheppard, *supra* note 11, at 1241 (noting that this "gimmick" has become a popular way for fund managers to lower their taxes). The ease with which fund managers recharacterize their income from being a portion of a management fee to being a portion of their carried interest has been cited as a reason why carried interest more closely resembles compensation for services rather than a capital gain from an investment. *See Carried Interest Part I*, *supra* note 13 (statement of Peter R. Orszag, Director, Cong. Budget Office, at 6).

46. *See Carried Interest Part I*, *supra* note 13 (statement of Peter R. Orszag, Director, Cong. Budget Office, at 11).

47. *Id.* Fund investors have criticized this practice, fearing that higher management fees will make fund managers less inclined to make profitable investments. *See* Tennille Tracy, *It's the Fees, Not the Profits*, WALL ST. J., Sept. 13, 2007, at C1.

48. Fleischer, *The Missing Preferred Return*, *supra* note 40, at 82.

general partners, the fund managers devise and implement investment strategies, providing mostly intellectual, rather than monetary, capital.[49] The general partners contribute a nominal one-to-five percent of the monetary capital and generate the remainder of the capital from the investors.[50] The individuals working for the general partner usually have several years of experience working on Wall Street, and some of them have even worked as Secretary of the Treasury or Chairman of the SEC.[51] The investors, usually public institutions or wealthy individuals, become limited partners and commit capital to the fund.[52]

When the partnership is formed, each partner receives interests that can be conceptually divided into capital interests and profits interests.[53] A capital interest entitles the partner to a portion of the value derived from the sale of the partnership's assets for fair market value upon its liquidation.[54] The capital account measures the value of the assets that the partner contributes to the partnership, plus his distributive share of income, minus his distributive share of losses and the value of the distributions that he received.[55] The partner's receipt of a capital interest is considered to be a taxable event,[56] and under Treasury Regulation section 1.721-1(b)(1) it is taxed as ordinary compensation. However, the IRS does not treat a profits interest that an individual receives "for the benefit of a partnership in a partner capacity or in anticipation of being a partner . . . as a taxable event for the partner or the partnership."[57] The profits interest is only loosely defined as being "a partnership interest other than a capital interest."[58] A fund manager's right to receive his or her carried interest is considered to be a partnership profits interest in the investment fund partnership, and therefore it is not taxable upon receipt.[59]

The issue of whether a general partner's future profits interest should be deemed taxable upon receipt was heavily disputed in the early 1990s. In *Diamond v.*

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49. *See id.*

50. *See id.* One percent was previously required as a capital contribution for the entity to qualify as a partnership for tax purposes prior to the enactment of the check-the-box rules. *See id.* at 82 n.25.

51. *See* JICKLING & MARPLES, *supra* note 14, at 3. As Weisbach notes, the fund managers' firms have "expertise, contacts, deal flow, valuation systems, methods of managing companies, and other intangibles that potentially allow it to profit . . . ." *See* Weisbach, *supra* note 25, at 505.

52. *See* JOINT COMM. ON TAXATION, PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS AND RELATED ISSUES, PART II, at 2 (2007), *available at* http://www.house.gov/jct/x-41-07.pdf.

53. *See id.* at 5.

54. *See* Rev. Proc. 93-27, 1993-2 C.B. 343.

55. *See* I.R.C. § 702(b) (2006).

56. I.R.C. § 83 (2006).

57. Treas. Reg. § 1.721-1(b) (as amended in 1996).

58. *See* Rev. Proc. 93-27.

59. *See* Rev. Proc. 2001-43, 2001-2 C.B. 191; Rev. Proc. 93-27. Carried interest is considered to be a profits interest in the fund partnership, rather than a capital interest, because its value is uncertain when it is received and it is not measured in terms of a partner's contribution. Weisbach, *supra* note 25, at 505. In *Campbell v. Commissioner*, the Eighth Circuit noted that a profits interest refers to a right to share in profits and losses rather than the capital assets of the partnership. 943 F.2d 815, 818 (8th Cir. 1991).

Commissioner,[60] the Seventh Circuit affirmed the Tax Court's decision to treat the receipt of a profits interest as a taxable event if the interest had a "determinable market value."[61] Several years later, in *Campbell v. Commissioner*, the Eighth Circuit held that the receipt of a partnership profits interest did not have an ascertainable value for tax purposes.[62] In *Campbell*, the taxpayer argued that a service partner (one whose partnership interest is given in exchange for services provided to the partnership) who receives a profits interest does not realize income upon receiving that interest.[63] The court held that a service partner should not be taxed upon receiving his profits interest in the partnership because the future performance of a limited partnership was unpredictable, and therefore the profits interest did not have a fair market value.[64] The *Campbell* holding created an unintended opportunity for taxpayers to characterize portions of income received as compensation for services as capital gains income.[65] As a result of *Campbell*, the receipt of a profits interest by a partner performing services for the partnership is not treated as a taxable event.[66] Scholars note that it would be difficult, if not impossible, to tax a carried interest at the time of its receipt because its value is uncertain.[67]

C. Tax Benefits of Partnership Structure–Ongoing Business

The partnership structure is desirable because it provides several tax benefits. Unlike corporations, partnerships are pass-through entities.[68] The character of the gains realized by the partnership passes through to partners as though realized by each individual partner.[69] When a partnership makes a distribution, the partner is not required to *recognize*[70] that gain or loss,[71] nor is he required to pay tax on a

60. 492 F.2d 286 (1974).

61. *Id.* at 290. *See generally* Weisbach, *supra* note 25.

62. *See Campbell*, 943 F.2d at 823.

63. *Id.* at 818.

64. *See id*. at 823.

65. *See* Henry M. Ordower, *Demystifying Hedge Funds: A Design Primer*, 7 U.C. DAVIS BUS. L.J. 323, 360 (2007).

66. *See* Rev. Proc. 93-27, 1993-2 C.B. 343.

67. *See Fair and Equitable Tax Policy for America's Working Families: Hearing Before the H. Comm. on Ways and Means*, 110th Cong. (2007) (statement of Douglas Holtz-Eakin, Senior Fellow at the Peterson Institute and Former Director at the Cong. Budget Office), *available at* http://waysandmeans.house.gov/hearings.asp?formmode=view&id=7144 [hereinafter *Fair and Equitable*]. *But see* Sheppard, *supra* note 11, at 1240 (arguing that all partnership profits interests should be taxable upon receipt).

68. *See* I.R.C. § 702 (2006). Income, regardless of whether or not it is distributed to the partners, is taxed to the partners. Under the "Check-The-Box Classification Rules," a domestic partnership is taxed as a partnership unless it elects to be taxed as a corporation. *See* LEVIN, *supra* note 23 ¶ 302.8.1, at 3-20.

69. *See* PRESENT LAW AND ANALYSIS PART I, *supra* note 14, at 36.

70. A recognition event is different from a realization event. It is "[t]he act or an instance of accounting for a taxpayer's realized gain or loss for the purpose of income-tax reporting." BLACK'S LAW DICTIONARY 1299 (8th ed. 2004). A realization event is "[a]n event or transaction, such as the sale or exchange of property, that substantially changes a taxpayer's economic position so that income tax may be imposed or a tax allowance granted." *Id.* at 1292.

71. *See* I.R.C. § 731(b) (2006).

contribution to the partnership.[72] The partners are free to allocate profits and losses in the partnership agreement in any manner that they choose.[73]

Victor Fleischer, a law professor whose research on carried interest is believed by many to be responsible for initiating the policy debate in Congress, testified before Congress and expressed his belief that a partnership profits interest is "the single most tax-efficient form of compensation available without limitation to highly-paid executives."[74] To illustrate its efficiency, Fleischer compared a fund manager's receipt of a partnership profits interest to a corporate executive's receipt of restricted corporate stock.[75] When a corporate executive receives a restricted stock grant, he has the choice of recognizing income immediately on the current value of the property by making a § 83(b) election, making any further gain or loss on the stock a capital gain or loss,[76] or electing to "wait-and-see," making any further gain taxable as ordinary income.[77] However, private equity and venture capital general partners are not required to make a choice. They are simply permitted to benefit from deferring recognition of their gains and losses, and upon realization, their profits are taxed at the preferential capital gains rate.[78]

Moreover, a general partner's carried interest is conceptually similar to the incentive stock options (ISOs) of corporate executives.[79] With ISOs, preferential tax treatment is only permitted on up to $100,000 worth of stock.[80] However, the general partner's carried interest is not similarly limited to a specific dollar amount.[81]

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72. *See* I.R.C. § 721 (2006) (noting certain exceptions).

73. *See* DEL. CODE ANN. tit. 6, § 17-503 (2005).

74. *Fair and Equitable*, *supra* note 67 (statement of Victor Fleischer, Associate Professor, University of Illinois College of Law, at 3).

75. *See id.*; *see also* Michael S. Knoll, *The Section 83(b) Election for Restricted Stock: A Joint Tax Perspective*, 59 SMU L. REV. 721, 722 (2006) (noting that restricted stock is granted to employees as a portion of their compensation).

76. *See* Treas. Reg. § 1.83-2(a) (1978). Michael Knoll provides further elaboration in his paper:

> If the employee makes [a § 83(b)] election, she includes in her ordinary income for the tax year . . . the market value of the stock . . . as of the grant date less any payments she made for the stock. The employee then has a basis in her shares equal to the grant price, and any subsequent gain or loss is capital and taxed upon realization.

Knoll, *supra* note 75, at 723.

77. *See Fair and Equitable*, *supra* note 67 (statement of Victor Fleischer, Associate Professor, University of Illinois College of Law, at 3). *See generally* Knoll, *supra* note 75 (discussing the tax implications of receiving corporate stock for both the employer and the employee).

78. *See Fair and Equitable*, *supra* note 67 (statement of Victor Fleischer, Associate Professor, University of Illinois College of Law, at 3).

79. *See* Fleischer, *supra* note 23, at 25–26.

80. *See id.* at 26; *see also* I.R.C. § 422(d) (2006).

81. *See* Fleischer, *supra* note 23, at 26.

D. A Narrow Tax Benefit For Publicly Traded Partnerships

Private partnerships that later become publicly traded are also able to reap significant tax benefits. A publicly traded partnership is a limited partnership whose interests are traded on an established securities market, secondary securities market, or a substantial equivalent to one of the two.[82] Current law treats publicly traded partnerships as corporations for tax purposes, subjecting them to a thirty-five percent income tax with two exceptions. One exception applies to partnerships that derive at least ninety percent of their gross income from passive investments, including dividends, interest, rents, and capital gains.[83] These types of investments are identified in I.R.C. § 7704(d)(1) as "qualifying income."[84] A second grandfather clause exception allows general partners in partnerships that traded publicly as of December 17, 1987 to be taxed at the lower capital gains rate, as they would be under the law's prior treatment.[85]

II. THE LEGAL IMPLICATIONS OF RECENT EFFORTS TO TAX CARRIED INTEREST AS ORDINARY INCOME

The significant tax savings that fund managers have been able to achieve due to the low tax rate on carried interest and the unintended loophole for publicly traded partnerships under section 7704 sparked a politically polarizing debate in Congress in 2007.[86] Congress proposed two bills aimed at increasing the income tax rate for investment management partnership income.[87] Congress sought to prevent unintended opportunities for many already-wealthy fund managers to significantly augment their incomes.[88] According to a study published in 2008, Congress would be able to raise an additional two to three billion dollars by increasing the income tax rate for fund manager profits.[89] While the utility of raising additional federal revenues is apparent, in the short term these potential revenues are limited by the fact that private equity deal-making is at a standstill.[90] The diminished returns on private equity investments will

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82. *See* LEVIN, *supra* note 23, ¶ 302.8.3, at 3-22.

83. JICKLING & MARPLES, *supra* note 14, at 5.

84. I.R.C. § 7704(d)(1) (2006).

85. JICKLING & MARPLES, *supra* note 14, at 5 n.9.

86. *See* Kevin Drawbaugh, *Bush Says 'Hesitant' on Private Equity Tax Issue*, INT'L BUS. TIMES, Aug. 9, 2007, *available at* http://www.ibtimes.com/articles/20070809/private-equity-tax_all.htm; *see also* Ryan J. Donmoyer & Alison Fitzgerald, *Schumer Says He'll Sponsor Tax Rise on Fund Managers (Update 1)*, BLOOMBERG.COM, Oct. 3, 2007, http://www.bloomberg.com/apps/news?pid=20601087&sid=aG.b8SM8Gvc4&refer=home.

87. *See supra* note 3 and accompanying text.

88. *See* PRESENT LAW AND ANALYSIS PART I, *supra* note 14, at 24.

89. *See* Michael S. Knoll, *The Taxation of Private Equity Carried Interests: Estimating The Revenue Effects of Taxing Profit Interests As Ordinary Income*, 50 WM. & MARY L. REV. 115, 139 (2008). Knoll notes, however, the strong likelihood that transactional structures will change in response to changes in the tax law. *Id.* at 149–57; *see also* Ryan J. Donmoyer, *Buyout Firm Tax Boost Won't Raise Revenue, Study Says (Update 2)*, BLOOMBERG.COM, Aug. 22, 2007, http://www.bloomberg.com/apps/news?pid=20601087&sid=aFTZWOQ3BEzg&refer=home.

90. David Marchick, a managing director of the Carlyle Group, recently commented that the environment has changed dramatically since the carried interest debate was initiated in 2007.

mean less carried interest for general partners.[91] When the issue is revisited by Barack Obama's administration, it will be important to draft a legislative solution that is consistent with the tax code and that recognizes the economic relationship between the limited partners and the general partners.

A. The Preferential Treatment of General Partner Carried Interests

H.R. 2834 (the "Levin Bill"), introduced by Congressman Sander M. "Sandy" Levin (D-Mich.) on June 22, 2007,[92] was a broad measure that sought to recast carried interest from capital gain to ordinary income. The Levin Bill never became law, but since its introduction, Congress has revisited the issue when it attempted to pass H.R. 3970,[93] and subsequently H.R. 6275,[94] which passed in the House on June 25, 2008.[95]

If enacted into law, the tax increase on carried interest would significantly affect private equity and venture capital firms and their partners in light of their substantial reliance on carried interest profits. These firms seek "speculative situation[s] with substantial opportunit[ies] for value enhancement if the business succeeds . . . ."[96] While both types of firms utilize the investment partnership structure, each engages in a different sort of investment strategy to achieve its goals.[97]

Private equity funds manage approximately $1 trillion globally, with an estimated $374 billion in assets under management concentrated among the thirteen largest funds.[98] These firms generally purchase privately held securities. They frequently

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"It's shifted because there is no carry. Look at Blackstone's earnings. People can't do deals, and that affects carry." *Dealmakers Discuss a Potential Carried-Interest Tax Hike in 2009*, Posting of George White to Dealscape, http://www.thedeal.com/dealscape/2008/11/dealmakers_discuss_a_potential.php (Nov. 12, 2008, 12:32 EST).

91. *See Obama Victory May Revive Buyout Tax Debate*, *N.Y. Times*' DealBook Blog, http://dealbook.blogs.nytimes.com/2008/11/06/obama-victory-may-revive-buyout-tax-debate/?scp=1&sq=Obama%20Victory%20May%20Revive%20Buyout%20Tax%20Debate%20&st=cse (Nov. 6, 2008, 11:11 EST).

92. H.R. 2834, 110th Cong. (2007).

93. H.R. 3970, 110th Cong. (2007). This is a broader measure that was passed by the House and largely intended to generate revenue to eliminate the alternative minimum tax.

94. H.R. 6275, 110th Cong. (2008).

95. 154 CONG. REC. H6044 (daily ed. June 25, 2008).

96. *See* LEVIN, *supra* note 23, ¶ 104, at 1-6.

97. While hedge funds are also impacted by the legislation, the tax issues that pertain to hedge funds will not be discussed in this Note, because many hedge fund holdings constitute short-term capital gains and are thus taxed as ordinary income. Hedge funds generally engage in financial arbitrage, investing in liquid assets in an attempt to make a profit from pricing mistakes in capital markets. *See* PRESENT LAW AND ANALYSIS PART I, *supra* note 14, at 9. While some seek to profit from taking "speculative positions" on the future value of stocks, bonds, commodities, and other financial assets, others design portfolios that span several different asset classes and markets in the hopes of gaining an overall profit. *See id.*

98. PRESENT LAW AND ANALYSIS PART I, *supra* note 14, at 16. As Peter Orszag relates in his congressional testimony, the private equity market is dominated by a small group of key firms who together have raised an average of thirty billion dollars in capital over the past five years. *See Carried Interest Part I*, *supra* note 13 (statement of Peter R. Orszag, Director, Cong. Budget Office, at 4).

purchase stakes in companies with the hope of restructuring them.[99] The general partners and limited partners usually agree to an investment period of five to seven years and a partnership term of ten to twelve years.[100]

In recent years, leveraged buyouts (LBOs) have been a popular private equity investment strategy.[101] In a LBO, the general partners provide management and contribute equity to the purchase of a business.[102] The remainder of the business's purchase price is funded by bank loans with the company's assets functioning as loan collateral.[103] Contrary to the "buy-and-bust" strategy that was popular in the 1980s, firms are more frequently pursuing a "buy-and-build" strategy, which involves consolidating small entities to create a larger entity equaling "more than the sum of its parts."[104] While the buyout market thrived from 2003 until 2007 thanks to a favorable economic climate and the widespread availability of cheap debt,[105] the recent credit crisis has largely halted private equity LBOs as financing has withered.[106]

Venture capital funds, like private equity funds, collect capital from limited partners. However, their target companies are typically early stage companies.[107] Once the general and limited partners form a venture capital fund, the general partners identify and invest in innovative industries, seeking to fund entrepreneurial activity.[108] For companies seeking to expand their business, the general partners provide capital, market expertise, and management with the goal of selling the companies at a profit or profiting through an initial public stock offering.[109] Only about twenty percent of all venture capital investments generate realizable gains.[110] Venture capital partnerships managed approximately $236 billion in assets in 2006.[111]

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99. *See Carried Interest Part I*, *supra* note 13 (statement of Peter R. Orszag, Director, Cong. Budget Office, at 3).

100. *See* DAVID M. TOLL, PRIVATE EQUITY PRIMER, at vi (2005), *available at* http://www.sba.gov/idc/groups/public/documents/sba_program_office/inv_primer.pdf.

101. *See id.* at ii.

102. *See id.* at iii.

103. *Id.* at ii.

104. *Id.*

105. *See* HEINO MEERKATT & HEINRICH LIECHTENSTEIN, GET READY FOR THE NEXT PRIVATE EQUITY SHAKEOUT: WILL THIS BE THE NEXT SHOCK TO THE GLOBAL ECONOMY? 1 (2008), *available at* http://www.bcg.com/impact_expertise/publications/files/Get_Ready_Private_Equity_Shakeout_Dec_2008.pdf; James Mawson, *Buyout-Firm Failure Rate Will Top 20%, Study Says*, WALL ST. J. EUROPE, Dec. 22, 2008, at 25.

106. *See* Michael J. de la Merced, *Buyout Industry, Once Booming, Staggers Under Weight of Debt*, N.Y. TIMES, Mar. 11, 2008, at A1.

107. Venture capital is defined as "[f]unds invested in a new enterprise that has high risk and the potential for a high return." BLACK'S LAW DICTIONARY 222 (8th ed. 2004).

108. *See* Kirkpatrick, *supra* note 39, at 485–86.

109. *See id.* 485–86.

110. *Id.* at 487.

111. Posting to Global Entrepreneurship Institute Blog, http://blog.gcase.org/archives/363 (Jan. 16, 2008, 17:16 PST). Venture capital firms have contended that they should not be grouped together with hedge funds and private equity firms, and assert that the proposed legislation should not apply to them. *See* Andrew Ross Sorkin, *A Professor's Word on a Buyout Tax Battle*, N.Y. TIMES, Oct. 3, 2007, http://www.nytimes.com/2007/10/03/business/03tax.html?pagewanted=2&sq=buyout-tax&st=nyt&scp=1.

1. Ordinary Income v. Capital Gain

The principal legal question in the carried interest debate concerns its identity. More specifically, Congress must determine whether its attributes make it taxable as compensation for services performed, or whether it is truly a gain from a capital investment.[112]

Congress has long maintained a purposeful difference between the tax rates for ordinary income and capital gains. The preferential tax treatment accorded to capital gains flows from the nature of the underlying business activity. A capital investment that results in a gain more closely resembles an entrepreneurial or investment risk than labor.[113] The lower rate also encourages investors to subject their capital to market fluctuation. Maintaining a lower capital gains tax rate reduces what has been described as "the lock-in" effect—essentially, a phenomenon where investors hesitate to sell their appreciated assets due to a higher tax rate on their sale.[114]

Proponents of the Levin Bill have contended that taxing carried interest at a higher rate would be consistent with the Code because a carried interest is akin to a performance bonus.[115] Therefore, carried interest resembles other similar forms of compensation taxed at ordinary income rates, such as sales commissions designed to align the incentives of employees with those of their employers.[116] Characterizing a carried interest as a capital gain is believed to distort the reality of the general partner's role in the transaction. If a lower tax rate on capital gains exists already, policymakers have little reason to "reward" the risk-taking of a fund manager who "contribute[s] to economic activity" rather than risks its own capital.[117] Under this view, the preferential tax treatment is misplaced because a fund manager's work more closely resembles that of a corporate executive or money manager rather than one who invests his own capital. Therefore, those who support the Levin proposal seek to maintain preferential

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112. *See Carried Interest Part I*, *supra* note 13 (statement of Peter R. Orszag, Director, Cong. Budget Office, at 10); PRESENT LAW & ANALYSIS PART I, *supra* note 14, at 8.

113. *See* Weisbach, *supra* note 25, at 507; *cf. Carried Interest Part II: Hearing Before the S. Comm. on Finance*, 110th Cong. (2007), *available at* http://finance.senate.gov/sitepages/hearing073107.htm [hereinafter *Carried Interest Part II*] (statement of Joseph Bankman, Ralph M. Parsons Professor of Law and Business, Stanford Law School, at 4).

114. *See* Cunningham & Engler, *supra* note 23, at 137; *see also* Newt Gingrich, Speaker of the House, Remarks at the Cato Institute's Should We Lower the Capital Gains Tax? Policy Forum (July 16, 1998), *in* CATO POL'Y RPT. Sept–Oct 1998, at 6, 6, *available at* http://www.cato.org/pubs/policy_report/v20n5/capgains.pdf ("When people sell capital, the sale represents unlocking money to go from a less productive investment to a more productive investment . . . .").

115. It is likened to a "performance-related bonus" in Editorial, *The Fair Way to Tax Private Equity*, FIN. TIMES (London), July 18, 2007, http://www.ft.com/cms/s/0/4f233e38-355e-11dc-bb16-0000779fd2ac.html.

116. *Id.*

117. LILY BATCHELDER, DANA CHASIN, JONATHAN C. GOLDSTEIN & HEATHER SLAVKIN, ADDRESSING OBJECTIONS TO H.R. 2834—THE LEVIN CARRIED INTEREST BILL 2 (2007), *available at* http://www.ombwatch.org/files/budget/addrobjectionstocarriedinterestbill.pdf (citing *Carried Interest Part I*, *supra* note 13 (statement of Peter R. Orszag, Director, Cong. Budget Office)).

tax treatment for profits related to a fund manager's invested capital, or capital interests, and tax any remaining unrelated profits (primarily carried interest) as ordinary income.[118]

Supporters also contend that it is inequitable and economically inefficient to tax people at different rates based on their choices of profession.[119] They argue that the lower tax rate harms the economy by "distort[ing] career choice[s]" of capable individuals who decide not to pursue a corporate executive position because of the tax "subsidy" these individuals would receive by working for a private equity or venture capital firm instead.[120] Proponents of eliminating the preferential tax treatment argue that the lower tax rate is misplaced because a fund manager's work more closely resembles that of a corporate executive or money manager rather than one who invests his own capital.[121] They also assert that taxing carried interest at the lower capital gains rate encourages general partners to intentionally and improperly characterize income as carried interest rather than ordinary performance fees.[122] They note that the U.S. tax code should not extend fund managers a lifeline to help them stay afloat.[123]

Opponents of the carried interest legislation point out that carried interest is in fact different from other forms of employee compensation because its receipt is contingent upon the overall performance of its portfolio companies.[124] Carried interest therefore cannot be likened to a form of ordinary employee compensation, such as a stock option, because of the inherent risk involved.[125] While the recipient of a stock option is only subject to the upside of the company's performance, a general partner who receives a carried interest maintains an equity stake in the fund.[126] When the stock market plunges as it has in recent months, the general profits interests suffer.[127]

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118. *See* H.R. 2834, 110th Cong. § 710(c)(2) (as introduced to the House, June 22, 2007); Cunningham & Engler, *supra* note 23, at 125–26.

119. *See* BATCHELDER ET AL., *supra* note 117, at 3; Selwyn Parker, *When Private Equity Players Are Paying 'Less Tax Than a Cleaning Lady', the Question Is: Are We Being Taken to the Cleaners?*, SUNDAY HERALD (Scotland), June 23, 2007, *available at* http://www.sundayherald.com/business/businessnews/display.var.1494212.0.when_private_equity_players_are_paying_less_tax_than_a_cleaning_lady_the_question_is_are_we_being_taken_to_the_cleaners.php.

120. *See Carried Interest Part II*, *supra* note 113 (statement of Joseph Bankman, Ralph M. Parsons Professor of Law and Business, Stanford Law School, at 1).

121. *See Carried Interest Part I*, *supra* note 13 (statement of Peter R. Orszag, Director, Cong. Budget Office, at 9–10).

122. Peter Orszag notes that "22 percent of total current-year long-term capital gains reported on individual income tax returns" were capital gains from partnerships and S corporations in 2005. *Id*. at 4.

123. *See* Weiner, *supra* note 7, at 317.

124. *See Carried Interest Part I*, *supra* note 13 (statement of Kate D. Mitchell, Managing Director, Scale Venture Partners, at 11).

125. *See id.*

126. *See id.* at 10.

127. In the spring of 2008, reputable fund managers incurred multi-billion dollar losses on their investments. Steve Schwarzman of Blackstone personally lost $3.9 billion as Blackstone's stock price sank. *See* de la Merced, *supra* note 106.

Furthermore, a general partner is subject to partnership taxation rules that require the partners to report a combination of their income, gain, losses, and expenses on their annual tax returns. Any losses would be characterized as capital losses, which taxpayers may only use to offset capital gains plus $3000 of ordinary income in the current year,[128] or carry forward to future years.[129] If there is an early gain from the sale of a portfolio company and a later loss, the partner will lose the tax benefit of the carried interest,[130] since offsetting losses can only be deducted against future capital gains.[131]

Most importantly, fund managers cannot easily confine a carried interest to a single category of income because it possesses aspects of both ordinary compensation and investment risk.[132] As David Weisbach notes, the labor of a fund manager is similar to that of an ordinary investor who purchases stock through a margin account—a transaction that entails combining personal *and third-party* capital with labor. Current tax law does not attempt to isolate the labor component of the investor's gains.[133] Therefore, it would be arbitrary to premise the rationale for taxing carried interest at ordinary income rates or as capital gains on the presence or absence of labor in a fund manager's day-to-day management responsibilities.[134]

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128. *See* I.R.C. § 1211(b) (2006). It should be noted that capital losses are less favorable than ordinary losses, which can be deducted against ordinary income, which itself is taxed at a higher rate. *See*, *e.g.*, I.R.C. § 62(a)(3) (2006) (providing that adjusted gross income consists of gross income minus several different types of deductions, including losses incurred from the sale or exchange of property); *id.* §165(a) (providing that individual losses shall be allowed as a deduction); Ray A. Knight, Lee G. Knight & Brian Sellers, *Abandoning a Partnership Interest: Is the Loss Ordinary or Capital?*, CPA J., Mar. 1994, at 16, 16, *available at* http://www.nysscpa.org/cpajournal/old/15328443.htm.

129. *See* I.R.C. § 1212(b) (2006) (providing that any unused capital losses may be carried forward to later years, but not back to prior years); *see also* Cunningham & Engler, *supra* note 23, at 129 n.46.

130. *See Carried Interest Part I*, *supra* note 13 (statement of Kate D. Mitchell, Managing Director, Scale Venture Partners, at 10–11).

131. *See id.*; Cunningham & Engler, *supra* note 23, at 129 n.46.

132. As Kate Mitchell noted in her testimony before Congress, many have argued that venture capitalists do not deserve to be grouped with buyout fund managers because they purportedly invest more sweat equity. *See Carried Interest Part I*, *supra* note 13 (statement of Kate D. Mitchell, Managing Director, Scale Venture Partners, at 9–10).

133. Depriving the fund manager of capital gains treatment on its carried interest would mean that the ordinary investor's investment return should be taxed at the ordinary income rate. As David Weisbach notes in his article, "[i]nvestors get capital gains and losses on their stock sales, and we make no effort to isolate the labor component of their gains . . . ." Weisbach, *supra* note 25, at 507. Weisbach argues that the tax law does not provide a reason to tax a fund manager differently because he or she uses limited partnership interests as a financing vehicle rather than engaging in investment activity directly. *See* Weisbach, *id.* at 508.

134. As Jack S. Levin noted in his testimony before Congress:

> [T]he Code does not make, and never has made, the absence or presence of activity and ingenuity . . . the test for long-term capital gain . . . . Just because some private equity investors . . . make substantial amounts of money doesn't mean it is in America's best interests to impose tax penalties on them without carefully examining the macro-economic ramifications.

Fair and Equitable, *supra* note 67 (statement of Jack S. Levin, Partner, Kirkland & Ellis LLP).

The negative repercussions of the recent economic downturn on private equity deal-making lend support to the argument that carried interests cannot be likened to a guaranteed form of payment. A recent Private Equity Analyst-Holt Compensation Study revealed that the ongoing credit crisis would negatively impact carried interest distributions for 2008.[135] Indeed, firms that acquired companies with the hope of selling them for a profit have faced a difficult exit market.[136] Much of the debate that ensued in 2007 focused on leveling the playing field between investment fund partners, corporate executives, and other individuals whose annual compensation is subject to ordinary income rates.[137] However, taxing carried interest at ordinary income rates would not reflect the reality of the economic relationship between the general partner and the limited partner of a private equity or venture capital partnership.[138]

2. The Loan Approach

The strongest existing tax law analogy likens a general partner's carried interest to an equal nonrecourse, interest-free demand loan of the same amount of the capital managed by the general partner, which is then invested in the fund.[139] A nonrecourse loan prevents the lender from reaching the borrower's personal assets if the loan is not repaid.[140] The general partner agrees to the carried interest percentage that it will receive upon the sale of the portfolio company at the outset of the investment when the limited partners commit capital to the fund.[141] If the general partner's investments are not profitable, the limited partners cannot attach the general partners' personal assets and must bear the burden of the loss. Consider Victor Fleischer's example in "Two and Twenty":

> [I]magine a $100 million fund that appreciates to $150 million over three years. The GP would receive $10 million, or twenty percent of the $50 million in profits. Now, imagine that instead of a twenty percent profits interest, the LPs made the GP a $20 million loan. The loan would be made nonrecourse on the condition that

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135. *See Pay Rises and Performance Falls for Private Equity Managers*, Posting of Claire Cain Miller to *N.Y. Times*' Bits Blog, http://bits.blogs.nytimes.com/2008/09/03/pay-rises-and-performance-falls-for-private-equity-managers/?scp=1&sq=Pay%20Rises%20and%20Performance%20Falls%20for%20Private%20Equity%20Managers&st=cse (Sept. 3, 2008, 16:43 EST).

136. *See* Thomas Heath, *Private Equity's Loss of Leverage: Credit Crunch Puts Brakes on Buyout Blitz, Forces Firms to Change Direction*, WASH. POST, Jan. 2, 2008, at D08 (discussing losses evident at beginning of 2008); *Pay Rises and Performance Falls for Private Equity Managers*, *supra* note 135.

137. *See* ARON-DINE, *supra* note 5, at 2, 8.

138. As David Weisbach notes, the arbitrary distinctions made in recent tax reform proposals would encourage investment fund general partners to restructure their existing financial arrangements to avoid paying ordinary income tax rates. *See* Weisbach, *supra* note 25, at 505.

139. *See* Fleischer, *supra* note 23, at 30–40 (describing the "Accrual Income Tax Alternative"); Leo Schmolka, *Taxing Partnership Interests Exchanged for Services: Let* Diamond/Campbell *Quietly Die*, 47 TAX L. REV. 287, 302 n.92 (1992). *But see* Weisbach, *supra* note 25, at 509–10 (critiquing the approach advocated by Fleischer and Schmolka).

140. *See* Fleischer, *supra* note 23, at 40 n.163 (describing nonrecourse loans).

141. *See id.* at 40.

> the loan proceeds are invested in the fund. The fund would appreciate to $150 million, making the GP's share worth $30 million. The GP then pays back the $20 million, leaving it with $10 million, the same as if it had received the profits interest in the first place.[142]

Under the "loan approach," the inherent unfairness of a lower tax rate on carried interest lies with the general partner's ability to borrow a portion of the limited partner's capital without paying annual loan interest.[143] Critics of carried interest legislation contend that if carried interests were taxed at ordinary income rates, the general partners could simply restructure the limited partnership investment as a nonrecourse loan.[144] If the general partners modified their partnership agreements to reflect this change, these critics argue that general partner profits would again be taxed at the preferential rate of fifteen percent.[145] With limited partner investments now recast as a loan to the general partner, the carried interest would more closely resemble a gain on capital contributed by the general partner.[146]

While a carried interest is certainly analogous to a nonrecourse loan, converting the general partner's profits interest into a loan would produce undesirable consequences for the limited partner under the current tax law. If the carried interest is converted into a loan on twenty percent of the capital contributed, the limited partner would bear the burden of the forgone interest payments.[147] To prevent "disguised compensation," a loan that is given with a low interest rate or no interest rate at all has an imputed interest equivalent to the applicable federal rate.[148] For tax purposes, the limited partner "lender" would be deemed to have received annual payments on the loan's interest, and would consequently face a tax liability while the general partner would be entitled to a corresponding tax deduction for the imputed payments.[149] Therefore, while

142. *Id.*

143. *See id.* at 40–41.

144. *See* Cunningham & Engler, *supra* note 23, at 136; Fleischer, *supra* note 23, at 57; *see also* Weisbach, *supra* note 25, at 507 n.9 (discussing how carried interest can be restated as a nonrecourse loan that paid a fixed eight percent interest rate).

145. *See* Cunningham & Engler, *supra* note 23, at 68. Lawyers have recently advised fund managers to convert their carried interest fees into loans to avoid potentially higher taxes. *See* Donmoyer & Wee, *supra* note 10.

146. Regardless of whether Congress ultimately chooses to treat carried interest as ordinary income, fund managers have the ability to engage in avoidance measures because they have complete control over their compensation agreements and can modify their contractual provisions in response to changes in the tax law. *See* Sheppard, *supra* note 11, at 1241.

147. The mechanics of I.R.C. § 7872, the provision applicable to below-market loans, are discussed at length in John A. Lynch Jr., *Taxation of Below-Market Loans Under §7872: This Could Be a Lot Simpler!*, 21 AKRON TAX J. 33, 35–38 (2006). Basically, if the limited partner were to loan investment capital to the general partner without charging interest, the transaction would be treated as if the limited partner loaned the general partner the amount of the loan proceeds at the "statutorily designated rate," and the general partner transferred this designated rate to the limited partner. *See id.* at 35.

148. *See* I.R.C. § 7872(a), (f) (2006); Prop. Treas. Reg. 1.7872-3(b)(4), 50 Fed. Reg. 33,553 (Aug. 20, 1985).

149. *See* Cunningham & Engler, *supra* note 23, at 130.

a carried interest ostensibly resembles a loan, the consequence of treating it as one could drastically alter the underlying economics of the fund partnership.

3. A Modified "Cost-of-Capital" Approach

While a carried interest and a nonrecourse loan are not interchangeable, a carried interest's loan-like attributes provide a constructive approach to resolving the perceived unfairness of taxing carried interest as a capital gain. Victor Fleischer has suggested that, in light of a carried interest's resemblance to a nonrecourse loan, the fairest way to tax carried interest would be to recognize the fact that it falls somewhere "in between ordinary income and capital gain."[150] In his "cost-of-capital" approach, Fleischer suggests that taxing the general partner's implicitly forgiven loan interest at ordinary income rates would accurately reflect the economics of the transaction between the general partners and the limited partners and result in a net gain to the Treasury.[151]

Fleischer's theory operates in the context of a private equity fund in which a limited partner that is tax-exempt, a status that is applicable to a majority of private equity limited partners,[152] provides a general partner with the benefit of tax-free capital. The limited partners are theoretically entitled to a deduction because they are bearing the cost of this benefit to the general partners. In his article, Fleischer posits that in a fund with a $95 million contribution from the limited partners, the general partner would be taxed on eight percent, the cost of capital, multiplied by the general partner's twenty percent profits interest, multiplied by the source of capital outside of the general partner's contribution, multiplied by a thirty-five percent rate.[153] In his hypothetical, this amount is equivalent to $532,000. The limited partners would be allocated a $532,000 deduction in accordance with their capital interests, and their tax-exempt status would result in a net revenue gain to the Treasury.[154] If the arrangement were applied in the context of a taxable limited partner, the tax benefit to the general partner would be offset by the loss of a tax benefit to the limited partner, and there would not be a net revenue gain.[155]

Fleischer's theory would be difficult to implement in the form of a legislative enactment. For instance, the applicable Federal Rate used to impute interest does not accurately reflect the risk of fund investments.[156] The applicable Federal Rate (AFR) is a "risk-free" rate, whereas fund investments tend to be risky and bring potentially high

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150. Ryan J. Donmoyer, *Baucus Says Hedge-Fund Tax Bill Is 'Nowhere Close' (Update 3)*, BLOOMBERG.COM, May 7, 2007,
http://www.bloomberg.com/apps/news?pid=email_en&refer=home&sid=arqI0w6TMWkw.

151. *See* Fleischer, *supra* note 23, at 53 & n.210.

152. *See* Alan D. Viard, *The Taxation of Carried Interest: Understanding the Issues*, 61 NAT'L TAX J. 445, 457 (2008).

153. Fleischer, *supra* note 23, at 53 n.210. Essentially, the general partner would be reporting income in an amount equal to the deemed loan multiplied by the cost of capital rate. *See* Matthew A. Melone, *Success Breeds Discontent: Reforming the Taxation of Carried Interests—Forcing a Square Peg into a Round Hole*, 46 DUQ. L. REV. 421, 472 (2008).

154. Fleischer, *supra* note 23, at 53 n.210.

155. *Id.*

156. *See* Melone, *supra* note 153, at 472.

rates of return.[157] But despite the conceptual difficulties attributable to likening carried interest to a loan, Fleischer's approach illustrates the extent to which a fund manager's carried interest is comprised partially, rather than entirely, of ordinary income. Similar to an ordinary investor's investment in the stock market, a fund manager's return is sensitive to market fluctuations.[158] Taxing a portion, rather than the entirety, of a general partner's carried interest as ordinary income may be a way to recognize the risks and sweat equity taken on by private equity and venture capital partners without distorting the economics of the transaction.

III. THE PREFERENTIAL TAX TREATMENT OF PUBLICLY TRADED PARTNERSHIPS THAT QUALIFY UNDER § 7704(C)(2)[159]

In addition to scrutinizing executive pay in 2007, Congress sought to prevent publicly traded investment partnerships from structuring their IPOs and using amorphous fee structures to avoid corporate taxation. Senate Bill 1624, also dubbed the "Blackstone Bill," sought to amend I.R.C. § 7704(c) by providing that "the exception from the treatment of publicly traded partnerships as corporations for partnerships with passive-type income shall not apply to partnerships directly or indirectly deriving income from providing investment adviser and related asset management services."[160] The Senate bill attempted to thwart attempts by publicly traded partnerships to "act like a corporation" by professing to be engaged in active business services "but not pay corporate tax."[161]

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157. PRESENT LAW AND ANALYSIS PART I, *supra* note 14, at 62.

158. *See, e.g.,* Jason Kelly, *Schwarzman's Pay Falls 99% Amid Blackstone Losses, Stock Drop*, BLOOMBERG.COM, Mar. 3, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aBSbs77HhdSk (noting that Blackstone's Steve Schwarzman took a ninety-nine percent pay cut after the firm posted losses in excess of $1 billion). The article also notes that "[i]nvestment profits have virtually evaporated as credit markets prevent private equity firms from buying new companies or selling their existing holdings to other private buyers." *Id.* George Roberts, co-founder of the Kohlberg Kravis & Roberts Co. private equity firm, has observed, "No longer can you sit by, use the capital markets, put some leverage on a company and hope to make a good return. Those days are over with." He also said that the global financial crisis has resulted in his firm's first loss in nearly two decades. Lisa LaMotta, *KKR's Roberts Reflects*, FORBES.COM, Nov. 17, 2008, http://www.forbes.com/2008/11/17/roberts-kkr-credit-face-markets-cx_lal_1113autofacescan02.html.

159. "A partnership meets the gross income requirements of this paragraph for any taxable year if 90 percent or more of the gross income of such partnership for such taxable year consists of qualifying income." I.R.C. § 7704(c)(2) (2006). A partnership that qualifies under this provision is not treated as a corporation for tax purposes when it decides to go public. Otherwise, per I.R.C. § 7704(a), "[A] publicly traded partnership shall be treated as a corporation." I.R.C. § 7704(a) (2006).

160. S. 1624, 110th Cong. (2007). The services referred to are those provided by a person as an investment adviser as defined in section 202 of the Investment Advisers Act of 1940. 15 U.S.C. 80b-2 (2006). *See also* PRESENT LAW AND ANALYSIS PART I, *supra* note 14, at 41.

161. Committee on Finance News Release, *supra* note 1, at 1. It is worth noting that the IPO prospectuses of both Fortress and Blackstone described their activities as active. *See, e.g.*, Blackstone Group L.P., Registration Statement Under the Securities Act of 1933 (Amendment

The bill was largely a response to the way in which alternative asset manager Blackstone structured its initial public stock offering.[162] If the bill is revisited under the new presidential administration, its passage into law would be fair and consistent with the tax code. In contrast to the Levin Bill, which presents an overly punitive response to lucrative executive pay structures, the Blackstone Bill aptly forecloses unintended tax benefits for a private partnership that becomes a public entity.

A. Current Law and the Blackstone Bill

The current form of I.R.C. § 7704 was initiated by the House Ways and Means Committee in 1987, and its intent was largely to "preserve the corporate level tax."[163] The Committee's concern that the publicly traded partnership form was growing in popularity because parties could "tak[e] advantage of an unintended opportunity for disincorporation and elective integration of the corporate and shareholder levels."[164] While pass-through taxation rules do not generally apply to publicly traded partnerships, the ease with which Blackstone and Fortress structured their IPOs to qualify for preferential tax treatment reignited those same concerns over erosion of the corporate tax base.[165]

When Fortress initiated the process to make its private investment partnership public in November 2006, the event was hardly controversial.[166] However, as the first U.S.-based hedge fund to go public, Fortress paved the way for similarly situated firms, such as Blackstone, to benefit from preferential partnership tax treatment while dodging regulation by the Securities and Exchange Commission.[167] The tax lawyers who assisted Fortress executed a bold plan that revealed a fundamental problem with the current tax treatment of carried interest.[168] Investment management partners that choose to take their management companies public are permitted to perform active

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No. 2 to Form S-1) (May 21, 2007), *available at* http://www.sec.gov/Archives/edgar/data/1393818/000104746907004475/a2177304zs-1a.htm; Fortress Inv. Group LLC, Registration Statement Under the Securities Act of 1933 (Amendment No. 4 to Form S-1) (Feb. 2, 2007), *available at* http://www.sec.gov/Archives/edgar/data/1380393/000095013607000635/file1.htm.

162. Despite the upheaval following the Blackstone IPO because of its perceived profitability, the economic decline that followed the IPO resulted in negative consequences for Blackstone general partners and investors. As of March 2008, its stock price had dropped more than fifty percent from its IPO value. *See* de la Merced, *supra* note 106. As of November 2008, its stock price had dropped more than seventy-five percent from its IPO value. *Blackstone Posts $502.5 Million Loss*, *N.Y. Times'* DealBook Blog, http://dealbook.blogs.nytimes.com/2008/11/06/blackstone-loses-5025-million-in-3rd-quarter/ (Nov. 6, 2008, 8:41 EST).

163. Committee on Finance News Release, *supra* note 1, at 3.

164. *Id.*

165. *See id.* at 3–4.

166. *See* Beck, *supra* note 11, at 94.

167. Whereas a partnership is only taxed on income that flows to the partners, a corporation is taxed on the income that it earns, and is taxed again at the shareholder level when the shareholders receive dividends. *See id.* at 97; Alex Halperin, *Investors Storm Fortress IPO*, BUSINESSWEEK.COM., Feb. 9, 2007, http://www.businessweek.com/investor/content/feb2007/pi20070209_895342.htm.

168. *See* Fleischer, *supra* note 11, at 104.

services[169] as defined by the Investment Company Act of 1940,[170] while their income remains passive—and taxed at the lower capital gains rate—under I.R.C. § 7704.[171] And since the services undertaken by Fortress superficially bear a strong resemblance to those provided by publicly traded corporations registered under the Investment Company Act that pay the corporate tax rate, the firm has a significant, unfair competitive advantage over those competitors, such as Goldman Sachs Group, Inc.[172]

As Susan Beck has noted, Blackstone's IPO was bolder than that of Fortress.[173] Unlike Fortress, which went public as a limited liability company, Blackstone went public as a limited partnership, which enabled it to avoid several corporate governance requirements.[174] The unconventionally tax-friendly structure of its IPO troubled tax scholars and policymakers for several reasons.

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169. *See, e.g.*, Richard Teitelbaum, *The KKR Way*, BLOOMBERG MARKETS, Aug. 2007, at 36, 37–38 (discussing how private equity firm KKR has successfully purchased and turned around several companies by hiring consultants and assigning its own executives to serve on the board of directors). While carried interest technically constitutes passive income, the responsibilities undertaken by private equity general partners can hardly be considered passive.

170. Investment Company Act of 1940 § 3, 15 U.S.C. § 80a-3 (2006).

171. *See* Fleischer, *supra* note 11, at 102–04 (describing the mechanics of this phenomenon and accusing entities of exploiting arbitrage opportunities between the tax code and the Investment Company Act). It is believed that fund managers structure the publicly traded entity to avoid becoming a registered investment company and consequently maintain the ability to leverage transactions with debt, make risky investments, and allow fund managers to profit directly from the fund's investment return. *See* Ordower, *supra* note 65, at 333.

172. *See* Fleischer, *supra* note 11, at 92; Beck, *supra* note 11, at 97; Donmoyer, *supra* note 150. Blackstone and Goldman Sachs perform similar investment functions but Goldman Sachs recently paid $1.1 billion in corporate income taxes on its $3.4 billion second-quarter profits, whereas Blackstone Group only paid $14 million on its first-quarter earnings of $1.1 billion. *See* Weiner, *supra* note 7, at 315.

173. *See* Beck, *supra* note 11, at 94.

174. *Id.* at 98–99; Fleischer, *supra* note 11, at 95. As Susan Beck noted, Blackstone saved its partners billions of dollars in taxes. Beck, *supra* note 11, at 98. In the wake of the Blackstone IPO, several privately regulated entities started making arrangements to take their firms public to be grandfathered in under the existing rules. *See* Andrew Ross Sorkin, *Will Blackstone Have the Honor of Its Own Tax Law?*, N.Y. TIMES, June 17, 2007, § 3, at 7; Miles Weiss, *Fidelity Reorganizes; Move May Eliminate U.S. Taxes (Update 1)*, BLOOMBERG.COM, Nov. 2, 2007, http://www.bloomberg.com/apps/news?pid=20601087&sid=aRRYyU4Pi0Sc&refer=home. Despite the fact that Blackstone announced a third-quarter loss of $113 million, or 44 cents a share, in 2007, Kohlberg Kravis & Roberts Co. (KKR), Och-Ziff Capital Management, and AQR Capital Management were still interested in taking their hedge funds and private equity funds public. *Turning over the Rock, Commentary: Blackstone's Loss Brings Public Pressure*, MARKETWATCH, Nov. 12, 2007, http://www.marketwatch.com/news/story/blackstones-naked-loss-another-first/story.aspx?guid={E1C41AC4-BC70-47F8-8AF1-ADE074AB5D7A}&dist=msr_1. While the Blackstone IPO was the sixth richest IPO in U.S. history, raising $4.13 billion, it suffered losses late in 2007 due to IPO costs. Dana Cimilluca & Kaja Whitehouse, *Blackstone's Twin Hits: IPO Costs, M&A Drought*, WALL ST. J., Nov. 13, 2007, at C3. In late 2007 and early 2008, declining stock prices and market conditions persuaded KKR to abandon its IPO plans. *See* LaMotta, *supra* note 158.

First, the structure illustrated how an investment management partnership could reap substantial tax benefits by transferring $3.7 billion in goodwill—the value of its intangible assets—to offset a significant amount of its management fee income.[175] The Blackstone partners transferred the goodwill to a blocker corporation that it created.[176] In addition, the general partners used the blocker corporation as a depository for the partnership's personal service income.[177] Since goodwill presumably depreciates over time,[178] Blackstone's general partners can deduct approximately $1.3 billion in taxes, equivalent to thirty-five percent of the value of its goodwill,[179] from its personal service income over a period of fifteen years.[180] The blocker corporation effectively "blocks" personal service income from the partnership. Without the personal service income, Blackstone can qualify under the narrow exception provided in § 7704(c)(2), which permits it to avoid treatment as a corporation for tax purposes.[181]

Second, the Blackstone general partners provided for a lucrative Tax Receivable Agreement in the partnership's prospectus.[182] Under the Agreement, Blackstone's investors are able to receive fifteen percent of the goodwill deduction while the partners are entitled to the remaining eighty-five percent, which is approximately $1.1 billion.[183] The eighty-five percent cash savings achieved through the Tax Receivable Agreement result from increases in the tax basis of Blackstone's two subsidiaries, Blackstone Holdings I/II GP and Blackstone Holdings V GP.[184]

Third, Blackstone was able to maintain favorable tax treatment in its IPO despite its ostensible use of related entities.[185] Under the current tax law, a corporation may deduct depreciation or amortization on property that has been purchased,[186] but ordinary income will result from the sale of depreciable assets that would otherwise result in a capital gain to the seller if the sale is executed between parties that are directly or indirectly related.[187] Since the managing entity did not maintain fifty percent

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175. *See* PRESENT LAW AND ANALYSIS PART I, *supra* note 14, at 52 n.111.

176. *See, e.g.*, David Cay Johnston, *Tax Loopholes Sweeten a Deal for Blackstone*, N.Y. TIMES, July 13, 2007, at A1. The shell corporation is referred to as a "blocker corporation" because it is said to block taxes from reaching the Treasury. Beck describes it as "[a] corporation created as a subsidiary to a publicly traded partnership that takes nonqualifying fee income and turns it into qualifying dividend income." Beck, *supra* note 11, at 97.

177. *See* Beck, *supra* note 11, at 98.

178. *See* Johnston, *supra* note 176.

179. This figure is based on the corporate tax rate for depreciation. *See* Johnston, *supra* note 176.

180. *See* Sheppard, *supra* note 11, at 1241–42.

181. *See* PRESENT LAW AND ANALYSIS PART I, *supra* note 14, at 40. Since Blackstone qualifies under I.R.C. § 7702(b), it paid taxes on the $3.7 billion at the fifteen percent capital gains rate rather than the thirty-five percent corporate tax rate.

182. *See id.* at 1241–43.

183. Johnston, *supra* note 176.

184. *Id.* at 1242.

185. *See id.*

186. I.R.C. § 167 (2006).

187. *See* I.R.C. § 1239 (2006). In other words, if the person transferring assets to the partnership or a related person owns more than fifty percent of the acquirer, the gain that is recognized is ordinary income and will be taxed at a rate up to thirty-five percent. Timothy J. Devetski, *Practice Note: Avoiding a Tax-Free Transaction: When Taxable Is Tax-Efficient*, 5

of the company's value and merely maintained voting control,[188] it was exempt from the definition of "related persons" and consequently did not have to pay the applicable corporate tax rate.[189] Under the Tax Receivable Agreement, the annual payments to Blackstone's current owners and managers are expected to be between $40 million and $90 million, and these payments will be made regardless of whether the owners continue to own the enterprise.[190]

B. The Blackstone Bill and the Carried Interest Debate, Generally

The Blackstone IPO reveals the difficulty of confining a carried interest to being either ordinary income or a capital gain in a rapidly changing business landscape. As Lee Sheppard notes, "[fund managers] have figured out how to turn paying taxes into an annuity."[191] "[T]ax experts mix and match elements of partnerships and corporations, and bits and pieces of the tax code, securities laws, accounting rules and economic principles."[192] The Blackstone Bill had "independent merit as a matter of protecting the integrity of the tax system"[193] because it prevented investment fund general partners from exploiting the passive status of carried interest. In the specific context of publicly traded partnerships, it was an aptly drafted solution to an unintended tax loophole.

CONCLUSION

Treating publicly traded partnerships as corporations for tax purposes would be consistent with the Internal Revenue Code. However, it is not clear that taxing carried interest at ordinary income rates would be similarly consistent. A majority of the arguments in favor of taxing carried interest at ordinary income rates have attempted to posit an analogy between the labor of fund managers and the labor of employees whose profits are taxed at ordinary income rates. However, as David Weisbach notes, the presence of labor alone cannot justify a drastic change in the taxation of fund manager profits.[194] Justifying the tax increase on the grounds of labor alone would leave ample room for investment fund partnerships to engage in tax avoidance by restructuring their existing financial arrangements, and perhaps even coining new terms of art to disguise the true nature of their business transactions.[195]

Blackstone's IPO illustrated the ease with which investment management partnerships can benefit from identifying wrinkles in the tax code and engaging in tax avoidance that the law seeks to prevent. As Fleischer notes, the Blackstone Bill is a step in the right direction because it targets a specific avoidance strategy in a specific context.[196] However, articulating the appropriate policy approach to taxing private

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HOUS. BUS. & TAX L.J. 90, 93 (2005).

188. *See* I.R.C. § 1239(c) (2006) (defining controlled entity).
189. *See id.* § 1239(b).
190. Sheppard, *supra* note 11, at 1242.
191. Johnston, *supra* note 176 (quoting Lee Sheppard).
192. *Id.*
193. Fleischer, *supra* note 11, at 114.
194. *See* Weisbach, *supra* note 25, at 505.
195. *See id.*
196. *See* Fleischer, *supra* note 11, at 114 (noting that the bill has independent merit as a

investment partnership carried interests requires recognizing that at least a portion of a fund manager's duties entail investing capital in an uncertain market—an activity that the current statutory regime taxes at a preferential tax rate. The cost-of-capital approach introduced by Victor Fleischer[197] most closely approximates a reasonable tax reform that will minimize tax avoidance strategies and maintain consistency in the Code. Indeed, the tax code must keep up with the times, and consequently Congress should adopt a tax policy approach that suits the complex nature of the investment partnership fund fee structure.

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matter of protecting the integrity of the tax system).

197. *See* Fleischer, *supra* note 23, at 52–54.