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CONSEQUENCES OF CARRIED INTEREST REFORM FOR  
THE PRIVATE INVESTMENT INDUSTRY

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# CONSEQUENCES OF CARRIED INTEREST REFORM FOR THE PRIVATE INVESTMENT INDUSTRY

## PART I: INTRODUCTION

A great majority of present-day private investment funds are structured as *limited partnerships*.<sup>2</sup> This characterization typically applies to hedge funds, private equity funds, venture capital funds, real estate investment funds, and other similar entities. In the most common scenario, a limited investment partnership includes two types of participants: the general partner (the management company) and the limited partners (the investors). Usually, the limited partners provide the overwhelming share of the capital, and the general partner provides a token amount of capital and investment services.<sup>3</sup>

For its services, the management company (the general partner) usually charges two types of fees: a management fee and a performance fee. A typical management fee ranges between 1 and 2 percent of assets under management, whereas the performance fee can reach upward of 20 percent or more of the partnership's profits. As a result, historically, the performance fee has become a powerful incentive for successful fund managers.<sup>4</sup>

The general partner receives the performance fee through a disproportionate allocation of the partnership's profits, a compensation scheme commonly referred to as "carried interest." Because a partnership does not incur any entity level tax, all of the partnership's profits are "passed through" to its partners, including the general partner's performance fee. The pass-through gain also retains the taxable characteristics determined at the partnership level.

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<sup>2</sup> See generally TIMOTHY SPANGLER, THE LAW OF PRIVATE INVESTMENT FUNDS (2008) (documenting this trend).

<sup>3</sup> For greater detail concerning typical structure of alternative investment vehicles see *id.*

<sup>4</sup> In 2010, the highest-paid twenty-five hedge fund managers earned \$22.07 billion, more than \$3 billion more than the group collectively earned in 2009. See *Paulson Earns Almost \$5B in 2010, To 25 Hedgies Taken in \$22B*, FINalternatives, Apr. 1, 2011, <http://www.finalternatives.com/node/16161>. The trend is clearly accelerating: Another commentator reports that, for example, in 2007, the fifty highest paid hedge fund managers collected \$29 billion in carried interests. See Sanford M. Jacoby, *Finance and Labor: Perspectives on Risk, Inequality, and Democracy*, 30 COMP. LAB. L. & POL'Y J. 17.

In the case of investment partnerships, the gain is sometimes a capital gain because of the nature of the assets held by these partnerships.<sup>5</sup> Consequently, the bulk of individual managers' compensation can often be classified as a capital gain, taxed at lower capital-gain rates.

Quite predictably, this favorable tax treatment of what, at least at first glance, appears to be compensation for investment services stirs dissatisfaction among many,<sup>6</sup> and Congress has threatened to reform the present treatment of carried interests on several occasions.<sup>7</sup> So far, none of the congressional attempts have come to fruition. Nevertheless, many commentators and industry insiders agree that eventual congressional action is inevitable rather than probable.<sup>8</sup> In dollar terms, the stakes are high for the fund managers and for the government.<sup>9</sup> The policy considerations also exert pressure on the lawmakers to bring greater correlation to the tax rates of the country's wage earners and investment fund managers. Ever-increasing budget deficits, undoubtedly, stack the odds further in favor of reform.<sup>10</sup>

Assuming then, hypothetically, that the Congress does act, what alternative compensation structures will emerge in the private investment industry? This paper explores several options as well as provides a digest of many of the relevant issues surrounding taxation of carried interest.

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<sup>5</sup> Not all funds will derive long-term capital gains. Most hedge funds generally trade too often to generate long-term capital gains consistently. Private equity funds, on the other hand, will almost always have long-term capital gains as the bulk of their income.

<sup>6</sup> See, e.g., Darryll K. Jones, *Sophistry, Situational Ethics, and the Taxation of the Carried Interest*, 29 NW. J. OF INT'L L. & BUS. 675 (2009) (Jones describes his article as "strident expression of indignation about what a majority of tax scholars and, indeed, legislators consider a glaring yet persistent inequity in the tax code.").

<sup>7</sup> See *infra* Part IV.

<sup>8</sup> See, e.g., Howard E. Abrams, *Taxation of Carried Interests: The Reform That Did Not Happen*, 40 LOYALA UNIVERSITY CHICAGO LAW JOURNAL 197, 228 (2008) ("For carried interest reform to fail, it must be defeated every time it is proposed; for it to succeed, it must succeed only once. . . . Carried interest reform seems inevitable. Unwise, but inevitable.").

<sup>9</sup> Michael S. Knoll, *The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of taxing Profits Interests as Ordinary Income*, 50 WILLIAM AND MARY LAW REVIEW 115 (2008).

<sup>10</sup> President's State of the Union Address (President Obama's promise not to reduce budget deficit on the backs of country's most vulnerable citizens), available at <http://www.whitehouse.gov/the-press-office/2011/01/25/remarks-president-state-union-address>.

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Before undertaking a detailed examination of potential “industry responses,” it is first necessary to understand the existing framework of taxation of private investment funds and the mechanics of the proposed change. Readers who are well-versed in partnership taxation or (as one commentator puts in) are partnership taxation “jocks”<sup>11</sup> will likely wish to skip forward.

## **PART II: TAX CONSEQUENCES UPON THE RECEIPT OF CARRIED INTERESTS**

The present structure of private investment funds is driven, at large, by the realities of partnership taxation.<sup>12</sup> The flexibility afforded to the partnerships in allocating partnership profits,<sup>13</sup> together with the absence of entity-level tax, make possible a “tax-friendly” compensation arrangement that compares most favorably with wage employment.<sup>14</sup> Carried interest is at the heart of this arrangement.

There exist several possible fund structures. The make-up of investors and the fund’s investment strategy will largely determine the specifics.<sup>15</sup> The following discussion assumes the “plain vanilla” domestic structure, where the investors will be U.S. taxable individuals and the fund will be structured as a domestic partnership. The management team will also be comprised of U.S. individuals, who will receive part of their compensation through “carried interest.”

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<sup>11</sup> Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 16 (2008)

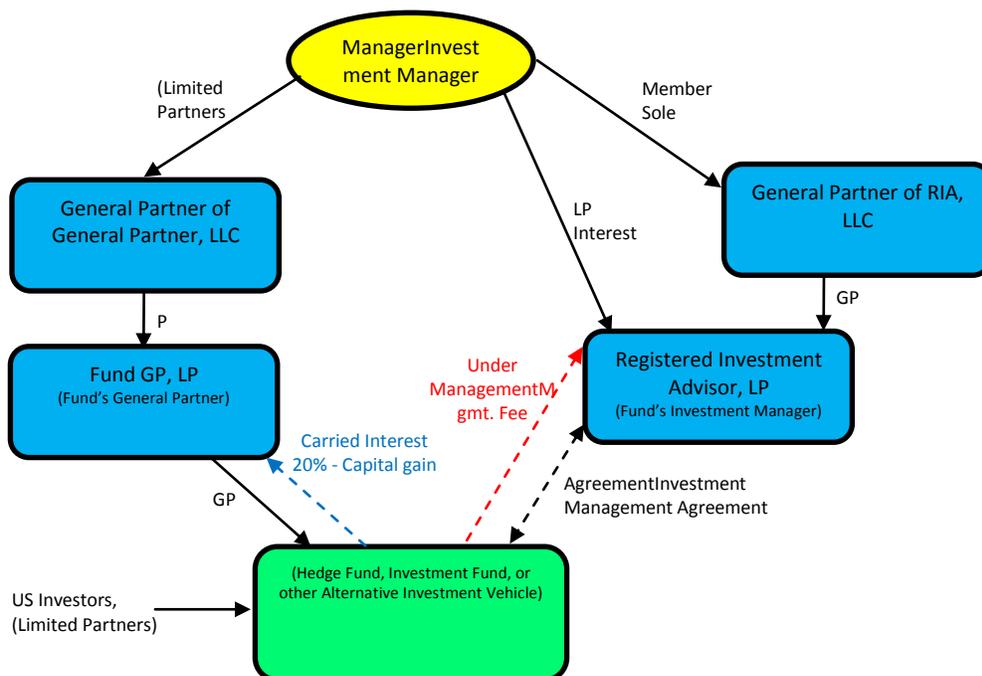
<sup>12</sup> *Private Equity Funds*, Tax Mgmt. Portfolios, Tax Mgmt. Inc. (BNA) No. 735, at A-13 (2004) (“Virtually every U.S. private equity fund, with the exception of certain parallel entities, is structured as a pass-through entity for tax purposes.”).

<sup>13</sup> See SPANGLER, *supra* note 2.

<sup>14</sup> See *infra* Parts III A, B.

<sup>15</sup> For greater detail on fund structures, see David S. Miller and Jean Marie Bertrand, *The U.S. Federal Income Tax Treatment of Hedge Funds, Their Investors and Their Managers*, pp 1-8, available at <http://ssrn.com/abstract=1758748>.

Chart 1: *Plain Vanilla Domestic Hedge Fund Structure*



**A. The Typical Arrangement**

Suppose Manager and Investor form a hedge fund or a private equity fund.<sup>16</sup> The fund is structured as a limited partnership where Investor is the limited partner, and the general partner is a one-member LLC wholly owned and controlled by Manager.<sup>17</sup> The LLC has not “checked the box” and therefore is treated as a partnership for federal tax purposes. At the outset, Investor and Manager agree that Investor will invest \$95 million and Manager will invest \$5 million in exchange for partnership’s capital interests. Consistent with the state law and the intent of the parties, Manager, as the general partner, will actively manage the fund. Manager subsequently

<sup>16</sup> The traditional distinction between hedge funds investing in liquid assets and private equity funds investing in illiquid assets has been slowly eroding because hedge funds increasingly often include in their investments illiquid and nonlisted assets, thus “blurring the lines between the previously well-defined structures.” See *A Hedge Fund Perspective*, GREG N. GREGORIOU AND FRANCOIS-SERGE LHABITANT IN GREG N. GREGORIOU AND FRANCOIS-SERGE LHABITANT, STOCK MARKET LIQUIDITY: IMPLICATIONS FOR MARKET MICROSTRUCTURE AND ASSET PRICING 407 (2008).

For the purposes of this paper, this distinction is of little relevance because the author is concerned primarily with the tax consequences resulting from “carried interest,” a compensation scheme common to both private equity funds and hedge funds.

<sup>17</sup> For a more detailed discussion of a typical private investment fund (hedge fund, private equity fund, real estate investment fund, and others), see generally DAVID STOWELL, AN INTRODUCTION TO INVESTMENT BANKS, HEDGE FUNDS, AND PRIVATE EQUITY (2010).

invests the partnership's funds into gold bars, betting that the precious metal prices will rise over the next decade (the agreed duration of this "alternative investment vehicle").<sup>18</sup>

Investor and Manager agree that despite their disproportionate capital contribution to the partnership, the partnership's profits will be split as follows: 20% to Manager and 80% to Investor. Investor will also pay Manager an annual Management Fee equal to 2% of the Fund's assets as valued at the end of each quarter.<sup>19</sup> This disproportionate allocation of profits is agreed to be fair by the parties because Manager will invest time and labor into maintaining and managing the Fund's day-to-day operations. Additionally, Investor believes that Manager will properly "hedge" against unacceptable investment risk and provide a level of return on investment that will justify the disproportionate allocation of profits. Investor is unable or unwilling to accomplish these objectives without Manager. The appropriate language memorializes this arrangement in the Limited Partnership Agreement.

### **B. Profits and/or Carried Interest**

There has been some conceptual inconsistency when it comes to describing the disproportionate share of profits that investment fund managers receive. The Treasury generally describes them as "profits (carried) interest,"<sup>20</sup> thus lumping the concepts of carried interest and profits interest together. However, several commentators have pointed out the conceptual shortcoming of equating profits interest with carried interest.<sup>21</sup> A pure *profits interest* would be the interest that a manager would receive solely in exchange for future services. A carried

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<sup>18</sup> Colloquially, an alternative investment vehicle is usually anything other than run-of-the-mill mutual fund, stock, bond, or other security available to an average investor.

<sup>19</sup> Following the 2008 financial crisis, the management fees have come down and now range between 1% and 2%.

<sup>20</sup> See, e.g., U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2012 REVENUE PROPOSALS 61 (Feb. 2011).

<sup>21</sup> See e.g., Paul Carman, *Taxation of Carried Interests*, 87 TAXES 111 (2009) ("A "carried interest," for the purposes of this article, is a right to a disproportionate allocation of profits when a manager has paid something for the manager's interest. A "profits interest" is an interest in respect of which the manager has paid nothing and would get nothing if the entity were liquidated immediately after the interest was issued.").

interest, on the other hand, is a disproportionate allocation of future profits to the manager's capital interest. That is, the manager contributed some capital to the partnership and received a special allocation of future income. The allocation may very well represent the effort the manager would exert in managing the fund, a perfectly fair and permissible result under the present framework of partnership tax.

### **C. Capital and Profits Interest Defined**

In a typical partnership a partner may receive a *capital interest* in the partnership and a *profits interest* in future income. These interests are distinct.<sup>22</sup> A capital interest gives its holder a right to a share of the proceeds from the sale of partnership assets in a complete liquidation of the partnership.<sup>23</sup> A profits interest, on the other hand, is a “partnership interest other than a capital interest.”<sup>24</sup> In our case, it is a right to receive a disproportionate share of partnership's future profits. More specifically, as a general rule, in the event of liquidation, a partner with a capital interest would receive money equal to the partner's capital account. The profits interest, on the other hand, would be worthless.<sup>25</sup>

### **D. Non-recognition of the Receipt of Capital Interest**

Within the general rule of Section 721, the partners' contribution of property in exchange for a partnership's *capital interest is tax free*: No gain or loss is “recognized to a partnership or any of its partners on a contribution of property to the partnership in exchange for an interest in the partnership.”<sup>26</sup> The non-recognition in this instance is based on the rationale that transfer of

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<sup>22</sup> Hereafter, this paper's focus is on tax consequences to Manager, therefore, for the most part, it ignores the consequences to Investor.

<sup>23</sup> See Rev. Proc. 93-27, 1993-2 C.B. 343.

<sup>24</sup> Descriptive, isn't it? See *id.*

<sup>25</sup> The profits interest is worthless in the sense that its value upon liquidation is zero. In reality, an investment fund's profits interest often becomes worth millions over the life of the fund.

<sup>26</sup> However, § 721(b) provides a narrow exception in the event when a partnership would be treated as an “investment company” if a partnership were incorporated. “Investment company” in this context is defined under

property in exchange for a partnership interest is considered a mere change of form in the partners' investment.<sup>27</sup> The Tax Code's intent not to impede the formation of business enterprises is frequently offered as another justification for non-recognition.<sup>28</sup>

### **E. Non-recognition of the Receipt of Profits Interest**

Using our previous example (and assuming briefly<sup>29</sup> that we could bifurcate carried interest into a capital interest and a profits interest), Manager received a 15% profits interest and a 5% capital interest. The capital interest was received tax-free in return for contribution of services. Today, the receipt of a disproportionate *profits interest in exchange for services* is also a *tax-free* event.<sup>30</sup> Much of the criticism surrounding the present tax treatment of private investment funds arises in the context of non-taxability of carried interests upon their issuance and the subsequent taxation of managers' profits at capital gain rates.

Assuming that bifurcation is absolutely correct and 15% of future profits is indeed received for the performance of services, *the profits interest remains untaxed due to the difficulty of valuing* the amount of future income represented by the profits interest.<sup>31</sup> In most cases, a

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351(e)(1) and Reg. § 1.351-1(c) and includes a company that aims to achieve tax-free diversification of its founders' interests.

Although tax-free diversification of interests is frowned upon by the Code in this instance (the Code attempts to impose a realization event), it is sometimes possible through certain financial products, such as private placement annuities.

<sup>27</sup> STEPHEN A. LIND, ET AL., FUNDAMENTAL OF PARTNERSHIP TAXATION 30 (8th ed. 2008).

<sup>28</sup> See *id.*; see also I.R.C. § 351.

<sup>29</sup> This assumption is very simplistic because it ignores the realities of permissible special allocations.

<sup>30</sup> Some scholars argue that non-taxability of profits interest is merely a negative implication from Rev. Proc. 93-27 and Reg. 1-721-1(b)(1). In other words, the Treasury has explicitly stated that the issuance of a *capital interest* in exchange for services is a *taxable event*. This, they argue, is *not* equivalent to saying that the issuance of a *profits interest* is a *non-taxable event*. Indeed, neither Rev. Proc. 93-27, nor Reg. 1-721-1(b)(1) state that the issuance of a profits interest is a non-taxable event. To the contrary, the proposed regulations state that an issuance of a profits interest in exchange for services is a taxable event, taxed at the fair market value of the interest. In a typical scenario, the value of an interest in future profits is entirely speculative and consequently of no present value.

Therefore, ignoring the semantics, the end result is identical whether (1) issuance of a profits interest in exchange for services is non-taxable or (2) the issuance of a profits interest is taxable at the fair market value of the interest, where the fair market value of the interest equals 0. If a profits interest can be reasonably valued, it will likely be taxed under Rev. Proc. 93-27.

<sup>31</sup> See, e.g., *St. John v. United States*, 841 USTC 9158 (C.D.Ill.1983); *Kenroy, Inc. v. Commissioner*, 47 T.C.M. 1749 (1984).

hedge fund or a private equity fund cannot guarantee profitability, let alone predict the rate of future return, if any. The uncertainty on valuation of future profits thus permits the receipt of a profits interest to be untaxed.<sup>32</sup>

#### **F. Distinction from the Receipt of Capital Interest in Exchange for Services**

The law's differentiation between capital interests and profits interests permits for a distinct tax treatment of the receipt of these interests by the partners *in exchange for partners' services* provided to or for the benefit of the partnership. Whereas the receipt of a *profits interest results in tax-free treatment*, the receipt of a *capital interest in exchange for services is immediately includible in taxable income*.<sup>33</sup> Accordingly, in our example, if Manager contributed \$5 million in cash **and** \$15 million in future services in exchange for a capital interest, Manager would be forced to include \$15 million as ordinary income in Year 1.<sup>34</sup> If following such contribution, the partners agreed that profits would be allocated "straight-up" (that is, in proportion to partners' capital interests), *the economic effect* would be equivalent to

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<sup>32</sup> A typical hedge fund or a private equity fund agreement sets forth provisions that disclaim any promise or guarantee of future gains. In certain instances, however, predictability and valuation of future income might be possible, for example, in funds where income would come from a "high quality debt security" or a "high quality net lease." See Rev. Proc. 93-27, 1993-2 C.B. 343 (establishing that a receipt of a partnership profits interest in exchange "for services provided to or for the benefit of the partnership" is generally nontaxable, but can be taxable in three situations: (1) if the profits interest relates to a substantially certain and predictable stream of income; (2) if within two years of receipt, the partner disposes of the profits interest; or (3) if the profits interest is a limited partnership interest in a publicly traded partnership within the meaning of Section 7704(b).).

Revenue Procedure 2001-43 clarifies that the result applies if the service partner taken into income his distributive share of partnership income, and the partnership does not deduct any amount either on grant or on vesting of the profits interest. See STAFF OF J. COMM. ON TAXATION, 110<sup>TH</sup> CONG., PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS 33-35 (Comm. Print 2007).

<sup>33</sup> See Treas. Reg. § 1.721-1(b)(1). This Regulation links Subchapter K with Section 83 of the Code by stating that a service partner's receipt of a *capital interest is taxable under Section 83*. Section 721 does not provide for non-recognition in this instance because the partner is not contributing "property." Partner contributing services is deemed as "being compensated" and thus realizes ordinary income under 61(a). In such case, the partner takes "tax-cost" basis in the partnership interest. I.R.C. § 1012.

Whether Section 83 applies to the service partner's receipt of a *profits interest* is subject to a considerable debate, which, nonetheless, "has been rendered moot" by Rev. Proc. 93-27 and Rev. Proc. 2001-43. See William R. Welke et al., *Compensating the Service Partner with Partnership Equity: Code §83 and Other Issues*, 79 TAXES 94, 105 (2001).

<sup>34</sup> The result assumes that the partnership interest is "transferable" and "not subject to a substantial risk of forfeiture." I.R.C. § 83(c)(1). In other words, the law wants to make certain that the property interest really results in income to the partner receiving the interest and timing for taxation is therefore appropriate.

compensating Manager with a carried interest. The tax bill, however, would vary significantly. Thus becomes apparent the value of tax planning.

### **G. Carried Interest**

The conceptual difficulty arises in determining the appropriate treatment of *carried interest* because, in the case of a carried interest, the partnership interest is given in exchange for a *contribution of capital and services*.<sup>35</sup> This difficulty is exacerbated by the present framework of partnership tax, which permits a partner to perform services for the partnership in her capacity as a partner. In such cases, the character of the partner's distributive share of income is not reclassified even if the share has been enhanced by the partner's performance of services.

Technically, therefore, the receipt of a carried interest does not fall squarely into the safe harbor of Revenue Procedures 93-27 or 2001-43.<sup>36</sup> Nevertheless, it has been a long-accepted practice to rely on this guidance for non-taxability of the receipt of carried interest. I feel important to mention again that the Service generally lumps together the concepts of profits interest and carried interest.

### **PART III: COMMON CRITICISM OF THE PRESENT TREATMENT OF CARRIED INTERESTS**

Examination of the proposed changes (which follows in Part IV) is better understood in light of the widespread criticism aimed at the present tax treatment of carried interest. Additionally, the industry's potential response (which is discussed in Part V) cannot be analyzed without keeping in mind the potential congressional intent, which, in all likelihood, will seek to end the present status quo. Accordingly, this section summarizes, in pertinent manner, some of the most frequent jabs at the present treatment of carried interest and offers one defense.

#### **A. Character of Carry**

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<sup>35</sup> See Carman, *supra* note 20, at 111.

<sup>36</sup> See Karen C. Burke, *The Sound and Fury of Carried Interest Reform*, 1 COLUMBIA JOURNAL OF TAX LAW 1, 10 (2010); *id* at 114.

The pass-through nature of partnerships requires the determination of the character of the partners' distributive share to be made at the partnership level. Today, based on the nature and strategy of the investment fund, the carried interest structure allows fund managers, in certain instances, to characterize carried-interest gains as long-term capital gains and/or qualified dividend.<sup>37</sup> In literature, the most frequent criticism of this arrangement is raised by the conceptual question: Is carried interest a form of compensation for services, or is it more similar to an interest in capital?<sup>38</sup> The critics generally argue that carried-interest gains are compensation for investment services and therefore should be taxed at ordinary income rates. The private investment industry, backed by a fairly subdued academic minority,<sup>39</sup> responds that the present treatment of carried interest is appropriate.

Contrary to the assertion of some critics that carried interest income is clearly compensation for services, the issue is not quite as axiomatic as it is often made out to be.<sup>40</sup> However, for practical purposes, the Service's application of Revenue Procedure 93-27 in the context of carried interest seems to indicate that (as far as the Service is concerned) fund managers receive disproportionate profits interest in *return for services*. The scope of this

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<sup>37</sup> Since qualified dividends are presently taxed at applicable capital gain rates, I will, for simplicity, omit qualified dividends from further discussion and simply focus on capital gains.

<sup>38</sup> See STAFF OF J. COMM. ON TAXATION, 110<sup>TH</sup> CONG., PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS 45 (Comm. Print 2007).

<sup>39</sup> See, e.g., David A. Weisbach, *The Taxation of Carried Interest in Private Equity*, 94 VIRGINIA LAW REVIEW 715, 763 (2008) ("The considerations discussed [in Weisbach's article] indicate that the treatment of carried interests should not be changed. Under current law, private equity sponsors are treated the same way they would be treated if they engaged in the activity directly rather than through a partnership. There are sound reasons, many deeply embedded in partnership tax law, for retaining this approach. Moreover, changes would likely be very complex and easily avoidable, imposing costs on the economy while raising little revenue. Distributional concerns are important, but they are not centrally related to the taxation of carried interests. Instead, they arise because of the capital gains preference and, if they are going to be addressed, should be dealt with directly."); see also Fleischer, *supra* note 10, at 5 ("Distributive justice, of course, is also a concern."); House Hearing, *supra* note 1 (Statement of Victor Fleischer), at 7 ("A few professors have been retained by the private equity industry to argue for the status quo; there may be a handful of others who independently support the status quo, but they are few and far between.") .

<sup>40</sup> See Jones, *supra* note 5, at 685 ("Generically, the grant of a carried interest is the promise to pay an uncertain amount in exchange for services. Even proponents admit this much.") .

Revenue Procedure is unambiguously clear – “to [provide] guidance on the treatment of the receipt of a partnership profits interest *for services provided* to or for the benefit of the partnership.”<sup>41</sup> Moreover, the Treasury stated on several occasions, most recently in the 2012 Revenue Proposal, that it deems income received from “profits (carried) interests” as income from the performance of services.<sup>42</sup>

### *1. Historical Perspective on Subchapter K*

When in 1954, a Congressional study was lamenting the inadequacy and confusion of statutory provisions relating to partnership tax law, it noted the following: “[The] confusion is particularly unfortunate in view of the great number of business enterprises and ventures carried on in the partnership form. It should also be noted that the partnership form of organization is much more commonly employed by small businesses and in farming operations than the corporate form.”<sup>43</sup> As a result, the study continued, the principle objectives of Subchapter K would be “simplicity, flexibility, and equity as between the partners.”<sup>44</sup>

Hardly the original drafters of Subchapter K envisioned that present-day alternative investment vehicles would utilize the partnership form to control assets valued by the trillions and do so virtually exclusively for tax purposes.<sup>45</sup> As it now stands, the antiquated framework of Subchapter K applies rather awkwardly to modern finance.

### *2. Historical Perspective on Capital Gains Treatment*

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<sup>41</sup> Rev. Proc. 93-27, 1993-2 C.B. 343 (emphasis added).

<sup>42</sup> See STAFF OF JOINT COMM. ON TAX’N, DESCRIPTION OF THE REVENUE PROVISIONS CONTAINED IN THE PRESIDENT’S FISCAL YEAR 2011 PROPOSAL 385 (Aug. 2010) (JCS-2-10).

<sup>43</sup> H.R. REP. NO. 1337, 83d Cong., 2d Sess. 65 (1954); S. REP. NO. 1622, 83d Cong., 2d sess. 89 (1954).

<sup>44</sup> *Id.*

<sup>45</sup> See, e.g., Curtis J. Burger, *W(h)ither Partnership Taxation*, 47 TAX L. REV. 105, 110 (1991) (“Partnerships of [1954] era were rather simple ventures: the neighborhood hardware store or lumber yard, the law firm or brokerage house, the band of theatrical angels or the oil and gas syndicate. These typified the general and limited partnerships that were familiar to the drafters of subchapter K.”).

Following the passage of the Sixteenth Amendment,<sup>46</sup> Congress, for the most part,<sup>47</sup> consistently awarded some manner of preference to individuals' capital gains rates.<sup>48</sup> As a result, labor income has normally been taxed at higher rates.<sup>49</sup> The general justification for the preferential treatment of capital gains is based on the idea that a lower tax rate will attract *capital investments*, fund entrepreneurial activity, and mitigate, to some extent, inflationary (as opposed to economic) appreciation of capital assets.<sup>50</sup> Another incarnation of the same argument is the prevention of the so-called "lock-in" effect. In other words, a potential tax liability deters taxpayers from selling capital assets, thus stagnating the economy. In *Burnet v. Harmel*,<sup>51</sup> the Supreme Court stated that the policy for the lower capital gains rate is "to relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions."<sup>52</sup>

Over the years, the preferential treatment of capital gains has received a fair amount of criticism, and many have questioned the rationale of lower capital gain rates altogether.<sup>53</sup> In many instances, the support has been advanced retroactively, following the actual introduction of the preference in 1921.

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<sup>46</sup> U.S. CONST. amend. XVI (granting Congress the power to "lay and collect taxes on incomes, from whatever source derived").

<sup>47</sup> From 1913 to 1921, capital gains were taxed at ordinary income rates; The Tax Reform Act of 1986 repealed most of the preferences, raising the maximum rate to 28% and 33% in some instances. Beginning with 1997, The Taxpayer Relief Act of 1997 brought back many of the preferences for capital gains.

<sup>48</sup> See STAFF OF THE JOINT COMMITTEE ON TAXATION, PRESENT LAW AND HISTORICAL OVERVIEW OF THE FEDERAL TAX SYSTEM 57-62, (2010) Committee Print JCX-51-10, (providing the complete list of historical capital gain and ordinary income rates); see also Charles J. Cooper et al., *The Legal Authority of the Department of the Treasury to Promulgate a Regulation Providing for Indexation of Capital Gains*, 12 VIRGINIA TAX REVIEW 631, 637 (1993).

<sup>49</sup> I.R.C. §§1, 61.

<sup>50</sup> See generally David Carris, *Capital Gains Taxation: A Full Circle?* 12 THURGOOD MARSHALL LAW REVIEW 43 (1989) (examining historical treatment of capital gains and the reasons behind the treatment).

The capital gain which results purely from inflation is still taxed even though the gain does not represent any true economic gain. For a discussion on indexation of capital gains for a reflection of true economic, and not inflationary, gain see generally Charles J. Cooper et al., *The Legal Authority of the Department of the Treasury to Promulgate a Regulation Providing for Indexation of Capital Gains*, 12 VA. TAX REV. 631 (1993).

<sup>51</sup> 287 U.S. 103 (1932).

<sup>52</sup> *Id.* at 106 (citing H.R. REP. NO. 350, 67th Cong., 1st Sess. 10 (1921)).

<sup>53</sup> See, e.g., Noel B. Cunningham et al., *The Case of a Capital Gains Preference*, 48 TAX L. REV. 319 (1993).

The Code provides no express definition of a capital asset, but it is generally understood to be investment property.<sup>54</sup> In any event, it is absolutely clear that labor is not a capital asset. Consequently, when an individual is compensated for labor or services, that individual realizes ordinary income and not a capital gain.<sup>55</sup> However, the line between labor and capital is not always clearly drawn because of our tax system's disposition to encourage entrepreneurship. On this frontier lay some of the more difficult cases.<sup>56</sup>

### 3. *Carried Interest: Capital Gain or Ordinary Income?*

#### What is a Capital Asset?

Section 1221 presumes that all assets are capital unless they are excluded by two broad categories of exemptions: assets that are used in a trade or business, such as inventory; and assets that are created through personal efforts of the taxpayer. The text of Section 1221 lists the specific exclusions.

For example, Section 1221 excludes copyrights, literary, musical, or artistic compositions if taxpayer's *personal efforts* created such property. Examination of legislative history reveals that congressional intent in exclusion of these assets was to prevent "amateurs" from selling their "book[s] or other artistic work" after holding them for the statutory period and receiving "long-term capital gain treatment on the product of [their] personal effort."<sup>57</sup> Building on this exclusion through reasonable extrapolation we could then conclude that one distinction between

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<sup>54</sup> *See id.*

<sup>55</sup> I.R.C. § 61(a).

<sup>56</sup> For a summary of arguments for and against capital gains, see Walter J. Blum, *A Handy Summary of the Capital Gains Arguments*, 35 TAXES 247 (1957).

<sup>57</sup> *See* S. REP. NO. 2375, 81st Cong., 2d Sess., at 3097, 3140. *See also Ferrer*, 304 F.2d 125, footnote 5.

capital and non-capital asset is difficult to define but nonetheless clear: Income that results from one's labor ought to be treated as ordinary income and not a capital gain.<sup>58</sup>

But this extrapolation falls apart in Section 1235. There, Congress states “in most contradictory fashion [that] . . . inventions in the hands of the ‘individual whose *efforts* created such property’ *are to be given capital gain treatment.*”<sup>59</sup> In this case, Congress is referring to the treatment of patents rather than copyrights. Conceptual analysis reveals little difference in the creative process of an artist and an architect: Both work and use their skills to create an asset. Yet, upon the disposition of their ultimate creations, the architect's gain from the sale of her patent is capital gain, but the artist's gain from the sale of his painting is ordinary income. Quite a disparate result.

Legislative history indicates that the inconsistency is largely due to “ad hoc reactions to political and economic events.”<sup>60</sup> Such inconsistencies substantially complicate identification of the *general intent* for awarding preferential treatment to capital gains, and confuse the already blurry definition. If this point is taken to the extreme, then determination of the character of the gain must be evaluated on a case-by-case basis, subject to a detailed examination of congressional intent. Clearly, this approach is not reasonable or practicable, and, in most cases – so long as one does not attempt too strenuously to connect *theoretical justification* of capital gains treatment with the *actual characterization* of an asset – the characterization law is reasonably clear and well-settled.

### The Difficulty of Characterization of Carried Interest

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<sup>58</sup> Albeit this is not the only distinction, another one being distinction between business income and capital gain. See I.R.C. 1221; see also Madelyn Shohen Cantor, *Tax Policy: Copyrights and Patents*, 31 VILLANOVA LAW REVIEW 931, 934 (1986).

<sup>59</sup> Cantor, *supra* note 57 (emphasis added).

<sup>60</sup> *Id.* at 989.

The law, however, is not clear or well-settled in those instances where capital assets mix with services, such as for example in carried interest arrangements. The determination of the appropriate theoretical character of a carried interest gain is complicated by several factors, including a lack of clear definition of a capital asset. The critics' assumption that carried interest compensation is axiomatically compensation for services does not reflect the complexity of the issue.

The Joint Committee on Taxation acknowledged this much in a widely cited committee print published in 2007.<sup>61</sup> For example, the Committee provides several appropriate ways to frame the issue of characterization:

[I]t could be said that an investment management business with respect to an investment fund requires the manager to contribute some capital, and the carried interest arrangement is merely a financing by the other investors of the managers' capital investment in the fund. Consequently it would be conceptually appropriate for the manager's income to have the character of capital gain. . . .

On the other hand, it can be argued that such a carried interest arrangement primarily involves the performance of services by individuals whose professional skill generates capital income for investors in the fund.<sup>62</sup>

Consider also an earlier judicial view of the matter: “[A] partner devoting his time and energies to the business of the firm is in fact working for himself and can not be considered an employee of the firm. . . . It follows, therefore, that he can not be paid a salary by the firm out of earnings.”<sup>63</sup> This view is still pervasive today, even though Section 707(a)(1) clearly establishes that a partner may transact with a partnership in a capacity other than a partner.

#### Parallels between Carried Interest and Self-created Assets

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<sup>61</sup> See STAFF OF J. COMM. ON TAXATION, 110<sup>TH</sup> CONG., PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS 33-35 (Comm. Print 2007) [hereinafter J. Comm., Carried Interest].

<sup>62</sup> J. Comm., Carried Interest, at 46.

<sup>63</sup> Tilton v. Commissioner, 8 B.T.A. 914, 917 (1927).

Conceptual criticism of carried interest is generally based on the premise that carried interest is disguised compensation for investment services, which is treated far more favorably than it deserves. There is, however, another way to look at this issue, and that is through comparing taxation of carried interest to taxation of self-created assets.

Taxation of self-created assets is an area where many theoretical issues related to taxation of carried interest come together. Particularly, the issues of timing and character can become more lucid when compared with taxation of self-created assets. I assume in this instance that this comparison is conceptually appropriate. For example, imagine an entrepreneur who starts a business by funding it with loan proceeds. During the next five years the entrepreneur grows the business. He has modest annual earnings on which he pays tax at ordinary rates. However, the majority of the return on his labor comes from the sale of the business, the proceeds of which are treated as a capital gain. In this case, the entrepreneur effectively deferred tax on the self-created asset because he paid no tax on unrealized imputed income;<sup>64</sup> and the character of income, once realized, was a favorable capital gain.<sup>65</sup>

Professor David Weisbach argues that a fund manager can also be viewed as an entrepreneur raising capital to make an investment.<sup>66</sup> He compares a fund manager to an investor who buys stock through a margin account<sup>67</sup> (investor who borrows money from her broker to finance the trade). Investor uses someone else's money and their own "effort and ideas about stock valuations to make money."<sup>68</sup>

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<sup>64</sup> Imputed income has been defined as "a flow of satisfactions from durable goods owned and used by the taxpayer, or from goods and services arising out of the personal exertions of the taxpayer on his own behalf." Marsh, *The Taxation of Imputed Income*, 58 POL. SCI. Q. 514 (1943).

<sup>65</sup> This result is not without its critics. See, e.g., Noël B. Cunningham & Deborah H. Schenk, *How To Tax the House that Jack Built*, 43 TAX L. REV. 447 (1988).

<sup>66</sup> See Weisbach, *supra* note 38, at 717.

<sup>67</sup> See *id.*

<sup>68</sup> *Id.*

The tax-planning strategy where one's labor is invested into a business and the return on labor is not taxed until the ultimate disposition of one's interest in the business is often referred to as sweat equity.<sup>69</sup> Generally, sweat equity is taxed preferentially compared to other labor income. This treatment is rather peculiar because the Code generally frowns upon conversion of labor income into capital gains: Consider, for example, the previously mentioned definition of a capital asset where certain assets created by one's *personal efforts* were not considered capital.<sup>70</sup>

Nonetheless, sweat equity has long been recognized as a real tax subsidy of entrepreneurial activity. To argue that this subsidy is unfairly used by fund managers when it remains available in all other businesses is inconsistent.

On the other hand, Professor Victor Fleischer argues that the comparison of carried interest and self-created assets, at least in the area of income deferral, is not entirely appropriate.<sup>71</sup> He makes the point that administrability concerns, such as accurate measurement of income and access to liquidity, do not apply to fund managers in the manner they apply to entrepreneurs.<sup>72</sup> Therefore, the "privilege not to be taxed on wealth in the form of self-created assets"<sup>73</sup> may not be the best policy when it comes to fund managers.<sup>74</sup>

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<sup>69</sup> See, e.g., James R. Walker, *Sweat Equity Planning Update: "Still Sweating to the Oldies,"* COLORADO LAWYER, June 2004, available on westlaw: 33-JUN COLAW 97.

<sup>70</sup> See also Howard E. Abrams, *Taxation of Carried Interests: The Reform That Did Not Happen*, 40 LOYALA UNIVERSITY CHICAGO LAW JOURNAL 197, 198 (2008), citing Rev. Rul. 2004-10, 2004-2 C.B. 960 ("It is too late in the day to argue that the naked sale of one's labor generates capital gain.").

<sup>71</sup> See Fleischer, *supra* note 10, at 36-37.

<sup>72</sup> See *id.*

<sup>73</sup> See Mark P. Gergen, *Reforming Subchapter K: Compensating Service Partners*, 48 TAX L. REV. 69, 79 (1992) ("Some defend the statutory line [that permits partners to defer income from a profits interest] on the ground that it preserves for partners a privilege they enjoy as individuals. This is the privilege not to be taxed on wealth in the form of self-created assets.").

<sup>74</sup> Professor Fleischer states the following:

Sweat equity is more lightly taxed than other forms of labor income. The entrepreneurial-risk subsidy that results can be justified by administrative concerns and, perhaps, by the widely shared view that entrepreneurship generates positive social externalities. As I discussed in the previous Part, however, the subsidy for entrepreneurship does not stem solely from the capital gains preference. Rather, it also comes from the choice we make to defer tax on the imputed income that accompanies working for oneself--the ability to invest with pretax dollars and not pay tax

Suppose, for example, the following scenario: Manager, acting as a sole proprietor, invests \$1 million of cash into gold bars. One year later, Manager sells the gold for \$2 million and realizes a gain of 100%. The sale proceeds in excess of Manager's basis are treated as a capital gain.<sup>75</sup> Now, to achieve scale, Manager, as entrepreneur, invites Investor to join Manager's fund. In order to buy into his successful fund, Manager charges Investor a fee equal to 20% of the Fund's future profits, but only if the Fund is profitable. Investor gladly agrees because in the absence of Manager, Investor was only able to achieve a 5% return on their money.

Some scholars argue that partners should not be penalized for pooling their labor and capital. Indeed, in this example, there is some difficulty in justifying that the benefit of favorable tax treatment available to Manager prior to his partnering with Investor should be taken away by virtue of conducting business in a partnership form.

#### Mix of Capital and Services

The difficulty of determining the theoretical character of carried interest is further complicated because fund managers usually contribute both services and capital. In a sterile environment, the line between services and capital would be clearly drawn, and the tax system would impose *capital gain rates* on that portion of income which is attributable to *capital* and *ordinary income rates* on the portion attributable to the *performance of services*. The difficulty here is parsing between the two and assigning a reasonable rate of return to capital. For

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until one's investment is sold. Doing away with the capital gains preference for sweat equity, therefore, would not extinguish the entrepreneurial risk subsidy.

Fleisher, *supra* note 10, at 44.

<sup>75</sup> See I.R.C. §§ 1001, 1222.

example, Professor Mark Gergen suggests that when partners contribute capital and labor, the rate of return on labor can be partially masked and difficult to determine.<sup>76</sup>

Consider an easy scenario again using our earlier example of gold bars. In this hypothetical, a \$100 million fund of gold bars doubled in price over a 10-year period. Manager received a total of \$20 million of \$100 million gain as carried interest. We now have to determine which portion of the \$20 million is return on capital and which portion is compensation for services. Here, it seems, we could confidently assign a 100% rate of return to capital (the capital doubled in price). If that's the case, then Manager would appropriately receive \$5 million as a capital gain resulting from doubling of Manager's capital contribution of \$5 million; and the remaining \$15 million would be characterized as income from investment services.

However, not all ventures include scenarios where returns could be clearly apportioned between capital and labor. Some funds invest in assets or companies that may be small and risky. In those cases, the distinction between labor and capital income can be hazy.<sup>77</sup> Additionally, present partnership rules permit uneven allocation of partnership profits so long as the allocations have substantial economic effect. In other words, even in those instances where a rate of return on capital can be ascertained with certainty, partners may have valid business reasons to allocate profits *not* in accordance with partners' capital contributions.

#### Attempting to Separate Returns on Labor and Capital

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<sup>76</sup> See Gergen, *supra* note 72, at 107 (This solution [of allocating all partnership items in accordance with relative balances in partners' capital accounts] is not perfect. One defect is that if both partners contribute capital and labor, returns on labor are masked. The extreme case is where partners contribute equal capital and labor. In this case, all returns would be treated as returns on capital. If all contribute capital and labor, but in unequal portions, returns on labor would be partially masked. There is no good way to deal with these cases. Returns could be apportioned between labor and capital if a reasonable rate of return could be set for capital. Most ventures, however, where all partners contribute labor and capital are small and risky. In these situations, it is difficult to assign a fair rate of return on capital.") (citation omitted).

<sup>77</sup> See *id.*

There have been a number of suggestions on ways to separate returns on labor and returns on capital. In the context of carried interest and the proposed reform, the partnership bar advanced what one commentator describes as “a truly ingenious and wonderfully complex solution that purports to disentangle the separate components of a service provider’s return: a service provider would be taxed on constantly shifting mix of ordinary income from labor and capital from labor converted into earned capital.”<sup>78</sup> Unfortunately, she then goes on to point out, “the existing capital account system is wholly inadequate” to handle this task accurately.<sup>79</sup>

Other commentators have suggested that all investment returns can be separated into three components: risk-free return, risk premium, and a supernormal return.<sup>80</sup> The character of the supernormal portion of the return, they suggest, should be taxed on par with a return to skill or a windfall.<sup>81</sup>

### Summary

Characterization of carried interest as compensation for investment services is not axiomatic. Rather, a carried interest represents a blended return on capital and services. Presently, the entire amount of gain flowing from carried interest is treated as return on capital. The proponents of this treatment compare this result to the treatment of sweat equity and thus suggest that it is appropriate. On the other hand, the critics argue that the comparison to sweat equity is misguided because the main advantage of carried interest is in exploitation of differences in tax rate of the manager and the investors.<sup>82</sup> Yet some suggest that even if

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<sup>78</sup> See Burke, *supra* note 35, at 33.

<sup>79</sup> *Id.*

<sup>80</sup> See David Elkins & Christopher Hanna, *Taxation of Supernormal Returns*, 62 TAX LAWYER 93, 115 (2009).

<sup>81</sup> See *id.* (“With regard to supernormal returns, we believe it should be viewed as a return on the taxpayer’s skill or labor, or in some cases, simply a windfall. It should not be viewed as an element of the return on capital.”).

<sup>82</sup> See Chris Sanchirico, *Taxing Carried Interest: The Problematic Analogy to “Sweat Equity,”* 117 TAX NOTES 239, 244 (2007) (“The tax advantage of carried interest is primarily an exploitation of tax rate differences across taxpayers. The supposedly ubiquitous tax advantage of sweat equity is described as if it were available to a single

comparison to sweat equity is appropriate, present taxation of sweat equity is problematic as a matter of policy.<sup>83</sup>

## **B. Concerns over Fairness**

The problems of characterization, and particularly the present treatment of carried interest as capital gains, also give rise to concerns over fairness.

Fairness is one of the central concerns of any tax system.<sup>84</sup> Although fairness is difficult to define without some measure of subjectivity and personal ethical judgment,<sup>85</sup> carried interest compensation has received virtually universal criticism as being “unfair.” Even if existence of carried interest is proper under the present law, issues surrounding its fairness will likely persist. Professor Howard Abrams contextualized the issues as follows: “Hedge fund and private equity managers make too much money, and it pours salt in the wounds when their tax rate is lower than everyone else’s.”<sup>86</sup>

### *1. Disproportionate Tax Burden*

Tax fairness is generally underpinned by the concepts of horizontal and vertical equity.<sup>87</sup> Horizontal equity requires that persons in similar positions carry similar tax burdens. Vertical equity, on the other hand, raises the issue of progressivity and proportionality of tax rates. A progressive rate is conceptually opposite to a proportional rate. In a progressive rate system, tax liability (as a percentage of income) rises with income; in a proportional system, the tax liability (as a percentage of income) remains constant.<sup>88</sup>

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taxpayer, and is, in fact, largely illusory. Consequently, the tax advantage of carried interest gains no real validity by attempts to associate it with sweat equity.”).

<sup>83</sup> See Victor Fleisher, *Taxing Founders' Stock*, available at <http://ssrn.com/abstract=1718749>.

<sup>84</sup> See JOEL SLEMROD ET AL., *TAXING OURSELVES* 59-60 (4th ed. 2008).

<sup>85</sup> See generally Victor Thuronyi, *The Concept of Income*, 46 *TAX LAW REVIEW* 45 (1990).

<sup>86</sup> Abrams, *supra* note 69, at 198.

<sup>87</sup> See SLEMROD, *supra* note 83, at 58-60.

<sup>88</sup> *Id.* at 60.

For example, the American tax system adopts the progressive approach.<sup>89</sup> That is, the greater one's income, the higher *percentage* of tax one will pay. In a proportional system, the tax rate remains constant for all taxpayers regardless of their income. If we accept then, without departure into the underlying reasons,<sup>90</sup> the premise that progressive rates are fair<sup>91</sup> as implemented by the American tax system, the present tax treatment of carried interest does *not* fit neatly within that system.

Successful fund managers are usually top-bracket taxpayers. In dollar terms, the carried interest received by fund managers is often measured by the millions, and in some instances, even by the billions of dollars.<sup>92</sup> The managers are able to reduce their effective tax rate through favorable tax rates on capital gains and preferred dividends.

Thus, horizontal equity is violated because a hedge fund manager may be in the same pre-tax economic position as a wage-earner, but the manager's effective tax rate will be lower due to the character of the manager's income. Vertical equity is violated because the manager's effective tax rate is below that of a lower-income wage earner.

## 2. Payroll and Self-employment Taxes

Another corollary of classifying carried interest as capitals gains is the exclusion of managers' income from payroll taxes. Employment taxes were authorized by Federal Insurance

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<sup>89</sup> See, e.g., I.R.C. § 1(a), (i).

<sup>90</sup> A debate exists on the fairness of the progressive system of taxation. A departure into this debate would require "taking several steps back" to evaluate the most basic definitions of fairness and justice. Indeed, such departure would be required if we were to reevaluate the fairness of progressive American taxation. In fact, it is my opinion that it would only be proper to reevaluate these principles through a "veil of ignorance" (entirely and objectively disinterested state) as described by John Rawls in *A Theory of Justice*, (Cambridge, Mass.: The Belknap Press of Harvard University Press, 1971), pp. 11-103. Such departure is outside the scope of this paper.

<sup>91</sup> See, e.g., Fleischer, *supra* note 10, at 43 ("Most tax scholars agree that we ought to tax labor income progressively so that the average tax rate rises with income."). See also Joseph Bankman et. al., *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905 1966-67 (1987) (stating that tax literature generally suggests that a fair tax system would implement progressive rates).

<sup>92</sup> See Jacoby *supra* note 3.

Contributions Act<sup>93</sup> and originally included two components: (1) the old age, survivors, and disability insurance (“Social Security tax”); and (2) the Medicare hospital insurance (“Medicare tax”). Employment taxes are calculated on employees’ wages. Self-employed individuals pay an equivalent tax under Self-Employment Contribution Act.<sup>94</sup>

Usually, the self-employment tax rate is 15.3%.<sup>95</sup> The Social Security portion of the tax (12.4%) is only applied against the first \$106,800 of one’s earnings.<sup>96</sup> The Medicare tax (2.9%) does not have a comparable ceiling. The payroll/self-employment taxes are a major source of revenue for the federal budget. In 2009, payroll taxes amounted to 42.3% of total federal revenues.<sup>97</sup> The share of the individual income tax for the same year was 43.5%.

Fund managers are generally subject to self-employment taxes on income derived from self-employment, e.g., managing the investment fund. However, managers are usually able to avoid a very substantial portion of the self-employment tax. First, the managers’ distributive share of partnership’s income that includes interest, dividends, and capital gains is not subject to self-employment tax.<sup>98</sup>

Second, the managers rely on the limited partnership exception contained in Section 1402(a)(13) to minimize self-employment taxes on the 2% of the management fee. The structure is as follows:

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<sup>93</sup> I.R.C. §§ 3101 - 3128.

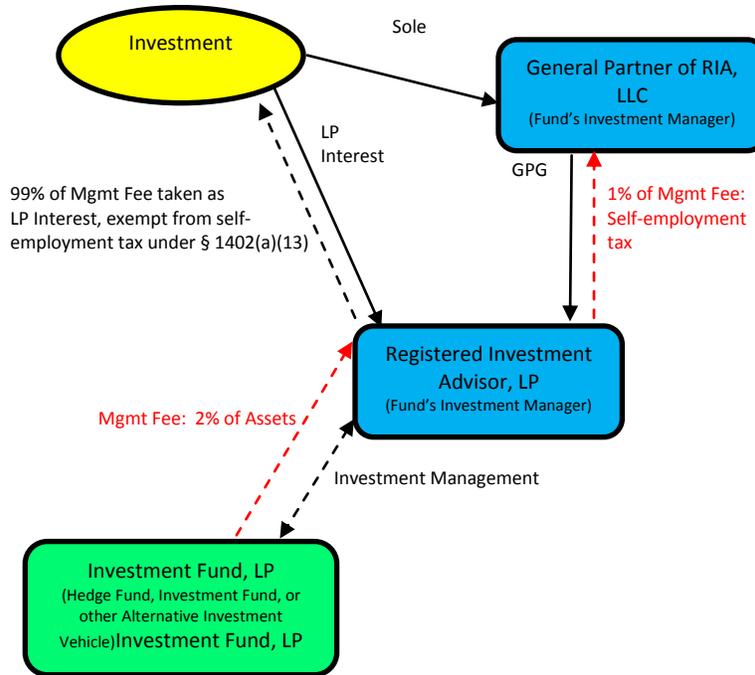
<sup>94</sup> I.R.C. §§ 1401 - 1403.

<sup>95</sup> It is reduced to 13.3% in 2011.

<sup>96</sup> Old age, survivors, and disability insurance tax is applied only against the wage base, \$106,800, in 2010. The hospital insurance tax does not have a maximum wage limit.

<sup>97</sup> The tax proceeds are then distributed into three separate trust funds: Old Age, Survivor Fund; Disability Insurance Fund; Hospital Insurance Fund.

<sup>98</sup> See I.R.C. § 1402(a)(2), (3), (13).



Recently, a somewhat similar, but distinguishable structure has been disallowed by the Tax Court in *Renkemeyer v. Commissioner*.<sup>99</sup>

### 3. Conversion of Management Fee into Capital Gain

In addition to avoiding a substantial portion of self-employment taxes on what may otherwise be compensation for management services, managers can also forego some or all of the management fee in return for a greater portion of carried interest.

### 4. Inconsistency with Treatment of Executive Compensation

<sup>99</sup> *Renkemeyer v. Commissioner*, 136 T.C. 7 (February 9, 2011).

“In *Renkemeyer*, the individuals were partners in a limited liability partnership. Unlike a limited partnership which requires at least one general partner with unlimited liability, in a limited liability partnership there is no general partner and none of the partners have unlimited liability. The Tax Court in *Renkemeyer* effectively held that none of the individual partners were “limited partners” within the meaning of section 1402(a)(13) because they actively participated in the partnership’s business of providing legal services. The position often taken by the individual investment professionals in a hedge fund is technically distinguishable from the facts in *Renkemeyer*. The investment professionals are 99% limited partners in a limited partnership that has a general partner and it would be the general partner that actively participates. However, the Tax Court in *Renkemeyer* was clearly influenced by the fact that the partners’ distributive share of income did not arise as a return on the partners’ investment but arose from the legal services they performed and was inclined to look through to the substance of the arrangement. Were the IRS to challenge the position taken by hedge fund investment professionals, surely it would cite to the *Renkemeyer* case to contend that the income earned by the investment professionals was really compensation for their investment management services.” Miller, *supra* note 14, at note 302.

Section 83 provides the general rule that property received in connection with the performance of services is included in gross income and is treated as ordinary income.<sup>100</sup> Inasmuch as carried interest is compensation for the performance of services, the tax treatment of carried interest is inconsistent with the general framework of Section 83. As a result, the executives of the largest U.S. companies are an unlikely group with a complaint against the fairness of the present treatment of carried interest. Recently, it has become quite common to scrutinize executive pay at many public companies. This trend accelerated following 2008 because a great number of companies receiving government funds continued to compensate their executives lavishly.<sup>101</sup> The Obama administration even appointed a “pay czar” to oversee and vet executive compensation at the companies receiving government aid.<sup>102</sup>

Some argue, however, that the government and the pay czar are missing the *real* compensation problem in the private investment industry. Indeed, the pay of the executives at the country’s top companies may be large, but it pales in comparison to compensation of many of the funds’ managers.<sup>103</sup> In addition, corporate executive usually pay tax at higher effective tax rates than fund managers.

The difference in tax rate is underscored by the character of the received income. On the one hand, fund managers reduce their tax rate by receiving capital gains and preferred dividends, as well as by avoiding the Medicare and Social Security taxes, whereas the executives are not able to minimize their tax rate in this manner. An unintended consequence of this disparity is

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<sup>100</sup> See I.R.C. § 83; Joint Committee, *Carried Interest*, at 8.

<sup>101</sup> See generally Stas Getmanenko, *Executive Compensation: The Law and Incentives*, 11 WAKE FOREST JN. OF BUS. L. & INTEL.PROP. 81 (2010) (describing recent executive compensation trends in detail).

<sup>102</sup> See Deborah Solomon, *White House Set to Appoint a Pay Czar*, WALL ST. J., June 5, 2009, at A2.

<sup>103</sup> See *id.*

what some industry experts have described as a “brain-drain” from public financial firms to private investment funds.<sup>104</sup>

The area of the greatest overlap in the treatment of executives and fund managers is that of Incentive Stock Options (“ISOs”).<sup>105</sup> And even there, the overlap is minimal.

An incentive stock option is an option that is granted to an “individual for any reason connected with his employment by a corporation.”<sup>106</sup> Section 422 describes these options in greater detail and imposes several limitations. The ISOs are generally considered among the most favorable types of executive compensation because an individual is not taxed on the exercise of the option but rather on the eventual disposition of the asset (usually stock). And then, if the holding period is satisfied, any gain from the sale of ISO stock is treated as a long-term capital gain.

In economic terms, the treatment of ISOs is very similar to carried interest: non-taxable on receipt and favorably characterized on disposition. One important difference however is in the amount of tax subsidy an executive receives in comparison with the fund manager. The favorable treatment of ISOs is limited to \$100,000 of stock in a year.<sup>107</sup> Carried interest, on the other hand, is not subject to any comparable limitation.

##### *5. Conversion of Ordinary Income into Capital Gain and Deferral*

Ever since the Revenue Act of 1921, with the exception of years 1987 to 1990, the preferential treatment of capital gains has given taxpayers a powerful incentive to convert

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<sup>104</sup> Stephen M. Salley, *Fixing Executive Compensation*, 70 OHIO ST. L.J. 757, 766 (2009); Mark Maremont and Joann S. Lublin, *Limits on Pay Left Unclear in New Law*, WALL ST. J., Feb. 18, 2009, at A4.

<sup>105</sup> See Fleischer, *supra* note 10, at 25; Adam Lawton (note), *Taxing Private Equity Carried Interest Using an Incentive Stock Option Analogy*, note, 121 HARV. L. REV. 846 (2008).

<sup>106</sup> I.R.C. § 422(b).

<sup>107</sup> See I.R.C. § 422(d).

ordinary income into capital gains.<sup>108</sup> This conversion is generally frowned upon by the Code, and various provisions attempt to prevent gamesmanship.<sup>109</sup> I have discussed above some of the theoretical shortcomings in classifying carried interest as a capital gain or a qualified dividend. Assuming those shortcomings are true, this is one area where the Code, arguably, fails to prevent capital gains gamesmanship.

Additionally, fund managers, and more broadly, service partners who receive profits interests are able to defer income from the performance of services into the future.<sup>110</sup> For instance, a manager of a private equity fund may labor for a number of years before the portfolio companies are liquidated, by the manager's income will be lumped together and taxed at a later time.

#### **PART IV: POTENTIAL LEGISLATION**

To date, there have been several proposals calling for a reform of the present treatment of carried interest. Naturally, each of the proposals has its own peculiarities, but, as a general matter, all are designed to take away the benefit that comes from classifying managers' compensation as long-term capital gains or qualified dividends, and to reclassify all or portion of the compensation as ordinary income as well as to impose a self-employment tax on any reclassified amounts. So far, none of the proposals have succeeded; however, the regularity with which carried interest are mentioned likely foreshadows a change at some time in the future.

#### **A. Legislative Proposals**

##### *1. 2007 Proposals*

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<sup>108</sup> See STAFF OF JOINT COMMITTEE ON TAXATION, PRESENT LAW AND HISTORICAL OVERVIEW OF THE FEDERAL TAX SYSTEM 57 (Joint Comm. Print 1955).

<sup>109</sup> See BITTKER & LOKKEN: FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶46.1 (Thomson Reuters/WG&L, 2d/3d ed. 1993-2003, updated February 2011 and visited on Mar 16, 2011).

<sup>110</sup> See Gergen, *supra* note 72, at 74.

In 2007, there were two bills dealing with carried interest that originated in the House of Representatives. On June 22<sup>nd</sup>, H.R. 2834 was introduced<sup>111</sup> by Congressman Sander M. Levin (D-Michigan), and on October 30<sup>th</sup>, H.R. 3996 was introduced<sup>112</sup> by Congressman Charles B. Rangel (D-New York), Chairman of the House Committee on Ways and Means. Although H.R. 3996 eventually passed Congress and was signed into law, at that point, it remained without any of the pertinent provisions relating to carried interest. Representative Rangel also introduced a comprehensive tax reform bill (H.R. 3970) on October 25<sup>th</sup>. That bill proposed an inclusion of Section 710 in the Internal Revenue Code.<sup>113</sup> The proposed Section 710 would reform the treatment of carried interest.

In a nut shell, the bills proposed to tax as ordinary and subject to self-employment tax that portion of a manager's share of partnership income that is attributable to the manager's performance of services.

More specifically, the bills introduced the concept of "investment services partnership interest,"<sup>114</sup> ("ISPI") which was defined as any interest in a partnership which is held by any person if such person provides (directly or indirectly), in the active conduct of a trade or business, a substantial quantity of any of the following services to the partnership:

- advising as to the value of any specified asset;
- advising as the advisability of investing in, purchasing, or selling any specified asset;
- managing, acquiring, or disposing of any specified asset;
- arranging financing with respect to acquiring specified assets;
- any activity in support of these services.<sup>115</sup>

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<sup>111</sup> H.R. 2834, 110th Cong. (2007)

<sup>112</sup> H.R. 3996, 110th Cong. (2007) (eventually becoming Public Law No: 110-166, but without the pertinent carried interest provisions).

<sup>113</sup> Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong. § 710 (2007).

<sup>114</sup> H.R. 3970 § 710(c).

<sup>115</sup> *Id.*

Any net income with respect to ISPI, would be treated as ordinary income, subject to self-employment tax.<sup>116</sup> Similarly, any gain on the disposition of an investment services partnership interest would also be treated as ordinary income and not a capital gain.<sup>117</sup>

An *exception* is made for *capital interests*.<sup>118</sup> Capital interest is defined as that portion of the ISPI that is acquired through contribution of “invested capital,” whether money or other property. A “reasonable allocation” of income with respect to manager’s “invested capital” will not be reclassified as ordinary income, where applicable.<sup>119</sup>

An allocation will *not* be treated as reasonable if such allocation would result in the partnership allocating a greater portion of income to invested capital than any other partner who is not providing services would have been allocated with respect to the same amount of invested capital.<sup>120</sup>

Additionally, proposed Section 710 would subject income allocated to ISPI to Social Security and Medicare taxes under Section 1402(a).<sup>121</sup>

## 2. 2008 Proposal

On June 17, 2008, Representative Rangel again introduced a proposal that would alter the present treatment of carried interest.<sup>122</sup> This proposal was substantially similar to the proposed 2007 legislation; however, it differed in one important respect.

The 2008 bill proposed that loan proceeds to service partners from other partners could *not* be used to capitalize the service partners’ share of partnership capital. In other words, this

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<sup>116</sup> H.R. 3970 § 710(a).

<sup>117</sup> H.R. 3970 § 710(b).

<sup>118</sup> H.R. 3970 §710(c)(2).

<sup>119</sup> *Id.*

<sup>120</sup> *Id.*

<sup>121</sup> H.R. 3970 § 710(a)(a)(A).

<sup>122</sup> H.R. 6275 § 201, 110th Cong. (2008).

provision foresaw fund managers borrowing money from fund investors in order to acquire a capital interest in the partnership and thus avoid ISPI.

The provision was drafted as follows: “an investment services partnership interest shall not be treated as acquired on account of a contribution of invested capital to the extent that such capital is attributable to the proceeds of any loan or other advance made or guaranteed, directly or indirectly, by any partner or the partnership.” This provision is of substantial importance and is discussed in greater detail *infra*.

### 3. 2009 Proposal

On April 2, 2009, Representative Levin re-introduced legislation intended to reform the treatment of carried interests.<sup>123</sup> This proposal built on the previous two. There was, however, one noteworthy addition.

The 2009 bill proposed to amend Section 83 to make possible an 83(b) election with respect to a partnership interest transferred in connection with performance of services. The valuation of the interest will be “equal to the amount of the distribution which the partner would receive if the partnership sold (at the time of the transfer) all of its assets at fair market value and distributed the proceeds of such sale (reduced by the liabilities of the partnership) to its partners in liquidation of the partnership.”<sup>124</sup>

In concert to the amendment to Section 83, the bill also permitted any capital interest acquired by the service provider under the revised Section 83 to be classified as a “qualified capital interest” under the proposed Section 710. Any distributive share of income properly arising from qualified capital interest (interest from contribution of money or property, or from

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<sup>123</sup> H.R. 1935, 111th Cong. (2009).

<sup>124</sup> *Id.* §1.

previously taxed income arising from 83(b) election) would not be reclassified under the proposed Section 710.

In essence, a *qualified capital interest* would be capital interest resulting from the contribution of previously taxed money, property, or services. Capital interest that is attributable to proceeds of a loan or other similar advance made or guaranteed by another partner in the partnership would be considered a *disqualified capital interest*.

The allocation restrictions would then be as follows: In the case of a qualified capital interest, all items of income, gain, loss, and deduction which are allocated to such qualified capital interest shall *not* be reclassified if

- (i) allocations of items are made by the partnership to such qualified capital interest in the same manner as such allocations are made to other qualified capital interests held by partners who do not provide any services described in paragraph (1) and who are not related to the partner holding the qualified capital interest, *and*
- (ii) the allocations made to such other interests are significant compared to the allocations made to such qualified capital interest.<sup>125</sup>

#### 4. 2010 Proposals

Carried interest resurfaced again in 2010 as part of the proposed *American Jobs and Closing Tax Loopholes Act of 2010*.<sup>126</sup> The 2010 edition included a good amount of new detail. For instance, a special rule for dividends was introduced. It stated: “Any dividend taken into account in determining net income or net loss for purposes of [classifying managers’ net income as ordinary] shall not be treated as qualified dividend income for purposes of section 1(h).”<sup>127</sup> The provision thus made clear that the preferential dividend rate also would not be available to

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<sup>125</sup> *Id.*

<sup>126</sup> H.R. 4213.EAH, 111th Cong. (2010).

<sup>127</sup> *Id.* § 411.

managers so long as the dividend flowed through to the manager in connection with a profits interest.

There was also a number of novel amendments, including an amendment introduced by Senate Finance Committee Chair Max Baucus, that would tax carried interest allocations at a “blended rate.”<sup>128</sup> That is, an “applicable percentage”, e.g., 75% of the net income from ISPI, would be taxed as compensation income at ordinary rates and be subject to self-employment tax, and the remaining 25% attributable to ISPI would be taxed as under the present law – any gain would retain its taxable character. Any income attributable to a qualified capital interest (capital interest acquired with after-tax money or property), as with the previous proposals, would not be recharacterized.

Several different ratios for applicable percentage were proposed. The House bill provided that prior to January 1, 2013, the percentages would be 50%/50%, and for the years beginning January 1, 2013, 75% of ISPI income would be recharacterized. The Senate amendment also proposed 50%/50% until 2013, but reduced the rate following 2013 to 65%.<sup>129</sup>

## **B. Obama Administration Revenue Proposals**

The Obama administration in revenue proposals for fiscal years 2010, 2011, and 2012 also proposed that treatment of carried interest should be changed. The proposals were very much along the lines of the legislative proposals discussed above.

As reasons for change, the revenue proposals cited, as a foregone conclusion, that income allocable to profits interest is received in connection with the performance of services. As a result, the proposals suggest, income attributable to a carried interest should be taxed (1) as ordinary income and (2) be subject to self-employment taxes.

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<sup>128</sup> “Blended rate” is a phrase used in Miller, *supra* note 14.

<sup>129</sup> Senate Amendment 4301 to H.R. 4213, 111th Cong. (2010).

The administration described the present system as including “an unfair and inefficient tax preference,” which permitted some of the “highest-income Americans” to benefit from the preferential treatment.<sup>130</sup>

### **C. Criticism of the Proposed Section 710**

Although the desire to reform taxation of carried interest is widespread virtually everywhere but within the private investment industry, the proposed Section 710 has not received universal support. Professor Howard Abrams has become one vocal critic of the proposed provisions. He wrote: “Will proposed section 710 become law? I don’t think so: it has too many technical flaws and too few conceptual underpinnings.”<sup>131</sup> Professor Abrams’ criticism is focused on two areas: First, he argues, it is inappropriate to tax carried interest as compensation for income without regard to partnership’s underlying activities. Second, the technical provisions of Section 710 are flawed because their reach went far beyond hedge funds and private equity funds.<sup>132</sup> Similar criticism has also been voiced by others.<sup>133</sup>

### **D. Outlook for Reform**

In October of 2010, there was a great deal of uncertainty on many of the tax provisions that were to become effective starting January of 2011. The Bush tax cuts were expiring, and no decision was yet made. Inability to know the law as it would be two months from then was frustrating to many tax practitioners, and especially to those practicing estate planning. At this time, I was fortunate to attend several events where Thomas A. Barthold, Chief of Staff of the

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<sup>130</sup> General Explanations of the Administration’s Fiscal Year 2012 Revenue Proposals, Department of the Treasury (February 2011), at 61.

<sup>131</sup> Howard Abrams, *Carried Interests: The Past is Prologue*, Emory University School of Law Research Paper No. 08-32, available at <http://ssrn.com/abstract=1085582>.

<sup>132</sup> *Id.* at 214-227.

<sup>133</sup> Bradford D. Whitehurst, UPDATE ON CARRIED INTEREST LEGISLATION (VCEXPERTS, Newsletter of Bingham McCutchen LLP), 2010.

Joint Committee on Taxation, was presenting. One estate planning practitioner asked Barthold whether he had any “gut feeling” on the estate tax in 2011. “No,” was Barthold’s simple reply.

Indeed, predicting legislature is an ungrateful task, and, nobody can foresee the future. All the same, carried interest reform—unmentioned before 2008—has become a regular point of tax conversation. The House, on several occasions, passed bills that would have changed the present treatment, but the reform then stalled in Senate. Perhaps, the “blended” approach from the previous legislative session may be the compromise that ushers in change. Or it might not. Certainly, the increasing budget deficits stack the odds further in favor of reform. The lobby behind carried interest does have deep pockets, but it does not necessarily have a broad constituent base, which makes the reform politically palatable. In any event, it is not inconceivable that a reform does occur. But will it be effective? How will the industry respond to change? The following section attempts to answer this question.

#### **PART V: POTENTIAL RESPONSES TO CARRIED INTEREST REFORM**

The previous Part revealed two main points of emphasis for the proposed reform. First, it would tax carried interest as ordinary income. Second, it would make carried interest subject to self-employment tax. The result could certainly increase the effective tax rate paid by fund managers. The increase could be rather substantial, both in percentage and dollar terms. The incentive to avoid the increase would also be high.

Whether the new tax would have behavior modifying consequences on the industry remains to be seen. Additionally, it is unclear who would ultimately bear the tax burden. In any event, the response would doubtfully be universal, at least in the short run. For some investment vehicles, such as, for example, hedge funds that derive little long-term capital gains due to trading strategies, the change may amount to an imposition of self-employment tax, which managers are often able to avoid through the limited partnership exemption of Section 1402(a)(13). On the other hand, private equity

funds would be more severely affected because the bulk of their income is, in fact, characterized as a long-term capital gain. If the present fund structure persists after the reform, the effective tax rate for private equity managers will likely jump by more than 20 percentage points.

Perhaps, there are even greater changes on the horizon. Certainly doubtful, but revisions of the present system of capital gains taxation may be in store as they were in 1986. They may take away or limit the significant preference long-term capital gains and qualified dividends receive in today's regime. If that is the case, Section 710 may be reduced to an imposition of self-employment tax.

In any event, in this Part, I attempt<sup>134</sup> to foresee some of the consequences arising from the adoption of Section 710, as it is presently drafted, for the industry as a whole. I also review some of the alternative compensation arrangements that may emerge in response.

#### **A. Consequences for the Industry as a Whole**

The appetite for alternative investment structures has been growing steadily over time and was not put out by the 2008 financial crisis.<sup>135</sup> By most conservative estimates, the hedge fund and private equity industries control between 4 and 5 trillion dollars globally.<sup>136</sup>

Recently, money has continued to flow into the alternative investment space.<sup>137</sup> For instance, hedge funds experienced an inflow of capital in every month of 2010 but one.<sup>138</sup> Much of the new capital is coming from institutional investors, such as university endowments and pension funds,

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<sup>134</sup> My attempt comes with a broad disclaimer, which I borrow from experienced practitioners: "Organizing a private equity fund to accommodate the differing interests of different types of fund investors and the different types of investments that may be made by the fund requires the fund's tax advisor to have an understanding of virtually every part of the Internal Revenue Code." See James H. Lokey & Donald E. Rocap, *Selected Tax Issues in Structuring Private Equity Funds*, PRACTICING LAW INSTITUTE (2008), available on Westlaw as 841 PLI/Tax 741.

<sup>135</sup> See DAVID. F. SWENSEN, PIONEERING PORTFOLIO MANAGEMENT: AN UNCONVENTIONAL APPROACH TO INSTITUTIONAL INVESTMENT 128-31 (2000).

<sup>136</sup> See *infra* notes 138-141.

<sup>137</sup> Sveya Herbst-Bayliss, *Hedge Funds Kept Taking in Money at End-2010*, REUTERS, <http://www.reuters.com/article/2011/01/11/uk-hedgefunds-flows-idUSLNE70A01L20110111> (Jan 11, 2011) (estimating November 2010 inflows at \$10.4 billion and hedge fund industry as a whole at \$1.3 trillion; June was the only month in 2010 with outflows.).

<sup>138</sup> *Id.*

which recently experienced significant funding deficits.<sup>139</sup> The trend of institutional financing appears only to be accelerating at the beginning of 2011.<sup>140</sup>

One study estimates that the bulk of the hedge fund money is now made up from institutional investors who increasingly view hedge funds and private equity funds as run-of-the-mill investments.<sup>141</sup> This trend is important and is discussed below. With the inflow of money, the total fees also continue to climb. In 2001, the combined income of the top 25 hedge fund managers was less than \$5 billion. In 2011, the same group earned more than \$22.07 billion.<sup>142</sup>

Despite the mammoth amounts of money earned by fund managers, funds' clients are still the ones with all the trump cards. It is precisely clients' money that enable fund managers to make their returns. For this reason, I doubt that fund managers will be successful in shifting the burden of the proposed tax onto the clients. Any proposed structural response would have to favor clients' interest first and managers' interest second.

To suppose that an increase in tax on fund managers will fundamentally alter the flow of money into the private investment industry is probably unrealistic. There will always be plenty of people who wish to manage large sums of money even if that means they have to pay a higher tax on their income. Hedge funds and private equity funds will continue to exist as long as they are able to generate wealth. Nevertheless, the structure and the composition of certain funds may change: To suppose that fund managers do not attempt to avoid the new tax is equally unrealistic. All the same, presently, there are no other tax-efficient alternatives to carried interest that exist without some type of limitations. The previously discussed Incentive Stock Options present the closest comparison, but

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<sup>139</sup> See *Pensions Pour \$18 billion into Hedge Funds*, FINALTERNATIVES, <http://www.finalalternatives.com/node/16169> (April 4, 2011); *Pensions to Increase Direct Allocation to Hedge Funds in 2011*, FINALTERNATIVES, <http://www.finalalternatives.com/node/16145> (April 1, 2011).

<sup>140</sup> See *id.*

<sup>141</sup> This study estimates that institutional investors make up 61% of hedge fund capital. See *Survey: Institutional Investors Account for Bulk of Hedge Fund Capital*, FINALTERNATIVES, <http://www.finalalternatives.com/node/15512> (February 10, 2011).

<sup>142</sup> See *Paulson Earns Almost \$5B in 2010, To 25 Hedgies Taken in \$22B*, FINALTERNATIVES, <http://www.finalalternatives.com/node/16161> (Apr. 1, 2011).

it is limited to \$100,000 a year. Therefore, if a reform is successful—that is, if the Treasury succeeds in raising any money—the returns somewhere in the industry will be trimmed.

## **B. Potential Structural Responses**

A few years ago, Professor Victor Fleischer in his well-read piece “Two and Twenty: Taxing Partnership Profits in Private Equity Funds”<sup>143</sup> made the following accurate observation: “To be sure, it is difficult to predict whether and how some fund managers might choose to restructure their affairs in response to a change in the tax law.”<sup>144</sup> This observation certainly remains true today. Nevertheless, several hypotheses have been advanced previously in the literature.<sup>145</sup> I compile a digest of them below and advance some other ones.

### *1. Loans to Finance Managers’ Capital Interest*

Loans from limited partners to managers would have been quite an easy solution to the original reform proposal.<sup>146</sup> Indeed, instead of making a special allocation, the fund would distribute income in proportion to the partners’ capital interests so as to fit within the “straight-up” exception of the proposed Section 710. In this case, the general partner instead of contributing a nominal or a small amount would contribute 20 percent of the fund’s initial capital, thus entitling him to 20 percent of partnership profits. The manager’s capital share, however, would be financed by the limited partners through a nonrecourse loan secured by the manager’s interest in the partnership. The manager would receive a fee from the partnership equal to the amount of the interest and use that fee

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<sup>143</sup> 83 N.Y.U. L. REV 1 (2008).

<sup>144</sup> *Id.* at 38.

<sup>145</sup> I rely primarily on the following: Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1 (2008); Michael S. Knoll, *The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of taxing Profits Interests as Ordinary Income*, 50 WILLIAM AND MARY LAW REVIEW 115 (2008); David A. Weisbach, *The Taxation of Carried Interest in Private Equity*, 94 VIRGINIA LAW REVIEW 715 (2008); Howard Abrams, *Taxation of Carried Interest*, 116 TAX NOTES 183 (2007); Karen C. Burke, *The Sound and Fury of Carried Interest Reform*, 1 COLUMBIA JOURNAL OF TAX LAW 1 (2010).

<sup>146</sup> The loan alternative was derived from Victor Fleischer’s alternative suggestions for reform of carried interest. See Fleischer, *supra* note 144, at 52 (Fleischer proposed to tax managers at ordinary rates on imputed value of interest. He referred to this method as the cost-of-capital method). It was also discussed by Howard Abrams in *Taxation of Carried Interest*, 116 TAX NOTES 183, 186 (2007)

to pay the interest on the loan. On the partnership side, the fee expense would be deductible<sup>147</sup> and would offset the interest income received by the limited partners thereby, in economic terms, making this structure equivalent to the present one.

This approach is not without its problems for several reasons. First, the proposed Section 710 prohibits such loans from limited partners and parties related to them. It remains to be seen if some independent source of financing will become available to the managers. Second, there would be some uncertainty as to whether limited partners would be willing to engage in such transactions.<sup>148</sup> Third—the reason previously unexplored—is a potential for implication of manager’s fiduciary obligations under the framework of present securities laws. Assuming, however, that the proposed Section 710 is adopted with the loan prohibition (and if it is adopted, it is more than likely that it would contain such a prohibition), this analysis would be entirely unnecessary.

## 2. *Conversion of Limited Partners into Creditors*

Another potential structure<sup>149</sup> would include forsaking the traditional limited partnership in favor of some other single-member entity that would be comprised solely of the manager. To finance its operations, this entity would borrow money from the investors (creditors). Loans could be secured by portfolio companies or securities which are later acquired. The entity would then proceed with the investment activity and upon liquidation would return the borrowed funds to its creditors and also pay them interest equal to 80 percent of the entity’s profits. In the event of a private equity fund, the manager could, for example, form an LLC and pay himself a reasonable salary during the years of operations (compare to a management fee). The remainder of the manager’s income would

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<sup>147</sup> However, the deduction may be worthless to many, if not most, fund investors, e.g., U.S. tax-exempt entities that invest through foreign blocker corporations. *See infra*.

<sup>148</sup> *See, e.g.,* Michael S. Knoll, *The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of taxing Profits Interests as Ordinary Income*, 50 WILLIAM AND MARY LAW REVIEW 115, 150-51 (2008) (“The reason that the transaction is problematic is that the loan is not at a market interest rate.”)

<sup>149</sup> This structure was originally proposed by David Weisbach, *supra* note 144, at 760-62, and discussed by Michael Knoll, *supra* note 144, at 152-53.

come from the sale of the portfolio companies and would be characterized as a capital gain. Manager would thus benefit from the entrepreneurial subsidy (sweat equity) previously discussed.

The obvious drawback of this structure is the unfavorable treatment of interest income to those creditors who pay tax. Instead of a long-term capital gain distributed to investors, creditors would receive ordinary interest income. However, untaxed investors would remain substantially unaffected.<sup>150</sup> Because corporate taxpayers do not receive capital gains preference, they would remain similarly indifferent. Additional detail is provided below.

#### Tax-exempt Entities, Unrelated Business Taxable Income, and Foreign Blocker Corporations

It is necessary, at this time, to depart, at least briefly, from the simplistic “plain vanilla” fund structure assumed throughout this paper to discuss several of the issues pertinent to U.S. tax-exempt and foreign investors. U.S. tax-exempt entities, such as pension funds and universities, are not taxed on income earned from tax-exempt activities.<sup>151</sup> However, they are taxed on “unrelated business taxable income” (“UBTI”).<sup>152</sup> UBTI can arise in one of two ways. First, the tax-exempt entity engages in business activities that are not related to its tax-exempt status.<sup>153</sup> Second, the tax-exempt entity uses leverage to receive gain from a debt-financed investment.<sup>154</sup> When non-profits invest into hedge funds directly, such investment generally give rise to UBTI under both of these scenarios.

To avoid UBTI, U.S. tax-exempt entities typically set up a foreign “blocker” corporation, which then becomes a limited partner in a foreign “feeder” fund, which then invests in a “master” fund.<sup>155</sup> The master fund can be organized either onshore or offshore, but, in any case, will usually be a partnership for U.S. tax purposes.

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<sup>150</sup> See *infra* for discussion on Unrelated Business Taxable Income.

<sup>151</sup> See I.R.C. § 501.

<sup>152</sup> See I.R.C. §§ 511(a)(1); Treas. Reg. 1.511-1. See also I.R.C. §§ 512, 513.

<sup>153</sup> See I.R.C. §§ 512(a); 513(a).

<sup>154</sup> See I.R.C. § 514(c).

<sup>155</sup> This is only one possible scenario. There are many other fund structure alternatives. See Miller, *supra* note 14, at 2-8.

Because the blocker corporation becomes a limited partner in a tiered pass-through structure, it will often receive U.S. source income from underlying fund investments. Assuming the blocker corporation does not engage in a U.S. trade or business, it will generally be subject to a 30% US withholding tax on its U.S. source income, unless an exception applies.<sup>156</sup> In fact, in many instances various exceptions do apply to reduce the 30% withholding rate. These exceptions include “portfolio interest,”<sup>157</sup> capital gains not attributable to U.S. real estate,<sup>158</sup> as well as reductions for various types of income under any applicable tax treaty.<sup>159</sup> Therefore, a foreign blocker corporation will usually pay a lower effective tax rate than a U.S. tax exempt entity if it were to invest directly into a hedge fund. In the event of direct investment a U.S. tax-exempt entity would generate UBTI, and as a result, would be taxed on it at the usual corporate rate.<sup>160</sup> By utilizing the foreign blocker, any income from a foreign blocker corporation is instead considered a dividend or Subpart F income to the U.S. tax-exempt.<sup>161</sup>

However, the blocker corporation may not always be necessary in certain instances because some types of income are treated as sufficiently passive, and not as UBTI. This passive income usually includes interest.<sup>162</sup>

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<sup>156</sup> See I.R.C. § 881.

<sup>157</sup> See I.R.C. §§ 871(h), 881(c).

<sup>158</sup> See I.R.C. § 865.

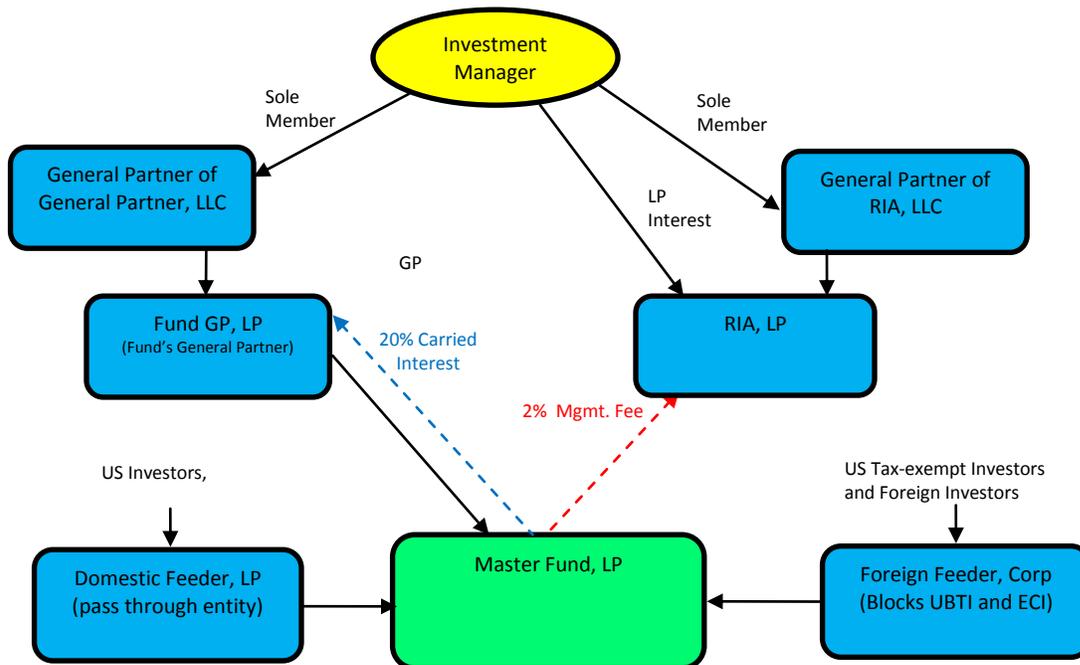
<sup>159</sup> Although, Cayman Islands, the home to many hedge funds, does not have a tax treaty with United States.

<sup>160</sup> See I.R.C. § 511(a)(1); Treas. Reg. 1.511-1.

<sup>161</sup> See Miller, *supra* note 14, at footnote 77.

<sup>162</sup> See I.R.C. § 512(b); Treas. Reg. 1.512-1.

Chart 3: *Master-feeder Fund*



Now, consider one alternative hedge fund structure employing the principles described above: A U.S. nonprofit could simply loan the money to an investment firm, secure it with the future investments with an option to demand repayment at any time (so as to assure liquidity), and classify any of the received income as “passive investment income” under Section 512(b). It is worth noting that a carried interest reform does not have to take place in order for some U.S. tax-exempt entity to attempt this structure.<sup>163</sup>

The important question is whether the designation of “creditor” will be respected. One commentator points out that in corporate jurisprudence there is a “long, confused, and, at times, contentions history of attempting to separate debt from equity.”<sup>164</sup> It will remain to be seen whether this structure will invoke similar scrutiny.

Foreign Investors, U.S. Blocker Corporations

<sup>163</sup> As an aside, because many U.S. tax exempts usually have a worthy social policy behind their tax-exempt status (retirement security, education, etc.), there have been some legislative proposals that would relax UBTI rules. Until then, however, U.S. tax-exempt investors will have to be mindful of UBTI rules.

<sup>164</sup> See Knoll, *supra* note 144, at 153.

Usually, foreign investors also invest through a blocker corporation so as to avoid U.S. source income that is “effectively connected” (“ECI”) with a U.S. trade or business.<sup>165</sup> The effective tax rate on repatriated ECI can at times reach 54.5%, not including state and local taxes. For this reason, foreign investors will usually invest through a foreign blocker corporation (feeder fund) that becomes a limited partner in the master fund. The master fund then serves as the primary investment vehicle. The blocker corporation thus does not engage in any business activities within the U.S. that could give rise to ECI. Usually, the foreign investors will invest alongside U.S. tax-exempt entities in the foreign blocker corporation as illustrated in the previous chart.

### *3. Transferring Carried Interest Deductions to Portfolio Firms*

This structure was originally proposed by Professor Michael Knoll and applies exclusively to private equity funds.<sup>166</sup> It also, hinges on several assumptions and a great deal of business foresight. Professor Knoll proposes this solution in light of the indifference by institutional and foreign investors to ordinary deductions. In essence, the deduction for paying the manager’s carry would be transferred from limited partners to the portfolio companies. That is, the portfolio companies would “hire” the fund manager for sums economically equivalent to carried interest. Managers would provide services, and the portfolio companies would deduct the service payments. The upside would be the indefinite deferral on the “recapture” of this deduction made possible by subsequent tax-free corporate acquisitions. The tax-benefit therefore would be enjoyed by the fund’s portfolio.

The difficult part would be estimating which companies could afford such operational payments and could benefit from a corresponding deduction. Also, the manager’s share would likely have to be financed prior to exit, and the portfolio companies would need to have sufficient taxable income to benefit from the deduction.

### *4. Equity Kickers/Options*

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<sup>165</sup> See I.R.C. §§ 871(b)(1), 882(a)(1).

<sup>166</sup> See Knoll, *supra* note 144 at 153.

In this structure, the fund would grant the manager an option to buy additional partnership interest in the fund at some predetermined price, for example, at the initial launch valuation. In this scenario, the manager would receive the benefit of the fund's appreciation without having to contribute (and risk) substantial sums of money upfront.<sup>167</sup> The manager could exercise this option at some later time (for example prior to liquidation), borrowing money short-term if necessary and repaying it upon receiving a distribution from the fund. The kicker, once exercised is treated as investment income, not as labor income, and therefore receives favorable tax treatment of long-term capital gains.<sup>168</sup>

An alternative to an "equity kicker" would be an option on a percentage of net increase in value. Professor Karen Burke gives the following example:

If [the manager] had an option on 20% of the net increase in the value of [the fund] (\$5 million)," [the manager] would recognize \$1 million of ordinary income upon exercise of the option; the tax would be deferred from grant until exercise of the option; all of the partnership's capital gain would be taxed to LP, and P would be treated as paying over compensation of \$1 million to [the manager] on exercise of the option, with a corresponding deduction (or capitalized expense).<sup>169</sup> This scenario would be economically equivalent to a profits interest.<sup>170</sup>

##### *5. The Benefit of Ordinary Deduction from Payment of Carried Interest*

Consider the general distinction between a hedge fund and a private equity fund. Hedge funds typically invest in liquid assets such as various types of market securities. Private equity funds, on the other hand, invest in illiquid assets such as stock of private companies. Although this distinction has become somewhat blurred over the years, it is still, for the most part, true. A typical hedge fund will engage in relatively frequent trading and therefore will rarely have long-term capital

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<sup>167</sup> See Burke, *supra* note 144, at 9 ("In economic terms, GP's profits interest is indistinguishable from an option, i.e., the ability to benefit from an increase in appreciation without risking capital.") (citation omitted).

<sup>168</sup> See Fleischer, *supra* note 144, at 11 ("In colloquial terms, if a service partner receives a cash salary and an at-the-money or out-of-the money equity "kicker," the kicker is treated as investment income, not labor income.")

<sup>169</sup> Burke, *supra* note 144, at 8-9, citing Treas. Reg. §§ 1.83-7(a) (as amended in 2004), 1.83-6(a) (as amended in 2003).

<sup>170</sup> See *id.*; Knoll, *supra* note 144, at 133.

gains to distribute. But a private equity fund will almost always hold its portfolio companies well over a year and thus qualify for favorable capital gains treatment upon disposition. Consequently, unlike investors in a private equity fund, hedge fund investors usually stand to receive very little long-term capital gains treatment.

Section 710 proposes to reclassify that portion of carried interest which is attributable to ISPI as ordinary income. This point requires additional emphasis: Section 710 would override “the long-standing character flow-through rule under § 702 and treat disproportionate allocations to GP as ordinary income (loss).”<sup>171</sup> Put another way, “the net effect is to increase the tax rate on GP’s implicit salary from 15% to 35%, *without* altering the tax consequences to LP.”<sup>172</sup> In this manner, Section 710 “finesses” the issue of worthless ordinary deductions that would exist if managers were instead paid a salary.<sup>173</sup>

In the event that a salary was paid, it would create a corresponding deduction to the investors. Professor Knoll proposes that this deduction against investors ordinary income may provide a way for the private investment industry to still “blunt the impact” of the reform.<sup>174</sup>

In this scenario, each limited partner would receive an ordinary deduction for their portion of the manager’s “compensation.”<sup>175</sup> Although manager’s will be forced to pay a higher percentage of tax on their income, the limited partners could reduce their effective tax rate by deducting the payment of the carry against their ordinary income.

Professor Knoll suggests that for the right investor, an investment fund that generates long-term capital gains, could become a very tax-advantageous investment if the investor can benefit from an ordinary deduction. For instance, Knoll uses the following numbers to illustrate this assertion: If

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<sup>171</sup> Burke, *supra* note 144, at 20.

<sup>172</sup> *Id.*

<sup>173</sup> See Mark P. Gergen, *A Pragmatic Case for Taxing an Equity Fund Manager’s Profits Share As Compensation*, 87 Taxes 139, 140 (2009) (“Code Sec. 710 tries to finesse this issue.”).

<sup>174</sup> See Knoll, *supra* note 144, at 157.

<sup>175</sup> See I.R.C. § 162(a)(1).

carried interest were taxed at a 35% rate (ignoring the self-employment tax) the manager would have to charge a 26.5% carry (salary) instead of the usual 20% to remain economically equivalent.<sup>176</sup>

Presumably, the investors would be willing to pay the extra carry because they can use the deduction to offset ordinary income.<sup>177</sup> However, for this scenario to provide any joint tax benefit it would require a very particular type of fund and a very particular type of investor.

First, it would require an investor who can benefit from an ordinary deduction, such as, for example, an individual, and not a domestic corporation. Since many institutional and foreign investors invest through passive foreign blocker corporations so as to avoid net basis taxation this deduction would be worthless to them. Second, the individual investor would most likely be subject to deductions limitations of Section 212<sup>178</sup> unless the fund is a “trader” fund,<sup>179</sup> in which case it would qualify for Section 162 deductions. Since private equity funds (the funds that generate the bulk of industry’s capital gains) will almost never be a “trader,” its investors will usually end up with a worthless deduction.

#### 6. *Tweaking the Investment Strategy*

I discussed previously the general trend of institutional investors (primarily U.S. tax-exempt entities) becoming very comfortable with allocating increasingly significant amounts of their portfolios to hedge funds. Institutional investors prefer liquidity, and for this reason gravitate toward hedge funds more so than towards private equity funds. Moreover, U.S. tax-exempt entities are generally indifferent to long-term capital gains because they invest through foreign blocker corporations, which are not taxed on U.S. source capital gains. In addition, hedge funds often do not generate long-term capital gains because they do not satisfy the holding period. The use of leverage

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<sup>176</sup> See 144, *supra* note 169, at 158.

<sup>177</sup> See *id.*

<sup>178</sup> Section 212 deductions are treated as “miscellaneous itemized deductions” and thus must first exceed 2% of the individual’s adjusted gross income to be deductible. See I.R.C. § 67(a), 641(b). There are potentially six other limitations on 212 deductions. See Miller, *supra* note 14, at 45-48.

<sup>179</sup> “Trader” rather than investor (as in a “trade or business” within the meaning of Section 162). Whether a fund is a trader is factual determination. For additional detail, see Miller, *supra* note 14, at 48.

also reduces the benefit of qualified dividends by treating them as “payments in lieu of a dividend,” which do not qualify for a preferential tax rate.<sup>180</sup>

In this light, Section 710 could amount to little more than an imposition of a self-employment tax on hedge fund managers’ carry. But because the social security portion of the tax is capped, the increase in the managers’ effective tax rate could be rather insignificant (in some instances it could be below 5%).<sup>181</sup> Additionally, fund managers could likely avoid self-employment tax in the manner previously discussed.<sup>182</sup>

In any event, the increase in managers’ tax bill could be adjusted by higher fees, and higher fees would be justified by tweaking the investment strategy in a manner that would minimize investor’s effective tax burden. Whereas today pooling of various types of investors creates the efficiency of scale and leverage, segregating the investors in different investment pools in accordance with the investor’s tax status could increase tax efficiency. For instance, a foreign fund could take advantage of a tax-treaty so as to minimize the effective tax rate for a specific type of foreign investors. The fund could then justify an increase in fees by tax savings.

#### *7. 83(b) Election and Catch-up Capital*

In this scenario, the manager would receive 20% of the fund’s capital interest in return for future services. The capital interest would be a qualified capital interest within the meaning of Section 710. There are several obvious drawbacks to this election. First, the manager will be forced to pay a very substantial tax bill at launch. Second, the manager would be running a substantial risk of economic loss in the event of the fund’s failure. Alternatively, the manager may want to make “catch-up” capital contributions during the life of the fund so as not to trigger the initial tax bill. Catch-up contributions could be similar in structure to equity kickers discussed previously.

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<sup>180</sup> See IRS Notice 2003-67; H.R. Rep. No. 108-94, 108<sup>th</sup> Cong., 1<sup>st</sup> Sess. 31 n.36 (2003).

<sup>181</sup> For example, 2.9% would come from Medicare tax, some relatively minor increase would come from the Social Security tax, and some other relatively small amount could come from reclassifying the carry.

<sup>182</sup> See *supra* Part III.B.2. For instance, fund managers could simply reduce the carry and increase the management fee and then use 1402(a)(13) exemption.

The upside of the election would be freezing of ordinary income at purchase price and avoiding self-employment taxes on ISPI. If the manager could obtain a non-recourse loan from the investors for the tax bill, the investors would continue to carry the entire economic risk of loss.

#### *8. The General Avoidance Strategy*

In this Section, I attempted to foresee the industry's response to the potential reform. I conclude that the impact of the proposed Section 710 would not apply with the same force to all private investment funds and managers. Some will be affected substantially more than others. Private equity funds and real estate funds would likely shoulder most of the impact because their income largely consists of long-term capital gains. But even here the detriment would mean that fund managers are forced to pay a percentage of tax that the rest of the country has been paying all along. The argument that the investment activity would be penalized is likely a bit exaggerated, and the industry will continue to raise money as long as it is able to outperform other investment alternatives. Even if managers are successful in shifting some of the tax burden on the investors, they will experience significant pressure to reduce fees. For example, the recent move by many of the country's pension funds to forego the fund-of-funds investment structure identifies a clear pattern in this direction.<sup>183</sup>

As with any other avoidance strategy, fund managers will have two main avenues available to them. First, they could look for an escape hatch within the proposed legal framework. Or, alternatively, they could attempt to restructure in a manner that would make the proposed Section 710 inapplicable altogether. Undoubtedly, if Section 710 is ever passed it will first undergo some substantive revisions as it has in every draft advanced so far. In addition, the Treasury would likely issue additional guidance. The Secretary would likely aim to implement congressional intent, which,

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<sup>183</sup>*Study: Pensions To Increase Direct Allocations To Hedge Funds In 2011*, FINALTERNATIVES, available at <http://www.finalternatives.com/node/16145>, (Apr 1 2009).

by all indications, would be to treat managers' share of income as ordinary and to subject it to self-employment taxes.

In a conversation on this subject with Professor Calvin Johnson of the University of Texas School of Law, I inquired whether he had any ideas on “tax-friendly” alternatives to carried interest. He said: “It’s hard to predict the direction that a group of very smart and determined people would take when there is that much money at stake.”<sup>184</sup> He then analogized to similar situations in the past, where “loopholes” that were closed only led to the discovery of the new ones.<sup>185</sup> “All the sudden, a sentence in a revenue ruling becomes the most significant thing that leads everyone on a new path.”<sup>186</sup> Until then, we will remain guessing.

### **C. Tax Avoidance and the Economic Substance Doctrine**

The Health Care and Education Reconciliation Act of 2010 added a Section 7701(o) to the Code. The provision is a codification of judicially-created economic substance doctrine. In essence, the codification of the doctrine and the adoption of associated strict liability penalty signals to the taxpayers a new era of tax enforcement.<sup>187</sup> The economic substance doctrine purports to prevent taxpayers from “subverting the purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit.”<sup>188</sup>

Although the hurdle of economic substance doctrine has not always been set very high, and “[t]here is no rule against taking advantage of opportunities created by Congress or the Treasury Department for beating taxes,”<sup>189</sup> any industry restructuring would certainly appear to be very tax-motivated. Inasmuch as economic substance of the transactions conflicts with the

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<sup>184</sup> Interview with Calvin H. Johnson, Andrews & Kurth Centennial Professor at University of Texas School of Law, in Dallas, Texas (Jan 21, 2011).

<sup>185</sup> *Id.*

<sup>186</sup> *Id.*

<sup>187</sup> See Bret Wells, *Economic Substance Doctrine: How Codification Changed Decided Cases*, 10 FLORIDA TAX REVIEW 411, 412 (2010) (“The codification of the economic substance doctrine begins an important new chapter for tax jurisprudence.”).

<sup>188</sup> *Id.*

<sup>189</sup> *Yosha v. Commissioner*, 861 F.2d 494, 497-98 (7th Cir. 1988) (Judge Posner writing for majority).

present legal framework, the government will have greater latitude to argue against its own previously issued positions.<sup>190</sup>

## **PART VI: CONCLUSION**

If viewed through the lens of current partnership law, carried interest is nothing more than a special allocation that reflects, in part, services performed by the partner in his capacity as a partner and, in part, a return on the partner's capital contribution. This structure is available to every partnership and is not reserved exclusively for investment funds. Sure, over the years there have been plenty of calls to reform the treatment of partnership allocations, but the criticism did not originate with the private investment industry.<sup>191</sup> Instead, it flows from some of the sticky issues surrounding the compensation of the service partners in the context of deferral and conversion of income. The proposed legislation singles out private investment partnerships. And although my normative case in favor of the present treatment of carried interest is weak, it grows mainly from my opposition to the reform as it is presently drafted.

The proposed legislation has been said to have some technical shortcomings. It singles out private investment partnerships in response to “astronomical”<sup>192</sup> returns generated by the fund managers. The theoretical underpinnings of the proposed change are questionable at best and, quite frankly, do not promote equity, simplicity, or efficiency. I agree wholeheartedly with several of the commentators who suggested that the thrust of the reform is misplaced.<sup>193</sup> The root of the problem is not the brazen hedge fund managers who make ridiculous amounts of

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<sup>190</sup> See Wells, *supra* note 186, at 452.

<sup>191</sup> See Gergen, *supra* note 72; William D. Andrews, *Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions*, 47 TAX L. REV. 3, 76 (1991) (partnership distribution rules “are seriously defective, in ways that permit serious tax abuse.”).

<sup>192</sup> Abrams, *supra* note 144.

<sup>193</sup> See generally *id*; see also Weisbach, *supra* note 144.

money and pay little tax. They are merely operating within a system they did not create. In fact, it would be strange if they did not take advantage of it.

A legislative reform that implements highly technical rules to appease political whim does not add conceptual clarity to the Code. Making one area of the law fair in some ways and unfair in others should not be justified by relatively modest amounts of revenue the reform is expected to raise<sup>194</sup> and by the satisfaction that would come from sticking it to the fund managers. Such approach distracts from the root problems. These problems include largely unjustified preference for capital gains and the so-called “heir investors.”

For instance, one commentator points out that a revocation of capital gains preference would “be far less avoidable than technical changes to the partnership tax rules: a technical change to the partnership tax rules leaves the capital gains preference generally available and relies on the ability of the government to distinguish labor income from capital income.”<sup>195</sup>

Another commentator suggests that “[a]rguably, the most telling and urgent juxtaposition is not the fund manager versus her secretary, but the fund manager *and* her secretary versus the wealthy heir investor whom they both service.”<sup>196</sup>

Perhaps, the legislators and the academy might be better off by focusing on these root issues instead.

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<sup>194</sup> See Knoll, *supra* note 144.

<sup>195</sup> Weisbach, *supra* note 144, at 763.

<sup>196</sup> See Sanchirico, *supra* note 82, at 1153.

Compare to: “[i]t 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.” Kevin Drawbaugh, *Hillary Clinton Slams Private Equity Tax Rate*, REUTERS.COM, Jul. 13, 2007.