CARRIED INTEREST: "THAT IS PURE POPPYCOCK!"[1]

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I. INTRODUCTION

Income classification with respect to private investment funds has been subject to heavy scrutiny over the past few years, as critics have attacked the management structures and compensation practices of fund managers.[2] At the foundation of the debate lies the disparate characterization of income as either "ordinary income" or "capital gains income," and the preferential tax rates afforded to capital gains income.[3] In the context of private investment funds, fund managers are

[1] Dodgeball: A True Underdog Story (20th Century Fox 2004).

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[2] Shrilaxmi S. Satyanarayana, *Tax Equality: Eliminating the Low Effective Marginal Tax Rates for Private Equity Professionals*, 82 St. John's L. Rev. 1589, 1589 (2008).

[3] *Id.*

generally compensated with a "two and twenty" pay structure.[4] The "two" refers to a small percentage of fund managers' compensation, which is treated as a management fee and taxed as ordinary income.[5] The major point of contention rests with the "twenty" portion of the pay structure, where fund managers are compensated with a 20% profits interest.[6] It is this profits interest that has been given the term-of-art colloquially known as "carried interest."[7] Although proponents of carried interest have not gone so far as to label carried interest as a "tax shelter," reformists point to the inequities of the status quo as a basis for legislative action.[8]

Part II of this note will provide background information on the different types of private investment funds, the difference between a profits interest and a capital interest, and a brief overview of how carried interest taxation is accomplished. Part III will elaborate on both the tax and fiscal policy considerations of carried interest taxation. Part IV of this note will briefly explain the history of proposed carried interest legislation. Part V will delve into the scholarly debate, describing legislative reform proposals. Part VI will consist of my proposal for carried interest reform, and Part VII will conclude the content of this note.

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[4] Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. Rev. 1, 3 (2008).

[5] *Id.* (recognizing fund managers generally in highest ordinary income tax bracket).

[6] *Id.*

[7] *Id.* (noting profits interests are labeled as "carried interests" in the Code).

[8] *See* Del Wright, Jr., *Financial Alchemy: How Tax Shelter Promoters Use Financial Products to Bedevil the IRS (and How the IRS Helps Them),* 45 Ariz. St. L.J. 611, 614-15 (2013) (citing B. John Williams, Jr., Chief Counsel, IRS, Address at the Chicago Bar Association Federal Taxation Committee: Resolving Tax Shelters: By Settlement or Litigation 2 (Feb. 25, 2003), *available at* http://www.irs.gov/pub/irs-utl/shelters-feb25.pdf).

II. BACKGROUND

A. HISTORY

Corporate scandals brought the media spotlight's focus on the level and composition of executive compensation, which generated enough public dismay to ultimately lead to the passage of the Sarbanes-Oxley Act of 2002.[9] Following the enactment of Sarbanes-Oxley and significant revisions to the accounting standards applicable to share-based compensation, the attention shifted to the private sector, particularly the compensation of investment fund managers.[10] In the private investment fund sector, free from the grasp of Sarbanes-Oxley,[11] leading investment fund managers were earning substantially more income than Wall Street executives.[12] Even Warren Buffet acknowledged the inequities of the current carried interest taxation regime, finding it wrong that investment fund managers could pay taxes at a lower rate "than our receptionists do or our cleaning ladies."[13]

B. DIFFERENT TYPES OF PRIVATE INVESTMENT FUNDS

Within the realm of private investment funds are three major entity forms: (1) Private Equity Funds, (2) Hedge Funds, and (3)

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[9] Matthew A. Melone, *Success Breeds Discontent: Reforming the Taxation of Carried Interests – Forcing a Square Peg into a Round Hole*, 46 Duq. L. Rev. 421, 422 (2008).

[10] *Id.*

[11] *See* Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745, *available at* https://www.sec.gov/about/laws/soa2002.pdf (denoting applicability to public corporations).

[12] Melone, *supra* note 9, at 422 (noting that in 2006, investment fund manager James Simons made $1.7 billion, while Lloyd Blankfein, Chairman and CEO of Goldman Sachs, earned a "mere" $54.3 million that year).

[13] Samuel D. Brunson, *Taxing Investment Fund Managers Using a Simplified Mark-to-Market Approach*, 45 Wake Forest L. Rev. 79, 81 (2010) (quoting Andrew Ross Sorkin, *Putting a Bull's-Eye on a Tax Loophole*, N.Y. Times, Mar. 10, 2009, at B1).

Venture Capital Funds.[14] All three are generally structured as limited partnerships, where the investors serve as limited partners, and the fund managers act as a general partners.[15] Private equity funds, the primary target of proposed carried interest legislation, are comprised of multi-million-dollar blocks of "private" capital from a limited number of wealthy investors or institutions.[16] Private equity fund investors contractually limit their ability to withdraw their capital in order to allow the fund managers to invest in illiquid assets to be held for long periods, and therefore, qualify for favorable long-term capital gains tax treatment.[17]

Hedge funds, on the other hand, typically trade regularly and make many different investments.[18] Thus, the committed capital is rarely inaccessible and investors generally have the right to withdraw their investment plus their share of returns at regular intervals.[19] Similar to private equity fund managers, who collect profits interests on the returns, hedge fund managers are paid an "incentive fee" against profits, which is taxable when paid at ordinary income rates rather than at preferential long-term capital gains rates.[20] Venture capital

[14] Heather M. Field, *The Return-Reducing Ripple Effects of the "Carried Interest" Tax Proposals*, 13 Fla. Tax Rev. 1, 8 (2012).

[15] *Id.*; *see* Note, *Taxing Partnership Profits Interests: The Carried Interests Problem*, 124 Harv. L. Rev. 1773, 1776-77 (2011) (explaining the difference between limited and general partners).

[16] Note, *Taxing Partnership Profits Interests: The Carried Interests Problem*, *supra* note 15, at 1776 (discerning "public" money from unlimited numbers of investors holding exchange-traded, SEC-regulated securities).

[17] *Id.* at 1777 (long-term capital gains taxed at maximum of 20%).

[18] *Id.* at 1779.

[19] Adam H. Rosenzweig, *Not All Carried Interests Are Created Equal*, 29 Nw. J. Int'l L. & Bus. 713, 720 (2009).

[20] *Id.* (describing hedge fund managers charge incentive fees on a regular basis based on the value of the assets of the fund at the time of the calculation). Notably, hedge fund managers primarily utilize mechanisms that permit income deferral as a means of accumulating significant wealth. *See, e.g.*, Miles Weiss, *George Soros May Face a Monster Tax Bill*, BloombergBusiness (Apr.

funds are similar to private equity funds, except the portfolio companies are start-ups rather than underperforming public companies, divisions of public companies, or privately held businesses.[21] The superior risk of investing in start-ups, coupled with the generally accepted time period necessary to generate a profit, have deterred proponents of carried interest reform from attacking venture capital fund pay structures.[22]

C. Private Equity and the Carried Interest Dilemma

While the 2% management fee taxed at ordinary income rates remains uncontested, the 20% profits interest, or "carried interest," draws harsh criticism because it typically qualifies for the lower long-term capital gains rates.[23] Whereas a capital interest is acquired in exchange for a capital contribution to the partnership and thus has an immediate liquidation value, a profits interest represents the right to receive future profits which are not supported by a capital contribution.[24] A partnership interest is defined by, and directly correlates with, a partner's capital account.[25] The capital account, which serves as a record of an investor's interest in the fund, is increased by an investor's contributions to the fund as well as the investor's proportionate share of the investment fund's income.[26]

30, 2015), http://www.bloomberg.com/news/articles/2015-04-30/george-soros-s-tax-bill?cmpid=BBD043015.

[21] Victor Fleischer, *The Missing Preferred Return*, 31 J. Corp. L. 77, 82-83 (2005).

[22] Fleischer, *supra* note 4, at 8.

[23] *Id.* at 3-4.

[24] Note, *Taxing Partnership Profits Interests: The Carried Interests Problem*, *supra* note 15, at 1778; *see* Rev. Proc. 93-27, 1993-2 C.B. 343 (1993); Rev. Proc. 2001-43, 2001-2 C.B. 191 (2001).

[25] Howard E. Abrams, *Taxation of Carried Interests: The Reform That Did Not Happen*, 40 Loy. U. Chi. L.J. 197, 201 (2009) (recognizing the greater a partner's capital account balance, the more value that must eventually be distributed to the partner).

[26] Brunson, *supra* note 13, at 85.

Whereas the fair market value of a capital interest at the time of receipt is easily calculable and thus taxable, the value of a profits interest at the time the interest is granted is uncertain, as the profits interest is generally non-transferable, highly speculative, and dependent on the partners' efforts.[27] Unlike a capital interest, a profits interest has no liquidation value upon receipt, despite the intuitive notion that a carried interest is valuable because it often turns out to be worth millions of dollars.[28] The current taxation of carried interest indicates private equity fund managers' profits interests are treated more like a financial investment than a payment for services rendered, as partnership profits are treated as a return on investment capital, not a return on human capital.[29]

Carried interest taxation is advantageous to private investment fund managers in two fundamental ways: (1) the character of income realized and (2) the timing of taxation.[30]

1. Character of Carried Interest

Current tax law treats partnerships as "pass-through" entities whereby partnerships' income flows through to individual partners, who are then taxed on an individual level.[31] Essential to the carried interest taxation regime is the principle that upon allocation of income and expenses to individual partners, such items retain the character borne at the partnership level.[32] Equally important, current tax law of partnership income is determined, not by reference to what the

[27] Fleischer, *supra* note 4, at 10-12 (noting the current regime treats the receipt of a profits interest as a non-taxable event).

[28] *Id.* at 11-12; Brunson, *supra* note 13, at 87.

[29] Fleischer, *supra* note 4, at 15. *But cf.* Philip F. Postlewaite, *Fifteen and Thirty-Five – Class Warfare in Subchapter K of the Internal Revenue Code: The Taxation of Human Capital upon the Receipt of a Proprietary Interest in a Business Enterprise*, 28 Va. Tax Rev. 817, 830 (2009).

[30] Brunson, *supra* note 13, at 88-89.

[31] Satyanarayana, *supra* note 2, at 1591.

[32] *Id.*

partners contribute to the venture, but rather the manner in which the partnership earns its profit.[33] It follows that to the extent the partnership realizes a long-term capital gain through the disposition of a capital asset, such gain retains the capital gains characterization when it "passes through."[34] As a result of this "pass through" taxation, partners are taxed on their proportionate share of the partnership's income, irrespective of whether such income is distributed to them.[35]

By treating carried interest as investment income rather than service income, current tax law permits the character of realized gain to be treated as capital gains rather than ordinary income, and therefore subject to preferential tax rates.[36] Accordingly, investment fund managers are largely compensated as partners in the form of profits interests, unlike corporate employees whose income is taxed at higher ordinary income tax rates.[37] The tax advantages of income characterized as capital gains are quite substantial, so much so that fund managers serving as general partners often relinquish the right to a portion of their annual management fee in exchange for additional profits interests in the partnership.[38] Proponents of carried interest reform focus on scenarios where the annual management fees being relinquished were already earned but are nonetheless being converted into favorably taxed long-term capital gains.[39]

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[33] Abrams, *supra* note 25, at 197 (explaining the purchase of capital assets held for more than one year results in the realization of long-term capital gains upon the sale or exchange of such assets).

[34] Fleischer, *supra* note 4, at 14-15 (explaining that except for hedge funds, which actively trade securities, most private investment funds generate long-term capital gains income by selling securities of portfolio companies); Satyanarayana, *supra* note 2, at 1591.

[35] Brunson, *supra* note 13, at 109.

[36] Fleischer, *supra* note 4, at 15.

[37] *Id.*

[38] Melone, *supra* note 9, at 434 (serving not only as a deferral of taxation on such income, but also as a conversion from what would otherwise be ordinary income to capital gains).

[39] *Id.*

2. Timing of Carried Interest Taxation

In addition to the benefit of capital gains being subject to significantly lower tax rates than ordinary income, what would ordinarily be taxable in the year compensation is earned is deferred in the context of profits interests.[40] Profits interests are not taxable upon receipt, rather such interests are not taxed until the partnership distributes profits to the partners.[41] The deferral of taxation is the edifice of tax shelters, as the time value of money principal recognizes taxes paid or saved today are worth more than taxes paid or saved later.[42] While in theory the taxable losses deferred should offset the deferred taxable gains, the realization doctrine benefits general partners who receive a substantial share of economic gains but only a small share of an investment fund's losses.[43]

The timing rules attributed to carried interest may have an immediate impact within the private investment fund itself, as it is arguably detrimental to the limited partners who will not recognize a current deduction for the value of the compensation awarded to the fund managers.[44] Yet, where the general partners and limited partners have the same marginal tax rates, the tax benefit to the general partners is offset by the tax detriment to the limited partners, an effect known as "substitute taxation."[45] Special allocations similar to this, as governed by Subchapter K, are largely responsible for the partnership entity appeal.[46] Problems arise, however, where the limited partners are pension funds, university endowments, and other tax-

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[40] Fleischer, *supra* note 4, at 11.

[41] *Id.*

[42] *Id.* at 12-13.

[43] *Id.*

[44] *Id.* at 13.

[45] *Id.* (resulting in no loss of tax revenue).

[46] *See generally* I.R.C. § 704 (West 2004).

exempts, in which case substitute taxation fails and government revenue pays the price.[47]

D. THE IRS: IN AND OUT OF COURT

In 1971, the Tax Court's monumental decision in *Diamond* held that the receipt of a profits interest in exchange for the contribution of services to a partnership is taxable as ordinary income to the service partner.[48] Deferring to the expertise of the Commissioner of Internal Revenue and the Judges of the Tax Court, the Seventh Circuit Court of Appeals affirmed the Tax Court's ruling, noting: "[o]nly if, by a strained construction, 'property' were said to include services would § 721 say anything about the effect of furnishing services."[49] In 1991, the Eight Circuit Court of Appeals reversed the Tax Court's finding that receipt of partnership profits interests constituted income.[50] The Appellate Court held the profit interests "had only speculative, if any, value" and therefore the appellants had not received any income from said interests.[51]

In response to the Eight Circuit's decision in *Campbell*, the IRS issued Revenue Procedure 93-27, which provides a safe harbor for the receipt of a profits interest in a partnership for the performance of services.[52] However, the Revenue Procedure's safe harbor does not apply where either (1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, (2) the partner disposes of the profits interest within two years, or (3) the profits interest is a limited partnership interest in a "publicly traded partnership" within the meaning of Section 7704(b).[53]

[47] Fleischer, *supra* note 4, at 13.

[48] Diamond v. Comm'r, 492 F.2d 286, 288 (7th Cir. 1971).

[49] *Id.*

[50] Campbell v. Comm'r, 943 F.2d 815, 823 (8th Cir. 1991).

[51] *Id.* (noting the interest was "without fair market value").

[52] Rev. Proc. 93-27, 1993-2 C.B. 343 (1993).

[53] *Id.*

Distinct from a profits interest, Revenue Procedure 93-27 defines a capital interest as an interest in the partnership that would yield proceeds to its holder if all the assets of the partnership were sold at their fair market value, and the proceeds of such sales were distributed in complete liquidation of the partnership.[54]

The IRS eventually clarified Rev. Proc. 93-27 with the issuance of Rev. Proc. 2001-43, which treats neither the grant of a substantially nonvested profits interest nor the event that causes the interest to become vested as taxable events.[55] Prior to this clarification, it was unclear whether the grant of a profits interest subject to substantial risk of forfeiture could trigger the application of Section 83 upon the vesting of the interest.[56] If so, the profits interest may have accreted some capital value at the time of vesting; therefore, absent a Section 83(b) election upon receipt of the interest, it would be subject to taxation.[57]

III. TAX AND FISCAL POLICY CONSIDERATIONS

Evaluating the effects of a tax policy requires an assessment of the implications on both tax and fiscal policy goals and objectives.[58] While in some instances tax and fiscal policy objectives complement each other, the two are often at odds with one another, particularly in the context of both enacted and proposed carried interest legislation.

A. Tax Policy Considerations

The four primary tax policy considerations are: vertical equity, horizontal equity, economic neutrality, and

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[54] Melone, *supra* note 9, at 454.

[55] *Id.* at 455.

[56] *Id.*

[57] *Id.*

[58] *See* Jason A. Sacks, *Effective Taxation of Carried Interest: A Comprehensive Pass-Through Approach*, 89 Wash. U. L. Rev. 449, 451 (2011).

administrability.[59] Although vertical and horizontal equity are inherently interconnected, vertical equity focuses on taxing different taxpayers at different rates under the notion of progressivity, whereas horizontal equity concentrates on taxing similarly situated taxpayers uniformly.[60] Current carried interest legislation effectively provides a tax subsidy to high-income earning fund managers through the preferential tax treatment of long-term capital gains.[61] Proponents of carried interest reform assert that taxing carried interest as ordinary income would promote vertical equity, because the high-income tax bracket fund managers benefiting from the lower long-term capital gains rates are wealthy taxpayers in a position to afford the imposition of greater taxation.[62] Likewise, these reformists submit taxing fund managers' carried interest at ordinary income rates furthers horizontal equity because other service-providing taxpayers receive compensation which is taxed at higher rates.[63]

Economic neutrality is primarily concerned with avoiding a change in taxpayers' preferences as a consequence of tax policy implications.[64] Proponents of carried interest reform argue the current regime inappropriately influences the decisions made by taxpaying individuals seeking lucrative professions, as a fund manager receives favorable tax treatment for compensation relative to compensation earned for services performed by a doctor or lawyer.[65] The fourth major tax policy consideration is administrability, focusing on the ease in which the federal government can administer and enforce the relevant sections of the Code and Treasury Regulations, as the effectiveness of a tax

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[59] *Id.* at 451

[60] *Id.* at 452-53.

[61] *Id.* at 457.

[62] *Id.* at 457 n.42.

[63] *Id.* at 458.

[64] *Id.* at 454 (focusing on "tax distortion").

[65] Sacks, *supra* note 58, at 458.

policy is curtailed by the government's ability to enforce it.[66] Critics of carried interest reform submit that the existing regime does not put a significant constraint on the IRS, as an elaborate factual analysis is not required to distinguish labor and investment income, or income from investment services partnerships versus other partnerships.[67]

B. FISCAL POLICY CONSIDERATIONS

The four primary fiscal policy considerations are: economic growth, economic stability, raising revenue for general and specific expenditures, and increased employment.[68] At odds with tax policy notions, critics of carried interest reform contend that because taxes impair economic growth, applying the higher ordinary income rates to carried interests would exceed the revenue-maximizing tax rate, ultimately decreasing tax revenue and stunting economic growth.[69] These critics also disagree with proposed carried interest legislation on the grounds that implementation would drive economic instability, contending the billions of dollars pumped into private equity funds annually would likely be tapered down as a result of the less favorable tax treatment. Such a result is credited to a fear of uncertainty as well as volatility of investment funds and the market.[70] Furthermore, fund managers' willingness to render future services without additional compensation results in an increase of assets available for investment at the fund's discretion.[71] Critics of carried interest reform also note the proposed legislation would be detrimental to employment.[72] Restricting

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[66] *Id.* at 452.

[67] *Id.*

[68] *Id.* at 474.

[69] *Id.* at 470 n.91.

[70] *See id.* at 469–70 n.90.

[71] Postlewaite, *supra* note 29, at 829–30.

[72] Sacks, *supra* note 58, at 460-61 n.96.

the flow of capital available to funds would reduce the allocation of resources necessary to maintain employment levels, ultimately driving outsourcing to foreign nations with preferable tax treatment on income.[73]

C. RECONCILIATION: TAX AND FISCAL POLICY CONSIDERATIONS

Proponents of capital interest reform stress the tax policy considerations, particularly the implications proposed legislation would have on furthering vertical and horizontal equity as well as economic neutrality. On the other hand, critics of the reform movement fall back on the administrative inconvenience of enacting and enforcing proposed legislation in addition to the negative drawbacks higher taxes would have on economic growth. Under current carried interest legislation, Congress has essentially found the fiscal policy considerations to carry greater weight than the relevant tax policy considerations. While Congress provides a plethora of financial incentives that run counter-intuitive to equitable considerations, the current taxation of carried interests is predominantly subject to pushback because the current regime also runs afoul with other Code sections. Generally, a contribution of services in exchange for a partnership interest is not entitled to the nonrecognition benefit of Section 721.[74] Yet, under the current regime, private investment fund managers acquire profits interests in the partnership with no right to existing capital and therefore are taxed on the valueless acquired partnership interest.[75] Consequently, fund managers effectively benefit from receipt of partnership interests just the same had their contributions qualified for nonrecognition under Section 721, as if they had made a Section 83(b) election. Ultimately, proponents of reforming the current regime seek to draft legislation serving as

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[73] *Id.*

[74] Abrams, *supra* note 25, at 206-07 (citing Treas. Reg. §1.721-1(b)(1) (as amended in 2005)).

[75] *See* Matthew A. Melone, *The Section 83(b) Election and the Fallacy of "Earned Income"*, 10 Berkeley Bus. L.J. 53, 84 (2013) (noting profit interests are "deemed to have a zero value when received").

a reasonable compromise to further both tax and fiscal policy considerations.

IV. PROPOSED LEGISLATION

Though there is debate over whether taxing some investment managers at preferential capital gains rates is "gamesmanship" or valid recognition of the speculative nature of carried interest, a series of failed legislative attempts to close the carried interest tax "loophole."[76]

In 2005, the IRS proposed regulations that would treat carried interest as "property" for purposes of Section 83(a), however fund managers could make Section 83(b) elections to include receipt of "property" in income on the grant date even though the profits interest would have no value.[77] Therefore, service providers making a Section 83(b) election within thirty days of the grant date would avoid recognizing income at the time the interest vests, and instead the appreciation would be taxed at long-term capital gains rates rather than ordinary income.[78]

The 2007 Levin Bill was introduced to Congress as part of the Temporary Tax Relief Act of 2007 and sought "to treat income received by partners for performing investment management services as ordinary income received for the performance of services."[79] While drafted broadly and applying beyond the investment management context, the unconcealed purpose of the bill was to change the treatment of carried

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[76] Note, *Taxing Partnership Profits Interests: The Carried Interests Problem*, *supra* note 15, at 1774.

[77] I.R.S. Notice 2005-43, IRB 2005-24 (June 13, 2005), *available at* http://www.irs.gov/irb/2005-24_IRB/ar10.html; Bill King, *Compensation and Benefits Bulletin: Limited Liability Companies Face Unique Executive Compensation Challenges*, Compensation & Benefits Bull. (Grant Thornton, Chi., Ill.), Oct. 2010, *available at* http://www.grantthornton.com/staticfiles/GTCom/Tax/CBB%20files/GrantThornton_CBBulletin_Oct10.htm.

[78] *Id.*

[79] H.R. 2834, 110th Cong. (2007).

interest received by managers in the investment management industry, an objective unsupported by a majority of Congress[80]

Congressman Levin modified his originally proposed bill and introduced the 2009 Levin Bill as part of the Job Creation and Tax Cuts Act of 2010, which proposed creating I.R.C. § 710.[81] The amended bill narrowed the scope, as proposed Section 710 sought to only target investment services partnership interests ("ISPIs").[82] With respect to carried interests, proposed Section 710 would tax a fixed percentage of any partnership distribution to "service partners" (i.e., fund managers) of investment management partnerships at ordinary income rates, regardless of whether the original character of the income may have led to favorable capital gains treatment.[83] In an attempt to compromise with critics of legislative reform, proposed Section 710 included a 75/25 compromise, whereby 75% of profits allocated to general partners based on profits interest would be recharacterized as ordinary income and 25% of such profits would maintain "pass-through" capital gains character.[84] Proposed Section 710 has elicited significant criticism, most of which declaring the solution to be an inadequate and over-simplistic interpretation to a very complex issue.[85] The arbitrary partial recharacterization of fund managers' income arguably conflicts with the general principles of Subchapter K insofar as "all partners are treated equally and that income 'passes

[80] James B. Sowell & Carol Kulish Harvey, KPMG, Wash. Nat'l Tax, Carried Interest Legislation: Out of Sight, but Not out of Mind 7 (2011), *available at* http://www.us.kpmg.com/microsite/taxnewsflash/2011/Mar/Carried_Interest.pdf.

[81] H.R. 1935, 111th Cong. (2009); S. 3793, 111th Cong. § 402, sec. 710 (2010).

[82] Note, *Taxing Partnership Profits Interests: The Carried Interests Problem*, *supra* note 15, at 1774-75 n.15.

[83] *Id.* at 1774-75.

[84] *Id.* at 1775.

[85] *Id.* at 1775 n.18.

through' a partnership conduit without interference or modification."[86]

The 2012 Levin Bill was introduced to Congress as part of the Carried Interest Fairness Act of 2012.[87] Distinct from the two previous proposals, which would have broadly applied to service partners' interests in all partnerships irrespective of the partnerships underlying businesses, the 2012 proposed legislation provided that only "investment partnerships" could constitute ISPIs.[88] The 2012 Levin Bill sought to amend Section 83 to include rules applicable to any transfers of partnership interests in connection with the performance of services for, or on behalf of, a partnership.[89] The Bill articulated that a partnership interest's fair market value would be deemed equal to the liquidation value associated with that interest.[90] Absent an affirmative election, the service partner would be deemed to have made a Section 83(b) election, causing the service providing partner to recognize ordinary income on the receipt of the property in an amount equal to its fair market value.[91] Since the liquidation value of a profits interest is zero, fund managers would recognize no income on the receipt of a carried interest in exchange for services, leaving proponents of carried interest reform unsatisfied with the result.[92] In addition to the valuation

[86] *Id.*

[87] H.R. 4016, 112th Cong. (2012).

[88] Sandy Presant & Richard Petkun, *Heavier Taxation of Carried Interest Proposed Again – Both in the Jobs Bill and by Rep. Levin*, Tax Alert (Greenberg Traurig, Miami, Fla.), Mar. 2012, at 2 (the Jobs Bill defines an "investment partnership" as a partnership in which more than half of the contributed capital is attribute to partnership interests that "constitute property held for the production of income"), *available at* http://www.gtlaw.com/portalresource/lookup/wosid/contentpilot-core-401-19922/pdfCopy.name=/GTAlert_Carried%20Interest%20Proposal%20Resurfaces_Mar2012.pdf?view=attachment; Sowell & Kulish Harvey, *supra* note 80, at 9.

[89] Sowell & Kulish Harvey, *supra* note 80, at 11.

[90] *Id.*

[91] *Id.* at 11 n.43 (citing H.R. 4016, 112th Cong. § 83(c)(4)).

[92] *Id.* at 11.

issue, the broad scope of the 2012 Levin Bill raised issues of characterization. The recharacterization of income under the proposed legislation goes beyond merely recharacterizing capital gain amounts to ordinary income by providing "loss deferral and mandatory gain recognition for C corporations, which are not taxed at different rates on capital gains or ordinary income."[93]

Most recently, the Camp Bill of 2014 proposed The Tax Reform Act of 2014, seeking to treat capital gains received by virtue of a partnership interest transferred directly or indirectly to a taxpayer in connection with the performance of services as ordinary income.[94] The ordinary income treatment concerns partnership interest distributions and dispositions by partnerships "engaged in a trade or business conducted on a regular, continuous and substantial basis consisting of: (1) raising or returning capital, (2) identifying, investing in, or disposing of other trades or businesses, and (3) developing such trades or businesses."[95] Republican Representative David Camp's Bill supports President Obama's goal of "shifting resources from wasteful to pro-work tax benefits", primarily by taxing carried interest as ordinary income "so that investment fund managers are subject to the same tax rules as everyone else."[96]

[93] Letter from Charles H. Egerton, Chair, ABA Section of Taxation, to Senate Committee on Finance and House of Representatives Committee on Ways & Means (Nov. 5, 2010), *available at* http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2010/110510comments.authcheckdam.pdf (commenting on carried interest proposals in Senate Amendment 4386 to H.R. 4213).

[94] Joint Comm. on Taxation, 113th Cong., Technical Explanation of the Tax Reform Act of 2014, A Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title III – Business Tax Reform 240, 247 (Comm. Print 2014).

[95] Comm. of Ways and Means, 113th Cong., Tax Reform Act of 2014: Discussion Draft – Section-by-Section Summary 121 (Comm. Print 2014) (noting the provision would not apply to a partnership engaged in a real property trade or business).

[96] Office of Mgmt. & Budget, Exec. Office of the President, The President's Proposal to Expand the Earned Income Tax Credit 15 (2014).

V. TAX BUFF BATTLE: A SCHOLARLY DEBATE

A. PROPONENTS OF CARRIED INTEREST REFORM: PROGRESS IS IMPOSSIBLE WITHOUT CHANGE

According to the IRS, a "'technical tax shelter' is distinguishable from a 'scheme or scam' or outright tax evasion that finds no support in either the law or the facts."[97] One practical definition was provided by former Treasury Assistant Secretary Eric Solomon, who described a technical tax shelter as a "tax-engineered transaction normally with little business purpose except to save taxes with minimal risk or profit potential often designed to create a tax loss without an economic loss or in some cases to make income nontaxable."[98] The technical tax shelters often appear to satisfy the technical requirements of the Internal Revenue Code, but run contrary to its spirit.[99] A technical tax shelter differs from an exploitation of the Code to create a benefit, such as private investment fund managers' conversion of management and performance fees into carried interest, taxed at long-term capital gains rates rather than ordinary income rates.[100]

Some proponents of carried interest reform insist legislative proposals must focus on "disaggregating [general partners'] remuneration into both a service-income component and an investment-income component," as carried interest cannot be characterized as either exclusively service or investment income.[101] Rather, consistent with tax principles inherent in the Code, amounts paid to general partners for management services should be taxed as ordinary income, while income

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97 Wright, *supra* note 8, at 614-15 n.14.

98 *Id.* at 615 n.16.

99 *Id.* at 615.

100 *Id.*

101 Note, *Taxing Partnership Profits Interests: The Carried Interests Problem*, *supra* note 15, at 1775 n.13.

attributable to general partners' investment risk should result in only capital gains taxation.[102]

Professor Victor Fleischer introduced the "Cost-of-Capital Method" as an alternative to measure and tax the value of carried interests, which eliminates deferral but allows some conversion.[103] The private investment fund manager or general partner would be treated as if having received a non-recourse, interest-free loan from the investors or limited partners, and would be taxed on the forgiven interest as if it were ordinary income.[104] The investors would then be allocated a deduction corresponding with the fund managers' income recognition. In addition to higher rates, Fleischer's proposed carried interest reform seeks to curb fund managers' opportunity to defer taxation.[105] Fleischer explains the current fund managers' "two and twenty" compensation scheme, where the 2% management fee is treated as ordinary income and 20% is a profits interest that retains its capital characterization, however fund managers' 2% management fee is often converted to tax-advantaged carry.[106] The "cost-of-capital approach to timing also provides a reasonable compromise on the character issue, . . . allowing service partners to receive the same capital gains preference that they would receive on other investments, but no more."[107]

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[102] *Id.* at 1775-76.

[103] Fleischer, *supra* note 4, at 6.

[104] *Id.*

[105] *Id.*

[106] *Id.* at 8.

[107] Paul Caron, *Fleischer Presents Partnership in Hedge Funds, and Private Equity Today at NYU*, TaxProfBlog (Mar. 30, 2006), http://taxprof.typepad.com/taxprof_blog/2006/03/fleischer_prese_1.html (quoting Vic Fleischer, Abstract, Two and Twenty: Partnership Profits in Hedge Funds, Venture Capital Funds, and Private Equity at the New York University Colloquium on Tax Policy and Public Finance (Mar. 30, 2006)); Fleischer, *supra* note 4, at 44 (comparing service partners to entrepreneurs taking below market salary and pouring their efforts back into the business as "sweat equity," where the appreciation in the private equity fund's value reflects a mix of labor income and investment income).

Although a profits interest is not taxable upon receipt given the absence of liquidation value, some scholars acknowledge the uncertainty of success but nonetheless conclude the general partner "receives something of value at the moment the partnership agreement is signed."[108] Rather than separate service income from investment income, Professor Postlewaite presents the idea of a repeal of Section 83(b) as an improvement to the current taxation of human capital.[109] Postlewaite describes Section 83(b)'s effect of minimizing, if not effectively eliminating, the difference between the taxation on receipt of a profits interest in a partnership and restricted corporate stock.[110]

Service providers in receipt of a partnership interest elect the acceleration of ordinary income, converting compensatory income into preferable long-term capital gain at the expense of deferral.[111] The current treatment of carried interest muddles together the portion of a return attributable to an investment of human capital with that attributable to its re-investment in the enterprise.[112] Professor Postlewaite contends that "[c]ritics ignore the re-investment of human capital as constituting a return on invested capital in an effort to determine the amount of the return attributable to human capital."[113] Postlewaite finds the "least defensible approach" to analyzing whether a return is a product of human capital or invested capital is to permit the return on human capital to be measured on the date of receipt under Section 83(b), "before any of the services have been rendered . . . [and] the only thing which is certain is that the service provider lacks complete dominion and control over the

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[108] Postlewaite, *supra* note 29, at 862 n.117 (quoting Fleischer, *supra* note 4, at 10).

[109] *Id.* at 887 (disagreeing with the notion that an elective choice is always a positive, rather than a negative, feature of the Code).

[110] *Id.* at 888.

[111] *Id.*

[112] *Id.* (acknowledging the treatment of the "re-investment" as "invested capital").

[113] *Id.*

interest."[114] Accordingly, Postlewaite concludes that permitting the Section 83(b) election, which determines the return on human capital before any services are rendered, is nonsensical given that a profits interest will only appreciate with time and the continued rendering of services.[115]

Rather than eliminate Section 83(b), Shrilaxmi Satyanarayana proposes how an expansion of Section 83 would constrain fund managers' ability to reclassify what would otherwise be ordinary income into long-term capital gains. Under Section 83, a fund manager would include the profits interest in gross income in the first taxable year that the rights of the recipient are transferable or not subject to a substantial risk of forfeiture in an amount equal to the excess of the profits interest's fair market value over any amount paid for the interest.[116] Currently, under Section 83(b), fund managers are permitted to elect to current inclusion of the profits interest received, even if restricted, to taxation in the year of transfer, thereby preserving capital gains treatment on any subsequent appreciation in that interest.[117] However, a fund manager that made a Section 83(b) election is not permitted to subsequently deduct any taxes paid on that property if that property is ultimately forfeited.[118] Nevertheless, the fund manager may recognize a loss in an amount equal to the excess of the amount paid for the property over the amount realized on the forfeiture.[119]

Satyanarayana proposes that general partners' carried interest be subject to "clawback" provisions, whereby general partners would forfeit their entitlement to the profits interest to the extent the limited partners' return of their invested capital

[114] Postlewaite, *supra* note 29, at 889.

[115] *Id.*

[116] Satyanarayana, *supra* note 2, at 1597.

[117] *Id.* at 1612.

[118] *Id.*

[119] *Id.* (noting the character of the loss corresponds with the character of forfeited asset).

falls short of a "hurdle rate."[120] Since the clawback provision would constitute a continuing restriction, Section 83 would treat the profits interest as being subject to a "substantial risk of forfeiture."[121] As a result, the issuance of a profits interest would defer taxation of the general partner until the general partner realizes the profits interest, at which time Section 83 would require inclusion, treating the interest as compensation rather than capital gain.[122]

Satyanarayana counters arguments "that such treatment is inappropriate, given that the general partners' remuneration is really a combination of compensation and capital gains" by highlighting the Section 83(b) election, which provides an opportunity for this split treatment.[123] Section 83(b) would provide the taxpayer with an election to pay tax on the carried interest in the year of issuance, irrespective of the restrictions constituting a substantial risk of forfeiture.[124] Because Section 83(a) would not include an interest in a service partner's gross income if subject to a substantial risk of forfeiture, a profits interest would not be subject to inclusion by virtue of the significant effort required of the service partner.[125] Nonetheless, permitting a service partner to make a Section 83(b) election would allow inclusion of the profits interest in gross income in the taxable year of grant.[126] When the property was eventually sold, if the amount realized exceeded what was already taxed as ordinary income, the service partner would report the difference as capital gains income.[127] If the amount realized was less than

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[120] *Id.* at 1612-13 (describing the "hurdle rate" as "the minimum return required by the limited partners in order to make an investment").

[121] *Id.* at 1613.

[122] Satyanarayana, *supra* note 2, at 1613 (highlighting the higher tax rates applicable to compensation as ordinary income).

[123] *Id.*

[124] *Id.*

[125] *Id.*

[126] *Id.*

[127] *Id.* at 1613.

what was already taxed as ordinary income, the service partner would realize a capital loss, which could not be used to offset capital gains income.[128]

In 2008, the *Harvard Law Review* analogized a grant of carried interest to a stock option, reasoning both are economically equivalent forms of ownership-based compensation.[129] The holder of a stock option has a right to purchase shares of stock at a fixed price, or "strike price."[130] Should the value of the stock rise above the strike price, the option holder can exercise the option and recognize a gain equal to the excess.[131] Conversely, should the value of the stock fall below the strike price, the option holder can choose not to exercise the option, thus avoiding gain or loss recognition.[132] Similarly, "[a] general partner who holds a 20% carried interest in a private equity fund has the same economic outlook as a holder of an option with a strike price of zero on 20% of the common stock of a corporation that is otherwise capitalized with participating preferred stock."[133] Therefore, a fund manager recognizes gain equal to 20% of the private equity fund's returns in excess of the partner's typically zero-cost acquisition of the interest, whereas a fund manager does not recognize gain or loss if the private equity fund loses money.[134]

Unlike the complications created by tax and accounting considerations that dissuade corporations from issuing in-the-money stock options, such does not affect private equity fund partnerships seeking to compensate their general partners with

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128 Satyanarayana, *supra* note 2, at 1613-14.

129 Note, *Taxing Private Equity Carried Interest Using an Incentive Stock Option Analogy*, 121 Harv. L. Rev. 846, 851 (2008).

130 *Id.*

131 *Id.*

132 *Id.*

133 *Id.*

134 *Id.* at 851 n.31 (quoting Fleischer, *supra* note 4, at 1) ("If the fund does badly . . . the manager can walk away.").

carried interest.[135] It is the distinct treatment of similar compensation mechanisms that legitimatize comparing the treatment of carried interest to a grant of stock and a stock option having a strike price of zero.[136]

Similar to carried interest, receipt of a stock option is generally not immediately taxable because Section 83 does not apply to "the transfer of an option without a readily ascertainable fair market value."[137] Receipt of a compensatory stock option typically results in a deferral of tax, whereby the option holder pays tax upon exercise of the option and receipt of the stock.[138]

While ISOs and nonqualified options provide the same economic rights and payout possibilities, "ISOs provide a more apt analogy" because of the different tax rules governing.[139] When a holder exercises an ISO, no income is recognized on the excess of the underlying stock's fair market value at the time of exercise over the strike price.[140] However, the holder recognizes capital gain on any subsequent appreciation of the stock, at which time the issuer does not receive deduction.[141] The closest analogy to carried interest is an ISO with a strike price of zero because neither subject the holder to immediate taxation, both produce deferrable capital gains, and neither allow for the issuer to take a deduction.[142] Yet, current applicable tax law provides

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[135] *Id.* at 853.

[136] Note, *Taxing Private Equity Carried Interest Using an Incentive Stock Option Analogy*, *supra* note 129, at 853.

[137] *Id.* (quoting I.R.C. § 83(e)(3) (West 2004)); *see id.* at 853 (citing Treas. Reg. § 1.83-7(b) (West 2004)) (acknowledging application to nearly all stock options because those issued by corporations to their employees are ordinarily not traded on public markets).

[138] *Id.*

[139] *Id.* at 854.

[140] *Id.*

[141] *Id.*

[142] *Id.* at 855.

for limitations that prevent ISOs "from being used to provide managers and other employees with pure, limitless capital gains."[143] The tax law applicable to ISOs thus provides insight into how "the Code can curtail the pure, limitless capital gains that carried interest now bestows."[144]

Under a mark-to-market system, a taxpayer would pay tax every year on appreciation of all assets, regardless of whether such assets have been sold.[145] Instead of amending Section 83(b), Professor Brunson's modified version of the mark-to-market regime would effectively nullify Section 83(b) abuse, requiring investment fund managers to pay annual ordinary income taxes on the amount of carried interest allocated to him or her, regardless of whether the fund had sold assets.[146] Under Professor Brunson's system, the fund manager would be treated as having contributed the amount of the carried interest to the investment fund, which would consequently increase his or her capital account.[147] Any gain realized as a return on the fund manager's deemed contribution would thus retain "pass-through" character as capital gain.[148] In addition to treating carried interest as ordinary income and aligning fund managers' incentives with investors' desires, Professor Brunson's proposal eliminates fund managers' ability to defer gain recognition.[149] Unlike the mark-to-market approach, which raises concerns of

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[143] Note, *Taxing Private Equity Carried Interest Using an Incentive Stock Option Analogy*, *supra* note 129, at 855.

[144] *Id.*

[145] Brunson, *supra* note 13, at 105.

[146] *Id.* at 106 (sharing the intent of Proposed Section 710 to tax carried interest at ordinary income rates, yet differing as to accommodate the capital gains analysis).

[147] *Id.* at 106.

[148] *Id.* at 106-07 (noting the simplified mark-to-market approach does not require an objective valuation of the investment fund's assets, thus reducing administrative costs which would otherwise be borne by the funds' investors).

[149] *Id.* at 115.

valuation and liquidity, the simplified version does not share these potential flaws.[150]

With respect to valuation, investment funds would not be required to obtain a separate valuation for tax purposes, but would instead base the fund manager's tax obligations on the fund's financial accounting.[151] As far as liquidity is concerned, fund managers' receipt of management fees alone should provide sufficient cash to pay tax at ordinary income rates on any allocation of carried interest.[152] This tax obligation would also prevent fund managers' conversion of management fees to profits interests.

Professor Brunson's simplified mark-to-market proposal treats a fund manager as having received a distribution, in the form of carried interest, in exchange for his or her labor, and is then deemed to have contributed the cash in exchange for an interest in the fund.[153] Dissimilar to carried interest, appreciation of a fund manager's capital account is subject to risk and therefore would justifiably be entitled to preferred long-term capital gains tax.[154]

Rather than approach the carried interest issue from Section 83, Professor Rosenzweig proposes utilizing the holding period of capital gains as a means of distinguishing returns attributable to labor as opposed to investment.[155] Under current law, if an investor owns an asset for more than one year while bearing the

[150] *Id.* at 108.

[151] Brunson, *supra* note 13, at 108 n.157 (citing Deborah A. Geier, *The Myth of the Matching Principle as a Tax Value*, 15 Am. J. Tax Pol'y 17, 19-20 (1998)) (reasoning tax accounting should follow financial accounting).

[152] *Id.* at 112 (recognizing that in situations where management fees are insufficient, fund managers could redeem a portion of their interest in the fund to pay the tax).

[153] *Id.* at 113 (noting tax law permits treating investors as having received a distribution and then recontributing the money, even where no cash changed hands).

[154] *Id.* at 114 (furthering horizontal equity with fund investors and capital accounts).

[155] Rosenzweig, *supra* note 19, at 739.

risk of appreciation and depreciation, then the asset is assumed to be held for investment purposes and is eligible for preferential capital gains rates.[156]

Professor Rosenzweig argues the holding period requirement fails to address the "blended labor/investment returns in the carried interest context, since the type of labor return addressed through the holding period rules (speculation) is different than the type of labor returns at issue in private equity (money/investment management)."[157] Unlike private equity, where assets are locked-in and held for long-term investment, hedge funds engage in frequent asset trading and thus the holding period rules effectively avoid the "line-drawing problem" by denying the benefit of preferential rates.[158] Yet, the holding period requirement remains relevant to private equity fund carried interest, where preferential long-term capital gains rates require an asset be held for more than one year "without the taxpayer significantly reducing the risk of loss related to the asset."[159] Thus, if a taxpayer owns an asset and then enters into an arrangement to hedge against the risk of loss, the holding period does not begin, or is suspended, during the time in which the taxpayer is hedging against the risk of loss in connection with the asset.[160]

The development of advanced financial instruments, which allowed taxpayers to legally own assets for the requisite holding period while remaining shielded from bearing all of the economic risks, led to the pronouncement of the "tolling" rules.[161] The legislative response highlighted the distinction

[156] *Id.* at 739 (citing I.R.C. § 1222 (West 2008)).

[157] *Id.*

[158] *Id.* (distinguishing hedge funds, which generate value by trading and speculation, from private equity funds, which generate value from investment returns subject to bunching and lock-in).

[159] *Id.* (citing I.R.C. §§ 1092, 1233 (West 2008)).

[160] *Id.* at 739-40 (citing Treas. Reg. § 1.1092(b)-2T(a) (2008)).

[161] Rosenzweig, *supra* note 19, at 740 (explaining the purpose of the "holding period is meant to reflect ownership of the capital asset only if it is subject to risk of loss").

between a capital asset owned without any risk of losing invested capital and a capital asset owned with exposure to a risk of loss.[162] The "tolling" rules rely on the adverse treatment of capital losses to limit abuse of capital gains.[163] Since capital losses generally can only be deducted to the extent of capital gains, taxed at lower rates, capital losses are less valuable than ordinary losses.[164] Yet, a taxpayer not bearing a risk of loss would remain unaffected by the adverse treatment of capital losses and therefore would not be disinclined to structure such investments.[165]

Professor Rosenzweig analogizes carried interest to short-term capital gains, noting each maintain a blended return; "in the case of day trading, part a return on investment and part on skill in speculation, while in the case of carried interest, part a return on investment and part a return on money management."[166] Furthermore, since a fund manager only has a profits interest, carried interest bears no risk of losing any invested capital.[167] Rather than re-characterize the investment as ordinary income, Congress took a more conservative approach by maintaining the treatment as capital gain but denying the preferential tax rate afforded to long-term investments.[168] Professor Rosenzweig's analogy suggests the proper treatment of carried interest is to continue treating the carried interest income as capital gain, but re-craft the holding period rules to deny the preferential tax rate.[169]

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162 *Id.*

163 *Id.* (internal citations omitted).

164 *Id.* at 740-41 n.133 (citing I.R.C. §§ 165(f), 1211 (West 2008)).

165 *Id.*

166 Rosenzweig, *supra* note 19, at 741.

167 *Id.* (noting a general partner with a profits interest is "not concerned about the limitations on the ability to deduct capital losses arising from a loss of invested capital").

168 *Id.*

169 *Id.* at 742.

Private equity fund managers would respond to any change in the tax law by restructuring their carried interest as a "loan outside the partnership[,]" where limited partners would lend a portion of their investment capital to the [general partners] directly rather than invest the money in the fund, and the [general partners] would then use the money to invest in the fund on its own behalf, with the loan being nonrecourse and secured only by the [general partners'] partnership interest.[170]

While seemingly mirroring the economics of carried interest, a general partner's investment of money from a nonrecourse loan would grant ownership of a capital interest rather than a profits interest; however, the holding period proposal would provide for short-term capital gain treatment and the taxpayers' avoidance scheme would be thwarted.[171] In such a case, a general partner would be considered to have a reduced risk of loss with respect to the partnership interest of the fund, resulting in a tolling of the general partner's holding period and a characterization of all gain allocated to the carried interest as short-term capital gain.[172]

Critics of reform nevertheless contend that regulatory arbitrage is inevitable because tax attorneys will find a way to circumvent the new rules, and therefore Congress should not bother trying to prevent it.[173] Professor Brunson asserts that even if fund managers are able to restructure arrangements as to transfer the tax burden on the investors, the transparency of such action would effectively detract from the mystique utilized by fund managers as leverage.[174] Alternatively, Professor Fleischer has responded to critics, arguing legal constraints on arbitrage are typically highly effective.[175] Fleischer avows

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[170] *Id.* at 745.

[171] *Id.*

[172] Rosenzweig, *supra* note 19, at 746.

[173] Victor Fleischer, *Regulatory Arbitrage*, 89 Tex. L. Rev. 227, 283 n.319-20 (2010).

[174] Brunson, *supra* note 13, at 121.

[175] Fleischer, *supra* note 173, at 283.

thoroughly drafted rules effectively shut down needless restructuring and allow regulatory regimes to function as intended, thereby shifting the "attention of the planners and regulators alike to the next battleground."[176] Fleischer notes constraints are incorporated into regulatory statutes when specific avoidance strategies are anticipated, however many provisions have "rifleshot" anti-avoidance rules to dissuade unforeseen abusive planning before it is discovered and the statute can be amended.[177]

Professor Sacks points out that a taxpayer distraught with the applicability of the existing tax regime to carried interest earned by fund managers would likely lack standing to challenge the status quo.[178] Even if a taxpayer subject to a tax had standing to challenge the Code provision's validity, two considerations prevent this from being relevant in the context of carried interests.[179] First, challenges rarely strike down Code provisions; rather such challenges typically enable taxpayers to only obtain a court's application "of the relevant income tax provisions to the particular facts and circumstances of the case."[180] Second, the existing regime's favorable treatment of carried interests implies no rational taxpayer earning carried interest income will challenge it.[181]

Proposed Section 710, which would convert the taxation of carried interest from capital gain to ordinary income, would not affect a general partner's financial investment in the partnership, which would continue to generate capital gains or losses.[182] Congress recognized one planning technique to

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[176] *Id.*

[177] *Id.* at 253.

[178] Sacks, *supra* note 58, at 450 n.6 (noting Congress clearly has the power to tax income from services).

[179] *Id.*

[180] *Id.*

[181] *Id.*

[182] Fleischer, *supra* note 173, at 253 (citing H.R. 1935, 111th Cong. § 2 (2009) (proposed I.R.C. §§ 710(a)(1)(A), (c)(2)(A))).

circumvent the intent of proposed Section 710: "rather than receive carried interest, general partners could borrow 20% of the capital of the fund from the limited partners and invest directly in the fund."[183] While the structures of carried interest and nonrecourse-debt-financed capital interest would be similar economic and strategic substitutes, the technical divergence could produce different tax outcomes.[184] Thus, Section 710 is crafted in such a way that general partners' debt-financed partnership investments would be treated analogous to receipt of a profits interest.[185]

Carried interest reform seeks to eliminate "a theoretical, artificial incentive to pursue a career as a fund manager over a different professional career."[186] It is critical that carried interest reform enacted be broad enough to prevent abuse and regulatory arbitrage, yet simultaneously be specific enough to avoid causing collateral damage by affecting taxpayers unintended by Congress.[187] Sacks avers that proposed Section 710 is "too broad because it will adversely impact corporations engaged in general trades or businesses (businesses other than investment management), and it may also reduce the number of investment options available to sophisticated investors."[188] While proposed Section 710 may increase the tax burden on carried interests in existing funds, Mr. Sacks insists new funds will be able to plan around the reform through either new compensation structures, which do not constitute investment services partnership interests, or other planning techniques.[189]

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[183] *Id.* (citing David J. Herzig, *Carried Interests: Can They Effectively Be Taxed?*, 4 Entrepreneurial Bus. L.J. 21, 26-27 (2009)).

[184] *Id.*

[185] *Id.* (citing H.R. 1935, 111th Cong. § 2 (2009) (proposed I.R.C. § 710(c)(2)(D))).

[186] Sacks, *supra* note 58, at 474 n.106.

[187] *Id.* at 475.

[188] *Id.*

[189] *Id.*

Sacks proposes the most efficient method of reforming carried interest taxation is by means of partner-level recharacterization, because such avoids collateral harm being done upon other partners in the partnership.[190] Sacks argues partner-level characterization "promotes both tax policy and broader fiscal policy by balancing the interests of a conceptually ideal tax framework against fiscal pragmatism;" however, Sacks prioritizes fiscal policy over tax policy where the two cannot be harmonized.[191] Ultimately, Sacks concludes that extending the opportunity for fund managers to be subject to preferential capital gains rates on their carried interest income is best to promote broader fiscal goals.[192]

B. Critics of Carried Interest Reform: If It Ain't Broke, Don't Fix It

Proposed Section 710 has been criticized by both scholars in favor of maintaining the current regime's taxation of carried interest, describing the proposed legislation as both too broad, affecting innocent taxpayers unintended by Congress to bear the burden, and too narrow, unjustly singling out managers of existing private funds whose interests constitute investment services partnership interests.[193] The proposed legislation has also been scrutinized for its effectiveness, reasoning competent tax attorneys will structure transactions to avoid the recharacterization.[194]

The American Bar Association (ABA) does not express support for the current taxation of carried interests, avowing, "Proposed Section 710 would add significant and burdensome

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[190] *Id.* at 475-76.

[191] *Id.* at 475.

[192] Sacks, *supra* note 58, at 476 (justifying preferential tax treatment for carried interests based on significant spillover benefits to the economy, whether in the form of risky investments in companies or more directly by means of improving employment and wages).

[193] *Id.* at 475.

[194] *See generally* Fleischer, *supra* note 173.

complexities to the Code and alter fundamental principles of partnership taxation."[195] The ABA finds the recharacterization of income allocations of Investment Services Partnership Interests (ISPIs) under Proposed Section 710 to exceed the scope of Congress' original purpose, which was to "tax the compensation element of a carried interest granted to fund managers as ordinary income."[196] The ABA contends the breadth of proposed Section 710 could affect C Corporations and impose an undue burden of compliance on small businesses that should be exempt from complying such complex provisions.[197]

While Professor Fleischer avers the pooling of labor and capital encouraged by Subchapter K was not intended to encompass partnerships holding colossal amounts of capital, Weisbach and Melone proclaim the amount of income to be irrelevant in the discussion of whether the current taxation of carried interest is principled or not.[198]

Professor Weisbach avers the fiscal pressure facing the government along with the increasing income inequality has led reformists to see private equity sponsors as financiers rather than investors adding value to the economy.[199] Weisbach's approach would alter the capital gains rate as opposed to changing technical rules for the taxation of carried interest.[200] Consequently, the outcome intended would be "far less avoidable" than a technical change to Subchapter K, which

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[195] Letter from Charles H. Egerton, *supra* note 93 (commenting on carried interest proposals in Senate Amendment 4386 to H.R. 4213).

[196] *Id.*

[197] *Id.*

[198] Fleischer, *supra* note 4, at 34-35; David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 Va. L. Rev. 715, 763 (2008) (declaring distributional concerns to be the underling factor driving the carried interest reform rather than technical concerns about identifying labor income).

[199] Weisbach, *supra* note 198, at 763 (explaining Bill Gates' wealth earned through labor efforts has not caused a clamor for change because he is seen as having invented a product).

[200] *Id.* (reasoning the distributional effects would be broader than merely picking off one class of beneficiaries of the preferred capital gains rates).

would otherwise leave capital gains preference generally available and rely on the IRS' ability to distinguish labor income from capital income.[201]

Ultimately, Professor Weisbach concludes the current tax treatment of carried interest should remain unchanged, continuing to treat private equity "sponsors" just the same as if they engaged in the activity directly rather than through a partnership.[202] Weisbach finds further support for retaining the status quo in the complexity of the proposed changes, which he characterizes as easily avoidable and an imposition of costs on the economy at the expense of raising limited revenue.[203] Professor Weisbach deduces the distributional concerns are not centrally related to the taxation of carried interest, but arise because of preferred capital gains rates, which should be dealt with directly.[204]

Akin to Professor Weisbach, Professor Melone finds support for maintaining the status quo in the fundamental premise of Subchapter K, which seeks to tax partners in parallel fashion to the manner in which they would have been taxed had they undertaken their activities in their individual capacities.[205] As a result, the investment income earned by service partners must retain its capital characterization irrespective of the labor attributable to the generation of such income.[206] As understood by Melone, the foundational issue proponents of carried interest reform have with the current tax treatment of carried interest is that the service partners are effectively working for someone else but manage to avoid ordinary income tax rates.[207] Melone

[201] *Id.* at 763-64 (discussing regulatory arbitrage concerns of proposed Section 710).

[202] *Id.* at 764 (evidencing the distinction between corporate and partnership law).

[203] *Id.*

[204] *Id.*

[205] Melone, *supra* note 9, at 487.

[206] *Id.* at 487-88.

[207] *Id.* at 488.

posits the taxation of carried interests should remain undisturbed, reasoning the perceived horizontal inequity of the current regime stems from the preferred tax rates of capital gain rather than the exploitation of a "tax loophole."[208] Further, Professor Melone distinguishes service providers in the context of a corporation from that of a partnership, where the rules of partnership tax are "intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity level tax."[209] Melone focuses on the disparity between the private equity fund arrangement, whereby limited partners invest raw capital and service providers contribute infrastructure, goodwill, know-how or other support, and a new partner at a law firm, who has the benefit of the firm's established reputation and infrastructure.[210]

Professor Field asserts that if the proposed legislation increasing taxes on carried interest were passed, such legislation targeting fund managers indirectly poses risks to fund investors who negotiated the terms of the fund agreement under the current tax regime.[211] Field reasons that "a change to the tax treatment of carried interests changes the economic relationship that investors and managers created and to which they consented in their fund agreement, often after extensive negotiations."[212] In light of "clawback" and "tax distribution" provisions often found in private equity fund agreements, increasing tax rates on fund managers' carried interest shifts some of the risk of loss to the investors without consideration.[213]

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[208] *Id.* at 491 (differentiating the issue from whether, and to what extent, capital gains should receive preferential tax treatment).

[209] *Id.* at 488-89 (quoting Treas. Reg. § 1.702-2(a) (1995) (recognizing "partners do not work for anyone" and "the I.R.S. has not challenged the status of fund managers as partners")).

[210] *Id.* at 490.

[211] Field, *supra* note 14, at 39-40 (explaining clawback and tax distribution provisions may cause fund managers to increase risk taking should the proposed legislation be enacted).

[212] *Id.* at 4-5.

[213] *Id.* at 5.

By shifting some of the risk of loss, the proposed legislation would produce a disconnect between the managers and investors incentives with respect to risk taking. Such a disconnect may impact the return of investors' capital contributions which may be delayed and therefore levy a time-value-of-money cost on the investors.[214] Professor Field explained the "indirect route" through which the carried interest tax proposals would create "return-reducing ripple effects," illustrating how unintended consequences would transpire in the context of economic relationships between private parties that consented to terms under then-current law as a result of changes in the law.[215]

Professor Abrams focuses on distinguishing equitable interests in the partnership context from those in the realm of corporations. Unlike Section 351(d)(1), which excludes "services" as "property" within the definition of Section 351(a), there is no equivalent provision in Section 721 disqualifying the contribution of services to be a tax-free exchange.[216] While acknowledging the political and technical arguments of carried interest reform proponents, Professor Abrams ultimately concludes the current statutory treatment of carried interests should remain unchanged.[217] Professor Abrams explains that the status quo should not be interpreted as a regime supporting the current taxation of the very wealthy, reasoning that, "(1) the current manner of taxing carried interests is more consistent with general principles of taxation than is admitted by its critics, and (2) changing the taxation of carried interests as suggested by its critics is far more difficult than claimed."[218]

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[214] *Id.* at 11-12.

[215] *Id.* at 6.

[216] Abrams, *supra* note 25, at 206 n.41.

[217] *Id.* at 198.

[218] *Id.*

VI. MY PROPOSAL

I recommend the current taxation of carried interest be amended to disallow long-term capital gains treatment of profits interests received by service providers from partnerships, limited liability companies, and other pass-through entities. My proposal to tax such profits interests at ordinary income rates begins with the enactment of the regulations proposed by the IRS in 2005, as contained in Notice 2005-43. Additionally, my proposal incorporates Professor Brunson's simplified mark-to-market approach, subjecting Section 83 to partnership interests. Furthermore, my proposal is comprised of an amendment to the language of Section 83, which concerns the performance of services in exchange for property, while cross-referencing the passive activity rules of Section 469 and "at risk" rules of Section 465.

First, I recommend finalizing the proposed revenue procedure of Notice 2005-43, which would renounce Revenue Procedures 93-27 and 2001-43. In substance, effectuating Notice 2005-43 through Proposed § 1.704-1(b) would apply Section 83 to the issuance of compensatory partnership interests, including transfers by a partnership of interests in partnership capital, partnership profits, and options to acquire capital or profits interests, in exchange for services provided to the partnership.[219] Since the compensatory partnership interest would constitute "property" under Section 83(a), fund managers would be required to recognize income upon the receipt of a profits interest in a partnership.[220] Accordingly, Professor Sacks' critique of Professor Postlewaite's comparison of carried interest to other forms of equity, such as a grant of corporate stock or partnership capital interest, would no longer have merit, as a partnership profits interest would be subject to taxation upon receipt.[221]

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[219] *See* I.R.S. Notice 2005-43, *supra* note 77 (citing Proposed Treas. Reg. § 1.704-1(b)(2)).

[220] *See* King, *supra* note 77.

[221] *See* Sacks, *supra* note 58, at 474 n.105 (citing Philip F. Postlewaite, *The Taxation of Compensatory Profits Interests: The Blind Men and the Elephant*, 29 Nw. J. Int'l L. & Bus. 763, 767-68 (2009)).

Second, in order to require investment fund managers to recognize carried interest income in the amount of carried interest allocated to them annually, regardless of whether the fund had sold assets, my proposal would incorporate Professor Brunson's modified version of the mark-to-market approach.[222] Fund managers would be treated as having contributed the amount of the carried interest to the investment fund, consequently increasing their capital accounts.[223] Any gain realized as a return on the fund manager's deemed contribution would thus retain pass-through character as capital gain, yet subject to a short-term capital gain tax equivalent to ordinary income rates.[224] Notably, Professor Brunson's simplified mark-to-market approach would be "invisible to passive investors," meaning the fund investors serving as limited partners would remain unaffected.[225] Akin to Professor Rosenzweig's holding period solution, the short-term capital gain approach would appeal to the proponents of reform whose focus is the marginal tax rate paid on carried interest by depriving private equity fund managers of the preferential capital gain, while also addressing the concerns of defenders of the current regime by maintaining the current rules regarding partnership accounting.[226]

Third, my proposal will amend the language of Section 83. Professor Postlewaite proposes eliminating Section 83(b) as a means of preventing fund managers from abusing preferred long-term capital gains tax rates on earned income at least partially attributable to labor.[227] However, akin to Professor Sacks' criticism of Proposed Section 710, elimination of Section 83(b) would have widespread consequences affecting taxpayers

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[222] *See* Brunson, *supra* note 13, at 105.

[223] *Id.* at 106.

[224] *Id.* at 106-07 (noting the simplified mark-to-market approach does not require an objective valuation of the investment fund's assets, thus reducing administrative costs which would otherwise be borne by the funds' investors).

[225] *Id.* at 116.

[226] Rosenzweig, *supra* note 19, at 744.

[227] *See generally* Postlewaite, *supra* note 29.

unintended by Congress.[228] My proposal bridges the gap. At the same time, my proposal goes a step further than Satyanarayana's, which would explicitly subject partnership profits interests to Section 83.[229] Whereas Satyanarayana's proposal would require valuation assumptions, ultimately vulnerable to manipulation, my proposal prevents general partners from making Section 83(b) elections, thereby avoiding the task of valuing a profits interest upon receipt altogether.[230] I propose the following language be added to the Code as Section 83(b)(3):

> "**(3) Exception.--**Notwithstanding any other provision of this Section, a taxpayer shall be precluded from making an election under paragraphs (1) and (2) if--
>
> > **(A)** the taxpayer is deemed to "materially participate" under Section 469(h), or
> >
> > **(B)** the taxpayer is not deemed to be "at risk" under Section 465(b)."

Under Proposed Section 83(b)(3)(A) above, taxpayers deemed to materially participate under Section 469(h) will be disallowed from making a Section 83(b) election. Fund managers will be treated as materially participating in the private equity fund's investment activities under Section 469(h)(1). As general partners, fund managers are involved in the operations on a regular, continuous, and substantial basis, satisfying the participation requirements of Treas. Reg. § 1.469-5T. Accordingly, fund managers will recognize short-term capital gain annually on profits interests, subject to ordinary income tax rates.

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[228] *See generally* Sacks, *supra* note 58.

[229] Satyanarayana, *supra* note 2, at 1612.

[230] *Id.* at 1614; *see also* Brunson, *supra* note 13, at 109 (admitting the simplified mark-to-market approach has room for valuation manipulation).

Theoretically, this solution should appease both proponents and critics of carried interest reform. The narrowly tailored exception would impose the higher ordinary income tax rates on wealthy fund managers, promoting vertical and horizontal equity. Simultaneously, fund managers' income would retain its capital gain characterization, accounting for the investment component of such income. Acknowledgement of fund managers' blended labor and investment income is consistent with Treas. Reg. § 1.469(f)(2)(ii), which treats an investor's direct involvement in day-to-day management or operations as participation outside an individual's capacity as an investor.

Additionally, under Proposed Section 83(b)(3)(B) above, taxpayers not deemed to be "at risk" under Section 465(b) will be disallowed from making a Section 83(b) election. As Professor Fleischer points out, tax lawyers would seek to conjure up a scheme to avoid the negative tax implications of carried interest reform.[231] One method of avoidance would include fund managers contributing debt-financed capital, acquired from fund investors, to the partnership in exchange for capital interests ultimately subject to preferred long-term capital gains tax rates. However, such capital contributions would not be treated as "at risk" under Section 465 and Treas. Reg. §§ 1.465-8, 1.465-20. If fund managers' debt-financed capital were nonrecourse, Section 465(b)(4) would exclude the borrowed funds from the fund manager's amount at risk. Additionally, even if the capital contributed by the fund manager was acquired on a recourse basis, the funds would not be treated as "at risk". Under Treas. Reg. § 1.465-8(a)(1), "[a]mounts borrowed with respect to an activity will not increase the borrower's amount at risk in the activity if the lender has an interest in the activity other than that of a creditor . . . ."[232] Therefore, fund managers will not be deemed "at risk" for capital acquired from fund investors and then contributed to the partnership.

Some tax lawyers may seek to avoid the "at risk" rules of Section 465 by forming a limited liability company to serve as the limited partnership's general partner. However, Section

[231] *See* Fleischer, *supra* note 173.

[232] Treas. Reg. § 1.465-8(a)(1).

465(c)(3)(B) aggregates the activities where taxpayers actively participate in the management of a trade or business. Therefore, creation of a shell company would be a futile method of avoiding the legislative reform.

VII. CONCLUSION

My proposal strikes a balance between the goals of proponents and critics of carried interest reform. Taxing carried interest at ordinary income rates promotes tax policy objectives, particularly horizontal and vertical equity, as well as fiscal policy objectives, by virtue of increased tax revenue. Although fund managers will no longer be able to avail themselves of preferred long-term capital gains tax rates, carried interest shall retain capital gain characterization. Consistent with the underlying principles of Subchapter K, maintaining capital gain character recognizes fund managers' blend of labor and investment income while simultaneously preventing an oversimplified conversion of capital gain to ordinary income irrespective of any investment component.

Although critics of carried interest reform distinguish service providers of corporations from those of partnerships, my proposal characterizes the distinction between the two as an illusory basis for maintaining the current regime in the context of carried interest. While a corporation is treated as a separate taxpaying entity under Section 11(a) and a partnership is not under Section 701, a limited partnership is nonetheless a form of entity that can be contractually bound by agreements entered into by general partners. Subchapter K seeks to treat taxpayers the same as if they engaged in the activity directly rather than through a partnership, however the structure of private investment funds is evidence of the true arrangement. In the context of private equity funds, the general partners invest the limited partners' capital in exchange for compensation in the form of "equity." Yet, without the mask of a partnership entity, a taxpayer is managing another taxpayer's money, hence the "equitable" remuneration takes the form of capital. In fact, fund managers' compensation is comparable to attorneys working under a contingency fee arrangement, who only receive payment if a contractually agreed upon target objective is met. Ironically, attorneys working on contingency recognize ordinary income, whereas private investment fund managers treat their "nonguaranteed" income as capital gain.

Amending Section 83 with cross-references to the "at risk" rules of Section 465 and "passive loss" rules of Section 469 achieves the goal of reforming the current regime's taxation of carried interest in a manner consistent with the purposes of Sections 465 and 469. My proposal parallels the legislative purpose of Sections 465 and 469, which were enacted to restrict taxpayers' ability to minimize tax liability. My proposal seeks to end Code exploitation by private investment fund managers who currently structure partnership agreements to provide investment services in exchange for profits interests ultimately taxed at preferred long-term capital gain rates.