

# EFFECTIVE TAXATION OF CARRIED INTEREST: A COMPREHENSIVE PASS-THROUGH APPROACH

## I. INTRODUCTION

Taxation of “carried interest” has been the subject of much recent scholarship.<sup>1</sup> Articles have discussed the unfairness of taxing carried interest differently than other compensation for services,<sup>2</sup> and addressed the dangers inherent in subjecting an intrinsically mobile tax base to rates higher than those presently applied to carried interest by the Internal Revenue Code.<sup>3</sup> Most of this scholarship, however, erroneously ignores that fund managers who receive carried interest income are often in a position to significantly impact the U.S. economy.<sup>4</sup> Ignoring this fact thereby forecloses an opportunity for Congress to utilize an efficient carried interest taxation regime as an instrument to promote its general economic goals, by means of rate differentials associated with policy objectives.<sup>5</sup>

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1. See, e.g., Howard E. Abrams, *The Carried Interest Catastrophe*, 129 TAX NOTES 523 (2010); Darryll K. Jones, *Sophistry, Situational Ethics, and the Taxation of the Carried Interest*, 29 NW. J. INT’L L. & BUS. 675 (2009); Philip F. Postlewaite, *The Taxation of Compensatory Profits Interests: The Blind Men and the Elephant*, 29 NW. J. INT’L L. & BUS. 763 (2009); Adam H. Rosenzweig, *Not All Carried Interests are Created Equal*, 29 NW. J. INT’L L. & BUS. 713 (2009).

2. See, e.g., Jones, *supra* note 1; Rosenzweig, *supra* note 1.

3. See, e.g., Rosenzweig, *supra* note 1, at 746–55. Some of the various proposed changes to taxation of carried interest include recharacterizing such income as ordinary income at the partnership level, see Jones, *supra* note 1; imposing a mandatory short-term holding period on carried interest capital gains, thereby converting any such gains into short-term capital gains taxed at ordinary income rates, see Rosenzweig, *supra* note 1; or maintaining the status quo, see Postlewaite, *supra* note 1. Notwithstanding the fact that a minority of academics disagree, the general academic consensus appears to be that carried interest income should be ineligible for preferential long-term capital gains rates. See Postlewaite, *supra* note 1, at 765 nn.6–7.

4. Most carried interest income subject to long-term capital gains tax rates is earned by private equity fund managers. Hedge fund managers generally do not earn carried interest income eligible for long-term capital gains rates because hedge funds often hold their individual investments for periods not greater than one year. See *infra* note 93 and accompanying text.

5. Colloquially, this may be referred to as a “sticks and carrots approach.” However, because the only appropriate “stick” should be taxation as ordinary income, the use of any “carrot” in the form of lower effective tax rates should actually be considered a form of “tax bribery”—or the use of the Internal Revenue Code to encourage certain conduct and promote particular outcomes. Key examples of such tax bribery include the Credit for Increasing Research Activities (the “R&D Credit”), I.R.C. § 41 (2006); the Low-Income Housing Credit, I.R.C. § 42 (2006); the deduction of income attributable to domestic production Activities (the “Domestic Production Activities Deduction”), I.R.C. § 199 (2006); and accelerated depreciation of both fixed assets, I.R.C. § 168 (2006), and certain intangible assets, I.R.C. § 197 (2006).

This Note will briefly discuss what constitutes carried interest and general tax policies and considerations. It will then discuss carried interest tax legislation recently proposed by Congress, address the legislation's shortcomings, and propose an alternative carried interest taxation regime. Lastly, it will address opportunities available to Congress for utilizing carried interest tax legislation as a means to obtain policy objectives.

### A. General Policy Overview

Carried interest taxation can be best modified by Congressional statute.<sup>6</sup> Congress generally considers a number of policy objectives and

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6. Technically, tax law can also be modified by constitutional amendment. Of the twenty-seven Amendments to the U.S. Constitution (at the time of this Note's publication), only one, the Sixteenth Amendment, has been ratified for the purpose of changing U.S. federal income tax law. See U.S. CONST. amend. XVI. The Sixteenth Amendment was ratified in order to empower Congress to enact direct income taxes without the need for apportionment amongst the several states based upon the census, and specifically to overrule *Pollock v. Farmers' Loan & Trust Co. (Pollock I)*, 157 U.S. 429 (1895), *aff'd on reh'g*, 158 U.S. 601 (1895). In *Pollock I*, the Supreme Court held that income taxes on income from real property, including rents, were direct taxes. *Id.* at 573, 580–81, 583. *Pollock v. Farmers' Loan & Trust Co. (Pollock II)*, 158 U.S. 601 (1895), reconsidered and broadened this holding, finding that taxes on income from both real and personal property (rent), as well as interest (from bonds) and dividends (from stocks), were direct taxes. *Id.* at 637. Accordingly, *Pollock I* and *Pollock II* held that Congress could only impose such taxes by means of apportionment amongst the States. The Sixteenth Amendment overruled these joint holdings and enabled Congress to impose such taxes upon income without regard to apportionment amongst the States.

One other amendment has technically modified the federal government's taxing powers. The Twenty-Fourth Amendment prohibits the imposition of poll taxes or other taxes which could impair individuals' rights to vote in federal elections, by either the U.S. Federal Government or the governments of the several states. See U.S. CONST. amend. XXIV. However, the purpose of the Twenty-Fourth Amendment was not to constrain Congress' taxing power or its ability to raise revenue, but rather to prohibit the effective disfranchisement of individuals by either Congress or the several states. At the time of the ratification of the Twenty-Fourth Amendment (1964), many states still discriminated against certain individuals on the basis of race, and Congress was finally beginning to comprehensively address this injustice by means of the Civil Rights Act of 1964 and the Voting Rights Act of 1965.

Courts also decline to deny the benefits of a generally applicable tax provision to a specific subset of persons. Any legal challenge to the applicability of the existing tax regime to carried interest earned by fund managers or others would almost certainly be dismissed due to lack of standing. *Cf. Frothingham v. Mellon*, 262 U.S. 447, 486–89 (1923) (holding that an individual plaintiff lacked standing to pursue a claim regarding application of federal income tax law). Individual taxpayers have been permitted to maintain suits in very limited circumstances. See *Flast v. Cohen*, 392 U.S. 83, 102–03 (1968) (establishing a two-prong test for taxpayers to demonstrate that an unconstitutional enactment, including tax legislation, has caused them injury). *Flast* has since been sharply curtailed and is inapplicable in instances in which the power exercised is clearly constitutional. See, e.g., *Hein v. Freedom From Religion Found.*, 551 U.S. 587, 593, 603 (2007). Because Congress clearly has the power to tax income from services, its decision to do so in a general or uniform manner should be immune to taxpayer challenges in courts, leaving it with the sole power to modify the existing carried interest taxation regime. Although a taxpayer subject to a tax may challenge its validity, there are two considerations that prevent this from being relevant in a carried interest context. First, such challenges rarely prevail at striking Internal Revenue Code provisions. At best, challenges usually only enable a

considerations when enacting tax legislation.<sup>7</sup> The interplay between these considerations is complex, and these objectives alternately complement and conflict with each other. Because taxation is an integral part of a comprehensive fiscal policy, Congress' primary objectives should be to promote economic growth, to promote economic (and price) stability, and to raise revenue to fund general and specific expenditures.<sup>8</sup> In light of these objectives, some of Congress' primary tax policy considerations include administrability, promotion of taxpayer compliance, equity (including both horizontal equity and vertical equity), economic neutrality, and economic incentivization.<sup>9</sup> As a general proposition, it is worth noting

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taxpayer to obtain a court's blessing to apply its understanding of the relevant income tax provisions to the particular facts and circumstances of the case. *See generally* Michael I. Saltzman & Leslie Book, IRS Practice and Procedure, ¶¶ 1.03, 1.05–07 (2011). Second, because the existing regime generally treats carried interest income favorably, no rational taxpayer earning carried interest income will challenge it.

As a final matter, the U.S. Department of the Treasury is entitled to draft regulations to interpret and apply the tax law enacted by Congress. Because no extant enactment distinguishes between carried interest income and other income from partnerships, and the Treasury cannot unilaterally promulgate tax regulations without a corresponding Internal Revenue Code provision, the Treasury will likely be limited in what it can unilaterally implement. *Cf.* I.R.C. § 7805 (authorizing the Secretary of the Treasury to prescribe rules and regulations for the enforcement of the Internal Revenue Code). Although its grant of authority is broad, I.R.C. § 7805 should not be interpreted to permit the Secretary of the Treasury to unilaterally enact tax provisions without a corresponding Internal Revenue Code provision. *Cf.* *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984) (establishing the so-called "Chevron Deference" standard of administrative deference, whereby courts generally should defer to administrative agencies' guidance if such guidance is based upon a reasonable construction of the relevant statute); *Mayo Found. for Med. Educ. & Research v. United States*, 131 S. Ct. 704, 711–14 (2011) (holding that Treasury's I.R.C. § 7805 authority should be interpreted broadly and subjected to *Chevron* deference).

However, it is worth noting that Professor Rosenzweig has proposed a possible method by which the Treasury can alter carried interest taxation by means of regulations which could be promulgated under existing statutory authority. Rosenzweig, *supra* note 1, at 755–62 & n.229. While I believe that Professor Rosenzweig's proposal to apply a short-term holding period to carried interest capital gains could be effective, I also believe it to be suboptimal because it allows substantial shielding of carried interest by capital losses and appears to be based more upon ease of execution than conceptual accuracy.

7. *See, e.g.*, U.S. DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH: THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT 13–20 (1984) [hereinafter TREASURY 1984]; Charles E. McLure, Jr., *Where Tax Reform Went Astray*, 31 VILL. L. REV. 1619, 1622–23 (1986); Nancy E. Shurtz, *A Critical View of Traditional Tax Policy Theory: A Pragmatic Alternative*, 31 VILL. L. REV. 1665, 1667 (1986).

8. I believe that a proper analysis of tax policy should evaluate tax policy in the context of broader fiscal policy, which should in turn be considered (along with such items as monetary policy) as part of an overall economic policy. Some practitioners group broader fiscal policy goals with more specific goals of tax policy. *See, e.g.*, TREASURY 1984, *supra* note 7, at 13–20; WILLIAM D. ANDREWS & PETER J. WIEDENBECK, BASIC FEDERAL INCOME TAXATION 8–10 (6th ed. 2009); Nancy Staudt et al., *Judging Statutes: Interpretive Regimes*, 38 LOY. L.A. L. REV. 1909, 1957–59 (2005).

9. *See, e.g.*, ANDREWS & WIEDENBECK, *supra* note 8, at 8–10; McLure, *supra* note 7; Shurtz, *supra* note 7; Staudt et al., *supra* note 8 at 1957–59.

that a tax regime should minimally impact individual decision-makers choices, unless the legislature enacting a particular tax policy specifically seeks to either incentivize or discourage specific behavior or outcomes.

Administrability focuses on the ease with which the U.S. federal government can administer and enforce the Internal Revenue Code, and the Treasury Regulations promulgated thereunder.<sup>10</sup> The law, including the Internal Revenue Code, is only as effective as the government's ability to enforce it. Promotion of taxpayer compliance focuses on both dissemination of information about the tax law to the taxpayers and the burden imposed on the taxpayers in understanding and complying with the Internal Revenue Code.<sup>11</sup> Provisions which are excessively cumbersome or costly are often prone to noncompliance, either due to willful disregard or unintentional error. Furthermore, courts have recognized the importance of administrability and promotion of taxpayer compliance by permitting the use of estimates for certain tax deductions, notwithstanding the general burden of proof imposed upon taxpayers in disputes with the Internal Revenue Service.<sup>12</sup>

Equity focuses on the fundamental fairness of a tax system. Horizontal equity and vertical equity are intrinsically related, but focus on different aspects of the overall fairness of a tax system. Horizontal equity focuses on treating similarly situated taxpayers similarly.<sup>13</sup> Vertical equity focuses on permitting (and sometimes encouraging) different treatment of differently situated taxpayers.<sup>14</sup> One of the key components of a horizontally equitable system is a focus on economic substance over legal form. Focusing on the economic substance should result in the imposition of similar tax burdens on taxpayers in similar economic positions. A key component of a vertically equitable system is a nonregressive tax structure.<sup>15</sup> Tax systems that are either proportionate<sup>16</sup> or progressive<sup>17</sup>

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10. *See, e.g.*, Shurtz, *supra* note 7, at 1667.

11. *Id.* at 1680.

12. *See, e.g.*, *Cohan v. Comm'r*, 39 F.2d 540, 543–44 (2d Cir. 1930) (establishing the so-called “Cohan Rule,” which generally permits taxpayers to use reasonable estimates for deductions, so long as (1) a deduction is allowed and (2) substantiation is not required); *see also* I.R.C. § 7491 (2006) (generally providing that taxpayers bear the burden of proof in court cases, but permitting a burden shift when taxpayers produce credible evidence to support their position); I.R.C. § 7454(a) (2006) (imposing burden on Secretary in cases involving fraud). However, it is worth noting that Congress can override this rule and has done so in limited circumstances. *See, e.g.*, I.R.C. § 274(d) (2006).

13. *See, e.g.*, Shurtz, *supra* note 7, at 1669.

14. *See, e.g., id.* at 1671.

15. A regressive tax system imposes a higher average tax rate on lower-income taxpayers. Such a system may (and usually does) impose a higher absolute-dollar tax burden on higher-income taxpayers, albeit at a lower marginal tax rate. However, this is not a per se requirement economically, and higher-income taxpayers may be subject to a lower absolute-dollar tax burden than lower-income

may be considered vertically equitable, but many proponents of vertical equity promote progressive income tax regimes.<sup>18</sup> Tax systems should be considered as integrated systems. Because income taxes are only one component of an integrated tax system,<sup>19</sup> and because other components of an integrated tax system have different impacts on differently situated taxpayers,<sup>20</sup> a progressive income tax regime might be necessary to ensure that an integrated tax system is nonregressive.

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taxpayers—either through negative marginal tax rates or through the imposition of higher consumption taxes on a mix of goods favored by lower-income taxpayers.

16. A proportionate tax system imposes a uniform (average) tax rate on all taxpayers, regardless of their income. Such a system imposes a higher absolute-dollar tax burden on higher-income taxpayers.

17. A progressive tax system imposes a higher average tax rate on higher-income taxpayers. Such a system imposes a higher absolute-dollar tax burden on higher-income taxpayers, (more so than a proportionate tax system). Progressive tax systems generally involve higher marginal income tax rates for higher-income taxpayers, although luxury consumption taxes may also be considered a part of a progressive tax system.

18. See Shurtz, *supra* note 7, at 1671.

19. Other components of an integrated tax system may include, *inter alia*, consumption taxes (e.g., sales taxes), employment taxes (e.g., Social Security and Medicare/Federal Insurance Contributions Act (FICA)/Self-Employment Contributions Act (SECA) taxes), unemployment taxes (e.g., Federal Unemployment Tax Act (FUTA)/State Unemployment Tax Act (SUTA)), property taxes (both real property and personal property), excise taxes (e.g., “sins”—such as tobacco, alcohol, and gambling—as well as other items, such as certain types of manufactured goods or extracted natural resources), transfer taxes (e.g., estate and gift taxes), tariffs, Value Added Taxes (VAT), and export taxes. At the time this Note was published, the U.S. was using all of the aforementioned taxes except for VAT and export taxes. Export taxes are unconstitutional. U.S. CONST. art. I, § 9, cl. 5; § 10 cl. 2.

20. Generally speaking, the progressivity of an income tax is determined both by reference to its explicit rate structure and to its tax base structure. To the extent that a tax base might vary based upon income, it might also contribute to or detract from the progressivity of a tax system. The progressivity of employment taxes, unemployment taxes, and transfer taxes also depends upon the explicit rate structure and the tax base. Within the U.S., employment and unemployment taxes tend to be regressive because the rates are nonprogressive and the tax base is capped. Specifically, the Social Security and unemployment taxes are regressive because they apply a uniform tax rate to certain types of income up to a statutory threshold, but they do not impose any additional tax on income above that threshold. The Medicare tax was historically regressive even though it had a uniform tax rate on an unlimited income tax base because certain types of income associated with high-income individuals (e.g., interest, dividends, and capital gains) were excluded from the base. The Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010), generally reversed this by subjecting high incomes to an additional incremental Medicare tax and by creating the new I.R.C. § 1411 tax—which is analogous to the Medicare component of the SECA tax but is imposed on most unearned income not otherwise subject to SECA taxes. *Cf.* I.R.C. § 1411(c)(6) (Supp. 2010). In the U.S., transfer taxes tend to be very strongly progressive. The estate and gift taxes only apply to estates and gifts in excess of a statutory threshold, and the statutory threshold is high enough to exclude most estates and gifts. Furthermore, the estate and gift tax rate structure is very progressive.

The progressivity of consumption taxes, excise taxes, VAT, and tariffs tends to be more focused on the mix of goods subject to such taxes. Taxes on luxury goods tend to be more progressive. Taxes on other goods are often less so. Moreover, because higher-income individuals are more likely to be able to save some of their income (or to “consume” wealth or future benefits, rather than immediate benefits), consumption taxes might be inherently regressive.

Economic neutrality focuses on avoiding “tax distortion,” which is a change in a taxpayer’s preferences or decisions due to a tax system.<sup>21</sup> Economic incentivization is the polar opposite of economic neutrality—it is the intent to encourage taxpayers to engage in certain conduct or consume certain goods (or, alternatively, to discourage certain conduct or the consumption of particular goods) by means of a tax system.<sup>22</sup> If an income tax is applied uniformly on all income and all income is taxed, then that tax should be somewhat economically neutral because each individual’s profit-maximizing behavior will generally encourage the same conduct. However, because taxes might increase taxpayers’ marginal preferences for leisure over work, or for consumption over saving, most taxes which are not uniform per capita levies will not be perfectly economically neutral.<sup>23</sup> On the other hand, Congress, at times, seeks to incentivize certain behaviors, such as the purchase of certain clean energy vehicles and energy efficient appliances.<sup>24</sup> Congress also seeks to discourage certain other behaviors, such as using corporations as personal savings vehicles or assisting unsanctioned international boycotts or storing passive income-producing assets in foreign corporations.<sup>25</sup> Although the tax code may seem to be something of a sledgehammer when it comes to incentivization, because it is often imprecisely targeted and may cause unforeseeable consequences, it is one of the most effective and easily-administrable means by which Congress can promote particular policies that require taxpayer buy-in.<sup>26</sup>

It is also worth noting that a taxpayer is appropriately entitled to pay the lowest rate of tax imposed upon it by the Internal Revenue Code. Persons who are subject to favorable tax rates on carried interest income are not necessarily greedy or unethical; rather, some of their income is merely eligible for preferred rates under current law. As Judge Learned Hand aptly stated in *Helvering v. Gregory*,<sup>27</sup> “Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose

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21. See McLure, *supra* note 7, at 1624–25.

22. See *id.* at 1626.

23. See, e.g., TREASURY 1984, *supra* note 7, at 13. It is also worth noting that because uniform levies involve a fixed tax and a zero percent incremental tax rate, they are brutally regressive and are therefore extremely violative of vertical equity.

24. See, e.g., I.R.C. §§ 25D, 30, 30B–D, 45M (Supp. 2010).

25. See, e.g., I.R.C. §§ 541–47, 908, 951–64, 999, 1291–98 (Supp. 2010).

26. Cf. TREASURY 1984, *supra* note 7, at 15 (discussing the use of tax policy as a means of subsidy); Staudt et al., *supra* note 8, at 1958 & n.174. See generally Peter J. Wiedenbeck, *Paternalism and Income Tax Reform*, 33 U. KAN. L. REV. 675 (1985).

27. 69 F.2d 809 (2d Cir. 1934).

that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."<sup>28</sup>

### *B. Definition of Carried Interest & Related Background Information*

Carried interest is a mechanism employed by many investment funds to compensate fund managers for delivering strong fund-level investment performance.<sup>29</sup> It is generally an allocation to the fund managers of a percentage of partnership income without a corresponding interest in the partnership's capital.<sup>30</sup> Most investment funds are structured as either limited partnerships or limited liability companies<sup>31</sup> and are treated as partnerships for U.S. federal income tax purposes.<sup>32</sup> Accordingly, the income of the funds is subject to tax at the partner level when it is realized and recognized at the partnership level, subject to partnership-level elections.<sup>33</sup> Items of partnership income generally retain their underlying character when they "pass through" to the partners.<sup>34</sup> Allocations of

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28. *Id.* at 810.

29. See David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 VA. L. REV. 715, 716 n.1 (2008). See generally Andrew W. Needham & Anita Beth Adams, "Private Equity Funds," 735-2d Tax Mgmt. (BNA) U.S.-Income (2010).

30. Weisbach, *supra* note 29, at 716 n.1. The measure of carried interest varies by fund, and is usually defined in the fund documents. Often, carried interest is only earned if a fund exceeds a target performance metric. If the carry is only earned on the amount by which a fund exceeds a target metric, then the fund is said to provide a "preferred return" to investors (and the target metric embodies that preferred return). If the carry is earned on all fund income and the fund exceeds a target metric, that target metric is referred to as a "hurdle rate." See generally Needham & Adams, *supra* note 29.

31. This is an extreme oversimplification of actual fund structures. Most funds are comprised of multiple levels of entities in order to optimize fund efficiencies in terms of general administration and costs, as well as taxes. Two major classes of fund structures are the parallel fund structure and the master-feeder structure. Recently, a new structure, called a mini-feeder structure, has increased in popularity. Specific discussion of these structures is beyond the scope of this Note.

Often, funds employ a fee structure whereby two separate fees are charged: a management fee and an incentive fee. The management fee, usually about 2 percent, is often paid to a management company, which is often an affiliate of the general partner (GP) (who is not actually a partner in the fund). The incentive fee is the carried interest, and it is usually about 20 percent of the fund's profits and generally allocated to the GP (In order to ensure pass-through of character of income, the allocation must be made to a partner.). Often, the GP is an LLC or S corporation. See Rosenzweig, *supra* note 1, at 718.

For additional background information on various funds, see generally GERALD LINS ET AL., *HEDGE FUNDS AND OTHER PRIVATE FUNDS: REGULATION AND COMPLIANCE* (2010–2011 ed.).

32. See I.R.C. § 7701 (2006); Treas. Reg. §§ 301.7701-1–301.7701-2 (2009), 301.7701-3 (2006); Rosenzweig, *supra* note 1, at 718.

33. See I.R.C. §§ 701–703(b) (2006). As a side note, it is worth mentioning that tax-exempt partners are only generally subject to tax on the Unrelated Business Taxable Income (UBTI) portion of the partnership income. Generally, if there is no debt-financing (at the partner or partnership level), then dividends, interest, and capital gains should not constitute UBTI. See I.R.C. §§ 511, 512(a)(1), (b)(1), (b)(4), (b)(5), 514 (2006). Many investors in investment funds are tax-exempt.

34. See I.R.C. § 702(a), (b).

partnership income, such as carried interest, are considered special allocations and retain their character when passed through to the partners.<sup>35</sup>

Under current law, the receipt of a profits interest in a partnership without a corresponding capital interest generally does not result in any immediate taxation.<sup>36</sup> Income (both general net income and separately stated items) is computed at the partnership level; the partnership then allocates income to the partners. Each partner is taxed on all income allocated to him or her, and the character of the income is determined at the partnership level and passed on to the partners.<sup>37</sup> Each partner is then afforded a basis adjustment for his or her allocable share of the partnership's total income or loss.<sup>38</sup> Accordingly, under current law, the profits interest that entitles a fund manager to carried interest income is not taxed upon receipt by the manager, and all items of income that are allocated to the fund manager retain their initial character, as determined at the partnership level.

### *C. Tax Policy Considerations of Current Carried Interest Taxation Regime*

As a matter of tax law, there are two conflicting viewpoints regarding carried interest taxation. Carried interest is generally a special allocation of partnership income.<sup>39</sup> Accordingly, under general partnership taxation, it

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35. See I.R.C. §§ 702, 704 (2006). Unlike an S corporation, which must allocate all items of income on a per-share-per-day basis, see I.R.C. §§ 1361(b)(1)(D), (c)(4), 1377(a)(1) (2006) (jointly requiring S corporations to have a single class of stock for purposes of distributions and allocations and applying pro rata allocation), partnerships have significant flexibility in how they allocate their income. A special allocation of partnership income provided for in the partnership agreement (or operating agreement for an LLC treated as a partnership for federal income tax purposes) will generally be respected for income tax purposes, so long as it has substantial economic effect. See I.R.C. § 704(a), (b). The concept of substantial economic effect is fairly complex, but generally, special allocations pursuant to a partnership agreement that provides that capital accounts will match tax allocations will likely be respected for federal income tax purposes, subject to certain targeted anti-abuse rules. See Treas. Reg. § 1.704-1(b)(2) (2008).

36. See Rev. Proc. 2001-43, 2001-2 C.B. 191; Rev. Proc. 93-27, 1993-2 C.B. 343. There are a few limited exceptions to this general rule, but they are rarely applicable, and most practitioners can easily avoid them. These exceptions are discussed in the aforementioned Revenue Procedures.

37. See I.R.C. §§ 702, 704.

38. See I.R.C. § 705 (2006).

39. Weisbach, *supra* note 29, at 716 n.1. By definition, an S corporation cannot have special allocations, although an S corporation can receive special allocations if it is a partner in a partnership. Corporations are only eligible for Subchapter S (pass-through taxation) if they maintain only a single class of stock. See I.R.C. § 1361(b)(1)(D). Failure to maintain only a single class of stock can terminate an otherwise valid S election. See I.R.C. §§ 1361(b)(1), 1362(d)(2) (2006). Classes of common stock that are identical in all respects, except for differences solely in voting rights, are



may properly retain the character of its underlying source income (such as long-term capital gains, I.R.C. § 1231 gains, dividends, ordinary interest, tax-exempt interest, etc.).<sup>40</sup> On the other hand, carried interest is not merely an allocation of income between separate passive partners, but rather, it is a means of compensating managing partners for their services in managing an investment fund to achieve specific returns.<sup>41</sup> Many critics of current carried interest taxation focus on the fact that compensation for services rendered is generally taxed as ordinary income, and therefore, permitting carried interest to be subject to potentially preferential tax rates (including long-term capital gains tax rates) effectively provides a tax subsidy to investment fund managers.<sup>42</sup> From a tax policy perspective, taxing carried interest as ordinary income would promote horizontal equity (by taxing it like other compensation for services), vertical equity (because

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considered to be part of a single class of stock. I.R.C. § 1361(c)(4). Furthermore, actual “straight debt” is also not considered a separate class of stock. I.R.C. § 1361(c)(5). Classes of common stock providing for varying distribution rights fit within neither such heading, and should cause automatic termination of S corporation status.

40. See I.R.C. § 702.

41. Rosenzweig, *supra* note 1, at 723–24.

Although the specific thresholds (“hurdle rates”) required for partners to earn carried interest vary, they will be defined in a partnership agreement or LLC operating agreement. Oftentimes, a threshold might be a measure of the “market,” such as the S&P 500, the Russell 1000, the Russell 2000, the Russell 3000, or the Wilshire 5000. See, e.g., ALEXANDER INEICHEN, AIMA’S ROADMAP TO HEDGE FUNDS 28 (2008), available at <http://www.aima.org/download.cfm/docid/6133E854-63FF-46FC-95347B445AE4ECFC> (discussing hedge funds); Andrew Metrick & Ayako Yasuda, *The Economics of Private Equity Funds*, 23 REV. FIN. STUD. 2303, 2309–11 (2010) (discussing private equity funds). Some funds (more often hedge funds than private equity funds) often provide for “high-water marks” whereby managers can only earn carried interest if the fund exceeds its highest previous return (possibly with an adjustment (often upward only) for expected market gains using its market measure). See, e.g., INEICHEN, *supra*; Rosenzweig, *supra* note 1, at 721 n.36 (citation omitted). However, without a “clawback,” which would cause managers to forfeit previously earned carried interest if subsequent fund performance failed to exceed the relevant threshold, this is often insufficient. As soon as it appears that a fund will be unlikely to exceed its high-water mark, then fund managers may liquidate their old funds and organize a new fund to purge the high-water mark threshold. This might be less of a concern for private equity funds, however, because they often have fixed investment horizons and receive capital over time in the form of capital commitments and capital calls. See, e.g., Metrick & Yasuda, *supra* at 2307, 2312–13. With respect to hedge funds, this might cause some additional turbulence in the market, but it might also permit investors to exit the fund and provide some social benefit. An efficient result could ensue if investors had the opportunity to “rollover” their investment in the old fund into the new fund or instead redeem their fund interest without penalty. With respect to private equity funds, a clawback is often necessary to ensure that fund managers cannot profit at their investors’ expense by liquidating investments with returns in excess of hurdle rates in years prior to liquidating investments with returns that do not exceed hurdle rates.

42. See, e.g., Jones, *supra* note 1, at 695. It is worth noting that many fund managers are high-income taxpayers. Accordingly, in effect, carried interest provides a tax subsidy to some of the wealthiest taxpayers. Some commentators have addressed the perversity of this result. See, e.g., Jones, *supra* note 1.

fund managers can “afford” the taxes), and economic neutrality (because individuals who are seeking high-income professions should not make the choice between being a fund manager and being a doctor or an investment banker solely on account of tax treatment of compensation). The existing carried interest tax regime provides uniform tax treatment to partnerships, is relatively administratively convenient, and promotes taxpayer compliance because substantial factual analysis is not currently necessary to differentiate between specially allocated income from investment services partnerships and income from other partnerships. This Note will briefly revisit the tax policy considerations of carried interest taxation in Part IV after discussing various alternatives.

## II. CONGRESS’ RECENT CARRIED INTEREST TAXATION PROPOSAL

### A. *Proposed I.R.C. § 710.*

The May 28, 2010, House version of the American Jobs and Closing Tax Loopholes Act of 2010<sup>43</sup> contained a provision to reform carried interest taxation, “Proposed I.R.C. § 710.”<sup>44</sup> The final, enacted version of the Unemployment Compensation Extension Act of 2010 did not include Proposed I.R.C. § 710. However, because Proposed I.R.C. § 710 has already been drafted by Congress in accordance with Congressional legislation standards, it is worth analyzing, in no small part because it can be readily included in a future bill.<sup>45</sup>

Proposed I.R.C. § 710 generally provides that carried interest income will be taxed as ordinary income and that carried interest losses, while generally taxable as ordinary losses, are only deductible to the extent of carried interest income earned in prior years.<sup>46</sup> In the event of a sale of an “investment services partnership interest,” any gain will be taxed as

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43. Pub. L. No. 111-205, 124 Stat. 1235 (2010). As ultimately enacted, this Public Law was referred to as the Unemployment Compensation Extension Act of 2010. *Id.* § 1.

44. H.R. 4213, 111th Cong. § 412(a) (as engrossed by House, May 28, 2010).

45. This Note addresses the House proposals from engrossed House Bill 4213. Congress has since considered other proposals to tax carried interest as ordinary income, *see, e.g.*, H.R. 2495, 112th Cong. § 501 (as introduced in the House on July 11, 2011), but many of these proposals are more misguided than House Bill 4213. For example, as discussed, House Bill 4213 could theoretically subject active trades or businesses to carried interest limitations, whereas an optimal carried interest regime would not do so. House Bill 2495 provides for similarly ludicrous treatment, without any attempt to limit the scope of carried interest reform to investment services partnerships. Because, in the author’s view, House Bill 4213 provides the best starting point of the proposed pieces of legislation, it will be the main point of comparison for this Note.

46. *See* H.R. 4213 § 412(a) (Proposed I.R.C. § 710(a)(1), (2)).

ordinary income, but loss will only be recharacterized as ordinary loss to the extent of prior years' net income, net of any prior years' previously allowed losses.<sup>47</sup> Proposed I.R.C. § 710 also overrides the general partnership rules regarding distributions of partnership property and instead provides that such distributions are generally immediately taxable as though they are distributions of money.<sup>48</sup> Investment services partnership interests are generally defined as interests in partnerships that advise, manage, acquire, dispose, or finance the acquisition of certain assets (usually stocks, securities, real estate, options and derivatives, interests in partnerships, or certain other assets (primarily investment assets)), or that provide related support services.<sup>49</sup> Exceptions are generally made for income allocations to capital interests not in excess of the capital interest's capital percentages, as long as those interests are attributable to either property contributed to the partnership or income previously recognized by the partner.<sup>50</sup> Proposed I.R.C. § 710 also provides that income from certain interests in entities, whose values are related to performance of investment management services by the taxpayer, is taxed as ordinary income.<sup>51</sup> The interests subject to this provision generally exclude partnership interests and interests in most C and S corporations.<sup>52</sup>

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47. *Id.* (Proposed I.R.C. § 710(b)(1), (2)). Proposed I.R.C. § 710(b) does not explicitly provide that loss in excess of prior years' net income is treated as capital loss, but rather, it only recharacterizes loss as ordinary loss to the extent of prior years' net income. Accordingly, to the extent that the loss on disposition exceeds prior years' ordinary income, that excess will retain its original character. It is worth noting, however, that because ordinary losses are allowed only to the extent of prior years' net income, some previously incurred but not previously allowed losses might be subsequently recharacterized as capital losses.

48. *See* H.R. 4213 § 412(a) (Proposed I.R.C. § 710(b)(6)).

49. *See id.* (Proposed I.R.C. § 710(c)). It is worth noting that the language in Proposed I.R.C. § 710(c)(2), referring to interests in partnerships, makes no mention as to the purpose or function of the investee partnerships. Accordingly, Proposed I.R.C. § 710 might subject tiered operating partnerships to taxation at ordinary income rates if they are unable to avail themselves of the special rules under Proposed I.R.C. § 710(d)(4) for tiered partnerships. While proper planning could likely mitigate this impact (by means of including debt financing or matching capital interests to profits interests), smaller businesses that might simply be seeking to avail themselves of a single level of taxation (through LLC structures) and that lack the resources for elegant tax planning might find themselves subject to Proposed I.R.C. § 710's recharacterizations. In effect, as currently drafted, Proposed I.R.C. § 710 might penalize a group of persons that it does not seek to impair. Yet it might fail to tax those who it seeks to tax but who can afford effective tax counsel. Proposed I.R.C. 710 is therefore both over- and under-inclusive.

50. *See* H.R. 4213 § 412(a) (Proposed I.R.C. § 710(d)(1), (7)).

51. *See id.* (Proposed I.R.C. § 710(e)).

52. *Id.* (Proposed I.R.C. § 710(e)(2)(A)(ii)).

Proposed I.R.C. § 710 applies to all taxpayers, including both individuals and corporations.<sup>53</sup> Individuals are afforded some relief in the form of an “applicable percentage,” which permits a certain percentage of net income or loss or disposition gain or loss to be taxed under the previous preferential tax regime.<sup>54</sup> However, corporations are ineligible for this benefit.<sup>55</sup>

Proposed tax adjustments that were excluded from the final version of House Bill 4213 included both Proposed I.R.C. § 710, as well as additional proposed amendments to the Internal Revenue Code relating to investment services partnerships. These additional proposed amendments included subjecting persons who own certain interests related to investment management services to enhanced underpayment of tax

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53. *Id.* (Proposed I.R.C. § 710(c)(1)). Proposed I.R.C. § 710(a) does not make any reference to taxpayers. Proposed I.R.C. § 710(c)(1) defines “investment services partnership interest” as “any interest in a partnership which is held . . . by *any person*” who meets certain requirements. *Id.* (emphasis added). The use of the phrase “any person” in Proposed I.R.C. § 710(c), combined with the absence of any limitations on which persons are subject to Proposed I.R.C. § 710, means that individuals and corporations (and other taxpayers) are subject to its recharacterization provisions. *Cf.* I.R.C. § 7701(a)(1) (2006) (generally defining the term “person” for purposes of the Internal Revenue Code, subject to express modifications in specific provisions). Furthermore, Proposed I.R.C. § 710(g) provides for special rules for individuals, which confirms, by implication, that corporations are also subject to the general rules.

54. H.R. 4213 § 412(a) (Proposed I.R.C. § 710(g)). This would serve to enable a portion of carried interest income to retain its original character (by recharacterizing only a portion as ordinary income). The portion recharacterized would be 50 percent for tax years beginning before 2013 and 75 percent for tax years beginning thereafter. *Id.* (Proposed I.R.C. § 710(g)(7)). From a policy perspective, the most apparent reason for this provision is compromise. The version of Proposed I.R.C. § 710 in House Bill 2495 excludes this relief. *See* H.R. 2495, 112th Cong. § 502(a).

55. *See* H.R. 4213 § 412(a) (Proposed I.R.C. § 710(g)) (titled “Special Rules for *Individuals*”) (emphasis added). While it is appropriate to subject S corporations to these measures for carried interest taxation, on account of the fact that S corporations can be used as management entities for partnerships or LLCs, it seems almost odd to subject C corporations to these measures. The net effect of most of these provisions on C corporations will be to limit and defer deductibility of ordinary losses until the partnership has sufficient income to offset the previously incurred losses and to convert ordinary operating losses into much harder to deduct capital losses, upon disposition of partnership interests.

Because Proposed I.R.C. § 710(c)(2) refers, by reference, to any stock as being considered a “specified asset,” Proposed I.R.C. § 710 will subject any corporate partner in a joint venture that has an investment in corporate stock or a partnership, receives a special allocation, and performs any service described in Proposed I.R.C. § 710(c)(1) to the aforementioned potentially punitive tax treatment. Proposed I.R.C. § 710 might require such a broad net (declining to provide an exemption for high-percentage ownership or 100 percent ownership stakes) in order to subject private equity funds to its provisions. Yet it might be more efficient to exempt C corporation partners from the provisions of Proposed I.R.C. § 710, with a possible offset and recapture to the extent that the corporate partner makes a subsequent Subchapter S election to the extent required to prevent abuse. Furthermore, active trades or businesses unrelated to investments should be exempt from the provisions of any carried interest reform.

penalties,<sup>56</sup> conforming adjustments to publicly traded partnership rules,<sup>57</sup> and adjusting net earnings from self-employment subject to SECA.<sup>58</sup>

### B. Critique of Proposed I.R.C. § 710

Proposed I.R.C. § 710 is a good barometer of the current climate of proposed carried interest taxation legislation. It has both some very strong points and some glaring weaknesses. While it is a good starting point for discussion, it appears to be more of an ill-considered compromise than a well-conceived theoretical and practical method of taxing carried interest.

Proposed I.R.C. § 710 jumpstarts the carried interest discussion by actually proposing to tax carried interest income as ordinary income. While this seems mundane, the fact that Proposed I.R.C. § 710 attempts to provide a comprehensive regime for the taxation of carried interest income is a major breakthrough. Prior to Proposed I.R.C. § 710, many proposals were bandied about, but few, if any, addressed even most of the relevant interests at stake.<sup>59</sup>

Proposed I.R.C. § 710 also subjects carried interest income to social insurance taxes.<sup>60</sup> Although fund managers will often be subject to only Medicare taxes on their marginal income,<sup>61</sup> there are currently many

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56. See H.R. 4213 § 412(c)(1) (Proposed I.R.C. § 6662(b)(8)); *id.* § 412(c)(2)(A) (Proposed I.R.C. § 6662(k)). Generally, a 20 percent penalty is applicable to underpayments of tax. However, for certain underpayments relating to Proposed I.R.C. § 710(e), the penalty would be 40 percent. See *id.* § 412(c)(1), (2)(A).

57. See *id.* § 412(b) (Proposed I.R.C. § 7704(b)(6)).

58. See *id.* § 412(d)(1) (Proposed I.R.C. § 1402(a)(18)). The proposed adjustments to House Bill 4213 also provided for inclusion of certain S corporation income in taxpayers' SECA tax base, including adjustments for family members' shares of S corporation income. *Id.* This provision was also not adopted.

59. See, e.g., Stephen M. Breirstone, *Carried Interest Bill—A 'Death Trap' for Real Estate Partnerships*, 128 TAX NOTES 1459 (2009).

60. See *supra* note 58 and accompanying text. Since I.R.C. § 1411 (Supp. 2010) was enacted, carried interests may be subject to the Medicare tax. However, House Bill 4213 proposed to subject carried interests to both the Medicare and Social Security taxes. See *supra* note 58.

61. See I.R.C. §§ 1401, 1402(b) (2006). Under current law, earnings from self-employment in excess of a statutory threshold are only subject to the 2.90% Medicare component of the SECA tax (3.8% in excess of \$200,000 for most filers, \$250,000 for married filers filing jointly, and \$125,000 for married filers filing separately). Earnings from self-employment below that threshold are subject to both the 12.40% Social Security and the 2.90% Medicare components of the SECA tax. Fund managers earning more than \$106,800 (during 2011) (of wages subject to SECA) are only subject to the Medicare component of SECA on their marginal income. The Social Security tax wage limit of \$106,800 is effective for 2011. See I.R.S., PUBLICATION 15: (CIRCULAR E), EMPLOYER'S TAX GUIDE (2011), available at [http://www.irs.gov/publications/p15/ar02.html#en\\_US\\_2011\\_publink1000202402](http://www.irs.gov/publications/p15/ar02.html#en_US_2011_publink1000202402).

proposals to increase the income base subjected to Social Security taxes.<sup>62</sup>

Proposed I.R.C. § 710 also has a number of shortcomings. As discussed previously in Part II.A,<sup>63</sup> C corporations are effectively penalized by this regime because they currently receive minimal benefit from carried interest but are likely to have legitimate business deductions deferred or possibly disallowed due to Proposed I.R.C. § 710's overbreadth.<sup>64</sup> Any proper carried interest taxation regime should exclude C corporations from its scope of taxpayers affected.<sup>65</sup>

Proposed I.R.C. § 710 also focuses on partnerships, rather than partners. This provision establishes artificial "buckets" whereby carried interest income from one fund cannot be offset by carried interest losses from a different fund. This provision is of particular concern to fund managers because some may manage multiple separate funds. If a fund manager has a large loss in one fund but a small gain in a different one, then that manager might be treated by the Internal Revenue Service under Proposed I.R.C. § 710 as having taxable income, even though that manager has actually incurred a substantial economic loss from the sum of his or her labor.<sup>66</sup> This result is further exacerbated by the fact that if the fund manager shuttered losing funds, it would only be able to treat most losses from those funds as capital losses and would be unable to use them to offset carried interest ordinary income.<sup>67</sup> A result of this distortion is

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62. Some of these proposals include completely eliminating the cap on income subject to Social Security taxes or alternatively, providing for a "collar" subject to only the Medicare tax such that after income exceeds a second, higher threshold, it is subject to an additional social insurance tax. The Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010), amended I.R.C. § 1401 (SECA) and I.R.C. § 3101 (FICA) by adding a new Medicare surtax of 0.9% onto incomes in excess of \$250,000 for joint returns, \$125,000 for separate married returns, and \$200,000 for all other returns, and by adding I.R.C. § 1411. See discussion *supra* notes 20, 58, 60, 61.

63. See *supra* notes 51–55 and accompanying text.

64. The fact that Proposed I.R.C. § 710 refers to qualified dividend income but not the dividends received deduction—the tax preference relating to dividends applicable to C corporations—suggests that the drafters of Proposed I.R.C. § 710 were not focused on C corporations. Rather, the chapters merely included C corporations in the scope of the provisions to "cover all of their bases," to penalize corporations (as a means of raising additional revenue), or as an oversight. However, the language of Proposed I.R.C. § 710(g) suggests that the inclusion of C corporations was not an oversight. See *supra* note 53.

65. It might be appropriate to consider subjecting closely held C corporations (or personal holding companies) to carried interest recharacterization provisions. See *infra* notes 73–76 and accompanying text. In addition, general active trades or businesses should be exempt from recharacterization.

66. Proper pass-through of carried interest should pass the taint of carried interest through GP entities to managers of GPs.

67. See H.R. 4213 § 412(a) (as engrossed by House, May 28, 2010) (Proposed I.R.C. § 710(a)(1), (a)(2), (b)); *supra* notes 46–52. Because most fund losses will result from declines in stock prices, they will often be taxed as capital losses unless they are subject to a specific statutory override. See I.R.C. §§ 165(f), 1211, 1212, 1221, 1222 (2006). Individuals are generally permitted to deduct an amount of

that fund managers might seek to focus on a single investment strategy. However, an incentive to do this already exists in the market in the form of risk and reward and expected return, and providing a large tax “stick” is unlikely to advance this. A more likely result is that fund managers will either consolidate disparate investment strategies into a single fund or decrease the number of funds they manage. This outcome will likely result in a decrease in the number of funds available, a conglomeratization of fund strategies, or a combination of both. The net result of this development will be reduced investor selection, both in terms of fund strategies and actual numbers of funds. Reduced consumer (and by extension, investor) selection is often broadly regarded as an undesirable outcome.<sup>68</sup>

One of the primary concerns that might have motivated some members of Congress to provide for partnership-level evaluation of carried interest is the notion that fund managers might seek to use losses from carried interests to offset gains from other income sources. This concern is largely overblown because most fund managers who have carried interests manage funds for a living; the primary reason for consideration of carried interest taxation reform is the fact that carried interest is, in effect, often a form of compensation for services subject to preferential tax rates. Taken together, it should be obvious why this concern is misplaced—most people would not seek to lose money performing their jobs. While some high-income individuals seek to reduce their taxable income by use of tax shelters, such tax shelters are predominantly passive investments.<sup>69</sup>

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capital losses equal to their capital gains for the taxable year plus \$3,000 (\$1,500 if married filing separately); any excess capital loss may be carried forward indefinitely. *See* I.R.C. §§ 1211(b), 1212(b). However, if a taxpayer has a \$1,000,000 capital loss, and a \$1,000,000 carried interest ordinary income gain, a \$3,000 deduction will be both inequitable and economically distortive.

68. *See, e.g.,* Avinash K. Dixit & Joseph E. Stiglitz, *Monopolistic Competition and Optimum Product Diversity*, 67 AM. ECON. REV. 297 (1977).

69. Congress has, in fact, previously addressed the problem of the use of tax shelters to shelter active income. Congress included one of its first major limitations on tax shelters in the Tax Reform Act of 1976, Pub. L. 94-455, 90 Stat. 1520 (1976), in the form of the At-Risk Limitations, which generally limited deductible losses to amounts deemed to be “at-risk.” Currently, amounts deemed to be at-risk include the sum of invested capital, recourse financing, and certain limited “qualified” non-recourse financing. *See generally* I.R.C. § 465 (2006).

Congress added a more robust limitation on tax shelters in the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085 (1986), in the form of the Passive Loss Rules. The Passive Loss Rules are generally considered very effective at limiting the availability of passive losses. *See generally* I.R.C. § 469 (2006). The Passive Loss Rules demonstrate that the determination of tax treatment should be made at the partner level, rather than the partnership level. Although partnerships report information about activities which may constitute passive losses to the partners, the partners are ultimately responsible for determining whether their investment in a partnership is a passive investment.

Accordingly, it might be appropriate to simply permit fund managers to use carried interest losses to offset other income or, at the very least, income from other investments.

### III. MY PROPOSAL FOR CARRIED INTEREST TAXATION

I will use the general concepts of Proposed I.R.C. § 710 as the starting point for the discussion regarding my proposal for carried interest taxation. I will do this both because it is a fairly comprehensive proposal and because it is readily available, thus saving the trouble of attempting to draft a proposal from scratch that would deal with the same subject matter. Also, it would be premature to reduce my proposal to a particular proposed enactment because it is more conceptual than applied.

First, C corporations should be explicitly exempted from recharacterization of income under carried interest tax provisions. As discussed in Part II.A–B,<sup>70</sup> carried interest recharacterization is punitive when applied to corporations because it generally defers deductions to which corporations are otherwise legitimately entitled and sometimes entirely disallows bona fide losses. Carried interest taxation should focus on ensuring that compensation for services is not eligible for artificial preferential tax rates without some significant affirmative policy consideration; because C corporations generally do not earn compensation for services, they should be exempt from this recharacterization. Furthermore, recharacterization may impede socially beneficial corporate development and evolution because joint ventures may be discouraged if they could subject their investors to a punitive tax regime. Lastly, it is worth noting that in the current tax environment, most individuals would not seek to use a C corporation as a means of avoiding carried interest recharacterization; because C corporations are subject to an entity-level tax, such a strategy would increase the effective tax rate applied to such shareholders' income.<sup>71</sup> If that is insufficient to dissuade the use of C corporations for purposes of avoiding carried interest recharacterization,

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Furthermore, partners are able to utilize their passive losses from one partnership to offset their passive income from other partnerships. *See id.*

70. *See supra* note 51–55, 63 and accompanying text.

71. This presumption against the use of corporations generally applies when corporate income tax rates are roughly equivalent to individual income tax rates. In the present U.S. tax environment, this presumption is appropriate. In other tax rate environments, this presumption might be inapplicable; if corporations are subject to lower tax rates than individuals, then income can generally be subject to reduced effective tax rates if it is retained by the corporation.



then that might be best addressed by reforming the Personal Holding Company tax regime.<sup>72</sup>

Second, carried interest taxation should focus on the partners rather than the partnership. This entails a number of changes to Proposed I.R.C. § 710. Initially, losses should not be trapped at the partnership level. Instead, the losses should flow through to the partners, as they otherwise would, and be subject to some form of suspension until the partners have sufficient income to offset them. This should be modeled on the Passive Loss Rules.<sup>73</sup> This result can be accomplished by generally permitting carried interest losses to only be offset by carried interest gains, either through formal bucketing (i.e., “carried interest capital losses,” as opposed to regular capital losses), or preferably, through a less formal recharacterization process. Ideally, carried interest losses should retain their original character, except that carried interest capital losses should be eligible for recharacterization as ordinary losses to the extent of unrecaptured recharacterized carried interest income.<sup>74</sup> As a corollary to this point, investment services partnerships should be required to report information to their partners regarding carried interest, but no formal adjustments should be made at the partnership level.<sup>75</sup>

Additionally, upon disposition, recharacterization should not freeze previously suspended losses as capital losses while taxing what would otherwise be capital gains as ordinary income. Again, one method to accomplish this is by modeling the eventual legislation after the Passive Loss Rules. Generally speaking, under the Passive Loss Rules, losses

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72. I.R.C. §§ 531–565 provide generally for two regimes for taxing corporations used to improperly avoid the imposition of tax upon their shareholders: the Personal Holding Company regime, *see* I.R.C. §§ 541–547 (2006), and the Accumulated Earnings Tax Regime, *see* I.R.C. §§ 531–537 (2006). Either could be properly used to combat attempts to shift carried interest income into a C corporation.

73. *See generally* I.R.C. § 469 (2006), and Treasury Regulations promulgated thereunder.

74. Carried interest income should be recharacterized as ordinary income (i.e., “recharacterized” carried interest income). To the extent that a partner has subsequent capital losses from carried interests, he or she should be able to “recapture” those losses by “recharacterizing” them as ordinary losses (thereby effectively offsetting the prior carried interest income). To the extent that a partner’s carried interest ordinary income still exceeds his or her carried interest capital losses that have been recharacterized as ordinary losses, he or she has unrecaptured recharacterized carried interest income.

75. From a quantitative perspective, this reporting should be fairly straightforward—to the extent that the partnership can look at the excess of each allocation over the amount that would have been allocated to a specific partner if the allocation had been made according to capital interests and report that amount as the potential carried interest pick-up.

From a compliance perspective, this requirement should be relatively innocuous. Partnerships already report significant amounts of information to their partners on Forms K-1 and attachments thereto. Because the quantitative computation required by the proposed reporting regime is minimal, the additional compliance burden, at least at the partnership level, should be equally minimal.

which have previously flowed through to a partner may be released from suspension upon termination of that partner's entire interest in the passive activity.<sup>76</sup> In the carried interest context, a similar provision could provide that upon termination of a carried interest any unrecaptured recharacterized carried interest income allocable to that carried interest would be recaptured as an ordinary loss to the extent of the loss on disposition.<sup>77</sup> As a conceptual matter, this might be best achieved by renumbering Proposed I.R.C. § 710 as either § 449, § 470A, or § 484.<sup>78</sup> Although adjusting the basis limitations and netting procedures would require reworking much of Proposed I.R.C. § 710, the final legislation would be cleaner and more conceptually accurate. By focusing carried interest reform on partners receiving carried interests, rather than on partnerships that have carried interests, Congress can ensure that partners who do not receive carried interests are generally not impacted by any changes.<sup>79</sup>

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76. See I.R.C. § 469(g).

77. If there is no loss on disposition, there should be no recapture. If there is a loss on disposition, it should be "recaptured" but only to the extent of the lesser of the unrecaptured loss or the loss on disposition as an ordinary loss.

Additionally, the proposed provision should specifically delegate Treasury authority to write regulations to ensure that the provision functions properly. In particular, the rules for allocation of unrecaptured losses should provide for attributing recapture of such losses to the carried interest that had generated them to the extent that that carried interest later has carried interest income, and it should provide for an allocation of carried interest income from other carried interests to a carried interest loss to the extent that such loss is recaptured using carried interest income from other carried interests. Cf. Treas. Reg. § 1.469-1T (2010).

78. The purpose of renumbering Proposal I.R.C. § 710 is to provide a more logical framework to the provision and its location with respect to the general organization of the Internal Revenue Code. Because my proposed recharacterization is a partner-level recharacterization, it is more analogous to an accounting method than a partnership item. Technically, I.R.C. § 484 would be most appropriate because Proposed I.R.C. § 710 is an adjustment. I.R.C. § 449 would be more appropriate than I.R.C. § 470A because Proposed I.R.C. § 710 is closer to an accounting method than a deduction. However, numbering Proposed I.R.C. § 710 as I.R.C. § 470A would place it near the At-Risk and Passive Loss rules, upon which it is modeled. Additionally, the partnership reporting requirement could be logically labeled I.R.C. § 710. Any such reporting requirement should be required for any disproportionate allocation of partnership income. However, actual tax treatment of the disproportionate allocation should be determined at the partner level.

One additional benefit of modeling carried interest reform on the At-Risk and Passive Loss Rules is that C corporations can be easily excluded from their application. Alternatively, if there is concern that closely held C corporations could become a source of abuse, then that too can be directly targeted by modeling carried interest reform on the At-Risk Rules. See, e.g., I.R.C. §§ 465(a)(1), 542(a)(2) (2006).

79. There might be some incidental spillover impacts on non-carried interest partners due to economic reallocations, but such changes might be inevitable. By focusing on partner-level recharacterization rather than partnership-level recharacterization, my proposal limits the impact of the carried interest reform legislation to economic reallocations and spillover effects rather than encompassing tax adjustments as well.

Third, carried interest reform should ensure that investors are not entitled to a deduction at ordinary income rates for carried interest earned by fund managers.<sup>80</sup> Providing for recharacterization at the partner level, rather than at the partnership level, will ensure that no such deduction is allowable.<sup>81</sup>

Fourth, as a practical matter, carried interest recharacterization should be limited to investment services partnerships, which exclude partnerships that meet certain statutory safe harbors. In theory, investment services partnerships should not include partnerships engaged in active trades or businesses (other than management of investments) and should also exclude partnerships that meet an asset test (i.e., at least a certain (determinable) percentage of their assets are non-investment assets). Care should be taken to ensure that expansions of existing businesses and stock of certain qualified subsidiaries (which should be carefully defined) are excluded from recharacterization, while stock of portfolio companies is subject to carried interest recharacterization.

Fifth, carried interest taxation legislation should affirmatively and succinctly address international tax consequences. Legislation should explicitly state that carried interest income retains its underlying character for purposes of Subpart F,<sup>82</sup> and particularly, the Foreign Personal Holding Company Income (FPHCI) regime.<sup>83</sup> Although nothing explicitly indicates that this would not be the case, explicitly indicating the appropriate tax treatment will forestall potential challenges associated with management of funds by means of foreign corporations. Affirmatively addressing international tax consequences will also ensure that carried interest income is generally treated as passive income for Passive Foreign Investment Company (PFIC) purposes.<sup>84</sup> Additionally, carried interest tax legislation

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80. This is a source of concern because without such an adjustment most carried interest reform could be tax neutral with respect to taxable investors and would only be revenue positive with respect to tax-exempt investors (who would not benefit from a deduction). *See, e.g.,* Jones, *supra* note 1, at 680 n.15 (citation omitted); Rosenzweig, *supra* note 1, at 732; *supra* note 1 and accompanying text.

Generally speaking, if carried interest is merely allocated from income then it does not provide an actual tax deduction, but rather, it provides a reduction in income resulting in reduced revenue via an opportunity cost. While some proposals would avoid permitting investors a deduction for carried interest earned by fund managers, *see, e.g.,* Rosenzweig, *supra* note 1, others might not, and providing for a recharacterization at the *partner* level would certainly avoid providing the *partnership* with a deduction for carried interest earned.

81. *See supra* note 79 and accompanying text.

82. I.R.C. §§ 951–65 (2006).

83. I.R.C. § 954(c).

84. I.R.C. §§ 1291–98 (2006). I.R.C. § 1297(b)(1) provides that passive income for PFIC purposes generally tracks the definition of I.R.C. § 954(c) (FPHCI). Generally, speaking, the PFIC tax regime is intended to discourage the use of foreign corporations as passive investment vehicles, and to

should either (a) explicitly provide that recharacterization of income for purposes of carried interest taxation does not affect the character of income for determining whether it is fixed or determinable, annual or periodical (FDAP) for purposes of withholding taxes, or alternatively, (b) expressly provide for treatment of carried interest income as Effectively Connected Income (ECI) (or perhaps both, such that—to the extent that actual investment management occurs outside the U.S.—U.S. source income could be subject to FDAP withholding).<sup>85</sup>

The broad goals of economic neutrality and horizontal and vertical equity can be promoted in the carried interest context by exempting C corporations from the proposed carried interest taxation regime, by evaluating carried interest taxes (and applying recharacterization and loss suspensions) at the partner level, and by addressing non-investment partnerships and international tax considerations. By focusing carried interest tax legislation on partner-level recharacterization rather than partnership-level adjustments, economic distortion should be minimized. The investment fund managers' focus should then revert to managing their

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punish taxpayers who seek to avoid the Subpart F regime. Permitting carried interest income that would otherwise be passive income (for PFIC purposes) to be recharacterized as non-passive income could enable a perverse result by enabling recipients of carried interest income to avoid PFIC taxation to which they would otherwise be subject.

85. Cf. I.R.C. §§ 871(a), 881(a), 882 (2006). FDAP is shorthand for interest, dividends, rents, wages, or other income (but not capital gains) earned by nonresident aliens and foreign corporations from U.S. sources. Generally, FDAP is subject to a withholding tax of 30 percent of the gross amount of the income earned, but this may be reduced by tax treaties. ECI is generally exempt from withholding and gross-income taxation, but is subject to U.S. taxation on a net-income basis, and foreign corporations receiving ECI must generally file U.S. corporate federal income tax returns. In order to ensure that this result is feasible, Congress might need to explicitly provide a limited override of I.R.C. § 864(b)(2) (2006). Such an override should automatically override regulations promulgated under I.R.C. § 864, e.g., Treas. Reg. § 1.864-2 (2010).

This is only a brief summary of some of the international tax consequences associated with carried interest tax reform. For a more thorough analysis, see Rosenzweig, *supra* note 1, at 746–55. Professor Rosenzweig provides a particularly insightful analysis as to why neither funds nor their managers would likely expatriate (and correspondingly, why fund managers are unlikely to renounce their U.S. citizenship) in order to avoid higher taxes resulting from carried interest reform. In short, individuals are likely to value the benefits of U.S. citizenship. These benefits include the opportunity to work in and travel to the U.S. (people who renounce citizenship for tax purposes may be denied entry into the U.S., 8 U.S.C. § 1182(a)(10)(E) (2006)). Furthermore, funds' activities in managing U.S. companies may be sufficient to establish either a U.S. trade or business (in the absence of a tax treaty) or a Permanent Establishment (in the presence of a tax treaty), either of which would subject them to U.S. taxation on their U.S. profits. See Rosenzweig, *supra* note 1, at 746–55. Because many investors in funds may be tax-exempt (and therefore not subject to tax on their investments in a partnership as long as they avoid UBTI), a manager might have trouble convincing tax-exempt entities to invest in a fund which will be subject to an entity-level U.S. income tax. See *id.*; see also United States Model Income Tax Convention art. 5, Nov. 15, 2006 (defining “Permanent Establishment”); OECD Articles of the Model Convention with Respect to Taxes on Income and Capital ch II, art. 5, July 15, 2005 (defining “Permanent Establishment”).

clients' portfolios in a manner that promotes client wealth-maximization rather than manager tax-minimization.

#### IV. TAX POLICY CONSIDERATIONS

As a general consideration, it should be noted that Congress can—and in certain limited instances has—provided for particular disfavored or punitive tax treatment for certain forms of income or income derived from particular conduct.<sup>86</sup> However, such instances should be, and generally are, limited to instances in which the income or conduct targeted is considered particularly violative of Congressional tax policy or societal norms and goals.<sup>87</sup> Because earning carried interest neither violates Congressional tax policy nor societal norms and goals, it would be inappropriate to subject carried interest to any punitive tax treatment. Rather, the harshest treatment to which it should be subject is taxation as ordinary income, rather than long-term capital gains.

There is, however, an opportunity to use carried interest taxation as a “carrot” to promote broader economic policies. As discussed in Part I.A,<sup>88</sup> tax policy has many competing goals. Many of these goals may incidentally or intrinsically conflict. Tax policy, however, is only one half of the fiscal policy equation.<sup>89</sup> The other half of the equation is the expenditure and, more broadly, the economic stability and growth side of

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86. Congress has done this by means of denying deductions, denying credits, or subjecting income to specific additional taxes. For an example of denial of deductions, see I.R.C. § 162(c) (2006) (denying deductions on bribes and kickbacks); I.R.C. § 162(f) (2006) (denying deductions on fines and penalties); I.R.C. § 162(m) (2006) (limiting deduction for salary paid to certain highly compensated employees of publicly traded corporations and denying deductions for salaries in excess of \$1,000,000); and I.R.C. § 280E (2006) (denying any deductions from gross income for expenses paid in connection with trades or businesses associated with illegal drugs). For an example of denial of credits, see I.R.C. § 908 (2006) (reducing foreign tax credits relating to participation in, or cooperation with, certain unsanctioned international boycotts). For an example of imposition of additional taxes, see I.R.C. § 531 (2006) (Accumulated Earnings Tax); and I.R.C. § 5881 (2006) (excise tax on greenmail).

87. See *supra* note 86 and accompanying text. The only provision amongst those discussed that does not address an explicitly perceived societal ill is the tax on improper accumulation of earnings. Much of the reasoning in support of this tax is that it is intended to discourage taxpayers from avoiding income taxes at the shareholder level by failure to pay dividends. In effect, the additional tax is in place in order to discourage taxpayers from avoiding taxes that the government has imposed by means of timing.

88. See *supra* notes 6–28 and accompanying text.

89. See *supra* note 8 and accompanying text. From a fiscal policy perspective, tax policy may generally be considered the revenue raising half of the equation. Tax policy considerations generally deal with how to raise revenue in the fairest way possible. See *supra* Part I.A.

fiscal policy.<sup>90</sup> I posit that an optimal carried interest taxation regime will not focus only on the myopic goal of short-term revenue maximization,<sup>91</sup> but rather, will consider both the economic effects that might naturally result from a standardized carried interest tax rate, as well as the opportunity for Congress to apply a “directed” tax rate to carried interest income in order to promote targeted nontax fiscal policy objectives.

It is worth considering whether certain funds, or certain investments, should be exempt from carried interest tax reform (i.e., permitted to retain the usage of long-term capital gains rates). Often, funds whose managers earn carried interest are divided into three general groupings: hedge funds, private equity funds, and venture capital funds.<sup>92</sup> Hedge fund managers are often ineligible for preferential long-term capital gains rates on carried interest due to the fact that many hedge funds focus on short-term trading. Accordingly, because hedge funds often sell much of their investments within one year of purchase, long-term capital gain taxation is often unavailable.<sup>93</sup> Private equity and venture capital fund managers are often

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90. This other half of the fiscal policy equation can generally be conceptualized as consisting of economic stability, price stability (i.e., low and “acceptable” inflation), economic growth (i.e., increasing GDP), and low unemployment.

91. See, e.g., Jude Wanniski, *Taxes, Revenues, and the “Laffer Curve”*, PUB. INT., Winter 1978, at 3, available at [http://www.nationalaffairs.com/doclib/20080528\\_197805001taxesrevenuesandthelaffercurvejudewanniski.pdf](http://www.nationalaffairs.com/doclib/20080528_197805001taxesrevenuesandthelaffercurvejudewanniski.pdf) (the famous/infamous “Laffer Curve,” which posits that increasing marginal tax rates always reduces economic activity and growth, and increasing marginal tax rates in excess of some particular rate will result in decreased tax revenues, due to a combination of willful noncompliance and decreases in economic activity); Arthur B. Laffer, *The Laffer Curve: Past, Present, and Future*, HERITAGE FOUND. BACKGROUNDERS, June 1, 2004, available at <http://www.heritage.org/Research/Reports/2004/06/The-Laffer-Curve-Past-Present-and-Future#pgfId-1121173> (discussing the Laffer Curve and historical and recent data). There is still considerable debate amongst economists as to whether maximizing tax rates results in maximum tax revenues, and if not, which tax rate will maximize tax revenues. From a conceptual perspective, because taxes can impair economic growth and development, one should never apply a tax rate higher than the revenue-maximizing tax rate. In such an instance, one is both reducing tax revenues and retarding economic growth. However, because at lower tax rates there is a tradeoff between economic growth and taxes, one might (and often does) choose a tax rate below the tax revenue-maximizing rate. To the extent that some resources might be somewhat inflexible (e.g., they exhibit a degree of short-term economic inelasticity such as tax-inelasticity), a tax policy could result in a short-term tax revenue maximization tax rate greater than the long-term tax revenue maximizing tax rate.

92. See Rosenzweig, *supra* note 1, at 714–15.

93. See I.R.C. §§ 1(h), 1221, 1222(3), 1223 (2006) (capital gains preferences); see also Rosenzweig, *supra* note 1, at 733. *But cf.* Jones, *supra* note 1, at 680–81 (noting that both private equity fund managers and hedge fund managers obtained favorable tax rates). However, it is worth noting that conceptually, hedge fund managers should not be entitled to any more favorable tax treatment than private equity fund managers. As such, recharacterization of hedge fund carried interest income as ordinary income will deny hedge fund managers the benefit of offsetting such carried interest income with capital losses. Additionally, if a hedge fund holds an investment for longer than one year, then carried interest associated with that investment may be eligible for long-term capital gains rates.

the primary beneficiaries of the current carried interest regime. However, conceptually, private equity funds are very different from venture capital funds. Venture capital funds tend to invest in early-stage companies, whose success is far from certain. They may invest in new ideas, concepts, or technologies. They also often improve the likelihood that their investments will succeed by helping founders network and attract additional talent, and sometimes providing other services. Lastly, they tend to only purchase an interest in a company, rather than a controlling stake.<sup>94</sup> Private equity funds, on the other hand, tend to invest in more mature enterprises, often engage in larger transactions, and often seek controlling stakes in their investments.<sup>95</sup> Accordingly, venture capital funds might provide significant societal benefits (“spillover benefits”), whereas private equity funds might not.<sup>96</sup> Therefore, it might be appropriate to permit venture capital funds to retain current-law carried interest tax preferences, while limiting the availability of such preferences for private equity funds.

An objective test should be utilized to effectively distinguish venture capital funds from private equity funds and hedge funds. Such a test can establish a bright-line rule, so a fund manager can easily determine whether his or her carried interest should be recharacterized on his or her individual income tax return.

Fortunately, various Internal Revenue Code provisions already provide models for objective tests which could be applied to distinguish venture

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94. See, e.g., LINS ET AL., *supra* note 31, § 12:2. Lins groups venture capital funds as a subset of private equity funds. While most do not include venture capital funds within the private equity space, a strong case could be made that a venture capital fund is, in fact, a form of a private equity fund. For purposes of my proposal, however, this nuance is superfluous because I propose evaluating funds based upon their investments (and objective characteristics related thereto) rather than according to mere labels. See *infra* notes 96–99 and accompanying text.

95. See, e.g., LINS ET AL., *supra* note 31, § 12:1. Many private equity funds are permitted to only invest in controlling stakes in companies by the terms of their offering and operating documents. *Id.*

96. By enabling new technologies and ideas to reach the market, venture capital funds may increase the availability of technologies for consumers, or alternatively, might increase overall societal efficiency by helping a novel or improved technology enter the mainstream market. This is not to say that venture capital funds ignore profits (they do not), but rather, that their activities provide benefits to society as a whole. On the other hand, private equity funds are often more focused on profit. Because private equity funds often focus on finding opportunities for profit in more mature companies, they often focus more on “cost-cutting” and “right-sizing.” Such activities, while potentially necessary to earn a profit, often result in job losses and reduced product availability. In particular, such focuses can result in offshoring, reducing employment in the U.S. and shifting jobs to other countries. This conduct often results in spillover costs to society, such as the demand for public funds to pay unemployment compensation (increased fiscal outlays), reduced income due to job losses (and a corresponding reduction in income tax revenue and decreased fiscal receipts), and other structural inefficiencies due to the need for terminated workers to learn new skills (inefficiencies associated with the start of a new learning curve). See *generally id.* at 12:1–2.

capital carried interest from private equity carried interest.<sup>97</sup> A proper test should focus on investments in individual companies, and should permit a fund manager to be eligible for long-term capital gains from the carried interest attributable to any sale or other disposition of stock of that individual corporation if the issuer had issued not more than a stipulated threshold of capital stock at the time of the venture capital fund's investment—provided that the fund directly invested in the company.<sup>98</sup> Such a provision should not be limited solely to venture capital funds because it would be wasteful to distinguish between venture capital funds and private equity funds. Rather, by focusing on the individual investee corporations, Congress can ensure investments that are deemed generally beneficial to society are eligible for long-term capital gains rates on carried interest.<sup>99</sup>

Additionally, as discussed in Part I,<sup>100</sup> investment fund managers (particularly private equity fund managers) often have the opportunity to wield inordinate influence over vast swaths of the U.S. economy. This is neither a virtue nor a vice, but rather, it is the state of the world. This situation presents a unique opportunity. Rather than applying a standardized tax rate to all carried interest income, Congress should consider providing that carried interest income will *generally* be taxed as ordinary income. If a particular fund meets certain specific policy objectives, then its managers might be permitted to treat a portion of its

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97. See, e.g., I.R.C. § 1202(d) (2006) (providing for certain modified capital gains preferences and limiting such preferences to C corporations with not more than \$50,000,000 in gross assets); I.R.C. § 1244(c)(3) (2006) (providing for limited ordinary loss treatment with respect to certain corporate stock and limiting such treatment to the first \$1,000,000 of stock issued).

98. The actual threshold could be determined by statute or Treasury regulation, but it should be based on the total amount of capital stock typically issued by a small company that receives venture capital financing immediately after it has completed its final round of venture capital financing.

Congress may also decide to impose additional requirements in its test. For example, it might require that gross receipts of the issuer have never exceeded a certain threshold or that the issuer corporation not have been in existence for more than a threshold time period. If such additional tests are imposed, anti-abuse provisions might be advisable in order to ensure that only certain investments can enable fund managers to obtain long-term capital gains rates on carried interest income. However, Congress should, at a minimum, impose the capital stock test because the test may be less subject to abuse (and Congress should consider whether additional requirements are advisable).

99. It is worth noting that some investments made by a venture capital fund might be ineligible for preferential rates under this provision, and alternatively, that some investments by private equity funds or hedge funds might qualify. This should not be a concern because the focus of this provision should be to promote investments that are likely to produce societal benefits. In addition, because venture-stage companies are often riskier investments than mature companies, tax subsidies in the form of preferential rates may be appropriate in order to encourage investment by increasing the mathematical expected after-tax return.

100. See *supra* note 4 and accompanying text.



carried interest income as being exempt from recharacterization.<sup>101</sup> This can enable Congress to honestly (for once) say it is not merely providing a favored constituency with a coveted tax break, but rather, that the constituency has, in fact, earned that tax break in exchange for providing a far greater benefit to the public. Exactly which policy objectives should be entitled to such a break is a matter for Congress to decide, but hypothetically, one example might be increasing, by a certain percentage, the headcount of (legal) U.S. workers earning 300 percent of the poverty income rate at investment companies (perhaps as reported in the form of W-2 wages).<sup>102</sup> In order to ensure that policy goals are the focus, Congress should generally enact broad guidelines, and Treasury should draft regulations to implement the broad Congressional mandate. Some of the Treasury guidance should specifically quantify what qualifies as meeting Congressional mandates.<sup>103</sup> Especially with respect to funds that can exercise control of portfolio companies, fund managers may be able to significantly aid Congress in achieving broad national goals. All it might take is a small nudge, and the “carrot” of non-recharacterization of carried interest income might be sufficient.

Taken as a whole, my proposed legislation would generally provide for partner-level recharacterization of carried interest income as ordinary income, but only for individual (or non-C corporation) partners who are partners in investment services partnerships. However, my proposal would also permit carried interest derived from venture-capital-type investments and from certain limited private-equity-type investments to avoid recharacterization. I would also recommend enacting the SECA/FICA reform embodied in the provisions related to Proposed I.R.C. § 710.<sup>104</sup>

Lastly, my proposal focuses on supporting broader fiscal policies, as opposed to merely tax policies. Accordingly, the portion of my proposal which generally provides for ordinary income tax treatment for carried interest (my “general proposal”) promotes horizontal equity, vertical equity, and economic neutrality. My general proposal promotes horizontal equity by taxing investment fund managers at the same rates as other

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101. That is to say, as retaining its original character.

102. Most of the focus of this proposed Internal Revenue Code provision will be targeted towards private equity funds. A fund should have a minimum ownership in each portfolio company that should be sufficient to enable it to exercise a degree of influence, if not outright control.

103. An example of some guidance might be minimum percentage increases, as well as baseline periods for measuring headcount in order to determine the amount by which headcount increased.

104. H.R. 4213, 111th Cong. §§ 412(d), 413 (as engrossed by House, May 28, 2010).

service providers.<sup>105</sup> My general proposal promotes vertical equity because it eliminates a regressive element of the tax code, thereby promoting a trend towards progressivity (and a direct push towards a more proportionate system). My general proposal promotes economic neutrality because it eliminates an incentive to establish one type of investment vehicle (LLC/LP investment fund with carried interest) over others.<sup>106</sup> My general proposal does not promote administrability compared to the status quo, but based upon the information reporting requirements, it should be reasonably administrable. Lastly, my general proposal also does not promote compliance compared to the status quo, but it should promote compliance when coupled with the information reporting requirements.

My targeted proposal (which provides for retention of current tax treatment for specific investments), however, provides specific economic incentives to fund managers who either invest in venture capital-type investments, or who actively promote specific Congressional fiscal policy objectives. In doing so, it slightly contributes to horizontal inequity (by treating some similarly situated taxpayers slightly differently) and vertical inequity (by providing lower income tax rates to some wealthy and high-income individuals), and it also contravenes economic neutrality (due to the incentivization) when compared to the status quo (but not when compared to my general proposal). My targeted proposal is also slightly more difficult to administer, and it might provide a small incentive towards non-compliance due to the opportunity for lower tax rates (and the fact that some might seek to obtain the benefits of those incentive rates without meeting the requirements to be entitled to such rates). However, my targeted proposal also promotes economic growth, economic stability, and increased employment. Because my general proposal applies to those who do not meet the requirements for my targeted proposal, I believe that my comprehensive proposal (both general and targeted components) should generally promote tax policy goals (for most fund managers, by application of my general proposal), and that it balances general fiscal

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105. *But see* Postlewaite, *supra* note 1, at 767–68. I disagree with Professor Postlewaite’s analysis regarding optimal taxation of carried interest (Professor Postlewaite appears to generally favor the status quo) because the other forms of equity he evaluates (grant of corporate stock and grant of partnership capital interest) have both been subject to tax as ordinary income prior to being entitled to long-term capital gains rates. By way of contrast, the grant of a partnership profits interest is not subject to taxation upon receipt. *See supra* note 36 and accompanying text. Therefore the recipient of such an interest is not similarly situated to a person who is subject to tax upon receipt of an equity interest.

106. More notably, it eliminates a theoretical, artificial incentive to pursue a career as a fund manager over a different professional career.

policy considerations in promoting critical fiscal policy goals at the expense of certain tax policy goals (with respect to certain taxpayers who act as stewards to promote those fiscal policy goals, by application of my targeted proposal).

#### V. CONCLUSION

Carried interest taxation is a very dynamic area of evolving tax policy. Although carried interest taxation is rapidly changing, it is important to remember that, while carried interest should generally be taxed as compensation income, it might be appropriate to provide fund managers with preferred tax rates to the extent that such an incentive can assist Congress in achieving broader policy objectives.

Congress must also be aware of the significant pitfalls attendant to any proposed changes to carried interest taxation. As soon as Congress enacts carried interest reform, fund managers will seek advice as to how to minimize the tax impact of the legislation, and practitioners will begin the process of planning to minimize its impact on their clients.<sup>107</sup> Therefore, as a practical matter, it is critical that the carried interest reform ultimately enacted be both robust enough to prevent abuse and focused enough to avoid causing collateral damage (by affecting too many taxpayers or taxpayers other than those Congress intended). Proposed I.R.C. § 710, as it currently stands, is far too broad because it will adversely impact corporations engaged in general trades or businesses (businesses other than investment management), and it may also reduce the number of investment options available to sophisticated investors. At the same time, although Proposed I.R.C. § 710 might impose an increased tax burden on carried interests in existing funds, new funds will likely be able to plan around it, either through new compensation structures which do not constitute investment services partnership interests, or through other planning techniques.

My carried interest tax reform proposal promotes both tax policy and broader fiscal policy by balancing the interests of a conceptually ideal tax framework against fiscal pragmatism; however, to the extent that there is a tension between the two, my proposal promotes broader fiscal policy at the expense of general tax policy principles. The most efficient method of reforming carried interest taxation is by means of partner-level recharacterization, because this avoids any collateral tax impact on other

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107. This process will actually begin as soon as any carried interest reform proposal is unveiled.

partners in the partnership. However, because some fund managers invest in companies that are very risky but provide significant spillover benefits to the economy, and others are in a position to more directly improve the U.S. economy by means of improving employment and wages, pragmatism suggests that extending the opportunity for such fund managers to be subject to preferential capital gains rates on their carried interest income will promote broader fiscal goals. My proposal is therefore an appropriate compromise in the context of carried interest taxation reform.

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\* J.D. Candidate (2012), Washington University; B.S. (2007), University of Virginia, McIntire School of Commerce. I would like to express my sincere gratitude to my family, friends, co-workers, colleagues, and the editors of the Law Review for their comments and suggestions in the development of this Note. Any and all errors in this Note are solely my own.