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THE LARGEST LOOPHOLE IN FEDERAL TAX LAW: PREFERENTIAL CAPITAL GAIN TREATMENT FOR PRIVATE EQUITY AND HEDGE FUND MANAGERS' CARRIED INTERESTS

MICHAEL R. PIECZONKA*

I. THE RICH GETTING RICHER, THE POOR GETTING POORER

"The top 1 percent of American households hold one-third of total household net worth,¹ more than the bottom 90 percent of households combined."² This group's aggregate net worth continues to increase and widen the gap between the rich and

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1. Net worth is the amount an individual's or corporation's assets exceed its liabilities. GILBERT LAW SUMMARIES POCKET SIZE LAW DICTIONARY 215 (Harcourt & Co. 1997); *see also* BLACK'S LAW DICTIONARY 1639 (8th ed. 2004) (defining net worth as a measure of one's wealth, usually calculated as the excess of total assets over total liabilities).

2. Press Release, Lawrence H. Summers, U.S. Dep't of the Treasury, Helping America to Save More Remarks by Treasury Secretary Lawrence H. Summers, Choose to Save Forum, Washington, DC (Apr. 4, 2000), <http://www.treas.gov/press/releases/l5524.htm>. "In 2001, there were an estimated 7.4 million adults, age 18 and older, with gross assets of \$675,000 or more." Barry W. Johnson & Brian G. Raub, *Personal Wealth*, 2001 120, <http://www.irs.gov/pub/irs-soi/01pwart.pdf> (last visited Dec. 24, 2008). The group had a total net worth of thirteen trillion eight hundred million dollars. *Id.* This top three and a half percent of top wealth holders held an estimated thirty-two point seven percent of the total U.S. net worth in 2001. *Id.* This confirms the notion that the rich are getting richer and the poor are getting poorer.

poor.³ Warren Buffet, one of the world's most famous professional investors worth fifty-two billion dollars, condemned Congress for allowing him to pay a lower tax rate than his secretary and cleaning lady.⁴ He went on to say he paid an effective tax rate of 17.7 % on his 46 million dollars in 2006, without trying to avoid paying higher tax rates, while his secretary paid 30 % on the 60,000 dollars she made.⁵ A major cause of the increasing disparity between wealthy and poor Americans is the difference between capital gains tax rates and ordinary income tax rates; the former having a maximum of 15%, the latter a maximum of 35%.⁶

This Comment will highlight one element of this tax disparity by discussing the tax treatment of private equity and hedge fund managers' carried interests. Part II will explain the present tax treatment of private equity and hedge fund managers' carried interests, and why the current tax treatment is an issue. Part III will discuss and analyze whether fund managers' carried interests should be characterized as compensation for services and subject to ordinary income rates, or characterized as capital gains. Part IV proposes, based on the current Internal Revenue Code ("IRC"), Federal Statutes, and case law, that Congress should treat fund managers' carried interests as ordinary income.

II. BACKGROUND

A. What are Private Equity and Hedge Funds?

Private equity⁷ and hedge⁸ funds are distinct from mutual

3. See generally Marco Cagetti & Mariacristina De Nardi, *Wealth inequality: data and models*, Fed. Res. Bank of Chi., WP 2005-10 (Aug. 17, 2005), available at http://www.chicagofed.org/publications/workingpapers/wp2005_10.pdf (analyzing the highly unequal distribution of wealth in the U.S. and determining what data of economic models has explained thus far).

4. Tom Bawden, *Warren Buffet Says Rich Should Pay More Taxes: World's Second-Richest Man Says Wealthy Owe Their Riches to the Rest of Humanity in Attack on US Tax System*, TIMESONLINE, (June 27, 2007), http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article1995931.ece. Buffet went on to say "If you're in the luckiest 1 percent of humanity, you owe it to the rest of humanity to think about the other 99 percent." *Id.*

5. *Id.*

6. I.R.C. § 1 (West 2008).

7. Private equity funds, from an investor's point of view, are a part of an asset class offering "potential high returns, somewhat higher risk and diversification from a traditional portfolio of marketable securities." MERCER INVESTMENT CONSULTING, INC., MERCER HUMAN RESOURCE CONSULTING LLC, KEY TERMS AND CONDITIONS FOR PRIVATE EQUITY INVESTING 3 (1996), available at http://www.empea.net/docs/GP_Toolkit_Mercer_Report_Key_Terms_and_Conditions_for_Private_Equity_Investing.doc?iMultId=3395&iLocId=1 [hereinafter "MERCER REPORT"].

8. There is no universal definition of "hedge fund." See U.S. SEC. & EXCH. COMM'N, STAFF REPORT TO THE UNITED STATES SECURITIES & EXCHANGE

funds⁹ and venture capital.¹⁰ Although private equity¹¹ and hedge funds are similar¹² in many ways, the two differ in four main respects. First, the “investment horizons”¹³ of the funds, or the duration the funds hold investments, differ. Second, whether the funds “control”¹⁴ the companies whose stock the funds purchase,

COMMISSION, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 3 (Sept. 2003), <http://www.sec.gov/news/studies/hedgefunds0903.pdf> [hereinafter “SEC HEDGE FUND REPORT”] (stating a “Hedge fund” refers to an entity (usually a partnership) that holds a pool of securities and other assets, whose interests are not sold in a registered public offering and which is not registered as an investment company under the Investment Company Act); *see also* BLACK’S LAW DICTIONARY, *supra* note 2 at 740 (defining hedge fund as “a specialized investment group, usually organized as a limited partnership or offshore investment company, that offers the possibility of high returns through risky techniques such as selling short or buying derivatives.”).

9. A mutual fund is an investment company that usually invests its shareholders’ money in a diversified selection of securities. BLACK’S LAW DICTIONARY, *supra* note 2 at 1045. *Cf.* Henry Ordower, *Demystifying Hedge Funds: A Design Primer*, 7 U.C. DAVIS BUS. L.J. 323, 327-39 (2007) (comparing and contrasting hedge funds and mutual funds).

10. Venture capital funds are funds invested in a new enterprise that have high risk and the potential for high return. BLACK’S LAW DICTIONARY, *supra* note 2 at 222. The venture capital fund is a typical private equity fund. JAMES M. SCHELL, *PRIVATE EQUITY FUNDS: BUSINESS STRUCTURE AND OPERATIONS* § 1.03[1], 1-21 (Law Journal Press 2008) (2000). Venture capital investing, broadly understood, involves infusing capital into business enterprises in the early stages of the development of new products or services. *Id.*

11. *See*, Private Equity Council, <http://www.privateequitycouncil.org> (last visited Dec. 24, 2008) (promoting, advocating, and disseminating information about private equity funds to the investment public).

12. Both private equity and hedge funds are sold in private offerings to accredited investors and require large capital commitments for participation, frequently five million dollars or more. Private Equity Council, *Private Equity and Hedge Funds: They’re Not the Same*, <http://www.privateequitycouncil.org/research-library/fact-sheets/private-equity-and-hedge-funds-they%E2%80%99re-not-the-same> (last visited Dec. 24, 2008) [hereinafter *They’re Not the Same*]; *see also* Private Equity Council, *Private Equity: Fact & Fiction*, , <http://www.privateequitycouncil.org/just-the-facts/private-equity-fact-and-fiction/> [hereinafter “*Fact & Fiction*”] (last visited Dec. 24, 2008) (disclaiming myths about private equity firms).

13. Private equity firms are long-term investors that buy controlling stakes in business entities and exercise control over the entity for an average of two to five years, and at times, much longer. *Fact & Fiction*, *supra* note 12. Hedge funds liquidate or divest investments more quickly than private equity funds. *Id.* However, both firms maintain their investments for a period of at least one year to take advantage of capital gains tax treatment. *See infra* text and accompanying notes 82–86 (discussing capital gains tax treatment).

14. A private equity fund obtains control of the firms it buys to implement governance and operational changes. *They’re Not the Same*, *supra* note 12. The majority of private equities have one hundred percent ownership and control of the purchased entity. *Id.* On the other hand, hedge funds purchase equity securities in firms at an insignificant level, which results in a lack of control over the firm and only possession of a minority interest. *Id.*

and if so its control strategy. Third, the funds' techniques of "exiting investments"¹⁵ differs. Finally, the funds have different "capital flow"¹⁶ structures.

Hedge funds routinely invest globally in listed securities,¹⁷ futures,¹⁸ options,¹⁹ and currencies,²⁰ but also invest in any financial assets and instruments that can be readily traded.²¹ Conversely, private equity funds invest in a wide range of illiquid assets,²² which are not freely tradable on a public stock exchange.

15. Private equity firms divest investments, after the entity has increased in value, in one of two ways. *Id.* Divestment occurs either through issuing stock in an IPO in the public stock markets or by selling the firm to another buyer whether it is another company or private equity firm. *Id.* A hedge fund merely sells its securities in the public exchanges after successfully executing its investment strategy. *Id.*

16. Private equity funds raise capital for each fund, invest the capital, return the gain and principal to the investors, and then raise capital for another fund. *Id.* Private equity funds have a typical life of ten to twelve years and investors are unable to redeem their interest early. *Id.* Hedge funds continuously reinvest a limited partner's capital until the partner requests the return of the investment. *Id.* Hedge fund managers require that all of the investor's capital be deposited in the fund at formation, while private equity fund managers call for infusions of capital from the investors, up to their committed amounts, as required for acquisitions. *Id.* Therefore, private equity fund investors can invest their funds in short-term investments and obtain a return on their capital until the fund calls for their investment, while hedge fund investor's capital obtains no return, other than possibly marginal interest, until used by the fund manager.

17. Listed securities are securities accepted for trading on a securities exchange. BLACK'S LAW DICTIONARY, *supra* note 2 at 1386; *see id.* at 1384 (defining security as an instrument that evidences the holder's ownership rights in a firm (e.g. stock), the holder's creditor relationship with a firm or government (e.g. bond), or a holder's other rights (e.g. an option)); *see also id.* at 950 (defining 'listed security' exchange as an organized secondary security market operating at a designated location, such as the New York Stock Exchange [hereinafter "NYSE"]).

18. Futures are standardized assets, such as commodities, stocks, or foreign currencies, bought or sold for future acceptance or delivery. *Id.* at 699; *see also id.* (defining a futures contract as an agreement to buy or sell a standardized asset at a fixed price at a future time).

19. Stock options are rights, but not obligations, to buy or sell a given quantity of securities, commodities, or other assets at a fixed price within a specified period of time. *Id.* at 1127. *Cf id.* (defining contract option as an offer included in a formal or informal contract, which places an obligation on the offeror to hold open a contract for a specified amount of time to prevent it from revoking the offer).

20. Currencies are denominations of monetary value, such as coins, government notes, or banknotes, which nations use as a medium to transact business. *Id.* at 411.

21. SCHELL, *supra* note 10, §§ 1.05[1], 1-33 to 1.05[2], 1-34.

22. BLACK'S LAW DICTIONARY, *supra* note 2 at 126 (defining illiquid asset as an asset that is not readily convertible into cash, usually because of (1) the lack of demand, (2) the absence of an established market, or (3) the substantial cost or time required for liquidation (such as for real property, even where it is desirable)).

This Comment focuses specifically on private equity and hedge funds.²³

B. What Are the Legal Structures of Funds?

Funds are usually structured as domestic limited²⁴ partnerships²⁵ to allow investors maximum benefit under the Internal Revenue Services²⁶ IRC.²⁷ Non-United States

23. For simplicity's sake, private equity and hedge funds will be collectively referred to as "funds" in this Comment.

24. The Uniform Partnership Act ("UPA") defines a partnership as "an association of two or more persons to carry on as co-owners a business for profit." J. WILLIAM CALLISON & MAUREEN A. SULLIVAN, *PARTNERSHIP LAW AND PRACTICE: GENERAL AND LIMITED PARTNERSHIPS*, § 2:3, 2-5 (Thompson/West 2008). There are two types of partnerships, (1) general and (2) limited. *Id.* The UPA defines a general partnership ("GP") as "a business organization consisting of two or more persons, all of whom are general partners with full status as such." *Id.* The UPA states that a limited partnership ("LP") consists "of one or more general partners and one or more limited partners." *Id.* § 2:4, 2-9. LPs are usually passive investors who do not participate in day-to-day decisions and operations, are liable only up to their initial investment, and share in firm profits and losses. *Id.* On the other hand, GPs have unlimited liability, participate in the day-to-day operations and decisions, and participate in profits and losses. *Id.* See generally JOHN E. MOYE, *THE LAW OF BUSINESS ORGANIZATIONS 1* (West Publ'g Co. 2d ed. 1982) (1974) (covering all aspects of the three major types of business entities: sole proprietorships, partnerships, and corporations); see also ALAN R. BROMBERG, *CRANE AND BROMBERG ON PARTNERSHIP 1* (Jesse H. Choper et al., eds., West Publ'g Co. 2d ed. 1968) (providing an all-inclusive education on partnerships, including formation, dissolution, rights and duties of partners, and partnership property and interests).

25. SCHELL, *supra* note 10, § 1.05[2], 1-30; see generally Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Start-ups*, 57 TAX L. REV. 137, 143-44 (2003) [hereinafter *VC Start-ups*]¹⁰⁰ (establishing why venture capital funds are organized as C-Corporations even though LLCs and partnerships are more advantageous for tax purposes when factoring in losses). However, the managers are very optimistic, so they believe only gains will result. *Id.* The article also contrasts the advantages and disadvantages of C-Corporations versus partnerships and LLCs. *Id.* at 143-77.

26. The Internal Revenue Service ("IRS") is a bureau of the U.S. Department of Treasury and is responsible for the administration and collection of Federal Tax. Internal Revenue Service, *The Agency, Its Mission and Statutory Authority*, <http://www.irs.gov/irs/article/0,,id=98141,00.html> (last visited Dec. 24, 2008) [hereinafter *The Agency*]. The Sixteenth Amendment to the U.S. Constitution, ratified in 1913, gave Congress the Power to enact an income tax. U.S. CONST. amend. XVI. The IRS helps willing Americans comply with the U.S. tax code, while ensuring noncompliant Americans pay their fair share of taxes. *The Agency*. Section 7801 of the IRC allows the Secretary of the Treasury to delegate its powers to administer and enforce the tax laws of America. *Id.* Section 7803 of the IRC allows for a commissioner of the IRS and allows for the administration, supervision, execution, and application of the internal revenue laws. *Id.*

27. See generally I.R.C. §§ 1 - 9833 (West 2008) (containing the tax provisions applicable to all U.S. individuals and entities).

individuals²⁸ and tax-exempt institutions²⁹ prefer or even require off-shore³⁰ funds to minimize or avoid tax liability.³¹ The fund's General Partner ("GP")³² is the fund manager, while the Limited Partners ("LPs") are the fund's investors.³³ Fund managers obtain investors through private placements³⁴ to avoid Securities Exchange Commission ("SEC") regulations. The limited partnership funds are designed and structured to avoid very costly SEC filings, compliance, and disclosures.³⁵ The limited partnership agreement³⁶ governs and controls the partnership.

28. See BLACK'S LAW DICTIONARY, *supra* note 2 at 789 (defining individual as a single person or thing existing as an indivisible entity); *see also id.* at 675 (defining foreigner as a citizen of another country); *id.* at 261 (defining citizenship as the status of being a citizen); *id.* (defining citizen as a person who, by either birth or naturalization, is a member of a political community and being entitled to enjoy all its civil rights and protections); *id.* at 1571 (defining United States person as a U.S. resident or national with the exception of one living outside the United States who is employed by someone who is not a United States person).

29. Tax-exempt institutions are not subject to U.S. taxation by law. *Id.* at 1501. Pension funds and university endowments are the two largest and most common tax-exempt entities that invest in funds. *VC Start-Ups*, *supra* note 25, at 158.

30. SCHELL, *supra* note 10, § 1.05[2], 1-30. Offshore funds are sometimes created as limited partnerships, but more commonly as trusts or corporations in low tax jurisdictions, such as Bermuda or the Cayman Islands, to minimize tax liability. *Id.* This is cognizant with avoiding taxation at the fund level. *Id.*

31. *See id.* §§ 5.04, 5-20 to 5.04[2], 5-28 (discussing the effect of "unrelated business taxable income" ("UBIT") on tax exempt partners (IRC section 501(c) tax exempt organizations); *see also* I.R.C. § 512 (West 2008) (defining UBIT and when tax exempt organizations are subject to tax thus losing their exempt status); SCHELL, *supra* note 10, §§ 5.05, 5-29 to 5.05[3], 5-35 (explaining the tax effects on a foreign partner in a fund which is engaged in a trade or business within the United States).

32. *See* DOUGLAS L. HAMMER ET AL., U.S. REGULATION OF HEDGE FUNDS, 370 (Am. Bar Assoc. 2005) (stating that the GP may be a partnership, C-Corporation, S-Corporation, or individual, adding yet another level of complexity). Many of the GPs are entities with limited liability to insulate the unlimited liability that GPs are subject to in limited partnerships and avoid double taxation. *Id.*

33. *See* Lartease Tiffith, *Hedge Fund Regulation: What the FSA Is Doing Right and Why the SEC Should Follow the FSA's Lead*, 27 NW. J. INT'L L. & BUS. 497, 500 (2007) (requiring capital investments by LPs of five million dollars in a Fund as common).

34. *See* SEC HEDGE FUND REPORT, *supra* note 8, at ix (listing two exceptions to avoid registration and substantive regulation under the Investment Company Act of 1940). *See infra* text accompanying notes 60-63 (discussing the Investment Company Act of 1940).

35. *See* SEC HEDGE FUND REPORT, *supra* note 8, at 13-20 (describing how a fund structures itself to take advantage of exemptions that allow it to escape the filing requirements of SEC Acts).

36. *See id.* at 49 (stating that limited partnership agreements set out the respective rights and responsibilities of the limited partners and the general

Fund managers are compensated in two ways³⁷ to ensure the transactions that the GPs enter into are aligned with the LPs' interests.³⁸ Fund managers hold a substantial stake in the funds they manage, but only on the upside.³⁹ The fund managers receive (1) an annual management fee⁴⁰ and (2) a "carry" or "carried interest."⁴¹ Fund managers' carried interests are currently the subject of two proposed Congressional regulations.⁴²

C. *How are Private Equity and Hedge Funds Regulated?*

Funds are nothing new to the seasoned investor;⁴³ however,

partners). Partnership agreements contain anything and everything the partners want to agree to, including contribution and profit and loss allocations. CALLISON & SULLIVAN, *supra* note 24, § 2:4, 2-9; accord BLACK'S LAW DICTIONARY, *supra* note 2 at 1153 (defining partnership agreement as a contract defining the partners' rights and duties toward one another and not the partners' relationship with third parties).

37. Fund managers are compensated by the fund in two ways: (1) a management fee and (2) a "carried interest." SEC HEDGE FUND REPORT, *supra* note 8, at 61. However, they may have three sources of income from the fund: (1) a yearly management fee (treated as ordinary income and subject to ordinary income rates); (2) a carried interest (currently treated as capital gains and subject to its respective rates); and (3) profits from the fund manager's invested equity capital in the fund (also treated as capital gains and subject to its respective rates). *Id.*

38. *See id.* at 109 (explaining that a properly configured performance fee arrangement and capital investment ensures an alignment of GPs and LPs interests).

39. A typical fund's limited partnership agreement with LP investors requires that the GP invest only one percent of the capital in the fund but provides the GP with a carried interest of twenty percent, resulting in twenty percent of the profits for a negligible outlay of cash. VC Start-ups, *supra* note 25, at 151-52. This permits the fund managers to obtain a large share on the potential upside gains, but almost none of the downside. *Id.*

40. A Fund managers' annual management fee is typically one to two percent of the funds' net assets. SEC HEDGE FUND REPORT, *supra* note 8, at 61. The management fee covers annual expenses, the managers' salary, and transaction costs. *Id.*

41. A fund manager's carried interest is the main form of compensation, amassing typically twenty percent of the increase in net asset value realized. *Id.* A fund manager's carried interest is the most common way for LPs to ensure the fund manager's intentions are aligned with those of the LP. *See* Victor Fleischer, *The Missing Preferred Return*, 31 J. CORP. L. 77, 83-86 (2005) [hereinafter *Preferred Return*] (discussing the different types of carried interest agreements and each agreements affect on fund managers' compensation). *See infra* Part I.A.4 (discussing the current tax treatment of fund managers' management fees and carried interests, capital gains and ordinary income treatment).

42. *See* H.R. 2834, 110th Cong. (2007) (attempting to amend the IRC to treat fund managers' carried interests as ordinary income); *see also* S. 1624, 110th Cong. (2007) (trying to amend the IRC to carve out an exception for publicly traded partnerships as corporations that provide investment advisory or management services).

43. *See* A.W. Jones, *History of the Firm*, <http://www>

funds have just recently gained broader public interest.⁴⁴ The public notoriety these funds now receive comes with increased scrutiny from multiple groups, such as the SEC,⁴⁵ Congress, and the IRS. Despite the additional government scrutiny, however, the information available⁴⁶ regarding the funds and their regulation⁴⁷ is both inadequate and insubstantial. Fund managers desire self-regulation while the SEC wants to increase fund regulation.⁴⁸ Although fund regulation is minimal, there are four major U.S. laws that affect funds in the United States: the Securities Act of 1933,⁴⁹ the Securities Exchange Act of 1934,⁵⁰ the Investment Company Act of 1940,⁵¹ and the Investors Advisers Act of 1940.⁵²

The Securities Act generally mandates full and fair disclosure

.awjones.com/historyofthefirm.html (last visited Jan. 1, 2009) (disclosing that A.W. Jones founded the first hedge fund in 1949 and was the first general partner).

44. See Tiffith, *supra* note 33, at 505-09 (discussing the Federal Reserve's and Wall Street's intervention in the largest hedge fund to date, preventing its ultimate demise); see also SEC HEDGE FUND REPORT, *supra* note 8, at 1 (stating that although information about hedge funds is very limited, it is estimated that 6,000 hedge funds in the United States have approximately 600 billion dollars in managed assets, up from 400 hedge funds in 1992). Hedge fund assets grew from 50 billion dollars in 1993 to over 592 billion dollars in 2003. *Id.*

45. The SEC is the primary regulating agency of securities in the United States. ROBERT H. HERZ ET AL., *THE COOPERS & LYBRAND SEC MANUAL* 7 (John Wiley & Sons, Inc., 7th ed. 1997). An enactment of Congress created the SEC, an independent agency, which plays a quasi-judicial role in regulating the business of distributing and trading shares. *Id.* The Securities Exchange Act of 1934 created the SEC. *Id.* See *infra* text accompanying note 50 (providing information about the Securities Exchange Act of 1934). The SEC's most important role is protector of the public investors, not the issuers or underwriters of the securities. HERZ, *supra* note 45, at 28; see also U.S. SEC. EXCH. COMM'N., *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, <http://sec.gov/about/whatwedo.shtml> (last visited Jan. 1, 2009) (stating its "mission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.").

46. But see Prequin, *Alternative Assets, Private Equity, Real Estate, Hedge Funds and Infrastructure*, <http://www.prequin.com> (last visited Jan. 1, 2009) (providing information, products, and services to private equity and venture capital firms, fund-of-funds, investors, and advisors in four key areas: (1) Private Equity, (2) Real Estate, (3) Hedge Funds, and (4) Infrastructure).

47. See generally, HAMMER, *supra* note 32, at 370 (covering all U.S. regulations affecting hedge funds).

48. See generally *supra* text accompanying note 8 (providing the Chairmen of the SEC with a staff report after an intensive investigation resulting in a recommendation for greater Fund regulation).

49. 15 U.S.C. §§ 77a-77aa (2006) [hereinafter Securities Act].

50. 15 U.S.C. §§ 78a-78nn [hereinafter Exchange Act].

51. 15 U.S.C. §§ 80a-1 to 80a-64 [hereinafter Investment Company Act].

52. 15 U.S.C. §§ 80b-1 to 80b-21 [hereinafter Investment Advisers Act].

in securities transactions.⁵³ First, all publicly offered securities are required to be registered with the SEC. Additionally, all purchasers must be provided with a prospectus, containing specified information requested by the SEC, unless an exception is met.⁵⁴ Funds are subject to the Securities Act because limited partnerships and limited liability corporations meet the SEC's securities definition.⁵⁵ Funds, however, rely on a private offering exception found in Section 4(2) of the Securities Act (Rule 506), available to issuers only, which allows funds to escape the registration and prospectus requirements.⁵⁶

The Exchange Act requires securities dealers to register with the SEC.⁵⁷ Funds that meet the definition of a "dealer" and the requirements of Section 78l of the Exchange Act are subject to the Act unless the fund has fewer than five hundred investors.⁵⁸ Most funds allow a maximum of four hundred ninety-nine investors, therefore, to avoid costly compliance with the Exchange Act.⁵⁹

The Investment Company Act requires that investment companies register with the SEC and regulates the companies' activities and transactions.⁶⁰ Sections 3(c)(1) and 3(c)(7) are two exclusions funds use to avoid registration and regulation under the Investment Company Act. Section 3(c)(1) excludes from the definition of "investment company" any "issuer whose outstanding securities are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities."⁶¹ Section 3(c)(7) of the Investment Company Act excludes from the definition of "investment company" any issuer that makes a private offering directly to qualified purchasers⁶² and does not at that time propose to make a public offering of those securities.⁶³ The Investment

53. Securities Act, 15 U.S.C. §§ 77a-77aa.

54. *Id.* §§ 77e-77aa.

55. *Id.* § 77d(2).

56. *Id.* For a more detailed analysis, description and application of the SECURITIES ACT with Hedge Funds see SEC HEDGE FUND REPORT, *supra* note 8, at 13-18.

57. Exchange Act, 15 U.S.C. §§ 78a-78nn.

58. *Id.* §§ 78c(a)(5)(A), 78l(a)-(l). For a more detailed analysis, description and application of the Exchange Act with Hedge Funds see SEC HEDGE FUND REPORT, *supra* note 8, at 18-20.

59. SEC HEDGE FUND REPORT, *supra* note 8, at 18-19 (stating that to avoid registration under the Exchange Act funds have fewer than 500 investors).

60. See generally Investment Company Act, 15 U.S.C. §§ 80a-1 to 80a-64 (providing investment companies with registration and filing requirements).

61. *Id.* § 80a-3(c)(1). Corporate investors count as one investor when trying to comply with the one hundred investor requirement. *Id.* § 80a-3(c)(1)(A).

62. See *Id.* § 80a-2(a)(51) (defining "qualified purchaser").

63. *Id.* § 80a-3(c)(7)(A). For a more detailed analysis, description and, application of the Investment Company Act with Hedge Funds see SEC HEDGE FUND REPORT, *supra* note 8, at 11-13.

Company Act, therefore, places an even greater restriction on the number of investors an investment company may have before being required to comply with costly compliance and filing requirements.⁶⁴

The Investment Advisers Act requires that investment advisers register with the SEC and comply with both the Act and any SEC rules.⁶⁵ The *de minimis* exception⁶⁶ has allowed most fund advisers to escape registration with the SEC. Depending on the actual activities of the fund, other Federal and state regulations may apply.⁶⁷

D. What are the Tax Implications of the Funds?

The majority of U.S. investor funds are structured as limited partnerships. Subchapter K of the IRC governs U.S. partnerships.⁶⁸ The IRC does not treat a partnership as a separate and distinct entity for tax purposes.⁶⁹ IRC Section 7704 treats certain publicly traded partnerships that engage in continuous business activities as corporations, however, for income tax purposes.⁷⁰ Income and expenses are determined at the

64. Compare Exchange Act, 15 U.S.C. §§ 78a-78nn (requiring compliance with costly filing requirements when dealers have five hundred or more investors), with Investment Company Act, 15 U.S.C. §§ 80a-1 to 80a-64 (requiring compliance with costly filing requirements when investment companies have one hundred or more investors).

65. See generally Investment Advisers Act, 15 U.S.C. §§ 80b-1 to 80b-21 (requiring registered investment advisers to keep a current Form ADV filed with the SEC and provide a disclosure statement to their clients). The SEC's website contains and describes the FORM ADV requirements. U.S. SEC. AND EXCH. COMM'N, *Form ADV*, <http://www.sec.gov/answers/formadv.htm> (last visited Jan. 1, 2009).

66. Section 203(b) of the Investment Advisers Act excludes "any investment adviser who during the course of the proceeding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser to any investment company registered. . . ." Investment Advisers Act, 15 U.S.C. §§ 80b-1 to 80b-21, at § 80b-3(b)(3). A legal organization such as a fund may be counted as a single client by the adviser. 17 C.F.R. § 275.203(b)(3)-1(2)(i) (2002). For a more detailed analysis, description and application of the Investment Advisers Act with Hedge Funds see SEC HEDGE FUND REPORT, *supra* note 8, at 20-22.

67. See generally SEC HEDGE FUND REPORT, *supra* note 8, at 23-31 (discussing the effects of the Commodity Exchange Act ("CEA"); the National Association of Securities Dealers ("NASD"); the Employment Retirement Income Security Act ("ERISA"); and regulations of funds promulgated by the Department of the Treasury).

68. See I.R.C. § 1 to § 9833 (West 2008) (providing tax provisions for individuals, corporations, and partnerships).

69. WILLIAM S. MCKEE ET. AL., *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 1.01, ¶ 1.01[1], 1-2 (Thompson/West 4th ed. 2007).

70. See I.R.C. § 7704 (West 2008) (resulting in double taxation of income). Section 7704(c) is an exception to taxing passive publicly traded partnerships, which have ninety percent or more of their gross income for such taxable year

partnership level, but flow through to the individual.⁷¹ Once the income flows through the partnership to the individual, the individual computes his tax liability as an individual.⁷²

The partnership agreement determines each partner's allocation of partnership income, gain, loss, deduction, or credit and may differ from the partner's ownership interest.⁷³ Each partner has a capital account which is increased by contributions to the partnership and partnership profits, and decreased by distributions of capital and property and allocation of partnership losses.⁷⁴ Deductibility of partnership losses by a partner, therefore, is limited to the basis⁷⁵ of his partnership interest.⁷⁶

LPs also have to consider "at-risk"⁷⁷ rules and "passive loss"⁷⁸ rules. A fund is generally not considered to be engaged in passive activity and thus not subject to the passive loss rules regarding distributive shares of income, gains, and losses.⁷⁹

GPs managing U.S. funds can receive three sources of income: (1) annual management fees⁸⁰ that are taxed as ordinary income;⁸¹ (2) performance-based carried interest allocations from the fund

consisting of qualifying income. *Id.* § 7704(c)(2).

Qualifying income means (A) interest, (B) dividends, (C) real property rents, (D) gain from the sale or other disposition of real property, (E) . . . (F) any gain from the sale or disposition of a capital asset held for the production of income . . .

Id. §§ 7704(d)(1)(A) - 7704(d)(1)(G).

71. Compare *id.* § 701, (stating partnerships are not subject to income tax, but rather the business partners are liable for income tax only in their separate or individual capacities) with MOYE, *supra* note 24, §4.06, 91-92 (showing income from C- Corporations is double taxed, one tax at the corporate level and a second tax when the individual receives the distributed income).

72. MCKEE, *supra* note 69, ¶ 1.01[1], 1-2 to 1-3.

73. *Id.* at ¶ 1.01[1], 1-3.

74. I.R.C. §§ 704(a)-(f) (West 2008).

75. *Id.* §§ 705(a)-(b).

76. *Id.* § 704(c).

77. *Id.* § 465.

78. *Id.* § 469.

79. See 26 C.F.R. § 1.469-1T(a) (providing that trading personal property, including stocks, bonds, and other securities, on account of other owners of the trading entity, a fund in this case, is not a passive activity, whether the trader is conducting trading as a trade or business). Therefore, the partner's ability to deduct losses is not limited by the passive loss rules.

80. See I.R.C. § 707(c) (West 2008) (treating annual fund management fees as guaranteed payments and taxing them as ordinary income).

81. See *id.* § 64 (defining ordinary income as including:

any gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b). Any gain from the sale or exchange of property which is treated or considered, under other provisions of this subtitle, as 'ordinary income' shall be treated as a gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b)).

Ordinary income may be taxed up to 35%. *Id.* §§ 1(a)-(e).

which retain the tax character of the fund's income; and (3) profits on the GP's own proprietary capital.⁸² Fund income is usually characterized as long-term capital gains.⁸³ Only income generated from the divestment of a capital asset⁸⁴ held for more than a year,⁸⁵ however, can obtain long-term capital gains tax treatment. Long-term capital gains tax rates apply only when an individual has a "net capital gain."⁸⁶ If a "net capital loss" is computed, the loss can be used in accordance with IRC Sections 1211 and 1212 to offset ordinary income.⁸⁷ The fund's proceeds from selling public

82. A fund manager's capital interest is considered either long-term or short-term capital gains, interest, or dividend income because it retains the partnership's characterization. *Id.* § 702. Long-term capital gains are taxed at a maximum of 15%. *Id.* § 1(h).

83. *See id.* § 1222 (defining long-term, short term, capital gains and losses, and net capital loss and net capital gain).

84. *Compare id.* § 1221(a) (stating that "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include") [Section 1221(a) of the IRC includes all items as a capital asset other than the eight expressly exempted items], *with id.* § 1231 (extending capital asset classification to property used in a trade or business or involuntarily converted).

85. *See id.* § 1223 (requiring a capital asset to be held for "a year and a day" to qualify as a long-term capital gain or loss).

86. *See id.* § 1222 (defining "net capital gain" as the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year."). To determine if capital gain tax rates apply, you must first determine if the divested property meets the definition of a capital asset under Sections 1221(a) or 1231(b). *Id.* §§ 1221(a), 1231(b). If it is determined that the property is not a capital asset, the proceeds or loss are considered ordinary income or loss, and taxed at the normal tax rates. *Id.* § 64. However, if the property is a capital asset then the taxpayer's holding period must be determined. *Id.* § 1223. IRC Section 1223 requires that the asset must be held for over one year, the "year and a day" rule, to qualify as long-term capital gains or losses. *Id.* §§ 1222(3)-(4). Thus, if the capital asset is held for a year or less the gain or loss is considered short-term capital gains or losses. *Id.* §§ 1222(1)-(2). After characterizing the divested property, the short-term capital gains and losses have to be netted, offset against each other, and the long-term capital gains and losses have to be netted, offset against each other, resulting in net short-term capital gain or loss and net long-term capital gain or loss. *Id.* §§ 1222(5)-(8). Thereafter, the net capital gain or loss has to be computed. *Id.* §§ 1222(10)-(11). A net capital gain results if there is an excess of net long-term capital gain over net short-term capital loss. *Id.* § 1222(11). A net capital loss results if there is an excess of losses over gains. *Id.* § 1222(10). Only if a net capital gain results will the Section 1(h) fifteen percent capital gain tax rate apply. *Id.* § 1(h). If a net capital loss results for an individual, Section 1211(b) allows the lesser of the actual net capital loss, or a three thousand dollar set-off, as an equal amount of ordinary income. *Id.* §§ 1211(b)(1)-(2). If the net capital loss exceeds three thousand dollars, Section 1212(b) allows a carryover to offset ordinary income in other tax years. *Id.* § 1212(b).

87. *See supra* text accompanying note 86 (describing the process of determining if capital gains tax rates apply rather than ordinary income tax rates).

securities, if held for over a year, results in a net long-term capital gain. The income's character as net long-term capital gain is maintained and flows through the partnership to the GP, resulting in a fifteen percent tax rate.⁸⁸

E. Why Is Congress Interfering with Fund Managers' Carried Interest Tax Treatment?

There are many reasons⁸⁹ why Congress has decided to try and amend the tax treatment of fund managers' carried interests. Two major reasons are: (1) the Alternative Minimum Tax ("AMT"),⁹⁰ and (2) recent discussions of funds in the news.⁹¹

1. AMT—The U.S. Government's Multi-Billion Dollar Windfall from Middle-Class Americans

AMT is defined as a tax amount equal to a taxpayer's tentative taxable excess over the regular income tax for the taxable year.⁹² The taxable excess is the amount of the alternative minimum taxable income that is the taxpayer's taxable income, increased by preference items and certain adjustment items that exceed the taxpayer's applicable AMT exemption amount.⁹³ AMT was originally enacted by Congress to tax the very rich that had low "adjusted gross incomes."⁹⁴ AMT affects more of the middle class, however, than originally anticipated.⁹⁵ AMT is scheduled to

88. See I.R.C. § 1(h) (West 2008) (stating that if a taxpayer has net capital gain for any taxable year, the tax imposed for such year shall not exceed the sum of 15 % of the adjusted net capital gain).

89. See Aviva Aron-Dine, CTR. ON BUDGET & POLICY PRIORITIES, *An Analysis of the "Carried Interest" Controversy* 1-3 (Aug. 1, 2007), <http://www.cbpp.org/7-31-07tax.pdf> (stating that economic efficiency, revenue implications, and tax equity are three additional reasons why legislatures are concerned with carried interest).

90. See I.R.C. § 55(a) (West 2008) [hereinafter "AMT"] (explaining that generally an Alternative Minimum Tax is imposed).

91. See, e.g., Thomson Fin., *Who's Who in Private Equity*, WALL ST. J., Jul. 12, 2006, available at <http://online.wsj.com/public/resources/documents/info-pecquity0607-12.html> (stating Blackstone Group is the largest fund with 79 billion dollars in assets under management; Carlyle Group is second with 59 billion dollars in assets under management; and Bain Capital is third largest with 40 billion dollars in assets under management).

92. I.R.C. § 55(a) (West 2008).

93. JOINT COMMITTEE ON TAXATION, PRESENT LAW AND BACKGROUND RELATING TO THE INDIVIDUAL ALTERNATIVE MINIMUM TAX, JCX-37-05 2 (May 23, 2005), available at <http://www.house.gov/jct/x-37-05.pdf> [hereinafter "JOINT COMM. ON TAX JCX-37-05"].

94. See I.R.C. § 62(a)(1)-(20) (West 2008) [hereinafter "AGI"] (listing the deductions available when calculating adjusted gross income). A taxpayer's federal tax liability is based upon AGI. *Id.*

95. The Treasury Department estimates that AMT will affect more than 23 million households in 2007 if the IRC is not amended. Sarah Lueck, Democrats Focus on Tax Relief for the Middle Class, WALL ST. J., Feb. 16,

expire after December 31, 2010.⁹⁶ It is unlikely, however, that AMT will expire because the Treasury Department is accustomed to the billions of dollars AMT generates each year.⁹⁷ Congress is aware that the AMT problem must be fixed to alleviate the impact on the middle class—an impact never intended in the first place. Congress has been searching other tax areas to determine where extra revenue can be obtained to replace any loss the AMT amendment would cause. Two bills have been introduced by Congress to resolve this issue: H.R. 2834 and H.R. 2785.⁹⁸

2. America Demands Congress to Act

Frequent headlines in the *Chicago Tribune*,⁹⁹ *The New York Times*,¹⁰⁰ and *The Wall Street Journal*,¹⁰¹ coupled with individuals

2007, available at http://online.wsj.com/article/SB117159389782010715.html?mod=todays_us_page_one.

96. I.R.C. § 55 (West 2008).

97. One study indicates repealing AMT would adversely impact our national debt by as much as one hundred forty billion dollars in 2010 alone. Leonard E. Burman et al., *The Individual AMT: Problems and Potential Solutions*, 40 (Sept. 2002), http://www.taxpolicycenter.org/UploadedPDF/410561_AMT-DP-final.pdf.

98. See *supra* text accompanying note 42 (detailing the bills introduced into Congress); see also JOINT COMM. ON TAXATION, PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS AND RELATED ISSUES, PART I, JCX-62-07 47-50 (Sept. 4, 2007), available at <http://www.house.gov/jct/x-62-07.pdf> [hereinafter “JOINT COMM. ON TAX JCX-62-07”] (analyzing the carried interest Congressional Bills and their effects).

99. Using the following search terms, “private equity and hedge funds” in the Lexis-Nexis database solely searching the *Chicago Tribune*, returned one hundred articles between 1996 and 2007. See generally Becky Yerak, *Hedge Funds Blamed for Sell-Off; Assets Liquidated to Buy Big Debts*, CHI. TRIB., Aug. 11, 2007, Bus., Zone, at 1 (commenting on the recent housing market affect on the stock market and funds); see also Chuck Jaffe, *Hedge Funds Fall Short of Holders Aspirations*, CHI. TRIB., Jun. 20, 2006, Bus., Zone C, Smart Investing, at 5 (stating that hedge funds might not be providing investors with the returns once promised).

100. Using the following search terms, “private equity and hedge funds” in the Lexis-Nexis database solely searching the *The New York Times*, returned one hundred articles between 1995 and 2007. See generally Andrew Ross Sorkin, *Why the Buyout Kings Are Running Scared*, N.Y. TIMES, Aug. 7, 2005, Section 3, Column 1, Money and Business/Financial Desk, DEALBOOK, at 3 (describing how private equity firms are running scared as hedge funds are beginning to enter the buyout market rather than just dealing with quick-flip investments); see also Jenny Anderson, *As Money Pours In, Hedge Funds Come to Look More Like the Markets*, N.Y. TIMES, Jun. 8, 2007, Section C, Column 2, Business/Financial Desk, STREET SCENE: INSIDER, at 6 (discussing leading hedge fund manager’s comments on how hedge fund returns are not supposed to look like stock market returns, but some argue they recently have).

101. Using the following search terms, “private equity and hedge funds” in the Lexis-Nexis database solely searching the WALL STREET JOURNAL,

making more money than ever,¹⁰² have placed funds into the focus of mainstream conversations. In general, people envy those with more money and this envy increasingly turns to anger when the income disparity results from a tax provision when only the top one percent of Americans can feasibly utilize this advantage.¹⁰³ Congress can no longer avoid the carried interest issue as Americans are 'increasingly aware that the wealthiest Americans pay fifteen percent on much of their income while teachers, mailmen, police officers, secretaries, and even attorneys are paying up to thirty-five percent on their income.'¹⁰⁴

III. ANALYSIS

A. *What Is the Right Answer: Ordinary Income or Preferential Capital Gains Tax Rates?*

The primary issue in the current debate is whether fund managers' carried interests constitute compensation for services or are correctly characterized as capital gains.¹⁰⁵ If carried interest is characterized as compensation for services, then it must be taxed at ordinary income rates.¹⁰⁶ A corollary issue is whether some alternative hybrid should be adopted as a compromise between the

returned one hundred articles between 2000 and 2007. See *supra* text accompanying note 91 (disclosing which funds are the largest in the world); see also Jonathan Macey, *Regulatory McCarthyism*, WALL ST. J., Oct. 24, 2006, at A18 (discussing the argument that hedge funds pose a "systematic risk" on the financial markets); Elanor Laise, *Hedge Funds Beckon Small Investors --- As a Major Private-Money Management Firm Goes Public, Individuals Face 'Alternative' Choices of Varying Risk*, WALL ST. J., Feb. 14, 2007, at D1 (commenting on Fortress Investment Group LLC's IPO on the NYSE, which allows anyone with a brokerage account to own part of a company that manages the ultra rich's money).

102. See *The 400 Richest Americans: #53 Stephen A Schwarzman*, FORBES.COM, available at http://www.forbes.com/lists/2008/54/400list08_Schwarzman_KH57.html (stating Blackstone Group co-founder Stephen A. Schwarzman is ranked 53rd richest American with a net worth of 6.4 billion dollars).

103. See *supra* text accompanying notes 1 and 12 (discussing how only the richest of Americans have enough net worth to invest in funds). In theory, anyone should be able to take advantage of the tax provisions; but, in reality only the richest of the rich can, and do. *Id.*

104. JOINT COMM. ON TAX JCX-62-07, *supra* note 98, at 51. See also Bawden, *supra* note 4 (condemning Congress for allowing himself, Warren Buffet, to pay a lower income tax rate as the second richest man than his cleaning lady or secretary).

105. Aron-Dine, *supra* note 89, at 5; see also JOINT COMM. ON TAX JCX-62-07, *supra* note 98, at 52 (confirming that the primary question relating to carried interest is determining whether it is a form of compensation for services or whether it is more analogous to a right to income or gain from capital).

106. Aron-Dine, *supra* note 89, at 5.

capital gain and ordinary income advocates. Furthermore, issues of efficiency, fairness, equality, and practicality play a significant role in the carried interest debate.¹⁰⁷

1. *What Is the Correct Characterization of Carried Interest: Compensation for Services or Capital Gains Income?*

Properly characterizing carried interest as compensation for services ("labor income") or capital gains treatment determines whether ordinary income tax rates or alternative lower tax rates, such as preferential capital gains rates should apply.¹⁰⁸ Individuals' labor income, historically, has been treated as ordinary income and taxed accordingly.¹⁰⁹ In addition, labor income is subject to employment tax, thereby making it the highest individual ordinary income tax rate at 37.9 percent, as opposed to the 15 percent capital gains rate.¹¹⁰ Deliberate evasion of the employment tax by GPs significantly affects the American economy. Such evasion works a grave injustice on the American tax system.¹¹¹

a. *Why Is a Fund Manager's Carried Interest Compensation for Services?*

There are two main reasons why carried interest should be characterized as compensation for services. First, GPs perform services for which the carried interest clearly represents compensation.¹¹² It is often relatively clear whether money is paid for services rendered or for the use of capital, either as equity or debt.¹¹³ There is no bright line distinguishing the two, when a taxpayer enters into an activity involving his own time and effort investing in capital assets, rather than paying another to do the

107. See JOINT COMM. ON TAX JCX-62-07, *supra* note 98, at 59 (recognizing that the simplicity of the tax system must be weighed against fairness and accuracy of income measurement).

108. *Id.* at 51.

109. *Id.*

110. *Id.* Employment tax is 2.9% for amounts over \$97,500 in 2007 and is allocated to Medicare. *Id.* Thus, the highest individual income tax rate is 37.9%–35% plus the 2.9% employment tax rate. *Id.*

111. See Aron-Dine, *supra* note 89, at 2 (explaining that economic efficiency, revenue implications, and tax equity are additional justifications for looking into the treatment of carried interests). Capital gains are not subject to employment tax and therefore do not affect GPs carried interest. JOINT COMM. ON TAX JCX-62-07, *supra* note 98, at 61. However, a GP who earns a 500 million dollar carried interest (a large but not uncommon amount) absconds paying Medicare, which is scheduled to go bankrupt by 2019. NATIONAL WOMEN'S LAW CENTER, *Private Investment Managers Dodge Billions in Medicare Taxes*, Sept. 2007, http://www.nwlc.org/pdf/Dodging_MedicareTaxes.pdf.

112. Aron-Dine, *supra* note 89, at 6.

113. JOINT COMM. ON TAX JCX-62-07, *supra* note 98, at 52.

same work.

It is argued that irrespective of the capital structure of the fund and its GP, the carried interest arrangement primarily involves compensating the GP for individual services and professional skills, actions that generate income for the fund's LPs.¹¹⁴ Although the GP's and LPs' interests are aligned by using the carried interest, the GP still merely performs services for the LPs, and thus should be taxed at ordinary income rates.¹¹⁵ Commonalities found in carried interest agreements,¹¹⁶ recent IPO registration statements,¹¹⁷ and specifically hedge fund managers' compensation practices,¹¹⁸ further support the conclusion that GPs are compensated for services performed and should be taxed accordingly.

This argument for ordinary income treatment best applies when a fund manager makes no capital investment into the fund.¹¹⁹ Although the fund manager often does make a capital investment—usually one to three percent—this argument is convincing because the income the manager receives can easily be bifurcated into compensation for his services and capital gains or dividends for his capital investment portion.¹²⁰

Additionally, advocates for ordinary income treatment argue that fund managers lack any financial capital risk associated with their carried interest.¹²¹ Many ordinary income advocates argue

114. *Id.*

115. *Id.* at 53.

116. Time and effort clauses relating to the manager or to specific key persons arguably suggest that the fund manager is required to perform services. *Id.* In addition, "clawback" and "hurdle rate" restrictions on payment of carried interests are analogous to performance-based compensation, requiring the carried interest to be paid only when the funds' investment performance, managed by the GP, surpasses a hurdle rate, a predetermined threshold. *Id.*

117. Prior to Blackstone Group's IPO, it filed, as required by the Investment Company Act and the SEC, a registration statement stating, "We also believe that the primary source of income from each of our businesses is properly characterized as income earned in exchange for the provisions of services." Aron-Dine, *supra* note 89, at 6.

118. Income from hedge funds is often subject to ordinary rates as short-term capital or ordinary income. JOINT COMM. ON TAX JCX-62-07, *supra* note 98, at 53. Many of the GPs receive a carried interest from the U.S. portion of the fund and a similar income stream, denoted as compensation from the offshore portion of the fund, suggesting both income streams are compensation for services. *Id.*

119. *Id.*

120. *Id.*

121. Aron-Dine, *supra* note 89, at 6. As stated in Part I, GPs usually invest 1–3% of capital into the fund as equity partners. The tax treatment of the income associated with this equity investment is not the subject of debate. See H.R. 2834, 110th Cong. (2007) (stating that the portion of income attributable to a capital investment would continue to retain its character when it flows through to the GP).

that fund managers can, and should, invest in the funds they manage to take advantage of capital gains treatment.¹²² The advocates argue that the GP's carried interest is purely a profits interest rather than a capital interest.¹²³ The characterization of the fund manager's interest determines its' tax treatment. An immediate taxable event occurs when a partner receives a capital interest in return for rendering services to the partnership.¹²⁴ The tax treatment of a partner obtaining a profits interest is different and more difficult to ascertain.¹²⁵

Ordinary income advocates argue that IRC Section 83 applies to fund managers' carried interests.¹²⁶ Section 83 governs transfers of property in return for services, and determines the amount and timing of applicable income and deductions.¹²⁷ The service provider must generally recognize income in the first taxable year that the property¹²⁸ first substantially vests.¹²⁹ Property substantially vests when the property right is transferable, or not subject to a substantial risk of forfeiture.¹³⁰ The service provider must include in its income the excess of the fair market value of the property over the amount paid for the

122. *The Fair Way to Tax Private Equity*, FINANCIAL TIMES, July 18, 2007, available at <http://www.ft.com/cms/s/4f233e38-355e-11dc-bb16-0000779fd2ac.html>.

123. Victor Fleischer, "Two and Twenty": *Partnership Profits in Hedge Funds, Venture Capital Funds, and Private Equity*, UCLA draft at 7 (Feb. 22, 2006), available at <http://www.law.ucla.edu/docs/twotwenty.2.22.06.doc> [hereinafter "Two & Twenty"]. Partnership interests are usually divided into capital interests and profit interests *Id.* A profits interest allows the partner, the GP in this case, to obtain profits without bearing any risk of loss, but maintaining a liquidation value of zero. *Id.* A capital interest gives the partner certain rights in the partnership and a current liquidation value in proportion to its respective equity percentage. *Id.*

124. *Id.*

125. *Id.*

126. JOINT COMM. ON TAX JCX-62-07, *supra* note 98, at 27.

127. I.R.C. § 83 (West 2008).

128. Property is defined very broadly in Section 83 to include real and personal property, but does not include money or any unfunded and unsecured promises to pay in the future. JOINT COMM. ON TAX JCX-62-07, *supra* note 98, at 27. Fund managers' carried interest is considered property under Section 83. *Id.*

129. *Id.*

130. *Id.* Property is considered transferable if a person can transfer their interest in the property to anyone other than from whom the property was received. *Id.* at 28. Property is subject to a substantial risk of forfeiture under two situations: (1) if an individual's right to the property is conditioned on the future performance of substantial services or on the nonperformance of services; or (2) the right to the property is subject to a condition other than the performance of services, as long as the condition relates to a purpose of the transfer and a substantial chance the property will be forfeited if the condition is not met. *Id.* at 27.

property.¹³¹ Therefore, the fund manager should include the fair market value of its carried interest in the first taxable year it becomes substantially vested.¹³² This does not occur, however, under current practice; rather, fund managers pay capital gains rates upon liquidation of the fund, often years later.¹³³

In *Diamond v. Commissioner*, the Tax Court held that a partner's receipt of a profits interest constitutes a taxable event, but only when the profits interest has a "determinable market value."¹³⁴ A profits interest rarely has a "determinable market value" and, therefore, does not trigger a taxable event.¹³⁵ To avoid a taxable event, the receipt of a profits interest cannot relate to a substantially certain and predictable stream of income from partnership assets, cannot be disposed of within two years of receipt, and the partnership cannot be publicly traded.¹³⁶ The requirement forbidding partnerships from being publicly traded is highly controversial given Blackstone Group's recent IPO, consisting of the GP's partnership going public.¹³⁷

Arguably, current tax law provides a substantial timing benefit for GPs as long as their compensation is structured as a profits interest rather than a capital interest in the partnership by allowing deferral of the GP's carried interest income.¹³⁸ Under a

131. *Id.*

132. *Id.* The fund manager should include the fair market value of the carried interest because he normally does not pay for the interest. *Id.*

133. "Two & Twenty," *supra* note 123, at 10.

134. *Diamond v. Comm'r*, 56 T.C. 530, 545-46 (1971), *aff'd* 492 F.2d 286, 291 (7th Cir. 1974); *see also* *Campbell v. Comm'r* 943 F.2d 815, 819-23 (8th Cir. 1991) (concluding that a partnership profits interest is not a taxable event upon receipt by the partner because the profits interest is speculative and without fair market value); Rev. Proc. 93-27, 1993-2 C.B. 343 (conceding profits interests would not be taxed upon receipt and establishing that profits interests have no liquidation value).

135. "Two & Twenty," *supra* note 123, at 8; *see also* Aron-Dine, *supra* note 89, at 10 (instructing that valuation of carried interest is difficult, but private equity firms have already, in certain cases, assigned a value to the carry for purposes of their financial statements).

136. Rev. Proc. 93-27, 1993-2 C.B. 343.

137. *See* Posting of Victor Fleischer to Conglomerate Blog: Business, Law, Economics, & Society, *The Blackstone IPO: Regulatory Arbitrage Extraordinaire*, http://theconglomerate.org/2007/03/the_blackstone_.html (Mar. 22, 2007) (discussing the IPO of Blackstone Group's fund manager's partnership); *see also* Posting of Victor Fleischer to Conglomerate Blog: Business, Law, Economics, & Society, *Blackstone IPO: Analysis of The Tax Risk*, http://theconglomerate.org/2007/03/blackstone_ipo_.html (Mar. 25, 2007) (analyzing tax implications of Blackstone GP fund management partnership going public); Posting of Victor Fleischer to Conglomerate Blog: Business, Law, Economics, & Society, *The Politics of Taxing Blackstone*, http://theconglomerate.org/2007/03/the_politics_of.html (Mar. 26, 2007) (evaluating the potential results Congress may take as a result of Blackstone's recent IPO).

138. "Two & Twenty," *supra* note 123, at 8.

purely economic system of income, the GP should pay tax upon receipt of his carried interest, take a basis in the carry, amortize the basis over time, and recognize additional income (or loss) as the partnership makes (or loses) money.¹³⁹

Current tax law and practice differs substantially from the economic view. Tax law allows deferral of the GP's carried interest by not recognizing the initial receipt of a carried interest as a taxable event. This allows the GP to treat its respective profit as capital gains, even though the carry compensates the GP for its performed services.¹⁴⁰ This provides a windfall to fund managers that is unavailable to the majority of Americans.

b. Why Should a Fund Manager's Carried Interest be Characterized as Capital Gains?

Capital gains advocates argue that capital gains treatment is proper for fund managers' carried interests for many reasons.

(a) Sweat Equity and Capital Gains

If a fund manager performed the same activities performed for the fund, but directly for himself, the income would be properly characterized as capital gains.¹⁴¹ This concept is known as "sweat equity" because the owner contributes equity to the activity in the form of his hard work or "sweat."¹⁴²

This concept is intertwined with the concept that the fund manager's carried interest is a bundle of capital and labor income.¹⁴³ Some argue that it is too difficult to separate the income into its respective forms and tax it appropriately.¹⁴⁴ It is undisputed, however, that an individual investor who takes his own money, or even loaned money, and invests it in corporate stock, acquires a partnership interest, purchases an existing business, or even starts his own business, and then divests his interest, receives income in the form of capital gains.¹⁴⁵ This is true even though the investor's income has two components: (1) income from his efforts managing his investments, and (2) income

139. *Id.* at 10.

140. *Id.*

141. David A. Weisbach, *The Taxation of Carried Interests In Private Equity Partnerships*, 6 (July 2007), available at <http://www.rer.org/atf/cf/%7B42EE8980-837F-4AF0-A738-D43F0925666B%7D/PROF%20WEISBACH%20CARRIED-INTERESTS-07-24-07-FINAL.PDF>. Weisbach's research for this article was funded by the Private Equity Council. *Id.* at 1 n.*. See *supra* text accompanying notes 11–17 (providing information regarding the Private Equity Council and information available on its website).

142. "Two & Twenty," *supra* note 123, at 20.

143. JOINT COMM. ON TAX JCX-62-07, *supra* note 98, at 55.

144. *Id.*

145. Weisbach, *supra* note 141, at 7.

from the sale of the capital assets. Current tax law, however, does not bifurcate the income in this situation and treats it entirely as capital gains.¹⁴⁶

Proponents argue the above should apply to fund managers, based on a central premise of partnership taxation: there should not be a fundamentally different tax result when using a partnership rather than engaging in the activity directly.¹⁴⁷ The partnership, therefore, is engaged in the entrepreneurial activity and determines the character of the individual's income.¹⁴⁸

Although this premise is generally true, there are situations where partnership law departs from the pure look-through approach.¹⁴⁹ Arguably, a fund manager is more like an entrepreneur than an employee because he has the ideas and skills to make the project work.¹⁵⁰ Furthermore, the GP has exclusive control over the fund's activities, and thus bears all of the residual risk, while LPs' interests are merely a financing method.¹⁵¹ Finally, it is argued that where an individual may directly perform and obtain capital gains treatment, the result should not differ when a partnership is used as the financing vehicle rather than securing debt another way.¹⁵²

The above argument is flawed because if the prior investor paid a third party to purchase the asset (e.g. stock), the third party would recognize service revenue subject to ordinary income rates. However, the investor would still enjoy capital gain treatment when the asset was sold, whether by the third party or himself. Fund managers are the third party in the above example and are performing the service of purchasing and selling assets for the LPs. Any compensation received from the fund, therefore, other than compensation attributable to the manager's capital interest, should be treated as service income and taxed as ordinary income.

"Sweat equity" advocates incorrectly assume that all of a partner's partnership interest is subject to capital gains treatment when sold after one year. This is incorrect and misconstrues the current tax treatment.¹⁵³ Current tax law generally grants capital

146. *Id.*

147. *Id.* This premise is based on the character and other attributes of income as determined at the partnership level and flows through to the individual partners. *Id.*

148. *Id.* at 7-8.

149. *See id.* at 8-10 (stating that Sections 707(c), guaranteed payments, and 707(a)(2)(A) are two exceptions which treat distributions of income to a partner as compensation for services, compensating the partner as an employee and subject to ordinary income rates).

150. *Id.* at 10.

151. *Id.*

152. *Id.*

153. The sale of a fund manager's carried interest, rather than the ongoing income received through the GP's carry, obtains capital gains treatment.

gains for the sale of a partnership interest, except to the extent the amount realized is attributable to inventory or to accounts receivable, including rights to payments for services rendered or to be rendered.¹⁵⁴ Present tax law, therefore, properly treats a fund manager's capital interest, or any partner who is a service provider, as capital gains to the extent of his capital interest and as ordinary income to the extent of his right to payment for services.¹⁵⁵ If a partner of the GP sells his capital interest, only then may he receive capital gains treatment. This is further restricted to the portion not relating to compensation rights for services rendered or to be rendered.

(b) Founders' Equity and Capital Gains

A second basis in support of capital gains treatment rests on the premise that one is generally not taxed on the wealth of self-created assets;¹⁵⁶ rather, one is taxed on the income generated by those assets.¹⁵⁷ This concept, known as "founders' equity," is a variant of the aforementioned "sweat equity" argument.¹⁵⁸ A self-created asset can be something as simple as a sweater an individual knitted or as complex as a multibillion dollar construction company that an individual started from scratch, and everything in between.¹⁵⁹ An individual entrepreneur, the business founder, who successfully starts a business, receives capital gains treatment on the sale of the business.¹⁶⁰ The activities venture capital fund managers engage in, namely obtaining financing and helping startup businesses, is analogous to the preceding situation.¹⁶¹ Under this premise, the fund manager's carried interest should also receive capital gains treatment when the fund is liquidated.

This position is deficient because it rests on the tenuous argument that because individual entrepreneurs receive capital gains treatment on the sale of enterprises they create, and venture capital fund managers also start new enterprises, fund managers

JOINT COMM. ON TAX JCX-62-07, *supra* note 98, at 58. This situation occurs when a partner in the GP's partnership sells its capital partnership interest to someone else. *Id.*

154. I.R.C. § 731(a)(2) (West 2008).

155. JOINT COMM. ON TAX JCX-62-07, *supra* note 98, at 58.

156. "Two & Twenty," *supra* note 123, at 17. For instance, planting, growing, and harvesting a back yard garden for your own personal use does not constitute a taxable event. *Id.* However, if you sold your garden fruits and vegetables you would be taxed on the income received. *Id.*

157. *Id.* at 17-18.

158. JOINT COMM. ON TAX JCX-62-07, *supra* note 98, at 57.

159. "Two & Twenty," *supra* note 123, at 17.

160. JOINT COMM. ON TAX JCX-62-07, *supra* note 98, at 57.

161. *Id.*

should receive capital gains treatment on their carried interests. This assertion is unwarranted because present law does not distinguish between individuals that start a business, buy into an existing business, rescue a failing business, labor in a successful business, or merely invest capital passively in a business.¹⁶² The argument also fails because the operating income of a business is taxed at ordinary income rates as it is earned.¹⁶³ The present tax treatment of current inventory and service revenue differs significantly from the current treatment of fund managers' carried interests.¹⁶⁴

(c) Risk-Taking Substantiates Capital Gains Treatment

The final argument is that fund managers' risk-taking supports capital gains treatment. Proponents believe that the fund manager takes on risk by investing substantial amounts of time and effort in managing the fund and receives compensation, by way of carried interest, only if the underlying investments are profitable.¹⁶⁵ This argument rests on the premise that capital gains treatment is appropriate when risks are taken.¹⁶⁶

To give this argument any weight would require treating the income of everyone that deals with risk as capital gains. This would include performance bonuses, lawyer contingency fees, incentive fees paid to managers of investment assets, contingent fees based on movie revenue for actors, royalties, most stock options, restricted stock grants, and most income of an S corporation, partnership, limited liability company, or sole proprietorship.¹⁶⁷ This is clearly not what Congress intended. Furthermore, capital gains rates apply to the disposition of capital assets and not to risk-taking unassociated with capital assets.¹⁶⁸ In fact, capital gains rates apply to the disposition of capital assets that bear very little risk, such as U.S. Treasury Bonds with a yield rate near the risk-free rate.¹⁶⁹ Under this rationale, anyone that could directly engage in an activity could circumvent the ordinary income rates and obtain capital gains treatment without any personal capital at risk. Unless a fund manager is risking his own

162. *Id.*

163. *Id.* For instance, a toy manufacturer pays ordinary income rates on the proceeds of its toys, and an attorney, a service provider, pays ordinary income rates on the revenue he obtains for legal work provided. *Id.*

164. *Id.* Fund managers' carried interests are deferred until the fund is liquidated, and the operating income from the investment advisory services is converted into capital gains. *Id.*

165. *Id.* at 56.

166. *Id.*

167. Aron-Dine, *supra* note 89, at 7.

168. JOINT COMM. ON TAX JCX-62-07, *supra* note 98, at 56.

169. *Id.*

capital and thus has a capital interest in the partnership, capital gains rates should not apply.

The analysis contained in this Section leads to only one rational conclusion: fund managers' carried interests should be characterized as compensation for services and appropriately taxed at ordinary income rates. The remaining question is whether a purely economic application of ordinary income treatment should be applied to fund managers' carried interests or some hybrid that balances equity, fairness, practicality, and efficiency.¹⁷⁰ Although a hybrid application may still provide GPs with a benefit that other Americans do not enjoy, it closes the large disparity between the net incomes of the richest and poorest Americans by recharacterizing part of their incomes from capital gains to ordinary income, thus, increasing their tax liabilities and decreasing their net incomes.

IV. PROPOSAL

This Section proposes that based on the IRC, federal statutes, and case law, Congress should treat fund managers' carried interests as ordinary income. This proposal focuses on fund managers' income constituting proceeds from the sale of inventory, resulting in ordinary income treatment. In the event Congress decides to create a hybrid compromise, however, the cost-of-capital or constructive loan approach should be adopted.

A. Ordinary Income: The Proper Characterization of Fund Managers' Carried Interest

Currently, there is great debate about why fund managers' carried interests should or should not be changed from the current tax treatment of capital gains rates to ordinary income rates. Changing the tax treatment will add additional complexities to an already complex area of tax law, partnership tax. There is also the fear that everyday investors (by way of pension funds) will be gravely impacted by the increased taxes and the fear that fund managers will move their funds offshore. All of these reasons compel Congress to allow capital gains treatment.¹⁷¹ Although these concerns may have some substance, in reality, they misconstrue the real issue and facts. The real issue is what makes the work of a fund manager so different from the work of a mailman, school teacher, fireman, police officer, secretary, or a cleaning lady, and therefore subject to a preferential capital gains

170. See generally "Two & Twenty," *supra* note 123, at 15 (demonstrating that a deferral concept has gained large support among academia and even practitioners because of the intuition that no one should be taxed currently on the value of self-created assets).

171. JOINT COMM. ON TAX JCX-62-07, *supra* note 98, at 57-59.

tax rate of fifteen percent? In short, the answer is nothing. Fund managers provide services to LPs and are compensated for their labor.

Proponents of capital gains treatment for carried interests neither disagree nor argue that ordinary income rates do not, or should not, apply to income derived from labor. Treating fund managers' carried interests as ordinary income will further reduce the net income disparity between America's rich and poor.

1. *Ordinary Income: The Only Proper Characterization for Fund Managers' Income from the Sale of Inventory*

The strongest reason to date for treating fund managers' carried interests as ordinary income is the compensation for services principle.¹⁷² The compensation for services general rule assumes fund managers' "trade or business" is providing services.¹⁷³ A position based on deriving fund managers' income from the sale of non-capital assets, however, is a stronger argument.¹⁷⁴ A closer look and analysis of Section 1221 of the IRC provides the strongest basis for taxing fund managers' carried interests at ordinary income rates.

IRC Section 1221(a)(1)¹⁷⁵ specifically excludes:

stock in trade of the taxpayer or other property of a kind which would probably be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. . .¹⁷⁶

from constituting a capital asset. Consequently, the sale of Section 1221(a)(1) property, no matter the duration of ownership, cannot satisfy the capital asset definition of Section 1221(a).¹⁷⁷

172. *Id.* at 51; *see also supra* Part II.A. (stating that labor income (compensation for services) is taxed as ordinary income and at respective rates).

173. In fact, the majority, if not all of the arguments substantiating ordinary income treatment are based on fund managers providing a service. JOINT COMM. ON TAX JCX-62-07, *supra* note 98, at 52-53.

174. This inventory argument is sounder than the compensation for services argument because characterizing the proceeds from the sale of inventory avoids implications of IRC Section 83, specifically the "substantial risk of forfeiture" requirements. *See* I.R.C. § 83(c) (West 2008) (providing an exception to including transferred property in one's income when services are provided). *See generally id.* § 471 (stating the taxpayer must account for income produced from inventory by the best method that represents the income for that "trade or business"); *see also id.* § 1001 (providing the rules to determine the amount of income recognized from the disposition of property, which includes inventory).

175. *See supra* text accompanying notes 81-83 (describing capital assets, the hold period for capital gains rates, and the netting process).

176. I.R.C. § 1221(a) (West 2008).

177. *Id.*

Additionally, the derived income from the sale of inventory, a non-capital asset, is ordinary income and taxed at ordinary income tax rates.¹⁷⁸ Finally, establishing that fund managers derive their income from the sale of non-capital assets unquestionably subjects their income to ordinary income rates.

Section 1221(a)(1) lists two different types of property that do not constitute capital assets: (1) property included in the taxpayer's inventory¹⁷⁹ if on hand at the close of the taxable year;¹⁸⁰ and (2) property held, by the taxpayer, for sale in the ordinary course of its "trade or business"¹⁸¹ to customers.¹⁸² Based on Congress' intentions, courts have reasoned that the definition of capital asset must apply narrowly and its exclusions interpreted

178. *Id.* § 64. See *supra* text accompanying note 78 (defining ordinary income).

179. The IRC does not define "inventory," but the Treasury Regulations do. *Cenex, Inc. v. United States*, 156 F.3d 1377, 1379 (D.C. Cir. 1998). Inventory includes all finished or partially finished goods and raw materials and supplies which, have been acquired for sale or will physically become part of merchandise intended for sale. Treas. Reg. § 1.471-1 (1960).

180. I.R.C. § 1221(a)(1) (West 2008). The legislative history of Section 1221 does not discuss or suggest the type of property that qualifies as "other property of a kind which would be properly included in the inventory of the taxpayer if on hand at the close of the taxable year." *Cenex*, 156 F.3d at 1379. The previous phrase has been interpreted broadly by the Supreme Court and has included substitutes for inventory, such as "hedging transactions that are an integral part of a business' inventory-purchase system." *Id.* (citing *Ark. Best Corp. v. Comm'r*, 485 U.S. 212, 222 (1988)). The Supreme Court, in *Corn Prod. Refining Co. v. Commissioner of Internal Revenue*, 350 U.S. 46, 50 (1955), held corn futures, the business purchased, fell within the above language.

181. The IRC does not define "trade or business" in Section 162 or any other section. I.R.C. § 62 (West 2008); see also *McDevitt v. Harris*, 498 F.Supp. 58, 60 (D.Pa. 1980) (stating Section 162 of the IRC does not define "trade or business"); *Doshi v. Sec'y of Health and Human Servs.*, No. 86 C 9425, 1988 U.S. Dist. LEXIS 879, at *5 (D. Ill. Jan. 29, 1988) (stating Section 162 of the IRC does not define the term "trade or business;" rather, no general definition can be found anywhere in the tax code). The Court in *Higgins v. Commissioner of Internal Revenue*, 312 U.S. 212, 217 (1941), held that a court is required to examine all the facts of the particular case when determining whether a taxpayer's activities constitute "carrying on a business." The regulatory definition derived from the IRC defines a valid trade or business as activity conducted over a substantial period of time during which a person holds himself out to the public as selling goods or services. *Doshi*, 1988 U.S. Dist. LEXIS 879, at *6. In *Commissioner of Internal Revenue v. Groetzinger*, 480 U.S. 23, 35 (1987), the Supreme Court tried to define "trade or business" for purposes of Section 162(a). The Court described that engaging in a "trade or business" requires a taxpayer to be involved in the activity with "continuity" and "regularity" and that the primary purpose of the taxpayer engaging in the activity is to produce income or a profit. *Id.* The Court went on to say a sporadic activity, a hobby, or an amusement diversion does not qualify as a "trade or business." *Id.*

182. I.R.C. § 1221(a)(1) (West 2008).

broadly.¹⁸³ Because inventory is an exclusion within Section 1221, what constitutes inventory must be broadly construed.

2. *What Constitutes Fund Managers' Inventory?*

Prior to determining fund managers' inventory, the managers' "trade or business" must be established.¹⁸⁴ In *Groetzinger*, the Court required the taxpayer to conduct an activity both "continuously" and "regularly," primarily to obtain income or profit, to be engaged in a "trade or business".¹⁸⁵ In addition to performing services, the GP conducts an activity for the primary purpose of acquiring income or profit. This is apparent, given the hundreds of millions of dollars GPs receive as carry and management fees each year.¹⁸⁶ The fund managers also satisfy the "routinely" and "continuously" requirements because they provide their activity solely to a single fund for eight to twelve years.¹⁸⁷ The fund manager's activity or "trade or business" is the continuous searching and supplying of business transactions to its fund.

Fund managers' carried interests and the fund LPs' interests are not inventory.¹⁸⁸ However, the deals fund managers bring to their funds¹⁸⁹ constitute inventory under the Court's broad interpretation of IRC Section 1221 exclusions.¹⁹⁰ Fund managers acquire raw materials in the form of attractive business

183. *Cenex*, 156 F.3d at 1380.

184. What constitutes an entity's inventory depends on its "trade or business." For instance, *SeaRay's*, a boat builder, inventory is all of its finished boats. However, *Carnival Cruise Line's* cruise ships, boats as well, are IRC Section 1231 property. I.R.C. § 1231(b) (West 2008). When *SeaRay* sells one of its boats, it recognizes income subject to ordinary income rates because it sold its inventory. *Id.* § 64. However, when *Carnival Cruise Lines* sells one of its cruise ships, IRC Section 1231 property—it recognizes capital gains—long-term capital gains if held for more than a year. *Id.* §§ 1221, 1231(b), 1223. Therefore, depending on what constitutes inventory for an entity, the disposition of corporate assets can have substantial tax consequences.

185. *Groetzinger*, 480 U.S. at 35.

186. See *Aron-Dine*, *supra* note 89, at 2 (stating that 500 million dollars is a high, but far from unprecedented figure for fund managers).

187. *SHELL*, *supra* note 10, § 9.02[1], 9-6. Private Equity funds usually have a partnership agreement term of ten years. *Id.*

188. Rather, the GP's carried interest and the LPs' capital interests are capital assets and treated as capital gains or losses upon sale, and long-term capital gains or losses if the interests have been held for over a year. See *supra* text accompanying notes 82–86 (discussing how long-term capital gains and losses are determined).

189. A fund manager selling to only one customer, or one fund, is still considered performing sales to customers. See *Patterson v. Belcher*, 302 F.2d 289, 294 (5th Cir. 1962) (stating sales restricted to a number of customers—even a single vendee—may be considered sales to a customer per the IRC).

190. *Groetzinger*, 480 U.S. at 35.

investments and sell them to the fund receiving a carried interest in return. The fund managers' raw materials are the start-up, struggling, undervalued, or cash cow businesses they find and bring to the attention of the fund for purchase.¹⁹¹ The fund acquires these raw materials, attractive business investments, and processes them into finished goods, a profitable business, a process that can take years.¹⁹² A fund sells its finished inventory, a valuable business, and purchases more raw materials from the fund manager to begin the production of another finished product. The GP and fund continue this process until the partnership agreement terminates, dissolving the fund. The fund manager continues its "trade or business" by forming another fund with new LPs.

Adoption of the above proposal would result in, not only all of a fund manager's income being treated as ordinary income, but also all of the LPs' income.¹⁹³ This results from the fund engaging in the activities, which constitute a "trade or business," of purchasing raw materials, business investments, processing them for years, and then selling them as profitable businesses.¹⁹⁴ Therefore, even though the GP¹⁹⁵ and LPs invest equity into the

191. Although the lumber, nails, glue, and varnish purchased by a furniture maker to make a dresser clearly constitute raw materials, it does not mean that more unconventional types of property cannot be considered raw materials. For instance, a developer that purchases a rundown building, rehabs it, and converts the structure into new residential or commercial condominiums, which are later sold. The purchased building is one of the developer's raw materials. The developer then remodels the structure over a period of years by adding new floors, plumbing, walls, appliances, and fixtures, among much more. Upon completion the developer has inventory consisting of these finished units, which resulted from the purchase of the rundown building, infusion of other raw materials, and hours if not years of labor. Every unit of inventory—each condominium—sold results in ordinary income treatment for the builder. The sale of condominiums, by the builder, is considered a sale of its inventory and results in ordinary income treatment because the developer is in the "trade or business" of developing. However, that same condominium, when in the hands of an individual or a organization not in the "trade or business" of real estate development, is considered a capital asset and subject to capital gains rates if held for more than a year. See *supra* text accompanying notes 82–86 (discussing how long-term capital gains and losses are determined).

192. See *Fact & Fiction*, *supra* note 12 (stating funds retain ownership of business entities for two to five years before divestment).

193. I.R.C. § 701 (West 2008). As mentioned earlier, income is characterized at the partnership level and maintains its character as it flows through the partnership to the individual partners. *Id.*; see *supra* text accompanying note 184 (explaining how an entity's "trade or business" determines what property constitutes its inventory, and therefore affecting the characterization of proceeds from sale of entity property).

194. I.R.C. § 1221(a)(1) (West 2008).

195. See *supra* text accompanying note 40 (stating the GP invests anywhere from zero to two (an average of one percent) percent of his own capital into the

fund, partnership law would result in receipt of ordinary income from the sale of the inventory.¹⁹⁶ The GP's and LP's equity investment in the fund only affects the basis of their partnership interest.¹⁹⁷ It does not affect the GP's or LP's ability to reap the benefits of capital gains tax rates upon the disposition of their partnership interest or IRC Sections 1221(a) and 1231(b) partnership property.¹⁹⁸ This is consistent with current tax treatment for all taxable organizations. The inventory approach proposed above, therefore, proves that fund managers' carried interests have to be characterized as ordinary income.

B. The Loan or Cost-of-Capital Approach: A Reasonable and Realistic Compromise Between Ordinary Income and Capital Gains Advocates If Congress Believes Neither Side Is Entirely Correct.

In the event Congress decides to meet the two sides in the middle with a hybrid compromise, the cost-of-capital or constructive loan approach should be adopted. The most efficient, fair, and administratively enforceable compromise would treat the carried interest that the GP receives as a constructive loan from the LPs.¹⁹⁹ The fund manager would receive a nonrecourse loan

fund).

196. I.R.C. § 702(b) (West 2008). Income earned by a partnership retains its character as it flows through to the individual. *Id.* Furthermore, proceeds from the sale of inventory are characterized as ordinary income. *Id.* § 64. Therefore, the GP and LPs will recognize ordinary income.

197. *Id.* §§ 704, 705. See *supra* text accompanying notes 71–75 (explaining how a partner's basis in its partnership interest changes depending on the character of income received).

198. If any partner, GP or LP, sells its partnership interest for a profit he will receive capital gains and capitals gains tax rates, if the partner held the partnership interest for over a year. See *supra* text accompanying notes 82–86 (discussing how long-term capital gains and losses are determined). Capital gains tax rates apply to the sale of a partnership interest if held for over a year because a partnership interest qualifies as a capital asset under section 1221(a) of the IRC—it is not one of the eight listed exclusions. I.R.C. § 1221(a) (West 2008). Furthermore, if the partnership sells §§ 1221(a) or 1231(b) property held for over a year at a profit, the GP or LP will receive proceeds characterized as long-term capital gains. See *supra* text accompanying notes 82–86 (discussing how long-term capital gains and losses are determined). The partners receive income characterized as capital gains because of the flow through aspect of partnerships. See I.R.C. § 702 (West 2008) (stating income earned by a partnership retains its character as it flows through to the individual); see also *supra* text accompanying note 121 (stating that the portion of income attributable to a capital investment would continue to retain its character when it flows through to the GP).

199. See *The Taxation of Carried Interest: Hearing Before the U.S. Senate Comm. on Finance*, 110th Cong. 14 (2007) (statement of Peter R. Orszag, Director, Congressional Budget Office) [hereinafter "Orszag Testimony"], available at <http://www.senate.gov/~finance/sitepages/hearing071107.htm> (stating taxing imputed interest on an implied loan to fund managers will

from the LPs and the GP would be taxed on the implicit interest as it accrued.²⁰⁰ This would result in treating part of the carried interest as ordinary income and part as capital gains.²⁰¹ However, because the loan from the LPs is interest-free, the GP needs to count the foregone interest payments as ordinary income and pay the respective amount of ordinary income tax each year.²⁰² The GP's total tax due under the constructive loan approach is greater than under a strictly capital gains approach, but less than under an exclusive ordinary income position.²⁰³ Although ordinary income is the only appropriate treatment for fund managers' carried interests, the constructive loan or cost-of-capital approach will still help close the ever increasing gap between America's richest and poorest.

result in greater tax than the current capital gains treatment, but less than treating the income derived from the carry as ordinary income); see also JOINT COMM. ON TAX JCX-62-07, *supra* note 98, at 61-62 (describing the loan approach to taxing carried interests); "Two & Twenty," *supra* note 123, at 17 (calling the constructive loan concept the cost-of-capital approach).

200. "Two & Twenty," *supra* note 123, at 19

201. Orszag Testimony, *supra* note 199, at 14. The income apportioned to the 20% equity investment, which resulted from the nonrecourse loan, would be treated as capital gains and the forgone interest on the loan would be treated as ordinary income. *Id.* at 14-15.

202. *Id.* at 15. To illustrate this concept assume a fund begins with 1 billion dollars in fund assets in year 1. The GP receives a nonrecourse loan from the LPs in the amount of 200 million dollars ($1,000,000,000 * .20$). Further assume an appropriate market interest rate of 8% to calculate the forgone interest, and the fund assets are sold 5 years later for 2 billion dollars. Therefore, the GP will incur annual interest of 16 million dollars ($200,000,000 * .08$) for five years. This \$16 million will be treated as ordinary income—compensation for services—and subject to ordinary income rates. This results in annual tax due of 5.6 million dollars ($16,000,000 * .35$) for each of the five years, totaling 28 million dollars ($5,600,000 * 5$). Upon sale of the fund's assets the GP receives 400 million dollars ($2,000,000,000 * .20$), and repays his constructive loan amount of \$200 million, resulting in 200 million dollars of profits. This 200 million dollars is taxed at capital gains rates of 15%, resulting in \$30 million in tax ($200,000,000 * .15$). The GP's overall tax bill would be 58 million dollars (30 million dollars of capital gains tax and 28 million dollars from ordinary income).

On the other hand, assuming the same numbers above, if a purely capital gains rate was applied the GP would have a total tax bill of 30 million dollars ($((2,000,000,000 - 1,000,000,000) * .20) * .15$). Alternatively, assuming the same numbers above, under a completely ordinary income approach, the GP's total tax bill would be 70 million dollars ($((2,000,000,000 - 1,000,000,000) * .20) * .35$). Therefore, the tax payable by the GP under the constructive loan approach is greater than under the capital gains approach, but less than under the ordinary income approach ($CG = \$30 < CL = \$58 < OI = \$70$). See generally Orszag Testimony, *supra* note 199, at 14-15 (comparing the tax liability of a cost of capital approach with the tax liability on a fund manager's carried interest taxed at capital gains rates).

203. *Id.* at 15.

V. CONCLUSION

Although funds are nothing new to the financial community, their recent popularity has placed them under increased scrutiny. Fund managers wish this attention would disappear, but everyone knows that is no longer an option. Fund managers want to enjoy the windfall tax benefit they have received for approximately the last fifteen years, while all other Americans demand that GPs pay similar labor income tax rates.

Proponents from both sides agree that ordinary income rates are the appropriate tax treatment for labor income as compensation for services. The two sides disagree, however, whether the income that fund managers receive by way of a carried interest are capital gains or ordinary income. Some arguments advanced by capital gains advocates may have some substance, but they misconstrue the facts and the issue.

Capital gains advocates assert arguments based on maintaining capital gains rates and the potential implications of a change to ordinary income treatment and tax rates. However, these arguments are deficient. The real issue is whether fund managers' carried interests should be characterized as ordinary income or capital gains. Based on the fact that fund managers are compensated for their services by means of a profits interest, fund managers should be taxed at ordinary income rates. Furthermore, the proposed inventory approach provides a sounder argument for properly classifying all the GP's carried interest as ordinary income, rather than the compensation of services argument. Fund managers' carried interests must be taxed at ordinary income tax rates. In the event Congress decides to meet the two sides in the middle with a hybrid compromise, the cost-of-capital or constructive loan approach should be adopted. Either solution will generate more tax revenue for the U.S. Treasury than the current system and will help reduce the gap between America's richest and poorest.

