

CARRIED INTEREST: CAN THEY EFFECTIVELY BE TAXED?

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Abstract

During the April 2008 Democratic Debate, former Senator Obama with former Senator Clinton almost referred to the subject matter of this article verbatim at page three of the transcript. (“We saw an article today which showed that the top 50 hedge fund managers made \$29 billion last year-- \$29 billion for 50 individuals. And part of what has happened is that those who are able to work the stock market and amass huge fortunes on capital gains are paying a lower tax rate than their secretaries. That's not fair.”) (<http://abcnews.go.com/Politics/DemocraticDebate/story?id=4670271&page=1>). As stated by both candidates, the budget is going to be a major source of contention, and revenue raisers, such as the proposed legislation under Internal Revenue Code (I.R.C.) § 710, will be a hot button item. It was estimated by a Congressional committee that the fund managers would save \$30 billion in taxes over the next ten years if the rules did not change. As promised, on page 122 of President Obama's 2009 budget is the proposal to tax carried interest as ordinary income. It is suggested that this change will raise \$2.7 billion in tax revenue in 2011.

The initial public offering (IPO) of Blackstone Group stock caused a public and political backlash when an IPO memorandum showed how much built-up gain existed in Alternative Investment Vehicles (“AIVs”). These offerings spurred public interest in the quantitative net worth of the owners of the funds, like Stephen A. Schwarzman, a co-founder of Blackstone, and the tax rates paid by these owner-individuals. Congress also began to focus on the tax loopholes allowing these owner-individuals to monetize their carried interest at a significantly reduced tax.

This surge in public interest combined with political needs for offsets to eliminate the alternative minimum tax led

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several influential lawmakers to seek passage of tax legislation that would reduce the tax incentives currently in place. These tax incentives primarily benefited managers of AIVs. The legislation was introduced most predominately in H.R. 2834, which sought to add I.R.C. § 710 to the Code, changing the treatment of distributions to the service partners from capital gain rates to ordinary income rates. Thus, the bill contains provisions that seek to completely reverse over thirty years of jurisprudence with a shotgun approach in attempting to solve what is deemed an injustice by some.

This article addresses the social equity arguments and the tax and economic theories to solve the perceived problem. Will the managers, if subjected to higher taxes, attempt to maximize the value for the investors? If one believes that there are “enough people who want to be rich,” then there is no reason to further incentivize the fund managers by taxing the fruit of their labor at reduced rates. There will always be ambitious and smart people who would be more than happy to step in and do these services even at higher tax rates. Further, it has been argued that a lower tax rate will not be sufficient to change the behavior of this category of individuals. One would have to demonstrate that fund managers would have to either reduce their current work efforts, if the rates were raised, or that this class of individuals is more sensitive to tax incentives than other professions.

The article then concludes with a thorough discussion of the current law and the proposed changes to solve the social inequity. The article discusses the proposed H.R. 2834 and whether the proposed tax legislation will ultimately be successful in raising revenues as Congress intends. The article concludes with a thorough discussion of the current law and the proposed changes. Under the proposed legislation, the result would be to tax the general partner at ordinary income rates. This would mirror the treatment of nonqualified stock options. The carried interest would still retain the deferral characteristic but would be taxed when they are redeemed by the fund managers at ordinary income rates. However, it is argued that this approach would lead to tax planning such as the utilization of loans.

I. INTRODUCTION

On February 9, 2007, the management company for Fortress Investment Group LLC went public.¹ This was the first of a wave of initial public offerings of traditional private equity hedge fund management companies.² By March of 2007, the management company of The Blackstone Group, L.P., announced its initial public offering.³ These offerings spurred public interest in the quantitative net worth of the owners of the funds, like Stephen A. Schwarzman, a co-founder of Blackstone,⁴ and the tax rates of these owner-individuals. At the same time, Congress also began to focus on the tax loopholes allowing these owner-individuals to monetize their carried interest at a significantly reduced tax.⁵

In direct response to the Blackstone initial public offering,⁶ under the

¹ See Fortress Investment Group LLC, Form S-1 (Nov. 8, 2006), available at (<http://www.sec.gov/Archives/edgar/data/1380393/000095013606009310/file1.htm>).

² But this is not a new phenomenon. See, Veryan Allen, *Fortress IPO?*, Hedge Fund Blog, November 15, 2006 available at (<http://hedgefund.blogspot.com/2006/11/fortress-hedge-fund-ipo.html>) (“Plus ça change, plus c’est la même chose. There is NOTHING new about alternative investment firms being listed. Berkshire Hathaway and Man Investments among others have been public for many years. Some say Sears is really a hedge fund nowadays. Goldman Sachs, Morgan Stanley and most of the bulge bracket all have large alternative asset management businesses.”); Alex Halperin, *Investors Storm Fortress IPO*, BUS. WK., Feb. 9, 2007 (“Prior to the company’s [Fortress’] initial offering, Donald Putnam, founder of Grail Partners, an advisory merchant bank, predicted that “[I]f the Fortress deal goes through, I think there’ll be 30 hedge fund IPOs in the next 18 months.”).

³ See generally, Adam Lashinsky, *Blackstone’s IPO Thick with Irony*, FORTUNE MAGAZINE, Mar. 22, 2007; Zachary Kouwe, *Blackstone IPO: It’s a Multibillion \$ Payday for Schwarzman*, NY POST, Mar. 23, 2007.

⁴ See, David Cho, *Blackstone IPO Faces Road Block in Senate*, WASH. POST, June 15, 2007 (Schwarzman, the co-founder of Blackstone, is estimated to be worth “\$677 million and hold stock worth more than \$7.5 billion. Co-founder Peter G. Peterson, 80, would get \$1.88 billion in cash and hold a stake valued at \$1.3 billion.”)

⁵ See, Chow *supra* note 3 at D01. (“Publicly traded partnerships are rare, especially in the financial sector. The senators expressed concern that Blackstone’s offering would set a dangerous precedent and lead to a wave of financial firms reorganizing themselves to take advantage of the tax loophole.”); Lee A. Sheppard, *News Analysis: Blackstone Proves Carried Interest Can be Valued*, 2007 TNT 121-2, Jun. 22, 2007 (The structuring in the Fortress and Blackstone initial public offerings created basis increases and tax savings not previously available.).

⁶ Cho, *supra* note 4 at D01 (“[T]he committee’s ranking minority member, signaled a growing concern in Congress that private buyout shops taking over huge swaths of industry pay too little in taxes. Lawmakers rarely interfere with an individual firm’s plans to go public.”)

guise of spreading tax relief,⁷ several influential lawmakers, led by House Ways and Means Committee Chairman Charles Rangel, have sought to pass tax legislation.⁸ Such legislation would more than double the rate for the carried interest earned by service partners in partnerships with the least amount of resistance.⁹ The proposed legislation is more specifically targeted at investment managers in private equity, hedge funds, and real estate industries.¹⁰ These congressional critics believe that certain “richest of the rich”¹¹ should no longer be eligible for capital gains rates on their carried interest in the Alternative Investment Vehicles (“AIVs”).¹² Several

⁷Through the elimination of the alternative minimum tax. *See generally* Jessica Holzer, *GOP call Rangle Plan a Gift*, available at <http://thehill.com/leading-the-news/gopcalls-rangel-tax-plan-a-gift-2007-10-26.html> (“The legislation would rearrange the tax code, granting tax relief to 90 million Americans and cutting the corporate tax rate while shifting the burden onto higher earners, including managers of private equity and hedge funds. It would also permanently shield taxpayers from the Alternative Minimum Tax (AMT).”); Blog: Editor’s Cut, *Blackstone’s Greed*, THE NATION, Jun. 18, 2007, available at <http://www.thenation.com/blogs/edcut?pid=206228> (“Thank you, Blackstone, for being so greedy. Your decision to go public in an IPO has, at long last, led to much-needed scrutiny and legislation that may upend the rules of the game in which secretive private equity partnerships have exploited what is legal but should be illegal: a 20-year-old tax provision that allows partnerships like Blackstone to pay a 15 percent tax rate on capital gains as a limited partnership—rather than the 35 percent corporate rate.”)

⁸H.R. 2834, 100th Cong. (1st Sess. 2007).

⁹*See e.g.*, “The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least possible amount of hissing.” Jean-Baptiste Colbert (August 29, 1619 – September 6, 1683) (Colbert was the finance minister under King Louis XIV of France).

¹⁰For the purposes of this article, private equity firms, hedge funds, venture capital funds, real estate funds, funds of funds, mezzanine debt funds, structured debt funds, and other alternative investment vehicles shall be known as “Alternative Investment Vehicles” or “AIVs.” *See* Joann M. Weiner, *Saving Private Equity*, TAX NOTES TODAY, Oct. 24, 2007.

¹¹Ben Stein, *Hedge Fund Class and the French Revolution*, N.Y. TIMES, Jul. 29, 2007, available at (http://www.nytimes.com/2007/07/29/business/yourmoney/29every.html?_r=1&oref=slogin#). (stating, “[i]n these circumstances, is it fitting and morally right for the richest of the rich to be paying either very low taxes or no tax at all?”)

¹²At times, even the beneficiaries of this tax preference argue that they should not be the beneficiary of this arbitrage. *See generally*, Tom Bawden, *Warren Buffett Says Rich Should Pay More Taxes*, LONDON TIMES, Jun. 27, 2007. According to the article, Warren Buffet slammed the U.S. Congress for

‘allowing him to pay a lower tax rate than his secretary and his cleaning lady. Speaking at a \$4,600-a-seat fundraiser in New York for Democrat Senator Hillary Clinton, Mr. Buffett, who is worth an estimated \$52 billion, told the wealthy audience: ‘The 400 of us [here] pay a lower part of our income in taxes than our receptionists

congressional critics have charged that the carried interest of the fund managers should be treated as “ordinary income for the performance of services,”¹³ rather than at its current capital gains rates.¹⁴ The argument is that

do, or our cleaning ladies for that matter.’

‘If you’re in the luckiest 1 per cent of humanity, you owe it to the rest of humanity to think about the other 99 per cent.’ *See also, Warren Buffett and NBC’s Tom Brokaw: The Complete Interview, CNBC Interview, October 31, 2007.* (“Well, they say they work hard and that in the process of working hard they make other people money. And—and that’s true of you. That’s true of a whole bunch of people in the world. But that doesn’t entitle them to a preferential tax rate. And the truth is that their occupation is going to work everyday. Working on the companies they buy, or working on trying to find what securities are cheap.”); Sam Fleming, *City Fat Cats ‘Paying Less Than the Cleaners,’* DAILY MAIL, Jun. 5, 2007 (in the United Kingdom, where similar legislation is being proposed, Nicholas Ferguson, Chairman of SVG Capital, said, “[a]ny common sense person would say that a highly-paid private equity executive paying less tax than a cleaning lady or other low-paid workers can’t be right.”); U.S. Chamber of Commerce, *Taxes Increases on Partnerships Pose Great Risk to Economy*, U.S. Chamber of Commerce Radio Actuality, Nov. 16, 2007, available at (http://www.uschamber.com/press/actualities/2007/071116_carried_tax.htm) (“A recent study commissioned by the Chamber shows this tax increase will harm small businesses that do not have access to traditional financing. The report also found that it would lower pension benefits and create more volatile investment portfolios, and decrease the value of partnership assets by potentially 300 billion dollars. Partnerships are a fundamental tool used to spur growth in America. This tax increase would create a ripple effect from Main Street to Wall Street, choking a valuable tool for driving our economy and job growth.”).

¹³ *Taxation of Hedge Fund and Private Equity Managers, CRS Report for Congress, Mark Jickling and Donald Marples*, Order Code RS22689, Jul. 5, 2007. (Citing Representative Sander M. Levin introducing H.R. 2834 (Jun. 22, 2007)); *See, Transcript, Hamilton Project Event, Reforming Taxation in the Global Age*, Panel 2, Jun. 12, 2007 at 23 (Former Treasury Secretary and Goldman Sachs Chairman Robert Rubin stated,

frankly, but it seems to me that what is happening is that people who run a large fund are basically performing a service and the service is running the capital and as a consequence they get paid a fee in the form of a performance fee. You can characterize it as a performance fee, you can characterize it as a carried interest, you can characterize it any way you want, but basically I think what they’re doing is getting paid a fee for running other people’s money

AIV managers are no different than a corporate employee who receives a grant of stock options under I.R.C. § 83.¹⁵

Proponents of the bill state that by promoting the current tax arbitrage, we are actually responsible for stifling capitalism.¹⁶ Currently, H.R. 2834 was introduced on June 22, 2007 and a related bill, S. 1624,¹⁷ was introduced on June 14, 2007 by Senator Max Baucus, Senator Charles Grassley and others, which proposed changing the tax treatment of publicly held partnerships. As

and if that is essentially what's happening, while you can certainly create all kinds of analogies that are complicated and if I were arguing against this I think I would try to develop a lot of complicated analogies and use that as my way of trying to prevent something from happening, I think at the core there is a very good argument to be made for treating this as ordinary income.

Alan S. Blinder, *The Under-taxed Kings of Private Equity*, NY TIMES, Jun. 29, 2007 (“This judgment [of Rubin] does not dispute the fact that fund managers’ compensation is risky. But so are the incomes of movie actors, the royalties of authors and the prize winnings of golfers—none of which is treated as capital gains.”); ECONOMIST, Jun. 9, 2007 at 13 (“Even if you think capital gains and income should be taxed differently, carried interest looks like income, not equity, and should be treated as such. . .”)

¹⁴ See *Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991), Rev. Proc. 93-27, 1993-2 C.B. 343, and Prop. Reg. §1.83, Notice 2005-43, 2005-24 IRB 1221.

¹⁵ *Testimony Of Treasury Assistant Secretary For Tax Policy Eric Solomon Before The Senate Finance Committee On The Taxation Of Carried Interest*, available at <http://finance.senate.gov/hearings/testimony/2007test/071107testes.pdf>. (citing the following parenthetical in footnote 2. A stock grant is similar economically to a profits interest in certain circumstances. For example, assume an executive of a new corporation receives a grant of Class A shares, which by their terms provide the executive with an economic return only after payment to the capital investors in Class B preferred shares. In this case, the value of the Class A shares is speculative and contingent on performance of the business. Consequently, the Class A shares may have only nominal value. Under the rules for taxing a stock grant, the executive is subject to tax upon the receipt of the Class A shares, but the amount taken into income may be nominal.)

¹⁶ See also, Weiner, *supra* note 10 (citing Eugene Steuerle, a former Treasury deputy assistant secretary for tax analysis and now at the Urban Institute stating “[i]n testimony before Congress, Steuerle said tax arbitrage opportunities reduce national income, drive talented individuals into less productive jobs, and add substantially to the debt in the economy. He also noted that regardless of one’s political view, reducing tax differentials across types of income helps promote a ‘more vibrant and healthy economy.’”); see also, Testimony of Solomon, *supra* note 15, at 7, (“[t]he common theme in all these instances of the success of the enterprise and receives an ownership interest that is subject to entrepreneurial risk will succeed only if the enterprise succeeds. The service provider in each instance has acquired an ownership interest in the enterprise betting that his upside will provide an ample economic reward. The incentives provided by this structure contribute to innovation and risk-taking.”).

¹⁷ S. 1624, 110th Congress (1st Sess. 2007).

such, the time is ripe to analyze the premise of H.R. 2834 and to determine whether the tax arbitrage stifles capitalism or promotes it.

Pundits initially argued about the merits of changing the laws during congressional hearings¹⁸ and through the press.¹⁹ The arguments were centered on the question on the fundamental fairness for a perceived tax preference for the fund managers of the Alternative Investment Funds. Assuming that Congress desires to change the current law, as evident by the proposed legislation, the focus will be the most effective solution.

Regardless of whether Congress will address this issue with the current legislation or introduce other bills, the problem will not go away easily.²⁰ Then Senator Obama, during the April 2008 Democratic Debate with then Senator Clinton, stated

We saw an article today which showed that the top 50 hedge fund managers made \$29 billion last year--\$29 billion for 50 individuals. And part of what has happened is that those who are able to work the stock market and amass huge fortunes on capital gains are paying a lower tax rate than their secretaries. That's not fair.²¹

As stated by both candidates, the budget is going to be a major source of contention, and revenue raisers such as the proposed legislation under I.R.C. § 710 will be hot button items. It was estimated by a Congressional committee that the fund managers would save \$30 billion in taxes over the next ten years if the rules did not change.²² In now President Obama's first budget to Congress, on page 122, he proposes to tax carried interests as ordinary income.²³ It is suggested that this change will raise \$2.7 billion in tax revenue in 2011 alone.²⁴

There were four main theories set forth to address the perceived current

¹⁸ Senate Committee on Finance Hearings July 2007 and Testimony before the House Committee on Ways and Means, June and Sept. 2007.

¹⁹ See generally, Leonard E. Burman, *End the Break in Capital Gains*, WASH. POST, Jul. 30, 2007; Blinder, *supra* note 13; Stein, *supra* note 11; Bawden, *supra* note 12; Cho, *supra* note 4; and Andrew Ross Sorkin, *Putting a Bull's-Eye on a Tax Loophole*, N.Y. TIMES, March 10, 2009, B1.

²⁰ Sorkin, *supra* note 19 at B1 ("And with the economy swooning, the industry was hoping lawmakers might just forget about this little tax giveaway.")

²¹ Page 3 ,Transcript, ABC News, *available at* <http://abcnews.go.com/Politics/DemocraticDebate/story?id=4670271&page=1>.

²² Sorkin, *supra* note 19 at B1.

²³ A New Era of Responsibility: Renewing America's Promise, President Obama's Budget available at <http://www.gpoaccess.gov/usbudget/fy10/pdf/fy10-newera.pdf>. See also, Sorkin, *supra* note 19 at B1.

²⁴ Sorkin, *supra* note 19 at B1.

inequity: (1) change I.R.C. § 702(b) and use Subpart K to handle the adjustments;²⁵ (2) tax the carried interest when it is granted under an I.R.C. § 83 approach;²⁶ (3) tax the carried interest as ordinary income when realized similar to nonqualified stock options;²⁷ and (4) treat the carried interest as a nonrecourse loan subject to imputed interest.²⁸

II. POLICY CONSIDERATIONS: WILL THE PROPOSED CHANGES TO THE TAXATION OF CARRIED INTERESTS HELP OR HURT THE ECONOMY?

The fundamental question is whether one believes that people will or will not engage in high-risk investments if they are not adequately compensated.²⁹ Economists argue that people act in their self-interest and the amount of money people earn directly correlates to the efforts they expend.³⁰ In the wildly popular book, *Freakonomics*, Steven Levitt and Stephen Dubner, argue that a real estate agent hired to represent a home seller is not acting in

²⁵ This proposal employs an entity theory of tax law. Compare this with the current law that uses capital accounts to determine the distributive share which could be taxed as compensation that uses the aggregate theory of tax law. See Mark P. Gergen, *How to Tax Carried Interest*, Senate Committee on Finance Hearing, July 31, 2007 at 4.

²⁶ This is the current implementation of the law as Rev. Proc. 93-27. See also Statement of Peter R. Orszag, *CBO Testimony, Taxation of Carried Interest before the Committee on Finance*, U. S. Senate July 11, 2007.

²⁷ See H.R. 2834, 110th Cong. (2007). See also Statement of Orszag, *supra* note 26; Testimony of Solomon, *supra* note 15; Sheppard, *supra* note 5 at 2.

²⁸ Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, (University of Colorado Legal Studies Research Paper Series, Working Paper No. 06-27, June 12, 2007). See generally Statement of Orszag *supra* note 26, and Gergen *supra* note 25.

²⁹ See Associated Press, *Blackstone IPO Fetches Top Price at \$31 a Share*, CNBC, June 21, 2007, <http://www.cnbc.com/id/19349620> (“Sen. Richard Shelby, R-Ala., and the ranking Republican on the Senate Banking Committee, told CNBC he opposed efforts to increase taxes on Blackstone Group.

In an exclusive interview, Shelby said companies like Blackstone are the ‘enemies of inefficiency and waste’ and ‘have saved a lot of companies that weren’t well-managed.’; ‘We have a great economy, but if we tax it to death, we will be in trouble,’ Shelby added. ‘The Democrats always, it seems to me, are looking, to raise taxes rather than to promote efficiency in the economy and give people tax breaks. I believe we ought to look at the tax code, not for money, but to promote the economy.’”). See also, Sorkin, *supra* note 19 at B3 (“The National Venture Capital Association has said in position papers that ‘eliminating the capital gains incentive for venture investing would discourage long-term, high-risk investment and that the consequences would be extremely harmful to U.S. economic growth.’”)

³⁰ See e.g., William N. Goetzmann, Jonathan Ingersoll Jr., & Stephen A. Ross, *High-Water Marks And Hedge Fund Management Contracts* 27-29 (Working Papers Yale International Center for Finance, April 18, 2001).

the seller's best interest during the sale of the house.³¹ Mr. Levitt and Mr. Dubner argue that the real estate agent balances the risk of trying to maximize the seller's profits and potentially losing the sale against the reward of a lower commission but a completed sale.³² The economists' conclusion is that the real estate agent acts only in their interest and not the seller's.³³

The same analogy would appear to apply to the managers of the AIVs. Will the managers, if subjected to higher taxes, attempt to maximize the value for the investors? At some level, it would not make sense to hold investments because of the risk (alpha) the fund manager has in holding the investment for a longer time (beta) relative to the profit that is available to the fund manager at the proposed higher rates.³⁴ In other words, is it better to just invest in municipal bonds³⁵ or to take higher investment risk in the private equity and capital markets combined with additional fiduciary duties?³⁶

³¹ STEVEN D. LEVITT & STEPHEN J. DUBNER, *FREAKONOMICS*, 73 (2005) (“... agents keep her own house on the market an average of ten extra days, waiting for a better offer, and sells it for over 3 percent more than your house—or \$10,000 on the sale of a \$300,000 house. That’s \$10,000 going into her pocket that does not go into yours, a nifty profit produced by the abuse of information and a keen understanding of incentives. The problem is that the agent only stands to personally gain and additional \$150 by selling your house for \$10,000 more, which isn’t much reward for a lot of extra work.”).

³² *Id.*

³³ *Id.*

³⁴ Goetzmann, Ingersoll, Jr. and Ross *supra* note 30, at 27.

³⁵ See Jon Birger, *Why Munis Are a Buy Now*, *Fortune Magazine*, January 28, 2008.

In February of 2008, “the yield on a 15-year, single-A, state of California bond is 4.5 percent, according to Bloomberg data. That’s the equivalent of a 7.72 percent yield on a taxable investment for a California resident in the highest tax bracket.

...

[T]he default rate on munis is minuscule, especially for GOs, water-and-sewer revenue bonds, and the other plain-vanilla offerings that make up the majority of the muni market.”

³⁶ Whereas mega funds such as Tudor Investment Corp. had a drawdown of more than one billion dollars (\$1,000,000,000) for poor performance over a one-year period, through the years Tudor has performed extremely well. However, due to the volatile markets in summer 2007 and the sub-prime loan write downs the Raptor Fund, a subsidiary of Tudor Finds fell 8.5% in 2007. In a letter to investors, Mr. Pallotta, the manager of the Raptor Fund, who buys stocks he expects to rise while hedging trades with short sale stated, “[i]n a short sale, an investor sells borrowed stock in expectation of repaying the loan with shares repurchased at a lower price. Managers with a similar strategy lost 2.4 percent on average in November, cutting their 2007 advance to 10.4 percent, according to Hedge Fund Research.” During the “global equities selloff in the summer of 2007, . . . [s]wings in stock prices ‘simply crushed’ the fund’s ‘core longs,’ or stocks that Raptor managers expected to rise, according to an Aug. 21 client letter obtained by

If one believes that there are “enough people who want to be rich,”³⁷ then there is no reason to further incentivize the fund managers. There will always be people to step in and do these services. It is argued that merely the low rate will not be sufficient to change the behavior of this category of individuals.³⁸ One would have to demonstrate that fund managers would have to either reduce their current work efforts if the rates were raised, and that this class of individuals is more sensitive to tax incentives than other professions.³⁹ Professor Bankman, in his Senate testimony, states

This would be efficient (though still objectionable as unfair) only if it could be shown that doctors [who are taxed at higher rates] are relatively insensitive to tax, and so will continue to work notwithstanding the high rate, or that fund managers are extremely sensitive to tax, or that some combination of these two assumptions is true.⁴⁰

The counter economic argument is that the sensitivity to tax relates not to whether individuals will desire to be a fund manager but rather the investment decisions made by a fund manager. For example, will a fund manager incubate positions⁴¹ when potential gain is perceived to be incremental for them personally because of the additional tax burdens? The fund manager would weigh the fiduciary risks of maintaining that position against the incremental gains to them personally—the fund manager would essentially turn into the real estate agent.

A. *The Argument for I.R.C. § 710*

The current system is not fair.⁴² As Warren Buffett stated,

Bloomberg.” Jenny Strasburg, *Tudor Investors Pull More Than \$1 Billion From Raptor*, Bloomberg, December 14, 2007.

³⁷ Stein, *supra* note 11, at B6.

³⁸ Testimony of Joseph Bankman, Ralph M. Parsons Professor of Law and Business, Stanford Law School, *Carried Interest Part II, Senate Committee on Finance Hearing*, July 31, 2007 available at <http://finance.senate.gov/hearings/testimony/2007test/073107testjb.pdf>. *Cf.*, Sorkin *supra* note 19 at B3 (“At one point, Magic Johnson, the former basketball star and entrepreneur, joined the fight, arguing that changing the tax would hurt investments made in the minority community.”).

³⁹ *Id.* at 2.

⁴⁰ *Id.* at 2.

⁴¹ See Testimony of Kate D. Mitchell, Managing Director, Scale Venture Partners, *Carried Interest, Senate Committee of Finance Hearing*, July 11, 2007 at 2 (“This contribution has been achieved through high-risk, long-term investment of considerable time and dollars into small, emerging growth companies across the country and across industry sectors.”).

⁴² See *e.g.*, *supra* notes 11-12.

[a]nd when they [fund managers] get—the day is done, they are taxed at a lower rate on—on so-called carried interest and that sort of thing, they are taxed at a lower rate than the beginning rate for their cleaning lady and the payroll tax, forgetting about our income tax.⁴³

The argument put forth by proponents of the new § 710 is that there is no need for a tax incentive for the fund managers.⁴⁴ The carried interest is a result of the labor and know-how of the fund managers and should be compensation income.⁴⁵ Further, it is argued that the fund managers do not place their own capital at risk and thus should not receive the benefit of lower tax rates.⁴⁶

⁴³ Buffett and Brokaw *supra* note 12. See also Cho, *supra* note 4, at D1 (“Steve Schwarzman should not be paying lower taxes than a firefighter,” said Damon A. Silvers, associate general counsel of the AFL-CIO, which wants the SEC to delay the IPO. “We do believe that tax policy should not redistribute wealth in favor of the wealthiest people.”); Sorkin, *supra* note 19 at B1.

⁴⁴ Stein, *supra* note 11, at B6 (stating “AND please, let’s not haul out that old chestnut about having tax incentives to encourage entrepreneurship. We already have enough people who want to be rich (which is another phrase for “entrepreneurship”).”).

⁴⁵ See Blackstone Form S-1 at 49 (in the commentary to the Investment Company Act of 1940, Blackstone says the business is properly characterized as income earned in exchange for services.) See also Aviva Aron-Dine, *An Analysis of the “Carried Interest” Controversy*, Center on Budget and Policy Priorities, July 31, 2007 at 6 (<http://www.cbpp.org/7-31-07tax.htm>); Citizens for Tax Justice, *Myths and Facts About Private Equity Fund Managers – and the Tax Loopholes They Enjoy*, July 2007.

⁴⁶ See Testimony of Orszag, *supra* note 26, at 10.

Most legal and economic analysis suggests that carried interest represents, at least in part, a form of performance-based compensation for services undertaken by the general partner. Although individual analyses differ slightly, there are two important themes with which most analysts concur. First, a general partner in a private equity or hedge fund undertakes a fundamentally different economic role from that of the limited partners, because the general partner is responsible (by virtue of his or her expertise, contacts and experience, and talent) for managing the fund’s assets on a day-to-day basis. Second, the carried interest is not principally based on a return to the general partner’s own financial assets at risk. If the purpose of the preferential rate on long-term capital gains is to encourage investors to put financial capital at risk, there is little reason for that preference to be made available to a general partner, whose risk involves his or her time and effort rather than financial capital.

See also Greg Mankiw, Blog, *The Taxation of Carried Interest*, July 19, 2007. gregmankiw.blogspot.com/2007/07/taxation-of-carried-interest.html. (Mr. Mankiw

B. *The Argument against I.R.C. § 710*

The proposed new § 710 in H.R. 2834 would fundamentally change an area of tax law that has been common practice for decades.⁴⁷ The treatment of a carried interest has evolved through the application of the law, numerous tax court cases, revenue rulings, and regulations.⁴⁸

If the rules were to change, there would be far reaching implications. Fund managers, with their deep pockets, would not merely accept that their paradigm of existence has been turned upside down.⁴⁹ Attorneys for the fund managers would adjust the capital formation process for a range of industries that use the partnership structure including real estate, oil and gas, shopping centers, venture capital, and others in addition to all the companies, workers and pension funds who have benefited from the investments of private equity to take the proposed rules into account.⁵⁰ The current structure, it is argued, promotes the entrepreneurial risk-taking and investment that is fundamental to innovation and new businesses in America.⁵¹

is a Professor of Economics at Harvard and past Chair of the Council of Economic Advisors under President Bush. He comments that, “[d]eferred compensation, even risky compensation, is still compensation, and it should be taxed as such.”); Editorial, *The Fair Way to Tax Private Equity*, FINANCIAL TIMES, July 18, 2007 (commenting that managers typically receive compensation which is “exactly akin to a performance bonus”).

⁴⁷ R. Bruce Josten, *Letter Opposing H.R. 2834*, U.S. Chamber of Commerce, available at http://uschamber.com/issues/letters/2007/070711_hr2834_tax.htm (July 11, 2007).

⁴⁸ See also Testimony of Gergen, *supra* note 25, at 1.

⁴⁹ Statement of Adam Ifshin, President, DLC Management Corp., *Testimony Before the House Committee on Ways and Means*, September 6, 2007.

According to IRS statistics, in 2005, 46% of partnership tax returns came from the real estate industry. Over \$1 trillion in equity is invested in real estate through partnerships leveraged on average another \$300-\$400 billion in loans. Therefore, a major change in partnership tax rules, such as that proposed by H.R. 2834, would have a tremendous impact to the real estate industry – a significant economic driver in our nation’s economy. At the end of the day, this is not a Wall Street issue – it’s a Main Street issue. At stake are job creation, economic development, and revitalization of communities across the country.

⁵⁰ Solomon, *supra* note 15, at 7. (“The common theme in all of these instances is that a person who contributes skill and knowledge to the success of the enterprise and receives an ownership interest that is subject to entrepreneurial risk will succeed only if the enterprise succeeds. The service provider in each instance has acquired an ownership interest in the enterprise betting that his upside will provide an ample economic reward. The incentives provided by this structure contribute to innovation and risk-taking.”)

⁵¹ See generally, Testimony of Ifshin, *supra* note 49; Testimony of Solomon, *supra* note 15, at 7.

Proponents for the status quo refute the notion that the current system is inequitable.⁵² They argue that there must be a balance between the risks of the fiduciary managing other people's money against the backdrop of earning a fee.⁵³ The less the fee incentive becomes, the less the fund manager will want to assume the risks.⁵⁴

III. CURRENT TAXATION OF ALTERNATIVE INVESTMENT FUNDS

In general, a partnership is defined, for both tax and corporate purposes, to include any two or more persons that join together in a business activity for the purpose of making a profit.⁵⁵ Individuals choose a tax partnership often because a key feature of a partnership is that income is not taxed at the partnership level.⁵⁶ Income earned by the partnership passes through to the partners.⁵⁷ The character of the income in the partnership maintains the same character as if it were earned by the partnership (e.g., ordinary income or capital gain).⁵⁸

⁵² See Jonathan Silver, Core Capital Partners, *Testimony before House of Representatives Committee on Ways and Means*, September 6, 2007 at 7-10; Testimony of Mitchell, *supra* note 41; Weiner, *supra* note 10; Aron-Dine, *supra* note 45, at 6.

⁵³ See, e.g., *supra* note 52.

⁵⁴ However, many Private Equity and Real Estate Funds are trying to distance themselves from the Hedge Funds because the argument that a long term holding period is not applicable to those funds. See Testimony of Mitchell, *supra* note 41, at 2; Testimony of Orszag, *supra* note 26, at 1.

⁵⁵ I.R.C. § 7701(a)(2) (2008).

The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

See also Testimony of Solomon, *supra* note 15, at 2.

⁵⁶ See I.R.C. § 701 (2008).

A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.

⁵⁷ I.R.C. § 702(c) (2008).

In any case where it is necessary to determine the gross income of a partner for purposes of this title, such amount shall include his distributive share of the gross income of the partnership.

⁵⁸ I.R.C. § 702 (b).

The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (7) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the

A. *Alternative Investment Funds Structure*

Although every Alternative Investment Vehicle is different, there are some commonalities that generally apply. In a typical structure, an investment partnership will be formed.⁵⁹ This investment partnership will have two partners, a limited partner and a general partner.⁶⁰ Investors who contribute the capital for the investments are the limited partners (LP).⁶¹ The fund managers, who have the expertise, are the general partners.⁶² The general partner (GP) will generally charge the investment partnership a management fee of a percentage of assets under management and a bonus of a percentage of the profits the investment company makes if the investment is successful.⁶³ These fees range from one and ten percent, respectively, in most circumstances to as high as five and fifty percent.⁶⁴ Typically, this is referred to as the “2 and 20” charge.⁶⁵

It is unfair to put all the Alternative Investment Vehicles into one class for the carried interest discussion, although the House and Senate bills do. Private Equity Funds have their own rules that affect the value of the carried

partnership, or incurred in the same manner as incurred by the partnership.

⁵⁹ See Testimony of Mitchell, *supra* note 41, at 5; Testimony of Orszag, *supra* note 26, at 5.

⁶⁰ See generally, Testimony of Ifshin, *supra* note 49.

⁶¹ Testimony of Mitchell, *supra* note 41, at 5.

⁶² *Id.*

⁶³ *Id.* at 6. See also Testimony of Ifshin, *supra* note 49, at 2 (“[i]t is for the general partner’s business acumen, experience and relationships. Knowing when to buy, how much to pay, whether to expand or renovate, when to sell and to whom.”).

⁶⁴ “1 and 10” refers to a 1% management fee and a 10% share of future profits. Likewise, “5 and 50” means a 5% management fee and a 50% share of future profits. See generally Wikipedia Entry on Hedge Funds, www.en.wikipedia.org/wiki/hedge_fund.com, (“Typically, hedge funds charge 20% of gross returns as a performance fee, but again the range is wide, with highly regarded managers demanding higher fees. In particular, Steven Cohen’s SAC Capital Partners charges a 50% incentive fee [but no management fee] and Jim Simons’ Renaissance Technologies Corp. charged a 5% management fee and a 44%.”)

⁶⁵ See also Securities and Exchange Commission Web Site Entry on Hedge Funds, www.sec.gov/answers/hedge.htm.

Hedge funds typically charge an asset management fee of 1-2% of assets, plus a “performance fee” of 20% of a hedge fund’s profits. A performance fee could motivate a hedge fund manager to take greater risks in the hope of generating a larger return. Funds of hedge funds typically charge a fee for managing your assets, and some may also include a performance fee based on profits. These fees are charged in addition to any fees paid to the underlying hedge funds.

interest.⁶⁶ Real estate partnerships, although similar to private equity funds⁶⁷ in structure, have much different valuations of the carried interest throughout the holding period due to the illiquidity of assets.⁶⁸

⁶⁶ See Testimony of Mitchell, *supra* note 41, at 8.

Because the ultimate net profits of a VC fund are not determinable until the end of the fund's term which is typically well over 10 years, distributions of the carried interest to the GP are typically delayed until the LPs' capital contribution has been returned to them. These contributions include capital used to purchase companies that have not yet been sold *and* capital used to pay expenses, including the GP's management fee. The return of this capital typically will not begin to be achieved until 7 years into a fund. Only then is the carried interest shared with GPs.

The VCs must pay tax on their carried interest as soon as the VC fund is cumulatively net profitable, which typically occurs in years 3-4. Because the GP carried interest distributions typically are delayed until all capital and accumulated expenses have been returned, which typically occurs in years 6-8, a type of "reverse deferral" (an acceleration of tax) is created. This requires the GP to negotiate to receive "tax distributions" from the VC fund. Like an advance or a "sales draw," these tax distributions will reduce the amount of carried interest later paid to the GP.

⁶⁷ Real estate funds often have similar holding periods and partnership structures as private equity funds. The main difference is the class of assets each entity owns. Whereas, private equity funds have a certain level of liquidity, real estate funds tend to be illiquid during the holding period.

⁶⁸ See Testimony of Ifshin, *supra* note 49, at 3.

A carried interest is granted not for routine services like leasing and property management, but for the value it will add to the venture *beyond* routine services. It is granted for the general partner bringing the investors the "deal". It's for committing to a venture alongside the investors that will be highly illiquid. It is granted because the general partner is subordinating his return to that of the limited partners. It is for the general partner's business acumen, experience and relationships. Knowing when to buy, how much to pay, whether to expand or renovate, when to sell and to whom. This is the "capital" the general partner invests in the partnership.

The carried interest is also granted in recognition of the risk exposure the general partner has in the venture. This exposure is often far greater than the money it contributed. Typically, a general partner is responsible for all partnership liabilities such as environmental contamination and lawsuits, and often explicitly guarantees matters such as construction completion, operating deficits and debt. In the case of development, a carried interest recognizes development risks and opportunity costs borne by the

The most volatile of the group are hedge funds.⁶⁹ In hedge funds, this 20% carried interest is not a static number. There is usually a “high water mark” test applied to a performance fee calculation.⁷⁰ The manager does not receive performance fees unless the value of the fund exceeds the highest net asset value it has previously achieved.⁷¹

This investment partnership structure will provide a fairly straightforward result in its partnership taxation.⁷² At the onset, the investment partnership will make investments in a portfolio of companies.⁷³ The investment partnership will pay expenses, among others, for due diligence (e.g., legal, accounting, and financial) and deal structuring.⁷⁴ These expenses are all incurred in the early stages of the investment horizon so the investment partnership generally will only generate a net loss from expenses initially.⁷⁵ Under most investment partnerships, the cumulative losses are allocated to all partners in proportion to their capital contributions.⁷⁶

When, and if, a particular investment is sold at a gain, the net profit typically first “reverses” the net losses previously allocated.⁷⁷ After the chargeback occurs, the cumulative net profit typically is allocated in the manner agreed to in the investment partnership.⁷⁸ In the case of the traditional 2 and 20 models, twenty percent of the profits would be allocated to the GP and eighty percent to all limited partners in proportion to their capital contributions.⁷⁹

In private equity, the net profits of an investment partnership are not determined until the end of the term of the investment partnership.⁸⁰ This

real estate entrepreneur, both before and after admission of the financial partner.

⁶⁹ See Goetzmann, Ingersoll Jr., and Ross, *supra* note 30, at n.1. (“The term hedge fund is used to characterize a broad class of “skill-based” asset management firms that, for a variety of reasons, do not qualify as mutual funds or money managers regulated by the Investment Company Act of 1940.”)

⁷⁰ *Id.* at 1.

⁷¹ For example, in 1996 when George Soros’ Quantum Fund lost 1.5%, there was no incentive fee. Further, if the fund hypothetically gained 1.5% in 2007, the fund would still not be entitled to an incentive fee. Not until the fund exceeded the previous high would the manager be eligible for the fee. *See id.*

⁷² See Testimony of Solomon, *supra* note 15, at 4; Testimony of Gergen, *supra* note 25, at 1.

⁷³ Testimony of Mitchell, *supra* note 41, at 8.

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ *Id.* (Obviously, this gets substantially more complicated when these determinations are made on a yearly basis with a hedge fund.)

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ See Testimony of Ifshin, *supra* note 49, at 3; Testimony of Mitchell, *supra* note 41, at 9.

term can range from one year to over ten years.⁸¹ In hedge funds, the determination is made per the operating agreement, which is usually yearly.⁸² However, rather than the current distributions, the GPs can elect to have their interest rolled in the fund. The return of the limited partners' capital will vary depending on the type of fund.

B. *Current Tax Consequences to the General Partner*

The question at the core of the debate is when and at what rate the carried interest should be taxed. Under current law, there are two methodologies on the taxation of the carried interest. The focus of the law is on a discussion of when this interest is earned or vests.

From the viewpoint of the fund managers, the current method established by the code and the regulations⁸³ accurately reflects the economic

⁸¹ Testimony of Mitchell, *supra* note 41, at 9.

⁸² Goetzmann, Ingersoll Jr., and Ross, *supra* note 30, at 1.

⁸³ See generally, I.R.C. § 83 (26 U.S.C. § 83) (2004); see also 26 C.F.R. § 1.83-3(1) (2005). Section 1.83-3(l) of the Income Tax Regulations § 1.83-3(l) of the Income Tax Regulations allows taxpayers to elect to apply special rules (the "Safe Harbor") to a partnership's transfers of interests in the partnership in connection with the performance of services for the partnership. The Treasury Department and the Internal Revenue Service intend for the Safe Harbor to simplify the application of § 83 of the Internal Revenue Code to partnership interests transferred in connection with the performance of services and to coordinate the principles of § 83 with the principles of partnership taxation. This revenue procedure sets forth additional rules for the elective safe harbor under proposed § 1.83-3(l) for a partnership's transfer of interests in the partnership in connection with the performance of services for that partnership.

If, instead, the service provider who receives a substantially non-vested partnership interest in connection with the performance of services makes a valid election under § 83(b), then the service provider is treated as the owner of the property. See Rev. Rul. 83-22, 1983-1 C.B. 17.; Rev. Rul. 83-22, 1983-1 C.B. 17. The service provider is treated as a partner with respect to such an interest, and the partnership must allocate partnership items to the service provider as if the partnership interest were substantially vested.

Section 1.83-3(b) provides that property is substantially non-vested for § 83 purposes when it is subject to a substantial risk of forfeiture and is nontransferable. Property is substantially vested for § 83 purposes when it is either transferable or not subject to a substantial risk of forfeiture. Section 1.83-3(c) provides that, for § 83 purposes, whether a risk of forfeiture is substantial or not depends upon the facts and circumstances. A substantial risk of forfeiture exists where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied. Section 1.83-3(d) provides that, for § 83 purposes, the rights of a person in property are

reality of an event that factors in the contingency of the interest.⁸⁴ The fund managers believe that their interest in the carried interest is analogous to the founder's stock in the company.⁸⁵ The contrary view states this is nothing

transferable if such person can transfer any interest in the property to any person other than the transferor of the property, but only if the rights in such property of such transferee are not subject to a substantial risk of forfeiture. Section 1.83-3 provides in relevant part:

Safe Harbor Partnership Interest. (1) Except as otherwise provided in section 3.02(2) of this revenue procedure, a Safe Harbor Partnership Interest is any interest in a partnership that is transferred to a service provider by such partnership in connection with services provided to the partnership (either before or after the formation of the partnership), provided that the interest is not (a) related to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease, (b) transferred in anticipation of a subsequent disposition, or (c) an interest in a publicly traded partnership within the meaning of § 7704(b). Unless it is established by clear and convincing evidence that the partnership interest was not transferred in anticipation of a subsequent disposition, a partnership interest is presumed to be transferred in anticipation of a subsequent disposition for purposes of the preceding clause (b) if the partnership interest is sold or disposed of within two years of the date of receipt of the partnership interest (other than a sale or disposition by reason of death or disability of the service provider) or is the subject, at any time within two years of the date of receipt, of a right to buy or sell regardless of when the right is exercisable (other than a right to buy or sell arising by reason of the death or disability of the service provider).

⁸⁴ See, Josten, *supra* note 47 (“H.R. 2834 would fundamentally change an area of tax law that has been common practice for decades. The treatment of carried interest has evolved through the application of the law, numerous tax court cases, revenue rulings, and regulations. The taxation of carried interest is not a new-found tax loophole but a long-standing part of the tax code.”)

⁸⁵ See, Testimony of Mitchell, *supra* note 41, at 11:

When founders start a company, they typically receive common stock in the company in exchange for their ideas and labor. At some time, the company may issue preferred stock to a financial investor in exchange for what is presumably far more financial capital than the founder invested, if the company is successful and is sold or goes public, the founder will be permitted to sell the founder's stock and receive long-term capital gains treatment.

See also, Testimony of Ifshin *supra* note 49, at 4-5:

H.R. 2834 discriminates against the partnership form. Under the bill, if an entrepreneur managed a partnership venture and received a carried interest, the return paid on the carried interest would be ordinary income. However, if instead of taking in a capital partner,

more than performance based compensation and should be taxed at ordinary income rates.

The argument is a policy matter: there is no reason for the preference given to the managers of the Alternative Investment Funds.⁸⁶ Thus, the fiction created under current law should no longer be applied, and the only question should be on the timing of the taxation of the ordinary income of the 20% carried interest.⁸⁷ Should it be on the outset⁸⁸ or at the end of the term?

1. *Contingency of Interest*

The position of most Alternative Investment Fund managers is that the carried interest is contingent upon the work of the particular fund manager.⁸⁹ If no value is achieved in the portfolio of companies, there will be no benefit to the fund manager.⁹⁰ The payment structure is very different from other service providers that receive guaranteed payments.⁹¹ This is not, according to

he is able to borrow the capital from a bank and operates as a sole proprietor, capital gain treatment would be allowed on the carried interest return. The entrepreneur is conducting the same activity in both scenarios yet the bill would result in different tax treatment.

⁸⁶ Sheppard, *supra* note 5, at p. 2. (“Fund managers are ‘basically performing a service,’ said Rubin. ‘There is a very good argument to be made about treating this as ordinary income. He also argued that the lower capital gains rate has not contributed to economic growth.”); *see also*, *Tax Notes Today*, 2007 TNT 114-3 (June 13, 2007); Mankiw, *supra* note 46, (commenting that hedge fund managers believe that they should be taxed at ordinary income rates initially then at capital gains rates on the growth. Mr. Mankiw also states, “[m]aybe so, but taxing the terminal value as ordinary income (as is proposed) seems strictly better for the manager in present value. It is as if the manager put the initial value of the carried interest in a tax-deductible IRA, deferring tax on this compensation until the money is withdrawn at a later date.”).

⁸⁷ Bankman, *supra* note 38. (“Is the basic and common sense rule of tax policy that we ought to have the same rate of tax across different occupations or investments? Or do we tax based on income and give preferences, credits or subsidies to area which we believe warrant them?”); *see also*, Rubin, 2007 TNT 114-3 (stating that fund managers are basically performing a service and that this should be taxed as ordinary income); Sheppard, *supra* note 5, at 2.

⁸⁸ *See* Testimony of Orszag, *supra* note 26 at 12. (Although § 83 property transferred to a person in connection with the performance of services is generally taxed on receipt, it can be difficult with the carried interest because of the valuation problems. It is because of that valuation issue most tax practitioners utilize the convention that this is a non-taxable event. As in Rev. Rul 93-27.) *Cf.*, Sheppard *supra* note 5, at 8 (noting that one can use Black-Scholes or other values currently as shown in the Blackstone IPO).

⁸⁹ *See generally*, Testimony of Mitchell *supra* note 41.

⁹⁰ *See* Goetzmann, Ingersoll, Jr. and Ross, *supra* note 30, at 1.

⁹¹ *See* Testimony of Orszag, *supra* note 26, at 9. (citing such guaranteed payments as performance bonuses, stock option and restricted stock grants.). *See also*,

advocates of this position, the same as a stock option in the hands of an employee.⁹² In fact, the fund manager treats their guaranteed payments, the 1% management fee, as income.⁹³ As Ms. Mitchell stated in her congressional testimony:

[O]ther performance-based compensation, whether paid by a company to its executives or paid to a lawyer as a contingency fee upon winning a case, does not involve the sale of a capital asset—a condition currently and historically required to receive capital gain treatment.⁹⁴

The distinction made for fund managers is that the carried interest is granted long-term capital gain treatment because the income was generated from the sale of a business, a capital asset, in which value has been created.⁹⁵

According to the advocates, the more analogous situation is that of a founder in a company.⁹⁶ A sole proprietor is not taxed at ordinary income rates from the sale of their business even though it was through such person's efforts—sweat-equity—that the business grew in value.⁹⁷

2. Performance Based Compensation

The advocates whose position is that the carried interest should be performance based compensation focus on whether the interest is a capital

Testimony of Mitchell, *supra* note 41, at 11 (citing the management fee as a guaranteed payment).

⁹² See Testimony of Mitchell, *supra* note 41, at 11.

⁹³ Although, planners are now counseling fund managers to waive their fees before they are earned. The management fee would increase the fund managers' distributive share. See *e.g.*, Sheppard, *supra* note 5, at 6.

⁹⁴ Testimony of Mitchell, *supra* note 41, at 11.

⁹⁵ Testimony of Mitchell, *supra* note 41, at 11.

⁹⁶ See Testimony of Mitchell, *supra* note 41, at 11; see also Testimony of Ifshin, *supra* note 49, at 4-5.

⁹⁷ Testimony of Mitchell, *supra* note 41, at 11; see also Testimony of Ifshin, *supra* note 49, at 5. The corollary in the corporate world is seen in companies such as Google and Microsoft where the founders took the earliest (and greatest) risk in launching the enterprise and were later joined by financial partners who purchase preferred stock for a much larger capital contribution per share than that made by the founders. Neither Congress nor Treasury questions the wisdom or fairness of affording capital gains treatment to such founders when they ultimately sell their stock. The same logic should apply to a partnership between the "founder" of a real estate project and its subsequent financial backer. See also, Sorkin, *supra* note 19, at B3 (venture capital firms argue that "they are crucial to America's entrepreneurial spirit" and that "[t]hey are long-term investors who often hold investments for more than a decade.")

interest or a profits interest.⁹⁸ Under this line of thinking, a capital interest in the Alternative Investment Fund will provide the fund manager with a share of the partnership:

Liquidation proceeds if, immediately after the interest was transferred, all of the partnership's assets were sold at their fair market value, all liabilities were paid in full, and the remaining amount was distributed to the partners.⁹⁹

It is argued:

A profits interest, by contrast, does not provide the service provider with a share in the liquidation proceeds. Rather, a profits interest allows the service provider to share only in the partnership's future income or appreciation in the partnership's assets.¹⁰⁰

A fund manager would not be taxed on a receipt of a profits interest but would be taxed on the receipt of a capital interest. This prevents the double taxation that would occur if the fund manager were taxed at ordinary tax rates on the value of the profits interest at the time of the transfer.¹⁰¹ Then the fund

⁹⁸ See Testimony of Orszag, *supra* note 26, at 1-2; see also Testimony of Solomon, *supra* note 15, at 4.

⁹⁹ Testimony of Solomon, *supra* note 15, at 5.

¹⁰⁰ Testimony of Solomon, *supra* note 15, at 5.

¹⁰¹ Testimony of Solomon, *supra* note 15, at 5. (This is generally determined by reference to the anticipated future stream of partnership income. Section 83 of the Code requires a service provider to recognize compensation income when vested property is transferred in connection with the performance of services.); see also, I.R.C. § 83 (2008), in relevant part:

(a) General rule. If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of—

(1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over

(2) the amount (if any) paid for such property, shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. The preceding sentence shall not apply if such person sells or

manager would be taxed again at the time the income is recognized by the partnership under I.R.C. § 707.¹⁰² The issue of determining the fair market value of a profits interest is difficult because the interest is contingent.¹⁰³

3. Current Case Law

It has long been settled that a partner who receives a capital interest in a partnership as compensation has ordinary income—generally when the interest no longer is subject to forfeiture.¹⁰⁴ For over thirty years, the issue of when to tax the receipt of a profits interest has been litigated by the Service and taxpayers.¹⁰⁵ Under current law, the manager of the Alternative Investment Fund is taxed on the receipt of a capital interest, but generally not taxed on the receipt of a profits interest.¹⁰⁶

otherwise disposes of such property in an arm's length transaction before his rights in such property become transferable or not subject to a substantial risk of forfeiture.

(b) Election to include in gross income in year of transfer.

(1) In general. Any person who performs services in connection with which property is transferred to any person may elect to include in his gross income, for the taxable year in which such property is transferred, the excess of—

- (A) the fair market value of such property at the time of transfer (determined without regard to any restriction other than a restriction which by its terms will never lapse), over
- (B) the amount (if any) paid for such property.

If such election is made, subsection (a) shall not apply with respect to the transfer of such property, and if such property is subsequently forfeited, no deduction shall be allowed in respect of such forfeiture.

(c) Special rules. For purposes of this section—

(1) Substantial risk of forfeiture. The rights of a person in property are subject to a substantial risk of forfeiture if such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual.

(2) Transferability of property. The rights of a person in property are transferable only if the rights in such property of any transferee are not subject to a substantial risk of forfeiture.

¹⁰² Testimony of Solomon, *supra* note 15, at 5.

¹⁰³ However, it has been argued that the interests may be valued. *See infra* IV, A.

¹⁰⁴ Testimony of Gergen, *supra* note 25, at 1.

¹⁰⁵ *Diamond v. Commissioner*, 492 F.2d 286, 287 (7th Cir. 1974).

¹⁰⁶ The fund manager would receive a share of the partnership's liquidation proceeds. *See also* Testimony of Solomon, *supra* note 15, at 4.

The general rule is that property transferred to a service provider in connection with service rendered is income under I.R.C. § 83.¹⁰⁷ The service provider includes in gross income the value of the property rights (*i.e.*, the fee charged) in the first year that the rights are freely transferable or not subject to a substantial right of forfeiture.¹⁰⁸

I.R.C. § 721 provides that no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership. It is helpful to review the history of the regulations associated with I.R.C. § 721. In 1956, Treasury Regulation § 1.721-1(b) was issued and provided in part:

To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation (or in satisfaction of an obligation), section 721 does not apply.¹⁰⁹

The 1956 regulation provided that “the value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61.”¹¹⁰ Then in 1971, the Treasury issued proposed regulations. Proposed Treasury Regulation section 1.721-1(b) provided that the transfer of an interest in partnership was a transfer of property subject to I.R.C. § 83 and subject to said timing and recognition rules.¹¹¹

The same year in which the Proposed Treasury Regulations were issued, 1971, the Seventh Circuit decided the *Diamond* case.¹¹² In *Diamond*, the court upheld the Tax Court opinion that the receipt of a partnership profits interest for services rendered was taxable income to the recipients.¹¹³ The taxpayer, a mortgage broker, entered into an agreement with the purchaser of an office building.¹¹⁴ The agreement provided that the taxpayer would receive a 60% share in the profit or loss if he were able to arrange financing.¹¹⁵ The taxpayer

¹⁰⁷ I.R.C. § 83(a).

¹⁰⁸ *Id.*

¹⁰⁹ See also, A.B.A. Sec. Tax'n Commentary to H.R. 2834 (November 13, 2007) at 4, available at <http://www.abanet.org/tax/pubpolicy/2007/071113commentshr2834.pdf>.

¹¹⁰ *Id.*

¹¹¹ Treatment of Property Transferred in Connection with Performance of Services, 36 Fed. Reg 10,787 (June 3, 1971) (although proposed regulation was withdrawn in 1995). See also, A.B.A. Sec. Tax'n, *supra* note 109, at 4.

¹¹² *Diamond*, 492 F.2d at 286.

¹¹³ *Id.* at 291-92.

¹¹⁴ *Id.* at 286.

¹¹⁵ *Id.*

was successful in obtaining the financing.¹¹⁶ In early 1962, a third party offered to buy the taxpayer's interest for \$40,000.¹¹⁷ The taxpayer sold his interest to the third party for \$40,000.¹¹⁸

On the taxpayer's return, he reported the \$40,000 of proceeds as short-term capital gains.¹¹⁹ The taxpayer's reasoning for reporting the proceeds as short term capital gains was that "his receipt of this type of interest in partnership is not taxable income although received in return for services."¹²⁰ The taxpayer further argued that upon receipt of the interest there was no realization and that upon the sale there should be capital gains treatment.¹²¹ The Service took the position that this was compensation for service and taxable at ordinary income rates.¹²²

The Tax Court held that the receipt of this type of interest in a partnership in exchange for the services provided does not fall within I.R.C. § 721 and is taxable under I.R.C. § 61 when received.¹²³ There was no statute or regulation in effect at that time to cover the fact pattern.¹²⁴ The Tax Court relied on the general principle that property received in return for services is compensation and thus income.¹²⁵ The Seventh Circuit affirmed the Tax Court agreeing that this was compensation income to the taxpayer.¹²⁶

The next major case addressing the topic was *Kenroy, Inc. v Commissioner*.¹²⁷ The taxpayer, a real estate developer, provided real estate services.¹²⁸ In 1971, the three principal shareholders of the taxpayer agreed to develop a piece of land on their own account.¹²⁹ In December of 1971, while the purchase of the land was being consummated, the taxpayer was offered to participate in the project with the principals.¹³⁰ In connection with a real estate development project, the taxpayer received an 88.2% interest in the partnership.¹³¹

The taxpayer argued that the receipt of a partnership interest was not compensation for services, but rather, a contribution of capital under I.R.C. § 351 or as a participation right under I.R.C. § 721.¹³² As in *Diamond*, the Tax

¹¹⁶ *Id.* at 286-87.

¹¹⁷ *Id.* at 286.

¹¹⁸ *Diamond*, 492 F. 2d at 287.

¹¹⁹ *Id.*

¹²⁰ *Id.*

¹²¹ *Id.*

¹²² *Id.* at 288.

¹²³ *Id.* at 287.

¹²⁴ *Id.* at 288.

¹²⁵ *Id.*

¹²⁶ *Id.* at 292.

¹²⁷ *Kenroy, Inc. v. C.I.R.*, T.C.M. (P-H) P 84,232 (T.C. 1984).

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ *Id.*

¹³¹ *Id.*

¹³² *Id.*

Court held that the receipt of interest on partnership profits related to services provided should be compensation income.¹³³ The value of the compensation income is the liquidation value of the interest.¹³⁴

In *St. John v. United States*,¹³⁵ the taxpayer received a 15% interest in a partnership.¹³⁶ The court found that the partnership interest received by the taxpayer was not capital but rather a profit/loss interest.¹³⁷ Further, there was a substantial risk of forfeiture on the interest, and once this risk terminated, the taxpayers were subject to taxation.¹³⁸ The court held that “[b]y the end of 1976, the partnership interest was not subject to a substantial risk of forfeiture. The additional income received by the Plaintiffs in the form of a partnership interest was therefore properly assessed against them for the taxable year 1976.”¹³⁹

Diamond remained the law until *Campbell* was decided almost twenty years later.¹⁴⁰ The court in *Campbell* held that there was no taxable event if there was not an ascertainable value.¹⁴¹ The Eighth Circuit Court of Appeals utilized I.R.C. § 83¹⁴² to hold that the profits interest transferred to the service provider had no fair market value because of its speculative and contingent nature.¹⁴³

The taxpayer in *Campbell* was an employee of a company.¹⁴⁴ He was responsible for packaging and selling interests in transactions entered into by his employer.¹⁴⁵ The taxpayer entered into an agreement with his employer in which he would receive 15% of the net proceeds for his services in the form of limited partnership units.¹⁴⁶ The taxpayer did not believe that these units would be compensation income upon receipt.¹⁴⁷ In 1983, the taxpayer was issued a deficiency notice alleging that the value of the partnership interests he was granted were ordinary income.¹⁴⁸

The Tax Court upheld the Commissioner’s determination.¹⁴⁹ The taxpayer argued to the Eighth Circuit that a service partner who receives a

¹³³ *Id.*

¹³⁴ Kenroy, T.C. Memo. 1984-232 at 232.

¹³⁵ *St. John v. U.S.*, 84-1 U.S. Tax Cas. (CCH) P9158 (C.D.Ill. 1983).

¹³⁶ *Id.*

¹³⁷ *Id.*

¹³⁸ *Id.*

¹³⁹ *Id.* at 9158.

¹⁴⁰ *Campbell v. C.I.R.*, 943 F.2d 815 (8th Cir. 1991).

¹⁴¹ *Id.* at 823.

¹⁴² This section was not in the code during *Diamond*.

¹⁴³ *Campbell*, 943 F.2d at 823.

¹⁴⁴ *Id.* at 816.

¹⁴⁵ *Id.*

¹⁴⁶ *Id.*

¹⁴⁷ *Id.*

¹⁴⁸ *Id.* at 817.

¹⁴⁹ *Id.*

partnership interest does not realize income upon receipt of that interest.¹⁵⁰ The taxpayer and several amici curiae briefs argued that the Tax Court's decision to tax a service partner substantially damaged established partnership tax law principles.¹⁵¹

The Eighth Circuit first concluded that the Tax Court's decision was based on the application of the *Diamond* case.¹⁵² The Court continued to state the established law at the time was that when a service partner received an interest in partnership capital, a taxable event occurred.¹⁵³ "The receipt of the capital interest must be included in the service partner's income."¹⁵⁴ However, if a service partner receives solely a profits interest, the tax consequences were not clear.¹⁵⁵ The Eighth Circuit distinguished *Diamond*, opining that in *Diamond* the taxpayer was becoming a service partner solely to avoid receiving ordinary income.¹⁵⁶ The Court concluded that the taxpayer's interests were not transferable and were unlikely to provide immediate returns.¹⁵⁷ The Court continued to state that the interests were speculative in value and held that they were not income.¹⁵⁸

Campbell was followed-up by Rev. Proc. 93-27¹⁵⁹ in which the Treasury confirmed they would follow *Campbell* by stating that there was no current taxation on the receipt of a profits interest and, therefore, it is not a taxable event.¹⁶⁰ In order to clarify portions of Rev. Proc. 93-27, the Service promulgated Rev. Proc. 2001-43.¹⁶¹ Rev. Proc. 93-27 enumerated certain circumstances in which a service partner would be subject to current taxation regardless of whether the interest is subject to a substantial risk of forfeiture.¹⁶² Some of the examples are (i) if the partnership and service provider treat the service provider as the owner of the partnership interest and (ii) neither the partnership nor any partner deducts any amount as wages, compensation, or otherwise for the fair market value of the interest at any time.¹⁶³

In 2005 the Treasury Department and the Service published proposed

¹⁵⁰ *Id.* at 818.

¹⁵¹ *Id.* at 818-19.

¹⁵² *Id.* at 820.

¹⁵³ *Id.*

¹⁵⁴ *Id.*; *See also* United States v. Frazell, 335 F.2d 487, 489 (5th Cir. 1964), *cert. denied*, 380 U.S. 961 (1965).

¹⁵⁵ *Campbell*, 943 F.2d at 820.

¹⁵⁶ *Id.*

¹⁵⁷ *Id.* at 822-23.

¹⁵⁸ *Id.* at 823.

¹⁵⁹ Rev. Proc. 93-27, 1993-24 I.R.B. 63.

¹⁶⁰ There are three exceptions to the rule: (1) an interest in a substantially certain and predictable stream of income; (2) the partner sells the interest within 2 years; and (3) a limited partnership interest in a publicly traded partnership.

¹⁶¹ Rev. Proc. 2001-43, 2001-34 I.R.B. 191.

¹⁶² *Id.*; *see also*, A.B.A. Sec. Tax'n, *supra* note 109, at 5

¹⁶³ Rev. Proc. 2001-43, *supra* note 161, at 191; *see also*, A.B.A. Sec. Tax'n, *supra* note 109, at 5.

regulations,¹⁶⁴ which maintained the position in Rev. Proc. 93-27 while integrating it with I.R.C. § 83.¹⁶⁵ The proposed regulations stated that partnership interests are property and that transfers which may be compensatory in line with § 83 would be governed by § 83.¹⁶⁶ By making the § 83(b) election, the value of the partnership interest would be based on its liquidation value at the time of the grant.¹⁶⁷ If this was a profits interest in the partnership, the value would be zero.¹⁶⁸

However, if the partnership affirmatively elects under the Proposed Regulations, it would have to determine the fair market value of the interest. This fair market value would be in reference to its liquidation value.¹⁶⁹ The Proposed Regulations attempted to create symmetry so that the fund manager would report no income in connection with the transfer of a profits interest, and that neither the partnership nor any partner would take a deduction.¹⁷⁰

IV. APPROACHES AVAILABLE TO TAX CARRIED INTEREST

Congress has determined that the subject of the timing and character of the taxation of carried interests is ripe for discussion. Through the proposal of H.R. 2834 and S. 1624 and the hearings associated therewith, Congress has invited commentators to participate in the discussion. Through these discussions, four central themes have developed regarding how to tax the carried interest in the Alternative Investment Funds.

A. *Tax Carried Interest When Granted*

Under I.R.C. § 83, property transferred to a person in connection with the performance of services is taxed when the property is transferred.¹⁷¹ Generally speaking, tax practitioners and the service have not taken this approach because the claim is that the options are difficult to value.¹⁷² Many commentators argue that the *Diamond* and *Campbell* cases should not be the norm.¹⁷³ They believe that the current rule was established because the courts and Treasury did not want to establish taxation on the receipt because the value would be speculative.¹⁷⁴ This approach is affirmed in Rev. Proc 93-

¹⁶⁴ Partnership Equity for Services, 70 Fed. Reg. 29,675 (May 24, 2005); Notice 2005-43, 2005-24 I.R.B. 1221.

¹⁶⁵ See generally, Testimony of Gergen, *supra* note 25.

¹⁶⁶ 70 Fed. Reg. 29,675.

¹⁶⁷ *Id.*

¹⁶⁸ *Id.*; See also Testimony of Gergen, *supra* note 25, at 2.

¹⁶⁹ 70 Fed. Reg. 29,675; See also Testimony of Gergen, *supra* note 25, at 2.

¹⁷⁰ See Testimony of Gergen, *supra* note 25, at 2.

¹⁷¹ I.R.C. § 83(a).

¹⁷² See Testimony of Gergen, *supra* note 25, at 2; Sheppard, *supra* note 5, at 4.

¹⁷³ Testimony of Gergen, *supra* note 25, at 2; Sheppard, *supra* note 5, at 4.

¹⁷⁴ Testimony of Gergen, *supra* note 25, at 2; Sheppard, *supra* note 5, at 4.

27.¹⁷⁵ In light of the recent wave of initial public offerings for the management entities of hedge funds, the claim that the carried interest is hard to value *ab initio* seems not to hold water.¹⁷⁶

An example is the Blackstone Group, L.P. initial public offering.¹⁷⁷ During this time, outside investors were purchasing an interest in the management company (GP) which ran all of the different limited partnerships.¹⁷⁸ Blackstone analyzed two approaches regarding the valuation of their interest. Initially, they employed the Black-Scholes formula.¹⁷⁹ However, they ultimately utilized the Statement of Financial Accounting Standards No. 159 for the valuation of this interest.¹⁸⁰ Blackstone took the approach that existing carried interests were equivalent to options.¹⁸¹ Despite outside clamor that they booked unrealized profits, Blackstone followed generally accepted accounting principles to value these interests.¹⁸² Clearly, no one was arguing that Blackstone was undervaluing their interest, as this would be against their best interest. The initial public offerings of Blackstone, Och-Ziff, and Fortress, among others, have shown that it is possible to tax the granting of the carried interest at grant.

This taxation would result in an acceleration of income to the government given that yearly revenues would pour in from the taxing of the carried interest.¹⁸³ However, the managers would also get their wish that the future growth based on their efforts would be treated as capital gain. In this way they would be treated the same as the sole proprietor. However, they might also be in the position of having phantom gain with no income to support.

¹⁷⁵ Rev. Proc. 93-27, *supra* note 156.

¹⁷⁶ See Blackstone Group, L.P. (Form S-1), available at <http://sec.edgar-online.com/blackstone-group-lp/s-1a-securities-registration-statement/2007/05/01/Section3.aspx>; Och-Ziff Capital Management Group L.P. (Form S-1) available at <http://www.sec.gov/Archives/edgar/data/1403256/000119312507147770/ds1.htm>; and Fortress Investment Group L.P. (Form S-1) available at <http://www.sec.gov/Archives/edgar/data/1380393/000095013607000635/file1.htm>.

¹⁷⁷ Blackstone (Form S-1) *supra* note 176.

¹⁷⁸ *Id.*

¹⁷⁹ The formula basically takes the current price of the asset, applies an assumed volatility, and then compares that number to the present value of paying the strike price on the expiration date of the option. See Sheppard, *supra* note 5, at 4.

¹⁸⁰ Blackstone (Form S-1) *supra* note 176; See also Sheppard, *supra* note 5, at 4.

¹⁸¹ Blackstone (Form S-1), *supra* note 176.

¹⁸² *Id.*

¹⁸³ See Testimony of Orszag, *supra* note 26, at 14.

B. Tax the Carried Interest as Ordinary Income When Realized—the H.R. 2834 Rangel Approach

This approach would allow initial deferral as established under the current law, but tax the carried interest as a fee at ordinary income rates when received. In H.R. 2834, the House lawmakers propose the addition of a new I.R.C. § 710 to the code.¹⁸⁴ The stated purpose of the addition of I.R.C. § 710

¹⁸⁴ In relevant part:

SEC. 710. SPECIAL RULES FOR PARTNERS PROVIDING INVESTMENT MANAGEMENT SERVICES TO PARTNERSHIP.

(a) Treatment of Distributive Share of Partnership Items- For purposes of this title, in the case of an investment services partnership interest--

(1) IN GENERAL- Notwithstanding section 702(b)--

(A) any net income with respect to such interest for any partnership taxable year shall be treated as ordinary income for the performance of services, and

* * *

(3) NET INCOME AND LOSS- For purposes of this section--

(A) NET INCOME- The term `net income' means, with respect to any investment services partnership interest, for any partnership taxable year, the excess (if any) of--

(i) all items of income and gain taken into account by the holder of such interest under section 702 with respect to such interest for such year, over

(ii) all items of deduction and loss so taken into account.

* * *

(4) DISTRIBUTIONS OF PARTNERSHIP PROPERTY- In the case of any distribution of appreciated property by a partnership with respect to any investment services partnership interest, gain shall be recognized by the partnership in the same manner as if the partnership sold such property at fair market value at the time of the distribution. For purposes of this paragraph, the term `appreciated property' means any property with respect to which gain would be determined if sold as described in the preceding sentence.

(c) Investment Services Partnership Interest- For purposes of this section--

(1) IN GENERAL- The term `investment services partnership interest' means 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:

(A) Advising the partnership as to the value of any

is “to treat as ordinary income (i.e., income taxed at regular income tax rates) income received by a partner from an investment services partnership interest.”¹⁸⁵ The bill defines “investment services partnership interest” as any interest in a partnership held by a person who provides services to a partnership by: (1) advising the partnership as to the value of specified assets (e.g., real estate, commodities, or options or derivative contracts); (2) advising the partnership about investing in, purchasing, or selling specified assets; (3) managing, acquiring, or disposing of specified assets; or (4) arranging financing with respect to acquiring specified assets.¹⁸⁶

The result to this approach is to tax the general partner at ordinary

specified asset.

(B) Advising the partnership as to the advisability of investing in, purchasing, or selling any specified asset.

(C) Managing, acquiring, or disposing of any specified asset.

(D) Arranging financing with respect to acquiring specified assets.

(E) Any activity in support of any service described in subparagraphs (A) through (D).

For purposes of this paragraph, the term ‘specified asset’ means securities (as defined in section 475(c)(2) without regard to the last sentence thereof), real estate, commodities (as defined in section 475(e)(2)), or options or derivative contracts with respect to securities (as so defined), real estate, or commodities (as so defined).

(2) EXCEPTION FOR CERTAIN CAPITAL INTERESTS-

(A) IN GENERAL- If--

(i) a portion of an investment services partnership interest is acquired on account of a contribution of invested capital, and

(ii) the partnership makes a reasonable allocation of partnership items between the portion of the distributive share that is with respect to invested capital and the portion of such distributive share that is not with respect to invested capital,

then subsection (a) shall not apply to the portion of the distributive share that is with respect to invested capital. An allocation will not be treated as reasonable for purposes of this subparagraph if such allocation would result in the partnership allocating a greater portion of income to invested capital than any other partner not providing services would have been allocated with respect to the same amount of invested capital.

¹⁸⁵ Bill Summary. <http://thomas.loc.gov/cgi-bin/bdquery/z?d110:HR02834:@@D&summ2=m&>.

¹⁸⁶ *Id.*

income rates.¹⁸⁷ This would mirror the treatment of nonqualified stock options.¹⁸⁸ The carried interest would still retain the deferral characteristic but would be taxed upon exercise at ordinary income rates.¹⁸⁹ It has been argued that the H.R. 2834 approach would lead to tax planning such as the utilization of loans as described in C below.¹⁹⁰

C. Tax Imputed Interest as an Implied Loan

Under this theory, the general partner's carried interest would be treated as a nonrecourse loan from the limited partners.¹⁹¹ The general partner would then owe tax based on the value of the implicit interest on that loan, as it accrued.¹⁹² This would result in a portion of the carried interest treated as capital gains and a portion as ordinary income.¹⁹³ This approach is also the most complicated: effectively, the carried interest is treated as nonrecourse, interest-free loan with the loan proceeds invested in the fund.¹⁹⁴ At the time the carried interest is granted, the amount would

¹⁸⁷ Testimony of Orszag, *supra* note 26; *cf.*, Hamilton Project Event, *supra* note 13, at 25 (thoughts attributable to Mr. Prater, this is not an easy issue to solve. There is a lot of impact on markets and a lot of different features.); U.S. Chamber of Commerce, *supra* note 12 (“This is a tax increase on partnerships and entrepreneurs, plain and simple.”).

¹⁸⁸ Testimony of Orszag, *supra* note 26, at 13; *cf.* Testimony of Solomon, *supra* note 15 at 7:

Upon receipt of a stock option, the employee has no ownership rights until the option is exercised and he receives the underlying shares. The employee has no voting rights and no economic rights to dividend payments with respect to the stock until the option is exercised. Upon receipt of a carried interest, the service partner has an immediate ownership interest in the enterprise with all of the attendant rights and responsibilities. The service provider is taxable on his distributive share of partnership taxable income and has the rights and responsibilities with respect to ownership of the partnership interest....

¹⁸⁹ Testimony of Orszag, *supra* note 26, at 13.

¹⁹⁰ Testimony of Orszag, *supra* note 26, at 14.

¹⁹¹ Testimony of Gergen, *supra* note 25, at 6; *See also* Testimony of Orszag, *supra* note 26 at 14; Sheppard, *supra* note 5, at 6; Fleischer, *supra* note 28.

¹⁹² *Id.*

¹⁹³ *Id.*

¹⁹⁴ *Id.* *See also*, Testimony of Ifshin, *supra* note 49:

H.R. 2834 would have the effect of favoring debt over equity. Partnerships with equity contributions would be subject to the bill's tax increase while loan arrangements would not. So, taxpayers would be encouraged to structure a transaction as a loan from the investor to the entrepreneur instead of forming a partnership with the investors making an equity contribution. Encouraging debt over equity is not good policy generally and certainly is not good policy

equal the loan amount and would vest.¹⁹⁵ The recognized gain by the general partner would be taxed as long-term capital gain.¹⁹⁶ However, the fund manager would have to go back and calculate the foregone interest payments as ordinary income and pay tax on them.

D. *Gergen Approach to Amend I.R.C. § 702(b)*

If Congress desires to tax carried interests at ordinary rates and not capital rates, a much simpler solution exists under the current law with slight modification. Professor Gergen in his Finance Committee Testimony suggested an alternative:

There is a fairly simple solution to the problem of the taxation of carried interests: amend Section 702(b) to treat a partner's distributive share as ordinary income when the partner receives the distributive share as compensation for services rendered by the partner to the partnership. The capital accounts system, which is the core of modern Subchapter K, makes this fairly easy to do. This change would also solve some other substantive and technical problems under current law.¹⁹⁷

Professor Gergen argues that through the use of capital accounts, Congress will provide a more consistent principle for the re-characterization of the compensation.¹⁹⁸ Through the use of the capital accounts system, Congress can apply the aggregate theory of partnership tax, rather than the entity theory that I.R.C. § 702(b) follows.¹⁹⁹

The result of modifying I.R.C. § 702(b) would be that a fund manager who did not invest capital into a partnership would treat their

in the current credit and liquidity climate. The world financial markets have been roiled by their exposure to an abundance (perhaps overabundance) of lending from subprime mortgages to commercial conduit financing. Mortgage backed securities are suffering steep declines in values. We will soon see how strong or fragile these markets are. Nevertheless, this does not appear the time to impose a tax that would affect the value of the real estate collateralizing a significant portion of the debt market.

¹⁹⁵ For example, if the fund was \$500,000,000 and the manager received a 20% carried interest, at outset, the manager would receive a loan of \$100,000,000 (20% of \$500,000,000). If the fund was liquidated 5 years later for \$750,000,000, the fund manager would receive \$150,000,000 (20% of \$750,000,000) less the \$100,000,000 loan or \$50,000,000.

¹⁹⁶ Assuming the holding periods under the I.R.C. are met.

¹⁹⁷ Testimony of Gergen, *supra* note 25, at 1.

¹⁹⁸ Testimony of Gergen, *supra* note 25, at 3.

¹⁹⁹ The character of income is determined at the partnership level.

distributions as ordinary income.²⁰⁰ If a partner in the investment partnership supplied both labor and capital, the distributions will retain the character at the partnership level.²⁰¹ However, those distributions must be in accordance with capital accounts.²⁰² Under Subchapter K, when the fund managers obtain their bonus 2 and 20 structure, any larger distributive share to service partners will be compensation.²⁰³

V. PITFALLS OF THE H.R. 2834 APPROACH

Assuming there is resolution to the taxation of the carried interest in the proposed H.R. 2834, there are various problems with the proposed language that already have been identified.²⁰⁴ Those issues fall within at least fourteen different categories.²⁰⁵ Despite having a multitude of unintended

²⁰⁰ The character of the income at the partnership level.

²⁰¹ Testimony of Gergen, *supra* note 25, at 4.

²⁰² *Id.*

²⁰³ *Id.*

²⁰⁴ See A.B.A. Sec. Tax'n, *supra* note 109, at 9.

²⁰⁵ *Id.* at 16-25. The categories, according to the ABA Section, are:

- (1) Differentiation among interest based on the type of service provided (discussed *supra*);
- (2) Differentiating between carried interests and purchased interests (discussed *supra*);
- (3) Taxation of issuance or vesting of carried interest – timing and potential double taxation (“To the date of the income event, a portion of the partnership equity may be based on the expected future profits to be allocated and distributed with respect to the interest. To that extent, the recipient will have compensation income twice if H.R. 2834 is enacted: once at the date of grant, and a second time when the actual profits are earned by the partnership and allocated to the partners.”);
- (4) Basis implications (“Thus, a partner with a carried interest and a purchased interest may receive a distribution in excess of the basis attributable to the carried interest, which H.R. 2834 may seek to treat as ordinary income (due to being in excess of the carried interest’s basis) or as tax-free (due to being less than the combined basis or perhaps because it was received on and properly attributable to the purchased interest). Thus, it may be necessary to calculate separately the basis of a carried interest and a purchased interest held by the same partner.”);
- (5) Interaction with loss limitation rules (“H.R. 2834 would add a fifth loss limitation rule. A net loss on a carried interest that is subject to H.R. 2834 would be allowed only to the extent the loss does not exceed the excess, if any, of the prior income from such interest over the prior losses from the interest. Similar to a loss limited under section 704(d), a loss limited by the provisions of H.R. 2834 would not reduce the basis of the

-
- partnership interest. However, it is unclear whether a loss to which section 704(d) and H.R. 2834 would apply would be limited by one provision, the other, or both (and, if both, in what order).”);
- (6) Limited or broad applicability of re-characterization (“However, the legislation does not specify whether this re-characterization affects only the conformed sections and section 1 or instead re-characterizes the income and gain for all purposes of the Code. If the re-characterization applies for all purposes, this may have a number of indirect consequences. . . . It is unclear whether a distributive share that is re-characterized by proposed section 710 is intended to be treated as an interest in profits for these purposes or, by virtue of the re-characterization, is separated from the partnership’s profits for such an analysis.”);
- (7) Interaction with section 704(b) (“If a service provider will have its income re-characterized as ordinary income, the other partners may desire to allocate ordinary income to the service provider (at least as to its carried interest) and allocate capital gains and/or tax-exempt income to the purchased interests. Whether this type of allocation would have substantial economic effect is not clear.”);
- (8) Interaction with section 707(a)(2)(A) (“If the Congressional intent behind enacting H.R. 2834 is essentially the same as that behind section 707(a)(2)(A), Congress should provide clear direction as to the priority of these rules so that taxpayers and the Service will know whether an allocation with respect to an interest covered by H.R. 2834 should be recharacterized as compensation payments to an independent contractor or employee under section 707(a)(2)(A) or instead should be recharacterized as ordinary income under proposed section 710.”);
- (9) Interaction with section 732(b) (“The basis rules applicable to distributed property (other than money) may require coordination with the changes proposed to be made by H.R. 2834.”);
- (10) Interaction with section 751(b) (“H.R. 2834’s differentiation as to carried interests and purchased interests may require special rules for the application of section 751(b). Specifically, proposed section 710 contains a rule that a disposition of the carried interest, including a distribution of money by the partnership to a partner in excess of the partner’s basis in the partnership, is considered ordinary income. Because of this special rule, it will most likely be necessary, when applying section 751(b), to treat the carried interest portion of a partnership interest as separate from the purchased interest portion of the same partnership interest.”);
- (11) Interaction with section 708(b)(1)(B) (“If a partner’s distributive share in a partnership will be recharacterized as

consequences, the three main areas that need to be addressed are: (1) the definition of terms within the proposed language; (2) the allocations that occur when there is a blended investment and carried interest; and (3) the implications to the financial partner.

A. *Definitional Problems*

The new legislation applies to a partnership interest if the holder of the interest provides services, such as advisory or management services.²⁰⁶ The

ordinary income under H.R. 2834 and if there is an intervening termination under section 708(b)(1)(B), the partner (who may or may not have transferred any portion of its interest in the partnership to trigger the termination and who may or may not have any control over whether the intervening termination occurred) should be allowed to utilize losses allocated to that partner after the termination from what, if no termination had occurred, is the same interest in the same partnership.”);

(12) Interaction with section 7704(b) (“H.R. 2834 refers, at times, to the income that it re-characterizes as ‘ordinary income for the performance of services.’ If a publicly traded partnership is a general partner of another publicly traded partnership, one consequence of the operation of H.R. 2834 may be to cause such general partner to be treated as a corporation, because what otherwise would be qualifying income under section 7704(c) would become (at least in part) non-qualifying compensation income under proposed section 710.”);

(13) Applicability in connection with tiered partnerships and related entities (“Revenue Procedure 93-27 addresses interests received for services provided ‘to or for the benefit of’ the partnership that issues the profits interests. If such services are the covered services, H.R. 2834 would appear to apply to the issued interest (as service performed ‘to’ the partnership would likely be services provided ‘directly’ to the partnership and services performed ‘for the benefit of’ the partnership would appear to be services provided ‘indirectly’ to the partnership). However, the intended meaning of ‘directly or indirectly’ is unclear and should be clarified.”); and

(14) Impact on partners not holding “investment services partnership interest” (discussed *supra*).

²⁰⁶ Proposed I.R.C. § 710(c)(1) (2007). *See also*, A.B.A. Sec. Tax’n, *supra* note 109, at 9 (The services which H.R. 2834 would apply are: “(1) advising as to value, (2) advising as to advisability of investing in, purchasing or selling such assets, (3) managing, acquiring or disposing of such assets, (4) arranging financing with respect to acquiring such assets, and (5) any activity in support of the foregoing. Specified assets are securities, real estate, commodities or options or derivative contracts with respect to such assets.”).

language in proposed I.R.C. § 710 leads to at least five major interpretive issues that the Service, the courts, and the taxpayers need to resolve.

Initially, the first interpretive term is “active trade or business.”²⁰⁷ Whose trade or business is being addressed? Is the requirement that the service provider have a separate trade or business providing services to the partnership (*e.g.*, a fund management company)?²⁰⁸ Or is the requirement that the partnership itself be an active trade or business?²⁰⁹ What happens if a partnership has real estate that is incidental to its primary business?²¹⁰ Does that bring that partnership within the scope of proposed I.R.C. § 710? Moreover, does “active” have the same meaning as in I.R.C. § 355?²¹¹ Or do the drafters have a different standard in mind?

Once you get through the trade or business component, the next issue concerns the terminology “substantial quantity.” How can one quantify services?²¹² There are certain Code sections that make reference to services in terms of time spent.²¹³ However, is the test compensation? Exclusivity? What is substantial? To the proverbial secretary, one million dollars may be substantial. However, to Danny Och, one million dollars may be a night out on the town.²¹⁴ Then, if you can determine the service provided was a “substantial quantity” of any services, do you also impute the activities of related parties?²¹⁵ The more difficult question to address is how far out is it reasonable to go? Do you impute the work of independent contractors or attorneys or appraisers?²¹⁶ It would appear, at first blush, far-fetched to impute the work of the attorneys conducting due diligence on behalf of the partnership to the quantity of work done by the service partner.

One of the more intriguing questions posed in the definitional section of H.R. 2834 is: once you fall within § 710, as an “investment services partnership interest”, will that last indefinitely?²¹⁷ What happens if the partnership is formed and funded in year one? In year two, the investment is made in one capital asset. The asset is held, but not managed, until year five when it is liquidated. Does § 710 apply only in the year that services were

²⁰⁷ Proposed I.R.C. § 710(c)(1) (2007).

²⁰⁸ A.B.A. Sec. Tax’n, *supra* note 109, at 9.

²⁰⁹ *Id.*

²¹⁰ *Id.*

²¹¹ *Id.*

²¹² *Id.*

²¹³ I.R.C. § 469 (2007) and Prop. Treas. Reg §1.1402(a)-2(h)(2)(iii). See A.B.A. Sec. Tax’n, *supra* note 109, at 9.

²¹⁴ See A.B.A. Sec. Tax’n, *supra* note 109, at p. 9 (“Substantiality might be viewed from the service provider’s perspective, the partnership’s perspective, the industry’s perspective, relative to the job type, or other benchmarks.”)

²¹⁵ *Id.* (Obviously the entity can only provide services through its employees, agent or representatives.)

²¹⁶ *Id.* at p. 10.

²¹⁷ *Id.*

provided—year two?²¹⁸ Is it applied in every year?

Finally, the scope of H.R. 2834 must be considered.²¹⁹ Many commentators have suggested that H.R. 2834 is so sweeping in breadth that there will be many unintended consequences for small partnerships.²²⁰ If the targeted legislation is attempting to attack the large Alternative Investment Funds, then there should be specific thresholds on the applicability of H.R. 2834.²²¹

B. *Allocations between Carried and Purchased Interests*

Under H.R. 2834, once it is determined that the service partner holds an “investment services partnership interest,” all of that partner’s income and gain is re-characterized as ordinary income for the performance of services.²²² The legislation appears to carve out an exception for invested capital by the service partner.²²³ Under the bill, the partnership is to allocate partnership items for the service partner between the two interest classifications.²²⁴ Under the proposed legislation, carried interests are taxed to the distributed partner at ordinary income rates while purchased interests will retain their character.²²⁵ Thus, the distinctions made at the partnership level will be very important. As Professor Gergen discussed during his testimony, the placement of this burden on the capital accounts system is not practical given the current language.²²⁶ Additionally, the bill would seem to treat two indistinguishable situations differently.²²⁷

²¹⁸ *Id.*

²¹⁹ See A.B.A. Sec. Tax’n, *supra* note 109, at p 11.

²²⁰ *Id.* See generally, Testimony of Orszag, *supra* note 26, at 11.

²²¹ *Id.* at 11. (It has been suggested that the following factors be considered: “(1) the size of the partnership (*e.g.*, whether by number of partners, number of partners providing the covered services, the asset base of the partnership, the value of the specified assets held by the partnership, or other quantitative measurement standards), (2) partnerships with certain other characteristics (*e.g.*, a lack of significant assets other than the specified assets), (3) the industry of the partnership’s primary business, (4) the size or net worth of the partner, or (5) the size of the partner’s interest (*e.g.*, measured in value or percentage interest)”).

²²² I.R.C., § 710(a)(1)(A), (b)(1), and (c)(1) (2009). See also, A.B.A. Sec. Tax’n, *supra* note 109, at 12.

²²³ Proposed I.R.C. § 710(c)(2)(A) (2009).-

²²⁴ *Id.* See A.B.A. Sec. Tax’n, *supra* note 109, at 11.

²²⁵ See A.B.A. Sec. Tax’n, *supra* note 109, at 12.

²²⁶ *Id.* See also, Testimony of Gergen, *supra* note 25, at 3.

²²⁷ See A.B.A. Sec. Tax’n, *supra* note 109, at 13. Even in simple partnerships, the distinction may become difficult to draw. In some partnerships, one or more partners will provide the capital and have limited management authority and one or more partners will provide solely services. However, even in such partnerships, if the cash or property associated with the partnership’s profits is not fully distributed, a service providing partner will end up with a positive capital account balance. If

However, the most telling and important aspect to the proposed law is the reconciliation between the state partnership law, requiring at least some level of participation in the entity and the new tax language.²²⁸ H.R. 2834 does not exempt from the allocation between carried and purchased interests a *de minimis* level of services.²²⁹ Is the tax-matters partner a service partner?

C. Impact on the Other Non-Service Partnership Partners

H.R. 2834 characterizes the gain recognized by the service partner as if the partnership sold the distributed property at fair market value at the time of the distribution.²³⁰ While the service provider is capturing this gain as ordinary income, there are no deductions allowed in regard to this income inclusion.²³¹ Under current tax policy, the majority of payments for services are deductible.²³² The failure of H.R. 2834 to permit the deductibility of the payment limits the use of the deduction.²³³

Another area of impact lies within the context of tiered partnerships. In a tiered partnership structure, the lower partnership provides the investment and the upper provides the service. Often in the upper partnership there are non-investment service partners. The impact of H.R. 2834 causes parties not generally subject to U.S. taxation to tax at ordinary income rates.²³⁴

the cash or property was fully distributed and the service providing partner re-contributed the cash or property received, it seems that, under the bill, the service providing partner would have some portion of its interest that is a purchased interest. As the origin of the capital account balance in the two situations is economically indistinguishable, there does not appear to be a strong policy rationale for differentiating between contributed cash and property, on the one hand, and cash and property (previously taxed as distributive share) that is retained by a partnership, on the other hand.

²²⁸ See Revised Uniformed Limited Partnership Act (2001); A.B.A. Sec. Tax'n, *supra* note 109, at 13.

²²⁹ *Id.*

²³⁰ Proposed I.R.C. § 710(b)(4) (2009). See A.B.A. Sec. Tax'n, *supra* note 109, at 25.

²³¹ See A.B.A. Sec. Tax'n, *supra* note 109, at 25.

²³² *Id.* at 26.

²³³ See A.B.A. Sec. Tax'n, *supra* note 109, at 26. (Such limitations include I.R.C. § 67, 68, 704 (d), 465, 469, and 470 (2009)).

²³⁴ See A.B.A. Sec. Tax'n, *supra* note 109, at 26. ("Additionally, foreign Non-ISP Partners may be drawn into the U.S. tax system and have a U.S. trade or business by virtue of the allocation of services income (which, before the application of H.R. 2834, may have been exempt from U.S. taxation as, for example, portfolio interest or capital gain). Tax-exempt Non-ISP Partners will experience the re-characterization of income from what may not have been unrelated business taxable income (*e.g.*, interest, dividends, or capital gains) to income that is subject to the unrelated business income tax.)

VI. CONCLUSION

The public offering of Blackstone Group caused a public and political backlash when the initial public offering memoranda showed how much built-up gain existed in Alternative Investment Vehicles.²³⁵ This groundswell, combined with political needs for offsets to eliminate the alternative minimum tax, led several influential lawmakers to seek passage of tax legislation that would reduce the tax incentives currently in place benefiting managers of the Alternative Investment Funds.²³⁶ The legislation, most predominately H.R. 2834, proposed to add I.R.C. § 710 to the Code, changing the treatment of distributions to the service partners from capital gain rates to ordinary income rates.²³⁷ Thus, the bill contains provisions that seek to reverse over thirty years of jurisprudence with a shotgun approach, attempting to solve what has been deemed an injustice. Currently, H.R. 2834 is in the House Committee on Ways and Means.

H.R. 2834 is likely to cause certain fund managers to pay ordinary income rates. As demonstrated by the recent influx of initial public offerings, however, these “masters of the universe” have not recently fallen off the turnip

²³⁵ See Cho, *supra* note 4, at D01. (“Publicly traded partnerships are rare, especially in the financial sector. The senators expressed concern that Blackstone's offering would set a dangerous precedent and lead to a wave of financial firms reorganizing themselves to take advantage of the tax loophole. ‘Right now, some businesses are crossing the line between reasonably lowering their tax burden and pretending to be something they're not to avoid most, if not all, corporate taxes,’ Grassley said. ‘If left unaddressed, the tax concerns presented by the public offerings of investment managers, like private-equity and hedge fund management firms, could fundamentally erode the corporate tax base. That would leave other individuals and business taxpayers with a greater share of the nation’s tax burden.’) See also, Hamilton Project Event, *supra* note 13, at 22 (Quoting Mr. Summers, “I think that the right view on this is that there are surely some abuses that are involved with stuff that gets capital gains taxation that no one would want to defend, that beyond that there are very difficult questions of line drawing if you’re going to have a capital gains treatment and you’re going to have partnership structures in how the tax law should be written and designed if you’re going to have fairness,”); Josten, *supra* note 47.

²³⁶ See, Cho, *supra* note 4, at D01. See generally, A.B.A. Sec. Tax’n, *supra* note 109.

²³⁷ See Press Release, Levin, *Democrats Introduce Legislation to End Carried Interest Tax Advantage* (June 22, 2007) (on file with Committee on Ways and Means). (http://www.house.gov/apps/list/press/mi12_levin/PR062207.shtml). (“It clarifies that any income received from a partnership in compensation for services is ordinary income for tax purposes. As a result, the managers of investment partnerships who receive a carried interest as compensation will pay regular income tax rates rather than capital gains rates on that compensation. The capital gains rate will continue to apply to the extent that the managers’ income represents a reasonable return on capital they have actually invested in the partnership.”).

truck.²³⁸ By increasing the tax to ordinary levels, H.R. 2834, or its progeny, is likely to transform the manner in which investment vehicles are structured and managed. Whether savvy fund managers and their planners take advantage of setting up shop in off-shore jurisdictions²³⁹ and using treaty jurisdictions to bring back in income, or they set up a vehicle which does not distribute income but rather lists on public exchanges, or they continue to pay lobbyists to prevent such a law from being enacted, the likelihood of a doubling of tax rates is not high.²⁴⁰ As such, H.R. 2834 is unlikely to raise the revenues as lawmakers anticipate.

²³⁸ See, Cho, *supra* note 4, at D01. (“Two key senators took aim at the initial public offering of Blackstone Group yesterday, introducing legislation that would foil a major tax advantage that the private-equity giant hopes to benefit from as a public company.”)

²³⁹ See, Sorkin, *supra* note 19, at B3 (“But if that were true, buyout titans like Henry R. Kravis and Stephen A. Schwarzman would have abandoned Manhattan long ago.”)

²⁴⁰ Stein, *supra* note 11, at B1 (“But the mark of a great society is that its laws approximate morality and fairness. Is this really what we have in the tax code now? If so, fine. If not, why are we not changing it? Is it because of the pitifully cheap contributions of the finance industry to the two parties? If so, the politicians are much more pitiful than I had thought. Contributions in the thousands and hundreds of thousands for tax breaks in the billions? This isn’t sensible even on an old Tammany Hall basis. Contribute a penny to get a hundred dollars? What’s up with that?”).

