

# Not All Carried Interests Are Created Equal

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*Abstract: Recently, a significant debate over the taxation of so-called "carried interest" in private equity funds has received much attention from scholars, the government, commentators, and the media. This debate has focused on whether private equity fund managers who earn a percentage of the returns generated by the fund should be entitled to preferential "capital gain" treatment on such returns. The primary concern in this debate revolves around whether managers are effectively being compensated for services normally taxed at higher rates while receiving the benefit of preferential rates reserved for capital gains. Proponents of reform point to the services being performed by the managers, while proponents of the current system point to the investment exposure to the underlying assets of the fund. In reality, however, both sides are partially correct: carried interest is "blended" in that it represents both a return to services and a return on capital. Since carried interest is blended in this manner, an analogy to either proves less than satisfying.*

*The issue of blended labor/investment returns is not new to the tax laws, however. Historically, one way the law has attempted to address the issue was not by deconstructing such returns into constituent parts, but instead by imposing a "holding period" requirement. Under this approach, not all capital investments are created equal; rather, only capital investments held for an arbitrary period of time while bearing the risk of loss qualify for preferential rates. The current debate over the taxation of carried interest in private equity has failed to incorporate this element into the analysis, i.e., the role that holding period plays in denying preferential rates to blended labor/investment returns, such as carried interest. This Article will do so, concluding that, to the extent any reform of the taxation of carried interest within the existing framework of the income tax is appropriate, a better approach may be through the application of the holding period rules rather than through current proposals to either change the definition of capital gains or further complicate the partnership tax rules.*

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## I. INTRODUCTION

Recently, a significant debate over the taxation of so-called “carried interest” in private equity funds has received much attention from scholars, the government, commentators, and the media—both within and without the United States.<sup>1</sup> This debate has focused on the treatment of carried interest as capital gain for the managers of private equity funds. In particular, it has focused on whether private equity fund managers who earn a percentage (typically twenty percent) of the gains generated by the investments held by the fund should be entitled to capital gain treatment (entitled to preferential tax rates) rather than ordinary income treatment on such largesse. The debate has generally been comprised of two separate but related points: (1) whether carried interest is properly analogized to “sweat equity”—that is, return on entrepreneurial effort—or salary (in this case, compensation for money management),<sup>2</sup> and (2) if so, whether the tax rules applicable to partnerships are the proper fora for addressing this issue.<sup>3</sup>

Often overlooked in this debate is that the tax treatment of managers of different types of private investment funds, including not only private

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the Symposium. Any errors are solely those of the author.

<sup>1</sup> See, e.g., JOINT COMM. ON TAXATION, PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS 6 (2007) [hereinafter JCT CARRIED INTEREST REPORT]; Bradley T. Borden, *Profits-Only Partnership Interests*, 74 BROOK. L. REV. (forthcoming 2009); Noël B. Cunningham & Mitchell L. Engler, *The Carried Interest Controversy: Let's Not Get Carried Away*, 61 TAX L. REV. 121; Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1 (2008); Matthew A. Melone, *Success Breeds Discontent: Reforming the Taxation of Carried Interests: Forcing a Square Peg into a Round Hole*, 46 DUQ. L. REV. 421 (2008); Philip F. Postlewaite, *Fifteen and Thirty Five: Class Warfare in Subchapter K of the Internal Revenue Code: The Taxation of Human Capital Upon the Receipt of a Proprietary Interest in a Business Enterprise*, 28 VA. TAX REV. (forthcoming 2009); David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 VA. L. REV. 715 (2008); *New Worries About Private Equity*, ECONOMIST, June 23, 2007, at 63; Robert Peston, *Tax and Private Equity*, BBC, June 15, 2007, [http://www.bbc.co.uk/blogs/thereporters/robertpeston/2007/06/tax\\_and\\_private\\_equity.html](http://www.bbc.co.uk/blogs/thereporters/robertpeston/2007/06/tax_and_private_equity.html) (“in the UK, MPs . . . are sending out a strong signal that they want private equity firms’ ‘carry’—their share of the capital gains made on the investments made by their funds—taxed at a higher rate than the prevailing 10%.”); Howard E. Abrams, *Carried Interests: The Past Is Prologue* (Emory U, Law & Econ. Research Paper Series, No. 08-32), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1085582](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1085582).

<sup>2</sup> Sweat equity is often thought of in terms of small business owners whose work effort increases the value of the business, which can then be sold for capital gain. Chris William Sanchirico, *Taxing Carried Interest: The Problematic Analogy to “Sweat Equity,”* 117 TAX NOTES 239, 240–42 (2007).

<sup>3</sup> See Postlewaite, *supra* note 1; Abrams, *supra* note 1, at 1; see also Howard E. Abrams, *Taxation of Carried Interests*, 116 TAX NOTES 183 (2007). In addition, another related but distinct issue recently discussed in the literature has been the “conversion” of management fees into carried interest. See Gregg D. Polsky, *Private Equity Management Fee Conversions*, 122 TAX NOTES 743 (2009).

*Not All Carried Interests Are Created Equal*  
29:713 (2009)

equity funds but also venture capital and hedge funds, is not necessarily the same. The debate has tended to group these funds together, mostly because the managers of each tend to charge some form of percentage fee based on the performance of the fund (the so-called “two and twenty”).<sup>4</sup> Each is significantly different, however, not only in its business model but also in its tax treatment. Most notably, the tax treatment of the equivalent of carried interest in most hedge funds raises little of the same preferential rate concerns that plague carried interests in private equity funds, precisely because *even under current law* the profits paid to hedge fund managers are generally not entitled to preferential rates.

The question that follows is: if the concern is over preferential rates for carried interest, why is there such a problem with the taxation of carried interest for private equity but not for other private funds? This Article contends that the answer lies in the failure of the carried interest debate to incorporate a crucial element into the analysis, i.e., the role that the holding period plays in denying preferential tax rates to blended labor/investment returns such as carried interest. The primary concern over the taxation of carried interest is that managers are effectively being compensated for their services but are receiving the benefit of the preferential rates applied to long-term capital gains. On the other hand, managers do have some investment exposure to the underlying capital asset. Thus, since carried interest is “blended”—it has some components of ordinary income and some components of capital gain—an analogy to either situation proves less than satisfying.

The issue of blended labor/investment returns is not new to the tax laws, however. Historically, one way the law has attempted to address the issue was not by deconstructing such returns into constituent parts, but by imposing a “holding period” requirement.<sup>5</sup> Under this approach, not all investments are created equal; rather, only capital investments held for an arbitrary period of time while bearing the risk of loss qualify for preferential rates. It is precisely these rules that prevent managers of certain private funds, such as hedge funds, from obtaining the benefit of preferential capital gains tax rates for their carried interest in most instances. In other words, not all carried interests are created equal.

This Article will incorporate the holding period analysis into the carried interest debate, concluding that, to the extent any reform of the taxation of carried interest is appropriate (absent complete overhaul of the taxation of partnerships, repeal of the capital gains preference, or other fundamental change to the tax laws), the proper approach may well be

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<sup>4</sup> Recent work has begun to emphasize these differences in other contexts, however. See Thomas J. Brennan & Karl S. Okamoto, *Measuring the Tax Subsidy in Private Equity and Hedge Fund Compensation*, 60 HASTINGS L.J. 27 (2008).

<sup>5</sup> See *infra* Section IV.

through the holding period rules rather than current proposals to either change the definition of capital gains or further complicate the partnership tax accounting rules. Not only would this more closely conform with the historical approach to blended returns and capital gains, and more closely fit within the existing tax regime, but it could also be less problematic than other current proposals with respect to incentives for private equity funds (or their managers) to move offshore to escape U.S. taxation altogether. As a result, the holding period approach could bridge the divide between two sides of a debate which have often talked past each other: reformers who want to impose higher rates on carried interest and those who note reform could cause more harm than good under the current structure of the income tax.

Section II of this Article will briefly summarize the structure of private equity and hedge funds and compare and contrast the carried interest in private equity and incentive fees in hedge funds so as to frame the role holding period plays. Section III will then summarize the current debate over carried interest, and discuss how current law applies to hedge funds to deny preferential rates. Section IV will analyze the policy behind the holding period requirement for long-term capital gains and explain why, as a normative matter, carried interest could be treated as short-term capital gain within this framework, both from a domestic and international standpoint. Section V will then discuss why, as a positive matter, the holding period approach would be an easier, more administrable means to address the concern over the taxation of carried interest under current law than other proposals.

## II. THE STRUCTURE OF PRIVATE EQUITY AND HEDGE FUNDS

Much has been written on carried interest and the structure and business model of private equity funds. This Article will not attempt to recreate such discussions in detail, but rather will briefly describe the structure of private equity funds for the purposes of comparing and contrasting them with hedge funds, thus framing the role that holding period plays in denying preferential rates to blended returns.

Both private equity and hedge funds are forms of private investment funds, or pools of money brought together in a non-regulated entity to make investments on behalf of the investors. All private investment funds share certain fundamental similarities: they raise money privately rather than through the public capital markets, the money is pooled and invested by managers who attempt to earn returns in excess of the market as a whole, and the managers charge a fee equal to a percentage of the gains generated on the investments.<sup>6</sup> Beyond these similarities, however, different types of

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<sup>6</sup> See JCT CARRIED INTEREST REPORT, *supra* note 1, at 34–36.

*Not All Carried Interests Are Created Equal*  
29:713 (2009)

private investment funds can differ significantly from an economic, business model, and tax perspective.

Private equity funds are generally those funds for which the business model is to use leverage to acquire controlling interests in portfolio companies, and to increase their value for the purpose of a future sale.<sup>7</sup> The increase in value may result from several reasons, including a more efficient capital structure, a more efficient management team, a better compensation structure, or simply through operating synergies or other more traditional strategic business models. Regardless, the intent of the private equity fund is to acquire control of a portfolio company, increase its value, and then monetize the investment within a relatively short time-frame, typically one to five years from the time of acquisition.<sup>8</sup>

Hedge funds, on the other hand, are less well-defined. Hedge funds are often referred to as lightly regulated pools of investment capital.<sup>9</sup> This definition misses the crucial defining characteristic of hedge funds, however: hedge funds are those private investment funds which seek to exploit small arbitrage or mispricing opportunities in the market, and to profit from them through the use of leverage.<sup>10</sup> Thus, rather than acquire controlling interests in companies, hedge funds engage in numerous investment activities such as trading of securities and derivatives, betting on the arbitrage of a proposed merger, providing liquidity to capital markets, or exploiting unperceived market arbitrages.<sup>11</sup> Regardless of the particular business model, hedge funds do not, as a general matter, profit from acquiring controlling interests in companies with the intent to create excess returns through implementing changes in the particular company.<sup>12</sup> As a result, hedge funds rarely hold investments for more than a short period of time or with any significant exposure to long-term price fluctuations.

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<sup>7</sup> *Id.* at 34.

<sup>8</sup> See Fleischer, *supra* note 1, at 8–9.

<sup>9</sup> See, e.g., HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT: REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS (1999), available at <http://www.ustreas.gov/press/releases/reports/hedfund.pdf>; INT'L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: MARKET DEVELOPMENTS AND ISSUES (Sept. 2004) [hereinafter GLOBAL FINANCIAL STABILITY REPORT]; SEC STAFF REP., IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS (Sept. 2003), available at <http://www.sec.gov/news/studies/hedgefunds0903.pdf>.

<sup>10</sup> Weisbach, *supra* note 1, at 726. See generally René M. Stulz, *Hedge Funds: Past, Present and Future*, 19 (Fisher C. Bus. Working Paper Series, No. 2007-03-003, 2007), available at <http://www.ssrn.com/abstract=939629> (“The skill of a hedge fund manager is required to produce alpha returns, but not to take beta risk.”).

<sup>11</sup> See Henry Ordower, *Demystifying Hedge Funds: A Design Primer*, 7 U.C. DAVIS BUS. L.J. 323, 366–70 (2007) (discussing investment policies and objectives of, and use of leverage by, hedge funds).

<sup>12</sup> See Weisbach, *supra* note 1, at 726; Andrew W. Needham & Christian Brause, *Hedge Funds*, 736 TAX MGMT., A-1, A-7 (2007).

The typical private equity fund is formed as a limited partnership.<sup>13</sup> The limited partnership issues limited partner interests to capital investors and the general partnership interest to an affiliate of the management team (the GP).<sup>14</sup> The management team operates through a management company which typically does not own any interest in the partnership, but does enter into an agreement with the partnership to provide management services in exchange for a fee (often two percent of the committed capital annually).<sup>15</sup> This fee paid to the management company is ordinary fee income and is generally used to pay administrative salaries, overhead, and other costs of operating the fund.<sup>16</sup>

The GP is an affiliate of the management company and invests some amount of capital in the partnership, typically one percent of the total committed capital, and also receives the right to share in a percentage, typically twenty percent, of the profits of the fund, if any.<sup>17</sup> This interest, usually referred to as the "carried interest," represents a right to share in future profits.<sup>18</sup> If the partnership were liquidated before making any investments, the carried interest would only be entitled to the initial invested capital as a distribution of assets and would receive nothing with respect to the profits interest.<sup>19</sup>

The carried interest of a private equity fund is structured so as to share in the total profits over the lifetime of the fund (limited to a fixed period, e.g., ten years).<sup>20</sup> The fund will typically make multiple investments in portfolio companies over the life of the fund, and will monetize a number of them well before the end of the life of the fund.<sup>21</sup> The income from these investments is divided among the partners of the fund as if it represented the total income from the fund.<sup>22</sup> Thus, upon the sale of the first portfolio company, a GP may be entitled to twenty percent of the gain even if the fund may lose money on future investments. As a result, certain private

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<sup>13</sup> JCT CARRIED INTEREST REPORT, *supra* note 1, at 2; Fleischer, *supra* note 1, at 8.

<sup>14</sup> Fleischer, *supra* note 1, at 8. The GP tends to be a partnership for tax purposes, ultimately owned by taxable individuals eligible for preferential capital gains rates. For purposes of simplicity, this Article will refer collectively to the "GP" to encompass both the entity and its owners.

<sup>15</sup> *Id.*

<sup>16</sup> See Postlewaite, *supra* note 1 (manuscript at 33).

<sup>17</sup> Fleischer, *supra* note 1, at 8.

<sup>18</sup> *Id.*

<sup>19</sup> See Postlewaite, *supra* note 1 (manuscript at 35).

<sup>20</sup> See Mark P. Gergen, *A Pragmatic Case for Taxing an Equity Fund Manager's Profit Share as Compensation*, 87 TAXES 139, 142 (2009).

<sup>21</sup> See Paul H. Asofsky, *U.S. Private Equity Funds: Common Tax Issues for Investors and Other Participants*, 630 PLI/TAX 1275, 1295-96 (2008) (referring to this as the "realized investment" model).

<sup>22</sup> *Id.*

*Not All Carried Interests Are Created Equal*  
29:713 (2009)

equity funds provide for a “clawback”—or the obligation of the GP to repay the fund for any excess carried interest it withdrew from the fund in earlier years.<sup>23</sup> In turn, the limited partners (LPs) are often subject to a “lockup”—requiring them to stay invested in the fund for the life of the fund.<sup>24</sup>

For this reason, most private equity fund GPs do not take distributions of carried interest on a current basis. Rather, cash must first be distributed to the LPs such that their capital is returned (and at times, a preferred return on capital is paid as well), and only then may the GPs receive distributions.<sup>25</sup> The one general exception is that the GP is permitted to withdraw cash advances against the carried interest from the fund to pay their personal taxes attributable to the carried interest.<sup>26</sup> These withdrawals are subject to the clawback, which makes the clawback meaningful even though the GP generally does not withdraw cash with respect to the carried interest before the LPs are paid.<sup>27</sup>

Carried interest in a private equity fund is economically similar to the LPs of the fund lending money to the GP on a nonrecourse basis to acquire a capital interest in the partnership.<sup>28</sup> That is, if the fund makes money on its portfolio investments, the GP shares in the profits only after “repaying” the loan to the LPs; in other words, the GP only receives money if the portfolio companies appreciate in excess of the LPs’ initial cost (plus a preferred return on capital in some cases). If the portfolio investments decline in value, the GP does not receive any distribution on the carried interest but at the same time does not owe anything to the LPs.

For example, assume a simplified private equity fund with one LP and one GP. The GP contributes one million dollars to the fund and the LP contributes ninety nine million dollars to the fund. The fund then acquires all of the stock of two different corporations as separate investments, each for fifty million dollars. The fund agreement provides that all proceeds will first be paid to the LP until it receives its ninety nine million dollars, and then paid to the GP until it receives its one million dollars, and then divided eighty percent to the LP and twenty percent to the GP. In year three, the first investment increases in value from fifty million to one hundred and fifty million dollars and the fund sells it for cash. First, the LP receives ninety nine million dollars, then the GP receives one million dollars, after

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<sup>23</sup> JCT CARRIED INTEREST REPORT, *supra* note 1, at 2; Weisbach, *supra* note 1, at 723.

<sup>24</sup> Needham & Brause, *supra* note 12, at A-7 (“After the initial capital commitment, an investor in a private equity fund assumes a passive role during the remaining life of the fund, waiting until the fund calls capital or sells an investment.”).

<sup>25</sup> Weisbach, *supra* note 1, at 722–23.

<sup>26</sup> Abrams, *supra* note 1, at 1.

<sup>27</sup> *Id.*

<sup>28</sup> Cunningham & Engler, *supra* note 1, at 126–27; Fleischer, *supra* note 1, at 40; Weisbach, *supra* note 1, at 734 (“The closest analogy to a profits interest is a taxpayer who takes out a nonrecourse loan.”).

which the GP receives ten million dollars and the LP receives forty million dollars of the remaining fifty million dollars. In year four, the second investment becomes worthless and the fund sells it for nothing. Over the life of the fund, the total profits were fifty million dollars—twenty percent of which is ten million dollars. Even after paying the carried interest, the LP received a return of slightly higher than forty percent on the initial capital investment, which is significantly better than most investment-based returns. The GP, on the other hand, earned a staggering return of one thousand percent on its invested capital.

Hedge funds operate in a fundamentally different manner. Since they tend to trade regularly and invest in numerous different investments, the committed capital is rarely locked-up in any significant manner (beyond perhaps an initial start-up period).<sup>29</sup> Rather, investors in a hedge fund typically have had the right to withdraw their investment, plus their share of investment returns, at regular intervals (for example, quarterly).<sup>30</sup> In turn, the hedge fund manager charges an “incentive fee” against the profits of the fund.<sup>31</sup> This incentive fee is then paid (in one way or another) to the hedge fund manager at that time; the payment is complete and not subject to any clawback or other right to claim a repayment from the investors, even if the fund loses money in the future.<sup>32</sup> Thus, investors in hedge funds own a much more liquid investment than a private equity LP interest but also are charged the equivalent of carried interest on an ongoing basis with no right to reclaim such amounts for future losses.<sup>33</sup>

Hedge funds are typically structured as multiple entities, some partnerships and some corporations; the capital is then pooled among these related entities and used to make the investments of the hedge fund.<sup>34</sup> The

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<sup>29</sup> See Needham & Brause, *supra* note 12, at A-7; see generally Ordown, *supra* note 11, at 366–67.

<sup>30</sup> In light of the recent financial crisis, however, some hedge funds have taken the extraordinary measure of limiting withdrawals or redemptions due to liquidity or financial constraints. See, e.g., Zachary Kouwe, *Hedge Fund Lets Investors Withdraw What Is Left*, N.Y. TIMES, Feb. 9, 2009, at B8 (“Several large hedge funds, including Citadel Investment Group and Farallon Capital Management, have halted investor redemptions in certain funds after having huge losses last year.”); Tom Petrino, *Exits Barred at Some Funds: Hedge Managers’ Limits on Withdrawals Amid Market Turbulence Could Hurt Investor Confidence*, L.A. TIMES, Aug. 2, 2007, at C-1; Louise Story, *A Squeeze on Leading Fund Chiefs*, N.Y. TIMES, Sept. 30, 2008, at C1 (“On Tuesday, RAB Capital, a British fund manager reportedly froze redemptions on its fund for three years . . .”); Louise Story, *Hedge Funds Are Bracing for Investors to Cash Out*, N.Y. TIMES, Sept. 29, 2008, at C1.

<sup>31</sup> Needham & Brause, *supra* note 12, at A-8.

<sup>32</sup> *Id.* at A-9; Weisbach, *supra* note 1, at 723 n.12.

<sup>33</sup> Needham & Brause, *supra* note 12, at A-7 (“The investor in a hedge fund has more control over the sales process. It initiates the process by notifying the portfolio manager that it intends to withdraw from the fund.”).

<sup>34</sup> Hedge funds use multiple structures to accomplish this, such as “master feeder” and

*Not All Carried Interests Are Created Equal*  
29:713 (2009)

manager of the hedge fund charges the incentive fee in one of two ways: (1) for the partnerships, the manager owns a profits interest similar to a carried interest and (2) for the corporations, the manager charges a fee for the investment services of the manager.<sup>35</sup> These incentive fees are charged on a regular basis based on the value of the assets of the fund at the time of the calculation.<sup>36</sup>

Assume the same facts as above, except that the fund is a simplified version of a hedge fund rather than a private equity fund and the incentive fee is calculated on an annual basis. In year one, the hedge fund purchases ten different assets for ten million dollars each. By the end of year two, the assets as a whole have increased in value to two hundred million dollars. As a result, the GP charges an incentive fee of twenty million dollars, or twenty percent of the one hundred million dollar profit, which is paid to the GP at the end of the year. The next year, the assets decline in value to one hundred million dollars. Since there is no profit, the GP does not charge an incentive fee in year three, but also is not required to repay any of the twenty million dollar incentive fee it received in year two.<sup>37</sup>

### III. TAXING CARRIED INTEREST: THE DEBATE

Given the significant differences in business model, legal structure, and economic agreement between the GP and LPs, it makes sense that the analysis for hedge funds and private equity funds might differ when

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“hub and spoke” structures—regardless, the basic premise remains that multiple entities pool capital to make investments on behalf of the fund. See Needham & Brause, *supra* note 12, at A-3-4; Ordower, *supra* note 11, at 361-64.

<sup>35</sup> See Needham & Brause, *supra* note 12, at A-8-9.

<sup>36</sup> See Ordower, *supra* note 11, at 347:

Rarely do fund managers return any portion of incentive fees they have collected previously when assets decline in value following an incentive fee. Rather managers agree to claim subsequent incentive fees only when the value of the investor's interest exceeds the incentive fee floor or “high water mark.” The floor is the highest value of that investor's interest upon which the manager previously collected an incentive fee. This floor computational method prevents the manager from collecting multiple incentive fees on cyclical increases and decreases in value in volatile markets. The floor, however, does not preclude retention of fees attributable to aberrant market spikes since the value of an investor's account is the investor's share of the net asset value of the fund without regard to whether the fund has realized any gain by disposing of positions.

<sup>37</sup> Under a provision sometimes included in hedge funds often known as the “high water mark,” the manager would not be able to charge an incentive fee again until the assets appreciate in excess of two hundred million dollars. See Jerald David August & Lawrence Cohen, *Hedge Funds—Structure, Regulation and Tax Implications*, 815 PLI/TAX 131, 142 (2008).

considering the tax treatment of carried interest, notwithstanding that both types of funds use a similar means to compensate GPs as an incentive to maximize returns. To examine these distinctions in more detail, this Section will summarize the current debate regarding the taxation of carried interest. Much has been written about the taxation of carried interest, and there is little need for a retelling of all the issues in detail, and thus this Section will only frame the existing debate.

As discussed in Section II, carried interest in private equity funds is typically issued in the form of a profits interest in the limited partnership. The GP receives the profits interest as an affiliate of the management company, which provides the investment services for the fund. Thus, the sole reason the GP is issued the profits interest is in exchange for the services. In general, for tax purposes, when a service provider receives property in exchange for services, the value of the property is treated as salary, or ordinary income, on the date of issuance.<sup>38</sup> The treatment of the receipt of a profits interest in a partnership has been more controversial, however, with the courts, government, and commentators often reaching contradictory conclusions.<sup>39</sup> In part to resolve this confusion, in 1993 the Internal Revenue Service (IRS) formally announced that, under certain conditions, it would treat a profits interest as if it had no value at the time of issuance, with the result that there would be no income to the GP upon the grant of a carried interest.<sup>40</sup>

The position of the IRS with respect to the issuance of profits interests in exchange for services is based on the theory that the value of a profits interest is equivalent to the amount of capital allocated to the interest in the "capital account" of the partnership, or the "liquidation value" of the interest.<sup>41</sup> Ignoring the minimal contributed capital, since the GP would receive no distributions if the fund never generated any profits, and is not entitled to any capital of the partnership at the date of the grant, the profits interest is deemed to have no value at issuance. This is clearly a legal fiction; the carried interest must have some economic value to the GP since the GP accepted it in the first place and could earn substantial amounts in the future. The fiction is consistent with the general methodology used to

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<sup>38</sup> 26 U.S.C. § 83 (2008).

<sup>39</sup> Compare *Diamond v. Comm.*, 56 T.C. 530 (1971), *aff'd* 492 F. 2d 286 (7th Cir. 1974) (ruling that a profits interest was taxable upon receipt) with *Campbell v. Comm.*, 943 F. 2d 815 (8th Cir. 1991) (reversing a Tax Court ruling that receipt of a profits interest was a taxable event). See also JCT CARRIED INTEREST REPORT, *supra* note 1, at 6; Weisbach, *supra* note 1, at 727 n.22; Leo L. Schmolka, Commentary, *Taxing Partnership Interests Exchanged for Services: Let Diamond/Campbell Quietly Die*, 47 TAX. L. REV. 287 (1991).

<sup>40</sup> See, e.g., Rev. Proc. 93-27, 1993-2 C.B. 343; see generally ARTHUR B. WILLIS, JOHN S. PENNELL & PHILIP F. POSTLEWAITE, *PARTNERSHIP TAXATION* ¶ 4.06[7] (6th ed. 2002).

<sup>41</sup> See WILLIS, PENNELL & POSTLEWAITE, *supra* note 40, ¶ 10.05.

*Not All Carried Interests Are Created Equal*  
29:713 (2009)

account for partnership income for income tax purposes, however.<sup>42</sup> Although the rules work such that by the end of the life of a partnership the items of taxable income and economic income should match, due to this fiction they do not match at the time of issuance.

The fund is treated like a partnership for tax purposes, meaning the income, gains, losses, deductions, and credits of the fund “flow through” to the partners of the fund regardless whether any cash is distributed.<sup>43</sup> The partners then include such items in their personal tax returns. The fund utilizes an accounting mechanism of “capital accounts” to keep track of which partner is entitled to what assets as income, gains, losses, and credits are generated at the fund level.<sup>44</sup> The fund allocates these tax items among the partners and the tax law generally respects the manner in which the partnership does so, as long as the allocations have “substantial economic effect”—effectively, so long as the allocation of the tax items also adjust capital accounts.<sup>45</sup> In this manner, the tax laws are structured so that the allocation of taxable items corresponds to the economic realities of how the partners are actually sharing profits and losses.

For tax purposes, as a partner of the fund the GP is allocated a share of profits from the sale of portfolio companies as they occur. These profits flow-through to the GP at the time of the sale, and the character of such income is determined at the partnership level.<sup>46</sup> Since the profits interest is considered an interest in the partnership under this approach, the income attributable to the GP is considered to be a portion of the income of the partnership. For the most part in private equity funds, the income is primarily gain from the sale or exchange of stock in portfolio companies. Thus, assuming the gain from the sale is capital gain for tax purposes, it flows through to the GP as a partner in the partnership and is reported as capital gain by the GP. Since the members of the GP ultimately are individuals, they are generally eligible for preferential rates on capital gain.<sup>47</sup>

The controversy that arose was not over the technical application of these rules, but rather that, through the application of these rules, managers of private equity funds were effectively being compensated for their services while receiving income in the form of capital gain for tax

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<sup>42</sup> The partnership tax accounting mechanism is intended to reflect the partner’s current share of assets of the partnership. This simplifying methodology is assumed solely for tax purposes to reflect the true economic relationship of the parties. *Id.*

<sup>43</sup> See generally *id.* ¶¶ 10.01–05.

<sup>44</sup> 26 U.S.C. §§ 701–704 (2008).

<sup>45</sup> See generally WILLIS, PENNELL & POSTLEWAITE, *supra* note 40, ¶ 10.04.

<sup>46</sup> 26 U.S.C. § 702(b) (2008). For a more detailed discussion, see *infra* Section IV.

<sup>47</sup> 26 U.S.C. § 1(h) (2008). For a more detailed discussion, see *infra* Section IV.

purposes.<sup>48</sup> This can be seen by returning to the example in Section II above, in which the LP received a return of almost forty percent on its invested capital while the GP received a return of one thousand percent on its invested capital. Why did the GP earn such a disproportionately higher return on its capital than the LP? It would appear that the only way to explain this disproportionate return for the GP would be that the return was not really on invested capital but rather compensation to the GP for finding and managing the investments of the fund. Since other money managers, such as those at mutual funds and investment banks, do not receive compensation as capital gain, but rather receive fees or salaries treated as ordinary income, proponents of changing the taxation of carried interest claim that this disparate treatment violates the norm of horizontal equity, which provides that similarly situated taxpayers should bear similar tax burdens.<sup>49</sup>

Proponents of maintaining the current law treatment of carried interest counter that horizontal equity may not be a useful tool in analyzing blended scenarios such as carried interest, because they can be considered “similar” to two different and opposite treatments.<sup>50</sup> In the words of Professor Weisbach:

It is as if we had to choose a color for three squares arranged in a line. The square on the right is red and the square the left is blue. If we must choose red or blue for the middle square, we cannot pick a color by noting only that the square to the right is red, ignoring the blue square on the left. Horizontal equity arguments fail entirely in this context.<sup>51</sup>

Under this analysis, the taxation of carried interest is purely an exercise in line-drawing across a spectrum, since the law creates two inconsistent poles at the far ends (capital gain on one and ordinary income on the other) while a third choice (carried interest) falls in the middle. Viewed from this perspective, proponents of the current law treatment claim less distortions would arise from treating GPs in private equity funds more like “sweat equity”—or the gain in the value of a business derived

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<sup>48</sup> Fleischer, *supra* note 1, at 11–16, 44–46.

<sup>49</sup> See, e.g., Henry Ordower, *Taxing Service Partners to Achieve Horizontal Equity*, 46 TAX LAW. 19, 41 (1992); see also Fleischer, *supra* note 1, at 44–47. The usefulness of horizontal equity as an independent norm in the tax laws has been challenged, however. See, e.g., Weisbach, *supra* note 1, at 740. This does not mean that GPs always earn such staggering returns, or that private equity funds never lose money, but rather that since such returns are possible it is difficult to argue that the returns on carried interest are solely in the nature of a return on invested capital, and thus horizontal equity comes into play.

<sup>50</sup> Weisbach, *supra* note 1, at 718.

<sup>51</sup> *Id.*

*Not All Carried Interests Are Created Equal*  
29:713 (2009)

from the work of its owners—than compensation for services.<sup>52</sup>

In addition to the claim that the taxation of carried interest as capital gain violates the norm of horizontal equity, proponents of reform also contend that such taxation violates the underlying policies supporting the distinction between ordinary income and capital gains.<sup>53</sup> In particular, as discussed in more detail in Section IV *infra*, capital gains are treated differently than ordinary income due to two policy concerns: (1) bunching and (2) lock-in. In general, bunching refers to the phenomenon that gains from sale of assets accrue over time but are realized all in one year, while lock-in refers to the concept that investors have an incentive not to sell an asset solely to avoid tax.<sup>54</sup> The primary concern with bunching and lock-in is that, as more gain accrues over time, the more tax will be paid upon a sale of the asset and thus the worse the problems become; to address bunching and lock-in, Congress adopted preferential rates for the taxation of capital gains.<sup>55</sup>

A fundamental aspect of the bunching and lock-in phenomena is that they require an upfront investment in an asset and gain derived from that investment; in other words, the gain subject to bunching and lock-in is the return on the initial capital investment. In the case of carried interest in a private equity fund, however, there is nominally no upfront capital investment by the GP. Rather, the GP is effectively earning a return generated on the capital contributed to the fund by the LPs. Thus, one

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<sup>52</sup> *Id.* at 719 (“From a line drawing perspective the choice is clear: we should not change the treatment of carried interests in private equity partnerships.”).

<sup>53</sup> See, e.g., Fleischer, *supra* note 1, at 43.

<sup>54</sup> See *Burnet v. Harmel*, 287 U.S. 103, 106 (1932). This is not to say that bunching and lock-in are the only justifications for the capital gains preferences, or that they are sufficient to normatively justify a capital gains preference, rather only that they are the beginning of any discussion as to the purpose of the capital gain preference under current law. See JOINT COMM. ON TAXATION, TAX TREATMENT OF CAPITAL GAINS AND LOSSES, 30–36 (1997) [hereinafter JCT CAPITAL GAIN REPORT].

<sup>55</sup> Of particular concern was that a large portion of such gain could be comprised solely of inflationary returns, and thus not represent any increase in the ability to consume. See Noel B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319, 337 (1993). It is arguable whether the capital gains preference is the optimal way to fulfill this policy, or whether it does so at all. See, e.g., John W. Lee, *Critique of Current Congressional Capital Gains Contentions*, 15 VA. TAX REV. 1 (1995); Michael J. Waggoner, *Eliminating the Capital Gains Preference Section I: The Problems of Inflation, Bunching, and Lock-In*, 48 U. COLO. L. REV. 313 (1977). For example, indexing basis for inflation could directly address the inflation issue. See JCT CAPITAL GAIN REPORT, *supra* note 54, at 36–39. It is clear, however, that these are the stated policies for the capital gain preference and that the rules crafted with respect to it have been justified in this manner, regardless of their efficacy. See, e.g., John W. Lee, *The Capital Gains “Sieve” and the “Farce” of Progressivity 1921–1986*, 1 HASTINGS BUS. L.J. 1 (2005). Thus, solely for purposes of analyzing the issue in the context of the carried interest debate, it is sufficient to focus on these policies.

argument has been that the income attributable to the profits interest is really income from services and not capital, and the GP should not be entitled to capital gain treatment because there are no bunching or lock-in concerns.<sup>56</sup> Critics of this argument counter that current law permits an identical result through borrowing funds to make an investment, and thus this result does not violate any deep norm regarding the capital gains preference.<sup>57</sup>

In addition to the normative debates over reform of the taxation of carried interest, critics have noted that there are multiple problems with the implementation of any reform proposal as well.<sup>58</sup> One particularly vexing problem is that any reform targeted solely or primarily at private equity funds would require some change to the underlying fundamental treatment of the allocation of income in a partnership for tax purposes.<sup>59</sup> For example, one way to address carried interest would be through an analogy to other property issued to service providers (i.e., ordinary income at the time of grant equal to the fair market value of the property and capital gain for any future appreciation).<sup>60</sup> Under current law, the capital account of the GP at the time of issuance is zero, and thus the partnership tax accounting rules assume it is worth zero. As a result, if the “forced valuation” proposal were adopted, the GP would be taxed on having received compensation, but the partnership tax laws would assume that the GP would not be entitled to any of the assets of the partnership, resulting in a mismatch that could lead to timing, character, and amount of income distortions.<sup>61</sup> One way to remedy this would be for the GP to receive a capital account equal to the amount of the income inclusion. Doing so would result in one of two anomalies—either the capital accounts would no longer reflect the value of the assets of the partnership, or the GP would have to “take” capital account away from the LPs. In either case, absent exceedingly complex

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<sup>56</sup> See Fleischer, *supra* note 1, at 44–46.

<sup>57</sup> Weisbach, *supra* note 1, at 741–44.

<sup>58</sup> E.g., Postlewaite, *supra* note 1; Weisbach, *supra* note 1; Abrams, *supra* note 1.

<sup>59</sup> Abrams, *supra* note 1, at 9–11; Postlewaite, *supra* note 1 (manuscript at 5) (“Critics examine only part of the evidence in compiling their case against the status quo. Furthermore, they fail to integrate the full fabric of Subchapter K and the taxation of partners and partnerships into their assessment of the area.”).

<sup>60</sup> See Fleischer, *supra* note 1, at 52 (referring to this as the “forced valuation” method).

<sup>61</sup> Abrams, *supra* note 1, at 9–11. A similar proposal to treat carried interest similar to ISOs suffers from this same malady, since any attempt to impose a valuation on the profits interest upon issuance requires facing the partnership accounting issue as well. See Adam Lawton, Note, *Taxing Private Equity Carried Interest Using an Incentive Stock Option Analogy*, 121 HARV. L. REV. 846 (2008). An additional proposal, to treat “human capital” as contributed capital so as to make the capital accounts work, may address the capital account issue but continues to confront the line-drawing issue for blended returns. See Sarah Pendergraft, Note, *From Human Capital to Capital Gains: The Puzzle of Profits Interests*, 27 VA. TAX REV. 709 (2008).

*Not All Carried Interests Are Created Equal*  
29:713 (2009)

adjustments, the capital accounts would no longer reflect the economic reality of the business arrangement, and could not be made to do so over time.<sup>62</sup>

Alternatively, rather than tax the issuance of the carried interest, the gain allocated to the GP at the time of the sale of stock in the portfolio company could be re-characterized as ordinary income rather than capital gain just for the GP, thus denying preferential rates.<sup>63</sup> Such an approach would require the partnership to change the character of income based solely on to whom the income is attributable, rather than based on the source of the income. This is contrary to the “aggregate” or “conduit” theory of partnerships that posits that the partnership tax rules should be drafted so as to, as closely as possible, treat partners in a partnership as if they owned a share of the underlying assets of the partnership.<sup>64</sup> If the GP owned shares of the portfolio company directly, there is no doubt that the gain on sale would be capital gain, except in limited circumstances.<sup>65</sup> Thus, the argument would have to be that something about the nature of investment partnerships, carried interest, or both, necessarily requires a deviation from this general theory of partnerships.<sup>66</sup>

All of these alternatives implicate difficult, if not intractable, line-drawing problems.<sup>67</sup> If carried interest truly is unique and needs unique

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<sup>62</sup> Abrams, *supra* note 1, at 9 (“without using liquidation values, the capital account values do not work out.”). This does not mean such an exercise is futile, rather just complicated. See Michael L. Schler, *Taxing Partnership Profits Income as Compensation Income*, 119 TAX NOTES 829 (2008). For anyone who has read, written, or tried to apply the capital account maintenance provisions of a private investment fund, however, the mere specter of increasing the complexity of their provisions would strike sufficient fear into their hearts as to make capital accounts untenable in any meaningful way.

<sup>63</sup> See Fleischer, *supra* note 1, at 51 (referring to this as the “ordinary income” method). This method was originally introduced in the context of profits interest for service partners in Mark P. Gergen, *Reforming Subchapter K: Compensating Service Partners*, 48 TAX L. REV. 69 (1992), as part of a broader set of reform proposals.

<sup>64</sup> WILLIS, PENNELL & POSTLEWAITE, *supra* note 40, ¶ 9.01[2].

<sup>65</sup> This is true if the GP purchased the asset, including if it was acquired with borrowed funds, and, if the GP were issued the asset as compensation for services, any gain accruing after the date of issuance or the date of lapse of substantial risk of forfeiture. See 26 U.S.C. § 83(a) (2008).

<sup>66</sup> Compare Fleischer, *supra* note 1, at 5 (arguing in the affirmative) with Weisbach, *supra* note 1, at 754–55 (arguing in the negative). See also Sanchirico, *supra* note 2, at 242 (“The tax advantage of *carried interest* must be something that switches on when carried interest is present and switches off when it is not.”) (emphasis in original). For a detailed critique of the current reform proposals, see Postlewaite, *supra* note 1 (manuscript at 58–64). This problem would not necessarily apply if fundamental overhaul of Subchapter K were undertaken to rationalize all of these moving parts. See *infra* note 139.

<sup>67</sup> Borden, *supra* note 1, at 35 (“The nature of partnerships make partnership disaggregation an unattractive method for reducing the inequities caused by the current tax treatment of profits-only partnership interests.”); Weisbach, *supra* note 1, at 755–62.

rules, then how should the tax law differentiate among partnerships that should be subject to the special rule and partnerships that should be subject to the general rule? If all profits interests were subject to the special rule just to attack carried interest, the rule could be overbroad in its application and impose ordinary income treatment on investments subject to bunching and lock-in.<sup>68</sup> Further, it might be quite easy to avoid, since there could be relatively simple substitutes for a profits interest in a partnership to replicate the economics but which would not be subject to the carried interest rule.<sup>69</sup> Any time behavior changes in response to the tax laws, not only would there be incremental transaction costs involved but there could also be deadweight loss resulting from changes in behavior.<sup>70</sup> In this manner, any attempt to draw a line to distinguish between carried interest, as opposed to any other type of partnership interest, could cause more harm than good.<sup>71</sup> Some have even argued that this is precisely why the current law treatment of carried interest may in fact be a second-best solution in itself.<sup>72</sup>

Problems such as these have plagued proposals to change the tax treatment of carried interest to date. For example, under proposed § 710 of the Internal Revenue Code (the Code), allocations of carried interest to a GP of an investment services partnership would be treated as ordinary income notwithstanding its character in the hands of the partnership.<sup>73</sup> The proposal addresses the definitional line-drawing problem by defining an “investment services partnership interest” as one held by a person providing investment services to the partnership with respect to stocks, bonds, real estate, derivatives, or other similar assets.<sup>74</sup> It then addresses the overbroad line-drawing problem by permitting “reasonable” allocations to capital to be treated as capital gain while treating “unreasonable” allocations as ordinary income.<sup>75</sup> It also addresses the change in behavior line-drawing problem by ignoring real loans from LPs to the GPs used to make a capital investment in the partnership.<sup>76</sup> Although each of these may be a reasonable approach

<sup>68</sup> But see *infra* note 139 for proposals to fundamentally reform the treatment of all non pro-rata allocations in partnerships, with the attendant changes to timing and capital account rules as well.

<sup>69</sup> Weisbach, *supra* note 1, at 759–60.

<sup>70</sup> David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1652 (1999).

<sup>71</sup> Weisbach, *supra* note 1, at 763. See also Schler, *supra* note 62.

<sup>72</sup> Postlewaite, *supra* note 1 (manuscript at 31) (“[T]he status quo is the second best approach to the issue. Given the administrative difficulties in disentangling in any meaningful way the return on human capital and the return on invested capital, the current system is the best we can do.”).

<sup>73</sup> Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong., § 1201 (2007) [hereinafter Proposed § 710].

<sup>74</sup> Proposed § 710, *supra* note 73, § 710(c)(1).

<sup>75</sup> Proposed § 710, *supra* note 73, § 710(c)(2)(A).

<sup>76</sup> Proposed § 710, *supra* note 73, § 710(c)(2)(D).

*Not All Carried Interests Are Created Equal*  
29:713 (2009)

to the line-drawing problems inherent in the re-characterization of carried interest as ordinary income, the combination leads to potentially insurmountable complexity issues.<sup>77</sup> As a result, both the New York State and American Bar Associations have issued reports with detailed lists of problems and complications with proposed § 710, as well as a list of possible modifications to address them.<sup>78</sup>

What can be learned from the lessons of proposed § 710 is that the re-characterization approach requires difficult choices to be made, leading to complex and potentially convoluted rules, because it uses the partnership accounting rules to attempt to remedy a more fundamental underlying problem: the blended labor/capital return embedded in carried interest.<sup>79</sup> Since the blended return problem has plagued capital gains since its inception, there is no reason to believe that adding the additional complexities of the partnership accounting rules into the mix will lead to a more rationalized or implementable solution. In fact, doing so likely only adds to the line-drawing problems, making them incrementally more difficult to overcome.<sup>80</sup>

In recognition of this fundamental problem with using the partnership accounting rules to attack what is essentially a blended labor/capital problem, two alternative approaches have been proposed. One proposed

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<sup>77</sup> See Howard E. Abrams, *A Close Look at the Carried Interest Legislation*, 117 TAX NOTES 961 (2007); see also Howard E. Abrams, *Taxation of Carried Interests: The Reform That Did Not Happen*, 40 LOY. U. CHI. L.J. 197, 227 (2009) (“A third explanation is that the proposed reform of carried interest taxation was a bad idea badly executed, and sometimes bad laws fail simply because they should.”).

<sup>78</sup> See AMERICAN BAR ASS’N SECTION OF TAXATION, COMMENTS ON H.R. 2384 (2007), available at <http://www.abanet.org/tax/pubpolicy/2007/071113commentshr2834.pdf>; N.Y. STATE BAR ASS’N TAX SECTION, REPORT ON PROPOSED CARRIED INTEREST AND FEE DEFERRAL LEGISLATION (2008), available at <http://www.nysba.org/Content/Content/Folders20/TaxLawSection/TaxReports/1166Rpt.pdf>. These issues have served as the basis for proposals to amend proposed § 710. See *Hedge Funds and the Financial Market: Hearing Before the H. R. Comm. on Oversight and Gov’t Reform*, 110th Cong. (2008) (testimony of Joseph Bankman, Professor of Law and Business, Stanford Law School), available at <http://oversight.house.gov/documents/20081113102023.pdf> [hereinafter *Bankman Testimony*]; Gergen, *supra* note 20, at 149 (“Many of the problems that have been raised . . . are technical in nature and solvable.”).

<sup>79</sup> See, e.g., Postlewaite, *supra* note 1 (manuscript at 67):

Once a compensatory equity interest is received, the clarity of the return on human capital begins to blur. Human capital begets invested capital, which begets invested capital, which begets invested capital, *ad infinitum*. Like conjoined twins, delineation between the two is virtually impossible, and any attempt to disentangle them is fraught with difficult obstacles.

<sup>80</sup> This does not mean they would be insurmountable, only that they would be marginally more difficult. See Gergen, *supra* note 20.

alternative has been to disregard the partnership altogether and look to the underlying economic fundamentals of the deal between the GP and the LPs.<sup>81</sup> Under this theory, the use of the partnership is irrelevant to the real underlying issue, which is the economic basis for the return to the GP. Thus, if the underlying economic transaction involves a return on capital, then the return should be capital gains, while if the underlying economic transaction involves compensation for services, then the return should be ordinary income.<sup>82</sup> This approach directly confronts and addresses the incremental complexity problem of using the partnership accounting rules to combat a blended labor/capital issue. The problem with such an approach is that it does not assist in solving the underlying blended labor/capital line-drawing problem, but rather directly presents it as the crucial consideration.<sup>83</sup> Given that the law has a difficult time enforcing a line in true blended return situations like “sweat equity,” such a solution could prove particularly difficult when attempting to create fictional transactions to represent the economic reality of the transaction between the parties.<sup>84</sup>

Another proposed alternative has been for the tax laws to assume that there is an embedded loan in the carried interest structure from the LPs to the GP.<sup>85</sup> This approach reflects the fact that the GP’s return is generated with respect to the capital contributed by the LP. In effect, the LPs could be thought of as lending some of their contributed capital to the GP, secured only by the partnership interest, and charging no interest. It is this embedded loan construct that proponents of the current treatment of carried interest point to as support for the contention that the GP has in fact earned a return on invested capital.<sup>86</sup> Since returns on borrowed capital are treated as capital gains outside of the carried interest arena, the argument is that

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<sup>81</sup> See Borden, *supra* note 1; Lee A. Sheppard, *News Analysis: The Unbearable Lightness of the Carried Interest Bill*, 116 TAX NOTES 15 (2007).

<sup>82</sup> Borden, *supra* note 1, at 43. Discussing the issue of adopting such an approach, the author states:

An analysis that assumes away a partnership must consider all possible outcomes and justify the selection of any particular one. If nothing justifies the fixation on a hired-services arrangement, an analysis that merely adopts that approach is unsound. A better analysis would examine the economics of an arrangement and allow the economic aspects to determine the classification.

*Id.*

<sup>83</sup> *Id.* at 38 (“[A]fter disregarding a partnership, the analysis must consider whether the arrangement is a hired-services arrangement or a hired-property arrangement. Unfortunately, the law is largely unhelpful with each of those determinations.”).

<sup>84</sup> See *id.*

<sup>85</sup> Fleischer, *supra* note 1, at 44–46.

<sup>86</sup> Weisbach, *supra* note 1, at 743–44.

*Not All Carried Interests Are Created Equal*  
29:713 (2009)

treating carried interest as capital gain is not particularly troubling in and of itself.<sup>87</sup>

Even assuming this is correct, if the embedded loan were a “true” non-interest bearing loan, it would be subject to special rules requiring imputation of interest income. Under current law, a compensation-related interest-free loan would be subject to a deemed payment schedule, in which it would be assumed that the LPs paid compensation to the GP, which the GP then used to pay interest to the LPs.<sup>88</sup> This set of deemed transactions would require the GP to include some amount of the value of the profits interest as ordinary compensation income and thus could offset some of the horizontal equity and capital gain policy problems with carried interest.<sup>89</sup> As a result, some have argued that even if carried interest is a return on borrowed capital, carried interest should be subject to these same rules so as to convert some of the return into ordinary income.<sup>90</sup>

As has been noted in the literature, however, doing so without also taking into account the deemed interest payment by the GP would again result in distortions of the tax system as compared to the business arrangement of the parties, and that itself could violate horizontal equity.<sup>91</sup> One solution proposed would be to permit the GP a deduction on deemed interest paid to the LPs.<sup>92</sup> The result would be that the GP would almost always have zero *net* ordinary income, which may be the correct answer but would defeat the point of the interest accrual proposal for carried interest as a means to further horizontal equity in the first place.<sup>93</sup> To impose a net tax on the GP, therefore, a deduction would have to be denied or limited for the deemed interest payment.<sup>94</sup>

Another interesting issue with the embedded loan approach is the treatment of the LPs. Presumably, deemed interest payments to the LPs would be taxable income, but in addition, the LPs would also have an offsetting deduction available; thus, once again, the issue comes down to whether the offsetting deduction can or should be disallowed in whole or in part.<sup>95</sup> In reality, however, LPs of private equity funds disproportionately tend to be tax-exempt investors (either exempt charities or pension funds or

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<sup>87</sup> *Id.*

<sup>88</sup> See 26 U.S.C. § 7872 (2008).

<sup>89</sup> Fleischer, *supra* note 1, at 53–54 (referring to this as the “cost of capital” approach).

<sup>90</sup> *Id.* at 57–58.

<sup>91</sup> Cunningham & Engler, *supra* note 1, at 129.

<sup>92</sup> *Id.*

<sup>93</sup> See Abrams, *supra* note 3, at 189.

<sup>94</sup> See Cunningham & Engler, *supra* note 1, at 130–31 (discussing the limitation on investment interest under 26 U.S.C. § 163(d) (2008)); Schmolka, *supra* note 39, at 311–12 (discussing the limitation on investment expenses under 26 U.S.C. § 212 (2008)).

<sup>95</sup> See Cunningham & Engler, *supra* note 1, at 194 n.23.

**Northwestern Journal of  
International Law & Business**

29:713 (2009)

non-U.S. persons not subject to U.S. tax on their investments),<sup>96</sup> and thus may be indifferent to the taxable income irrespective of the availability of a deduction.

It has been claimed that this, not the capital gain treatment of carried interest to the GP, is the real issue in carried interest, i.e., that tax-indifferent LPs permit exploitation of tax rules.<sup>97</sup> The argument looks to the tension among arm's-length parties that is typically relied upon to limit the ability to exploit such issues in other contexts. In short, under this argument, the GP wants the carried interest to be capital gains due to preferential rates, while taxable LPs want the carried interest to be compensation so that they can receive a deduction. The problem in private equity funds is that the LPs are mostly indifferent to the compensation deduction because they are not taxpayers; as a result, this internal discipline on the ability of GPs to structure returns so as to generate long-term capital gains with respect to their carried interest no longer exists.<sup>98</sup> This fact alone might be sufficient to determine that private equity funds need to be subject to a special rule separate from partnerships more generally;<sup>99</sup> in particular, this would be the case for partnerships where, among other things, this internal discipline could be sufficient to protect the fisc.<sup>100</sup> Any such approach would require not only rethinking the tax treatment of GPs, but also the treatment of the LPs, to determine if any particular reform would result in desired adversity of interest between the two.<sup>101</sup>

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<sup>96</sup> Sanchirico, *supra* note 2, at 243–44.

<sup>97</sup> *See id.* at 244–45.

<sup>98</sup> *Id.* Similarly, if taxable LPs are limited in their ability to claim the available deductions, they might also prefer deferred capital losses over a current ordinary deduction. *See* Polsky, *supra* note 3.

<sup>99</sup> *See* Fleischer, *supra* note 1, at 23–24.

<sup>100</sup> If the sole problem were the presence of tax-indifferent LPs, one solution would be to require exempt LPs to include gain from the fund as taxable income; while this might solve the internal discipline problem, it could cause more damage (by taxing exempt organizations) than it solves (by minimizing carried interest abuse). Further, it is not a problem unique to carried interest per se nor would it address any of the horizontal equity concerns addressed in the literature. *See* Weisbach, *supra* note 1, at 764 (“Distributional concerns are important but they are not centrally related to the taxation of carried interests. Instead, they arise because of the capital gains preference and if they are going to be addressed, should be dealt with directly.”).

<sup>101</sup> For example, it has been argued that such an approach would not necessarily accomplish anything other than shifting the LP base, because the resulting deduction from ordinary income for the LPs would make it more attractive for taxable investors to invest in private equity instead of tax exempt investors, resulting in little or no net revenue and only nominal changes to the after-tax treatment of the fund and the GP. Michael S. Knoll, *The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of Taxing Profit Interests as Ordinary Income*, 50 WM. & MARY L. REV. 115, 158 (2008):

[A] wealthy individual who is willing to pay a 20 percent carried interest under

*Not All Carried Interests Are Created Equal*  
29:713 (2009)

Contrast this with the income tax treatment of managers in hedge funds. The manager in a hedge fund takes either (or both) a profits interest in a partnership or/and a fee from a corporation. The incentive fee from the corporation is ordinary fee income, and thus the concerns present in private equity fund carried interest simply are not present.<sup>102</sup> With respect to the profits interest, however, the situation at first appears quite similar to that of the private equity fund: the manager receives a profits interest and is not subject to tax on its grant, and the manager receives an allocation of profits from the partnership taking the character of the income at the partnership level.<sup>103</sup>

The similarities end there, however, because the business model of the hedge fund differs significantly. The hedge fund engages in regular trading activity, such as buying and selling financial or derivative assets, and regularly hedges their investments through such means as short sales, offsetting future contracts and delta hedging.<sup>104</sup> The net result is that the income of the hedge fund is primarily short-term capital gains (other than certain fee income or other ordinary income generated by the fund), because the fund rarely owns assets for the one-year period necessary to be eligible for long-term capital gains.<sup>105</sup> Assuming this is correct, the income from the incentive fee or carried interest allocated to the manager is comprised primarily of these short-term capital gains, which retain their character in the hands of the manager.<sup>106</sup> Since short-term capital gains do not qualify for the preferential tax rate applicable to long-term capital gains, the perceived problems of private equity carried interest do not apply, even though the compensation structure on its face appears identical to private

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current law would presumably be willing to pay a 26.15 percent carried interest to that same fund manager, if payment of the carry were deductible against ordinary income. Similarly, the general partner is as well off with a 20 percent carried interest under current law as it would be with a 26.15 percent carried interest taxed at ordinary income tax rates.

Similarly, to the extent the deduction was more valuable to taxable investors than tax-exempt investors, it would have the effect of shifting the LP base to more taxable LPs or other LPs who could utilize such a deduction. *Id.* See also Polsky, *supra* note 3, at 746–48.

<sup>102</sup> Needham & Brause, *supra* note 12, at A-31. Until recently, managers of hedge funds were able to defer such fee income and thus obtain a time-value benefit, but recent legislation has at least partially curtailed this opportunity. See *infra* notes 158–59.

<sup>103</sup> Needham & Brause, *supra* note 12, at A-27–30.

<sup>104</sup> *Id.* at A-5.

<sup>105</sup> This could be because the fund sells assets at a gain quickly or because it enters into offsetting transactions which “toll” the holding period. See *infra* Section IV. Further, it is possible for certain hedge funds to elect to “mark to market” in which case all returns would be ordinary income, which would also not be eligible for preferential rates. 26 U.S.C. § 475(f) (2008).

<sup>106</sup> Needham & Brause, *supra* note 12, at A-43.

equity.

What lessons can be learned from the private equity/hedge fund distinction? Primarily, that the use of profits interest in partnerships to compensate managers is not itself fundamentally problematic. Hedge fund managers use the equivalent of carried interest as a form of compensation, with nearly identical legal and economic consequences, yet do not raise the same tax concerns. Accordingly, the focus in the carried interest debate should not be on the method of compensating the manager of a private investment fund, but rather on the types of income being generated and allocated by the fund to the manager. For certain proponents of reform of the taxation of carried interest in private equity funds, the concern is not that carried interest is different from any other profits interest (or any other non pro-rata allocation in a partnership), but that the private equity firms generate primarily long-term capital gains eligible for preferential rates. For hedge funds, which generate primarily ordinary income and short-term capital gain, these concerns are not present, since such income is not eligible for the lower rates.

#### IV. FRAMING A NORMATIVE CASE FOR CARRIED INTEREST AND HOLDING PERIOD

Any normative analysis of the taxation of carried interest must have a starting point. The starting point for much of the carried interest literature has been the current treatment of "sweat equity" entitled to capital gains treatment and the current treatment of "compensation" treated as ordinary income.<sup>107</sup> This Article will do the same, assuming that the capital gain/ordinary income distinction and the preferential rate structure are normative, without taking a position, in part to directly engage the existing literature and in part to more closely structure a positive prescription within the current law.<sup>108</sup>

Under this assumption, the line-drawing debate which has received the bulk of attention in the recent carried interest literature is whether carried interest should be treated as capital gain or ordinary income. Thinking of

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<sup>107</sup> See Brennan & Okamoto, *supra* note 4, at 35. For this reason, this Article will not discuss the normative treatment of deferred compensation more generally, or whether carried interest reform under current law would result in a greater or smaller tax than it would bear under an ideal system, although reform of carried interest as part of a comprehensive reform of deferred compensation more broadly would address other concerns such as the embedded time value issues. See, e.g., Ethan Yale & Gregg D. Polsky, *Reforming the Taxation of Deferred Compensation*, 85 N.C. L. REV. 571 (2007); Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 YALE L.J. 506 (1986).

<sup>108</sup> Of course, this also means that fundamental reform of either of these base assumptions, such as repeal of the capital gains preference, would also require a rethinking of the normative conclusions in this Section.

*Not All Carried Interests Are Created Equal*  
29:713 (2009)

this debate in terms of the line-drawing spectrum,<sup>109</sup> if ordinary income were a blue box and capital gain were a red box at opposite ends of a spectrum, carried interest would present a box in the middle, with the current debate being over whether it should be red or blue. A second line-drawing issue has received less attention in the debate, however: even if carried interest is capital, should it be entitled to preferential rates? One lesson of the disparate treatment of hedge funds and private equity funds is that these questions, although related, are not identical, since some capital gains—in particular, short term capital gains—are treated as capital under the first line drawing test but denied preferential rates under the second. In other words, rather than claim that carried interest should be red or blue, a short-term capital gain analysis would treat carried interest as purple; that is, capital gain, but not entitled to preferential rates.

A. Applying Holding Period to Carried Interest in a Domestic Tax Regime

As discussed above, the policy behind granting preferential rates to long-term capital gains is to overcome the problems of bunching and lock-in, which become exacerbated over time, but which generally do not apply to salary or compensation income.<sup>110</sup> By distinguishing between different types of income, however, taxpayers have an incentive to try to make compensation or blended labor/investment returns appear to be capital in nature solely to avail themselves of preferential capital gain rates (assuming those are the only two options) even if they are not subject to bunching and lock-in. Ultimately, this is the fundamental source of the concern over the taxation of carried interest.

This issue is not unique to carried interest, however. The problem of taxpayers attempting to make blended returns appear capital in nature has plagued the Code for generations, and was presciently described by Stanley Surrey, one of the all-time leading tax authorities,<sup>111</sup> in considering the treatment of capital gains over fifty years ago, referring to capital gains as “the subject singly responsible for the largest amount of complexity [in the Code].”<sup>112</sup> In particular, although capital gain has been in the Code since

<sup>109</sup> See *supra* note 46 and accompanying text.

<sup>110</sup> JCT CAPITAL GAIN REPORT, *supra* note 54, at 30–36.

<sup>111</sup> See, e.g., Bernard Wolfman, *Introduction*, 31 VILL. L. REV. 1615, 1616 (1986) (“Stanley S. Surrey was the country’s leading tax policy scholar and activist for more than 50 years.”).

<sup>112</sup> Stanley Surrey, *Definitional Problems in Capital Gains Taxation*, 69 HARV. L. REV. 985 (1956). More specifically, according to Surrey:

The subject singly responsible for the largest amount of complexity [in the Code] is the treatment of capital gains and losses. And the factor in that treatment which is accountable for the resulting complexity is the definition of capital gain and of capital loss. The fact that our tax law is complex does not necessarily mean that it

its modern inception, no single coherent theory of what precisely constitutes capital gain has ever been promulgated. According to Professor Surrey:

The term "capital gain" has been used in the tax law for so long a period of time and with such wide publicity that it has acquired a very familiar ring. We are led to believe that it has readily ascertainable content and as respects its comprehensibility and application stands on no different a footing from other items of income such as salary, interest, rent, and the like. But we must remember that a fully developed concept of "capital gain" has not been offered to the tax law by either the economist or the accountant, so that its content cannot readily be supplied by reference to those branches of discourse.<sup>113</sup>

As a result, it has generally come to be accepted that preferential rates for capital gains exist not because there is some natural or inherent distinction between capital and ordinary income, but rather to overcome perceived inefficiencies or unfairness applicable to certain types of investment returns that are not present in other types of income, i.e., bunching and lock-in.<sup>114</sup> Thus, any attempt to intuit whether a particular item of income should be treated as ordinary or capital without considering these policies proves futile.

This lesson was learned by the Supreme Court as recently as 1988 in the case of *Arkansas Best Corp. v. Commissioner*.<sup>115</sup> The Court in *Arkansas Best* was forced to revisit its previous holding in *Corn Products Ref. Co. v. Commissioner*,<sup>116</sup> which had held that corn futures were ordinary assets to the extent they were related to the inventory of the business, even if they were not explicitly defined as such in the Code. The response to *Corn Products* was an explosion of whipsaw arguments confronting the government, where taxpayers claimed assets were "ordinary" when there were losses but "capital" when there were gains, solely to obtain favorable

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is a poor law . . . . But if the complexity is to be kept within reasonable bounds, we must at all times have an awareness of the factors responsible for each particular complication and the values which that complication serves, so that the two may constantly be compared and weighed. So viewed, the complexities caused by the treatment of capital gains and losses far outweigh the values which it is asserted are served by that treatment. Moreover, the present congressional approach to the definition of capital gains and losses inevitably results in more and more complexity, so that the difficulties can only grow worse.

*Id.* at 985.

<sup>113</sup> *Id.* at 986.

<sup>114</sup> See *supra* notes 54–55.

<sup>115</sup> *Arkansas Best Corp. v. Comm'r*, 485 U.S. 212 (1988).

<sup>116</sup> *Corn Products Ref. Co. v. Comm'r*, 350 U.S. 46 (1955).

*Not All Carried Interests Are Created Equal*  
29:713 (2009)

tax treatment.<sup>117</sup> As a result, the Supreme Court in *Arkansas Best* was forced to revisit the issue, holding that capital gain has no inherent meaning, but rather can mean only what is explicitly defined in the Code.<sup>118</sup>

At least since the ruling in *Arkansas Best*, the law has focused on the types of gain subject to the bunching and lock-in problems that underlie the policy of the capital gains preference, rather than rely on some inherent concept of capital gain. By doing so, however, it recognizes that investments which provide returns comprised of both investment returns and labor returns do not fit neatly into the definition of either ordinary income or capital gains. In the words of Professor Surrey:

Congress answered in the affirmative when it commenced its phrasing of the definition of “capital asset” to include all “property” and then did not embark on the search for exclusions essentially related to the causes of the increase in value. Consequently, the additional value imparted to a taxpayer’s stock through factors within his control, such as the accumulation of corporate earnings or his personal efforts as corporate president, was regarded in the definition used as no different from increases in value caused by forces beyond his control. Taxpayers were quick to perceive the enormous range of possibilities in planning for capital gain under such a definitional approach. Here again, the pattern of definition was all in their favor.<sup>119</sup>

Thus, rather than attempt to list every possible instance of blended returns in the Code as a means to prevent taxpayers from obtaining the benefit of preferential rates for blended returns, the law adopted a different approach to maintain the capital gain preference while avoiding the concerns over abuse by taxpayers: holding period.

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<sup>117</sup> See, e.g., Edward D. Kleinbard & Suzanne F. Greenberg, *Business Hedges After Arkansas Best*, 43 TAX L. REV. 393, 413–14 (1988) (“The application of *Corn Products* . . . exposed the Service to essentially insoluble pragmatic whipsaws.”).

<sup>118</sup> See *Arkansas Best*, 485 U.S. at 221–22:

We believe petitioner misunderstands the relevance of the Court’s inquiry. A business connection, although irrelevant to the initial determination whether an item is a capital asset, is relevant in determining the applicability of certain of the statutory exceptions, including the inventory exception . . . . We conclude that *Corn Products* is properly interpreted as standing for the narrow proposition that hedging transactions that are an integral part of a business’ inventory-purchase system fall within the inventory exclusion of § 1221.

<sup>119</sup> Surrey, *supra* note 112, at 989. There are some relatively narrow, but interesting, exceptions not directly relevant to carried interest in which Congress determined labor was the primary source of value, specifically self-produced copyrights and artistic works (other than self-produced musical compositions). 26 U.S.C. §§ 1221(a)(3), (b)(3) (2008).

The original debate over holding period and capital gains focused on short-term investments deemed “speculative” in nature, which were considered not to raise the same bunching and lock-in concerns as long-term investments.<sup>120</sup> The solution adopted at the time was not to re-characterize such investment gains as ordinary notwithstanding that they arose from sales of property, but rather to maintain their status as capital assets but deny the benefits of preferential rates otherwise available to such gains.<sup>121</sup> In this manner, taxpayers would be required to remain invested in the asset, subject to the risk that it might decline in value, for a period of time before beneficial rates were available. In other words, the law presumes that taxpayers would prefer not to “lock up” their salary or other “pure” labor returns in risky assets for this length of time solely for tax benefits, so that assets which are held for the duration of the holding period can be presumed to be primarily investment in nature.

In effect, rather than solve the difficult line-drawing problems between capital gain and ordinary income in such blended situations, the law sought to provide disincentives to taxpayers to manipulate such returns solely for tax purposes by imposing an aging requirement. For example, according to legislative history revisiting this issue in 1974:

A holding period is an objective procedure for distinguishing between short-term and long-term capital gains. The holding period is an arbitrary and imperfect procedure that may be inaccurate in some specific situations, but it provides an approach under which there are significantly fewer administrative and compliance difficulties than would arise under a less objective standard . . .

. . . .

[I]t is argued that there should be special tax treatment for gains on assets held for investment but not on those held for speculative profit. The underlying concept is that a person who holds an investment for only a short time is primarily interested in obtaining quick gains from short-term market fluctuations which is a distinctively speculative activity. In contrast, the person who holds an investment for a long time probably is basically interested fundamentally in the income aspects of his investment and in the

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

<sup>121</sup> 26 U.S.C. § 1222 (2008). More specifically, this approach was adopted in 1934 after perceived abuses of holding period as a definitional aspect of capital gain. See Myron C. Grauer, *A Case for Congressional Facilitation of a Collaborative Model of Statutory Interpretation in the Tax Area: Lessons to be Learned from the Corn Products and Arkansas Best Cases and the Historical Development of the Statutory Definition of “Capital Asset(s),”* 84 KY. L.J. 1, 45–46 (1995–96). This further supports the contention that holding period was meant to remedy overbreadth in the definition of capital gains by denying preferential rates to specific types of capital gains.

*Not All Carried Interests Are Created Equal*  
29:713 (2009)

long-term appreciation in value.<sup>122</sup>

In essence, the law used holding period to distinguish returns attributable to labor (i.e., the ability to speculatively trade) as opposed to investment (i.e., long-term investments subject to bunching and lock-in), even though both types of returns derived from dispositions of investments in “capital” assets such as stocks or bonds.<sup>123</sup> Under this approach, if an investor owned an asset for a fixed period of time while incurring the full risk of the asset appreciating or depreciating, then it would be assumed the investor held the asset for investment purposes and thus would be eligible for preferential capital gains rates.<sup>124</sup> This period of time has changed over the years, but under current law it is one year.<sup>125</sup>

This solution to the problem of speculation in itself does not prove particularly helpful in resolving the carried interest issue, primarily because private equity fund investments tend to be held for at least one year. It is relatively easy for GPs of private equity funds to establish that the return on investment is not speculative in nature, at least not in the same manner as day traders or other short swing investors. As a result, the aging requirement of the holding period rules alone does not address the blended labor/investment returns in the carried interest context, since the type of labor return addressed through the holding period rules (speculation) is different than the type of labor returns at issue in private equity (money/investment management). Contrast this with hedge funds, however, which are primarily speculative in nature and which engage in frequent trading of assets. In this case, the holding period rules work remarkably well—they avoid the difficult line-drawing problem by permitting the assets of the hedge fund to be treated as capital assets, but deny the benefit of preferential rates because the value is generated by trading and speculation and not from investment returns subject to bunching and lock-in.

This does not necessarily mean that holding period is irrelevant to private equity fund carried interest due to the second, more recent, requirement for long-term preferential capital gains rates: that the asset be held for the requisite holding period without the taxpayer significantly reducing the risk of loss related to the asset.<sup>126</sup> Under these rules, if a taxpayer owns an asset and then enters into any form of offsetting position

<sup>122</sup> H.R. REP. NO. 94-658, at 3237–38 (1976).

<sup>123</sup> See JCT CAPITAL GAIN REPORT, *supra* note 54, at 24–26.

<sup>124</sup> Surrey, *supra* note 112, at 999–1003.

<sup>125</sup> 26 U.S.C. § 1222 (2008). Over recent years, the time period has fluctuated from six months to eighteen months. See JCT CAPITAL GAIN REPORT, *supra* note 54, at 7–8.

<sup>126</sup> As discussed in more detail in Section V *infra*, these rules are found in multiple parts of the Code, but primarily can be found in 26 U.S.C. §§ 1092, 1233 (2008) and the regulations promulgated thereunder.

which protects the taxpayer from losing money with respect to that asset, the clock for the holding period does not start or, if it had already started, stops during such time.<sup>127</sup> Thus, a taxpayer who owns a capital asset for three months, then enters into an offsetting position such as a put option against the asset for thirteen months, and then sells the asset in month sixteen, would not qualify for long-term capital gain, even though the taxpayer held the asset for longer than one year.<sup>128</sup> These rules were believed to be necessary in light of modern financial instruments making it possible for a taxpayer to legally own an asset for the requisite holding period while being fully divested or protected from part or all of the economic risks of ownership during such time.<sup>129</sup>

The policy behind these “tolling” rules is the converse of the policy behind the “aging” rules—that holding period is meant to reflect ownership of the capital asset only if it is subject to risk of loss.<sup>130</sup> In other words, a capital asset owned without any risk of losing invested capital does not implicate the same bunching and lock-in concerns as a capital asset owned with exposure to such risk of loss. In part, these rules rely on a built-in tension limiting the abuse of capital gains: the adverse treatment of capital losses.<sup>131</sup> In particular, although capital gains receive preferential tax rates, capital losses only reduce income subject to these same lower rates, and thus are less valuable than other deductions which can offset higher-taxed income.<sup>132</sup> Further, capital losses for the most part can only be deducted to

<sup>127</sup> See 26 C.F.R. § 1.1092(b)-2T(a) (2008).

<sup>128</sup> An offsetting position for these purposes can include a contract to sell the asset at a fixed price in the future or a “put” option on the asset. 26 U.S.C. § 1092(c)(2) (2008).

<sup>129</sup> See S. REP. NO. 97-144, at 145–46, reprinted in 1981-2 C.B. 412, 469 (1981):

The possibility that certain transactions called spreads or straddles can defer income and convert ordinary income and short-term capital gain into long-term capital gain has been recognized by the investment industry for decades . . . . Simple commodity tax straddles generally are used to defer tax on short-term capital gain from one tax year to the next tax year and, in many cases, to convert short-term capital gain realized in the first year into preferentially taxed long-term capital gain in a later year.

<sup>130</sup> *Id.* This is meant to serve as a compromise, i.e., something less than a realization event but more than a mere diversifying investment. See, e.g., Deborah L. Paul, *Another Uneasy Compromise: The Treatment of Hedging in a Realization Income Tax*, 3 FLA. TAX REV. 1 (1996); General Counsel Memorandum 39493, 1986 WL 372974 (discussing H.R. REP. NO. 81-2319, at 54 (1950)).

<sup>131</sup> Michael R. Powers, David M. Schizer & Martin Shubik, *Market Bubbles and Wasteful Avoidance: Tax and Regulatory Constraints on Short Sales*, 57 TAX L. REV. 233, 252 (2004).

<sup>132</sup> See Polsky, *supra* note 3, at 747. Of course, this is only the case if other deductions actually can reduce higher taxed income; if such deductions were limited in their ability to be used, a fully usable capital deduction could actually be more valuable to taxable investors. *Id.*

*Not All Carried Interests Are Created Equal*  
29:713 (2009)

the extent of capital gains.<sup>133</sup> Taken together, capital losses are less valuable than ordinary losses. The law relies on this tension to restrict the ability of taxpayers to manipulate the character of income since, at the initial time of an investment, a taxpayer would prefer capital treatment if the investment were to increase in value but ordinary treatment if the investment were to decline in value, without knowing at the outset which will occur.<sup>134</sup> A taxpayer not bearing any risk of incurring a loss would not be concerned about the adverse treatment of capital losses, however, and would thus be free to structure such investments to appear capital in nature without limitation.

This policy concern in the context of contractual reduction in the risk of loss parallels the fundamental concern at issue in the taxation of carried interest. The original concern over preferential capital gain rates was that the preference should only be afforded to those investors subject to the concerns of bunching and lock-in. Similarly, the concern over carried interest is that the GP is effectively being compensated for providing services, which does not suffer from bunching and lock-in, but is receiving the benefit of long-term capital gains preferential rates. Treating such returns as ordinary income would solve the preferential rate concern, but would ignore the reality that the GP does have some investment exposure to the underlying capital asset; after all, the GP only makes money if the portfolio company increases in value. Since carried interest is blended in this manner, an analogy to either situation proves less than satisfying.<sup>135</sup>

The analogy to short-term capital gains can prove more satisfying, however, at least within the framework of existing law. Short-term capital gains are similar to carried interest in that they represent a blended return—in the case of day trading, part a return on investment and part on skill in speculation, while in the case of carried interest, part a return on investment and part a return on money management. Further, and perhaps more importantly, carried interest bears no risk of losing any invested capital beyond the minimal invested capital of the GP, because economically the GP can only share in profits (and not losses). Thus, the GP is not concerned about the limitations on the ability to deduct capital losses arising from a loss of invested capital. Due to this combination of factors, carried interest appears more similar to short-term capital gains than either ordinary income or long-term capital gains, at least under current law. The answer that developed over time for such gains was not to re-characterize the investment as ordinary income, but to maintain the treatment as capital gain while at the same time denying the benefit of a preferential rate of tax.<sup>136</sup>

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<sup>133</sup> See 26 U.S.C. §§ 165(f), 1211 (2008).

<sup>134</sup> Powers, Schizer & Shubik, *supra* note 131.

<sup>135</sup> See Weisbach, *supra* note 1, at 741–42.

<sup>136</sup> There is a set of rules that serves as the primary exception to this approach: the rules

The analogy would suggest, therefore, that the proper normative treatment of carried interest should be similar—to continue treating the income attributable to carried interest as capital in nature but deny the preferential rate of tax through the use of holding period.<sup>137</sup>

Such a conclusion could bridge the divide in the carried interest debate. First, fundamentally the treatment of gains from the sale of stock in the portfolio company would remain capital gain. Thus, concerns expressed by supporters of the current regime regarding the re-characterization of income at the partnership level due to the nature of the partner to whom the income would be allocated no longer apply.<sup>138</sup> Similarly, concerns expressed about valuation problems or capital account shifting upon the grant of the profits interest to the GP would be addressed, since it would be the gain and only the gain allocated to the GP that would be included in the gross income of the GP. By removing both the partnership accounting problems and the characterization problems, this approach also ameliorates or avoids many of the difficult (and potentially prohibitive) line-drawing and complexity problems identified by some proponents of the current regime as prohibitive in reforming the taxation of

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dealing with embedded time value of money in debt instruments (the “OID” rules). 26 U.S.C. §§ 1271–1275. Under these rules, a portion of what would otherwise be treated as capital gain is converted into ordinary income based on an assumed yield to maturity. See KEVIN M. KEYES, FEDERAL TAXATION OF FINANCIAL INSTRUMENTS & TRANSACTIONS ¶ 4.03 (2009). Similar rules apply to debt instruments purchased at a discount in the secondary market. 26 U.S.C. § 1276 (2008). These rules primarily address time value rather than blended labor/investment returns, and thus are not directly relevant to the analysis. Further, to the extent returns exceed the deemed time value, they remain capital in nature. In the carried interest literature, the most similar approach is the deemed interest or cost of capital approach, which is not necessarily mutually exclusive with the holding period proposal. See *infra* note 144 and accompanying text. In other words, just as a single debt instrument could be subject to both the OID rules and the straddle rules, so could carried interest be subject to time value rules, such as the conversion transaction rules, and holding period rules, such as straddle rules. See 26 U.S.C. § 1258 (2008); KEYES, *supra*, ¶ 17.02[1][a]. Other re-characterization rules are similarly focused on unrelated concerns, such as tax arbitrage, and thus not directly relevant to carried interest. *E.g.*, 26 U.S.C. § 1245 (2008).

<sup>137</sup> As discussed in Section V *infra*, the mechanism to do so would be the straddle rules of 26 U.S.C. § 1092 (2008). For a discussion of extending these rules to specific transactions for policy reasons, see John J. Ensminger, *The Broad but Porous Net of the Straddle Rules: How Long Will the Fish Continue to Swim Through?*, 18 VA. TAX REV. 709, 757 n.144 and accompanying text (1999). This is not to say that the current regime is optimal in an ideal world, but only that to the extent reform is intended to work within the current tax regime the analogy to short-term capital gain can be a better fit than either ordinary income or long-term capital gain.

<sup>138</sup> In addition, this avoids the “endowment” concern identified in the literature, i.e., that the tax law is hesitant to tax individuals based on their endowed abilities rather than actual economic returns in the market. See Fleischer, *supra* note 1, at 28–31. Under the holding period proposal, returns on carried interest would remain capital gain, and thus treated as a return on capital rather than an imputed return on ability or services.

*Not All Carried Interests Are Created Equal*  
29:713 (2009)

carried interest.<sup>139</sup>

Further, the holding period approach would overcome the “joint tax” issue which has been noted in the literature as a problem with many reform proposals.<sup>140</sup> Under this theory, the problem with carried interest is not that it is taxed as capital gain but rather that GPs are arbitraging the low or zero rates of the LPs.<sup>141</sup> The holding period proposal addresses this, precisely because the gain remains treated as capital gain—that is, gain from the sale of a capital asset—and thus would not generate an incremental deduction for the LPs.<sup>142</sup> In this manner, since the GP would be denied the benefit of preferential rates but the LPs would also be denied an incremental deduction, the joint tax is increased as compared to current law regardless whether the LPs are tax-exempt or taxable investors.<sup>143</sup> To the extent the joint tax concern is solely one of net revenue raised rather than labels or nominal rates, this result should satisfy such concerns; this reflects the

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<sup>139</sup> See, e.g., Weisbach, *supra* note 1, at 755–58; Abrams, *supra* note 1, at 9. This conclusion applies to the current proposals to treat carried interest differently from other non pro-rata partnership items. The issue could also be addressed in a more fundamental manner by reforming the entire system for treating non pro-rata allocations for all purposes in partnership tax, which would require rethinking not only the character rules, but also the timing and basis rules as well as capital accounts, to achieve fundamental reform. See Gergen, *supra* note 63; Mark P. Gergen, *Reforming Subchapter K: Contributions and Distributions*, 47 TAX L. REV. 173 (1991); Mark P. Gergen, *Reforming Subchapter K: Special Allocations*, 46 TAX L. REV. 1 (1990).

<sup>140</sup> See Knoll, *supra* note 101, at 126–27; Sanchirico, *supra* note 2, at 241. The holding period proposal would achieve this in much the same manner as a re-characterization approach accompanied with a deduction disallowance, by increasing the tax rate on the GP while limiting the benefit of an offsetting deduction to the LPs.

<sup>141</sup> See Knoll, *supra* note 101.

<sup>142</sup> For example, under current law the GP is taxed on the carried interest at a rate of fifteen percent and the LP is not entitled to a deduction but is allocated less gain, which can be thought of as the equivalent of a deduction at a rate of fifteen percent. If, however, the carried interest was treated as ordinary income and generated an ordinary deduction for the LP, the parties could simply increase the carried interest to reflect this change; although the GP would pay twenty percent greater tax the LP would also be entitled to a twenty percent greater deduction—the result being that both the GP and the LP would have roughly the same after-tax return. See Knoll, *supra* note 101, at 158. By contrast, under the holding period proposal the carried interest would be subject to tax at thirty five percent but there would be no incremental deduction available for the LP (or the deduction would remain at fifteen percent), meaning the joint tax is increased. See Polsky, *supra* note 3 at 747–48.

<sup>143</sup> For taxable investors subject to limitations on their ability to claim ordinary deductions attributable to investments, this proposal might actually be preferable to alternatives where an ordinary deduction might be available. See Polsky, *supra* note 3, at 747. Regardless, by subjecting the carried interest to a higher rate of tax without changing the treatment of the LPs, the joint tax would still be increased. This is similar to one of the justifications for adopting § 7872, i.e., to prevent taxpayers from converting nondeductible or limited deductibility expenses into deductible expenses. See STAFF OF JOINT COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 528 (Comm. Print 1984).

strength of the holding period proposal—carried interest can be subject to a higher tax rate without re-characterizing the gain or fundamentally altering the partnership accounting rules.<sup>144</sup>

One potential problem with this approach is a variation of the line-drawing problem. Once it is determined that the law should treat the GP as receiving short-term capital gain for allocations of gain to a profits interest, the difficulty arises in determining which types of partnerships should be subject to this rule. Unlike the other carried interest proposals, however, this line-drawing problem should prove easier to overcome. More specifically, the allocation of gain to a profits interest could be treated as short-term capital gain any time the profits interest is such that the holder has a reduced risk of loss with respect to the underlying capital asset. Since a pure profits interest by definition has no invested capital to lose, holding a profits interest in a partnership in which capital was a material income-producing factor could be thought of as owning a capital interest in the partnership with some offsetting position reducing risk of loss.<sup>145</sup>

Due to these features, the short-term capital gain approach solves a number of the problems faced in the carried interest controversy, while avoiding a number of the problems with the current proposals being discussed. It would answer the proponents of reform whose focus is the marginal tax rate paid on carried interest by depriving private equity fund managers of the preferential capital gain, while also addressing the concerns of defenders of the current regime by maintaining the current rules regarding partnership accounting and issuance of partnership interests for services, as well as avoiding most of the line-drawing problems faced in a number of the other proposals (while creating a much more manageable

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<sup>144</sup> Further, for this reason, the holding period proposal is not necessarily mutually exclusive with the deemed interest proposal with a deduction disallowance. See Cunningham & Engler, *supra* note 1, at 129–32. One concern could be that by maintaining the capital nature of the carried interest, capital losses could be used to offset such gain—potentially freeing up otherwise limited deductions. Of course, this is the same for all blended returns treated as short-term capital gains, including pure speculation and day-trading. Further, other rules are in place which could limit the potential for abuse; for example, to the extent the straddle rules apply, such losses could not be claimed until the offsetting gain was recognized, potentially mitigating the concern. 26 U.S.C. § 1092(a)(1)(A) (2008).

<sup>145</sup> One benefit of this approach is that this line is already a familiar one in the tax laws. See 26 U.S.C. § 736(a) (2008); Philip F. Postlewaite & Adam H. Rosenzweig, *Anachronisms in Subchapter K of the Internal Revenue Code: Is It Time to Part with Section 736?*, 100 NW. U. L. REV. 379 (2006). One difficulty could be if taxpayers added some risk of loss to profits interests, such as a “deficit restoration obligation” or some form of top-tier loss allocation, presenting another potentially difficult line-drawing problem. To the extent these have “substantial economic effect” and thus actually change the structure of the deal and the economic risk of the GP, it is possibly not the worst result. See *infra* note 148 and accompanying text. Further, it could be possible to avoid an all-or-nothing approach even within this context through the “identified straddle” rules. See *infra* note 228.

*Not All Carried Interests Are Created Equal*  
29:713 (2009)

line-drawing issue).

This does not end the analysis, since presumably private equity fund managers would respond to any change in the tax law by restructuring their carried interest. In fact, this is one of the primary criticisms of any proposal to change to an ordinary income approach.<sup>146</sup> Presumably, the simplest way to avoid this problem would be to structure the carried interest as a true loan outside the partnership. In other words, the LPs would lend a portion of their investment capital to the GP directly rather than invest the money in the fund, and the GP would then use the money to invest in the fund on its own behalf, with the loan being nonrecourse and secured only by the GP's partnership interest. Such a structure would fairly closely replicate the economics of carried interest; the difference is that, since the GP would no longer own a profits interest but a "real" capital interest, the short-term capital gain solution would no longer apply.<sup>147</sup>

Perhaps this is not the worst result, however; providing incentives for taxpayers to enter into economically transparent transactions for which the tax laws have established rules may be a valuable end in itself.<sup>148</sup> First, the tax law has established rules to deal with loans made between related parties, regardless whether they bear adequate interest.<sup>149</sup> Thus, a number of the complexities introduced by involving the complex partnership accounting rules would be avoided by taxpayers shifting to a "true" loan structure.<sup>150</sup> Second, the more transparent structure would permit Congress to consider directly the treatment of such arrangements. In other words, if Congress wished to increase the tax rate on loans to fund managers by their investors, it could do so much more easily to "true" loans than to embedded or hidden loans within the partnership.<sup>151</sup> Third, papering an embedded loan in the carried interest as a true loan outside the partnership could be done in a manner so as not to distort any real economics of the transaction,

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<sup>146</sup> Weisbach, *supra* note 1, at 759–62.

<sup>147</sup> Although nonrecourse loans act to limit the risk of loss with respect to an asset purchased with the debt, and thus could be thought of in the same manner, for historic reasons it is not treated as an offsetting position reducing risk of loss (except in limited circumstances). See *infra* Section V for a discussion of the nonrecourse debt paradigm.

<sup>148</sup> In other words, the potential deadweight loss may be outweighed by the transaction cost savings and/or distributive benefits. See *Fair and Equitable Tax Policy for America's Working Families: Hearing Before the H. Comm. on Ways and Means*, 110th Cong. (2007) (testimony of Mark P. Gergen, Professor of Law, The University of Texas School of Law), available at <http://waysandmeans.house.gov/hearings.asp?formmode=view&id=6433> [hereinafter *Gergen Testimony*]; Wolfgang Schön, *The Odd Couple: A Common Future for Financial and Tax Accounting?*, 58 TAX L. REV. 111, 145 (2005).

<sup>149</sup> See 26 U.S.C. § 7872 (2008).

<sup>150</sup> See *Gergen Testimony*, *supra* note 148; Fleischer, *supra* note 1, at 57–58.

<sup>151</sup> This could include, among other things, imposing a higher implicit time value component on the loan than the "applicable federal rate" which is currently utilized under 26 U.S.C. § 7872(e)(1) (2008). See Knoll, *supra* note 101.

and thus should result in little, if any, incremental deadweight loss as compared with the carried interest structure.<sup>152</sup> Rather, the incremental cost would be purely an administrative one, making the cost/benefit analysis favorable towards the adoption of such a proposal.<sup>153</sup>

Lastly, the holding period proposal would bring the tax treatment of private equity fund sponsors closer to those of hedge funds—equalizing the tax treatment of the similar carried interest structures utilized by private equity and hedge funds. For example, there is little if any discussion as to why conversion proposals such as proposed § 710 should be applied to carried interest in hedge funds when there is often no concern of abuse in such situations (because they are not entitled to preferential rates under current law). Rather, application of proposed § 710 to GPs of hedge funds would appear solely to increase complexity while adding little normative benefit to the taxation of the managers of hedge funds—at least to the extent that rate concerns are driving the debate over the taxation of carried interest. Excluding hedge funds from the scope of § 710 would address this, but only by introducing yet another difficult if not impossible to enforce line-drawing problem (as well as the corresponding incentives to private equity to exploit the distinction). Under the holding period proposal, GPs of both private equity and hedge funds would receive short-term capital gain treatment on their investment-based returns, treating both similarly for tax purposes without requiring overly complex or arbitrary provisions.

#### B. Applying Holding Period to Carried Interest in an International Tax Regime

Once it is determined that a holding period approach would be preferable within a domestic context, it becomes useful to expand the analysis to one in which there are multiple taxing jurisdictions and mobility of capital to exploit differences among these jurisdictions, especially in the context of private equity fund sponsors, which have proven to be both tax sensitive and financially sophisticated, and which are relatively mobile as compared to other types of businesses.<sup>154</sup> To this end, two alternatives

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<sup>152</sup> See Weisbach, *supra* note 70.

<sup>153</sup> Further, it is possible (if not likely) that the carried interest structure itself is a distorted structure due to the current tax laws, in which case providing incentives to engage in a true loan structure could in fact be more efficient as a second-best solution.

<sup>154</sup> See, e.g., Peter Yeoh, *Should Private Equity Funds Be Further Regulated?*, 8 J. ASSET MGMT. 215, 224 (2007). Of course, this assumes the incidence of the holding period proposal would fall on the GP. To the extent the incidence of the tax falls on the LPs or on the portfolio company, the answer could differ. At first glance, however, it would appear that if the U.S. fund could shift the incidence of the increased tax to the LPs it would mean there was not a competition problem, since the LPs would continue to invest notwithstanding the increased cost, while if the fund could not do so then the incidence would return to the

*Not All Carried Interests Are Created Equal*  
29:713 (2009)

present themselves for consideration: (1) the incentive for private equity funds (including GPs) to move offshore and thus no longer be subject to U.S. tax and (2) the competitive position of private equity funds that remain within the United States as compared to those in other countries. From both perspectives, the holding period approach provides a satisfying resolution, at least within the structure of current law.

With respect to (1), once again contrasting private equity with hedge funds can be instructive. For a number of reasons, hedge funds tend to be organized offshore and not subject to U.S. income tax on a net basis.<sup>155</sup> For U.S. funds at least, the managers of the fund do tend to be located in the United States and subject to income tax on a net basis. As a result, long-term capital gain would be beneficial for these managers. As discussed above, however, the funds generally do not generate much long-term capital gain due to the limitations of their business model, notwithstanding the tax preferences of the managers. Consequently, the managers of these funds have historically structured their return as an incentive fee paid by an offshore corporation, which the manager can then defer and reinvest in the fund—deferring tax on the income as well.<sup>156</sup> At first glance, if a proposal to treat carried interest in private equity funds as short-term capital gain were adopted, presumably private equity funds would have a similar incentive to move offshore and structure their returns as deferred fees rather than as carried interest.<sup>157</sup>

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GP, making the inquiry relevant again. I am indebted to Gregg Polsky for highlighting this issue.

<sup>155</sup> This is generally so that foreign and tax-exempt investors can invest without being subject to U.S. tax. See Ordower, *supra* note 11, at 362–63 (“[E]xempt organizations capture their most favorable tax position by investing in offshore hedge funds.”). This is because businesses organized as foreign entities are generally not subject to U.S. income taxation on a net basis unless they are engaged in a “United States trade or business.” See 26 U.S.C. §§ 871(a)–(b), 881(a), 882(a), 864(b)–(c) (2008). See generally JOEL D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION ¶ A1.04 (2008). Hedge funds with significant foreign or tax-exempt investors can therefore organize offshore and engage only in investing activities in the United States that do not rise to the level of a trade or business, thereby avoiding subjecting the fund’s returns to United States tax. See Needham & Brause, *supra* note 12, at A-46, A-48–49.

<sup>156</sup> Ordower, *supra* note 11, at 364–65.

<sup>157</sup> Russell Berman, *Schwarzman Declines Invite To Speak on ‘Blackstone’ Bill*, N.Y. SUN, July 31, 2007 (citing Robert Stewart, spokesman for The Private Equity Council as saying “it doesn’t take much more than some smart men and women and some computers to set up a private equity firm, and clearly if the tax incentives are better overseas then that may well be where the economic activity occurs.”), available at <http://www.nysun.com/business/schwarzman-declines-invite-to-speak-on-blackstone/59458/>. Similarly, fund sponsors may have an incentive to move the fund offshore in whole or in part as a means to hold stock in an offshore corporation, which in certain circumstances could generate capital gain upon sale. See Lee A. Sheppard, *News Analysis: Hedge Fund Managers’ Year-End Tax Planning*, 121 TAX NOTES 1216, 1221 (2008) (“The Levin bill would be avoided and life would be greatly simplified if the fund itself were a [foreign corporation].”).

As with the true loan scenario, this may be less troubling than it initially appears. First, Congress has recently responded to the use of deferred fee structures by offshore hedge funds by denying the benefit of deferral in some of the most troubling circumstances.<sup>158</sup> Under these new rules, except in limited circumstances, the deferred fee would be included in the income of the managers in the year in which they were entitled to be paid without a significant risk of forfeiture.<sup>159</sup> Thus, as with the case of the true loan scenario, the incentive provided by the proposal may be simply for private equity funds to engage in more transparent transactions for which the tax law has established treatments.

Second, unlike hedge funds which act like traders in U.S. assets and thus claim they are not subject to U.S. income tax, the business model of private equity could make it difficult for the fund to move offshore while avoiding sufficient control over the day-to-day business inside the United States so as to become liable for U.S. income tax on a net basis.<sup>160</sup> In general, the United States does not tax the income of non-U.S. corporations; the primary exception being that it does impose U.S. tax on a net basis on the income effectively connected with the conduct of a U.S. trade or business.<sup>161</sup> For these purposes, however, trading in securities for the investor's own account is granted a "safe harbor" from being considered a trade or business.<sup>162</sup>

Hedge funds generally contend that they meet the requirement of trading for their own account, and thus are not engaged in a U.S. trade or business.<sup>163</sup> This "trading" safe-harbor is relatively limited, however; to the extent the offshore investor exerts any control over the day-to-day operations of the U.S. business, including actively managing officers or employees of the business, the investor likely would not qualify.<sup>164</sup> Similarly, offshore investors acting as the lead negotiators or lenders on behalf of a consortium may be considered engaged in the business of

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<sup>158</sup> See generally *Bankman Testimony*, *supra* note 78. This is not to say that the current response to deferred compensation is optimal, but rather that to the extent Congress has chosen to address the issue, subjecting taxpayers to the existing regime may not be the worst consequence of carried interest reform.

<sup>159</sup> Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343 § 801, 26 U.S.C. § 457A (2008).

<sup>160</sup> Arturo Requenez II & Timothy S. Shuman, *U.S. Private Equity Funds Making Cross-Border Investments*, 842 PLI/TAX 1091 (2008).

<sup>161</sup> 26 U.S.C. §§ 881(a), 882(a) (2008).

<sup>162</sup> 26 U.S.C. § 864(b)(2)(A)(ii) (2008).

<sup>163</sup> Richard M. Lipton & John (Jay) Soave III, *U.S. Taxation of Private Equity and Hedge Funds*, SP026 ALI-ABA 623, 634-35 (2008).

<sup>164</sup> David R. Sicular & Emma Q. Sobol, *Selected Current Effectively Connected Income Issues for Investment Funds*, 56 TAX LAW, 719 (2003).

*Not All Carried Interests Are Created Equal*  
29:713 (2009)

lending in the United States.<sup>165</sup> Since the business model of private equity is precisely to buy controlling stakes in companies and reorganize them to unlock value, it would be difficult for private equity funds to meet the “trading” safe harbor.<sup>166</sup>

This does not end the analysis, however, because private equity funds could contend that they are merely acting as passive investors in securities and thus have no business activity within the United States.<sup>167</sup> To the extent that a private equity fund wished to take such a position, it would have to be careful not to conduct any activities within the United States more consistent with a business than with the activities of an investor,<sup>168</sup> potentially increasing compliance and oversight costs and thus making operation of the fund more expensive. Further, if the private equity fund did not buy a controlling stake in a company but rather participated in a consortium, it would be possible that the one or more other members of the consortium could be considered to be engaged in a U.S. trade or business, potentially subjecting the fund to U.S. tax.<sup>169</sup> Consequently, restructuring as an offshore corporation could be riskier for private equity than for hedge funds, given the absence of a regulatory safe harbor. Such uncertainty, in addition to the increased transaction costs of maintaining non-U.S. status, could serve as a deterrent to private equity funds to relocate offshore.<sup>170</sup>

Due to the interactions of these rules, the tax law can better rely on the tension between the interests of the GP and the interests of the LPs to limit the ability of private equity to move offshore to escape the holding interest proposal. The move offshore would be solely to maximize the GP's tax treatment, while the risk would be that the entire fund would bear an entity

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<sup>165</sup> *Id.* at 752–53.

<sup>166</sup> It is possible that the fund would argue that it should be treated solely as a passive equity investor, although it could be a risky position depending on the involvement of the fund in the day-to-day operations of the portfolio companies. *Id.* at 776–77. See also Kimberly S. Blanchard, *Cross-Border Tax Problems of Investment Funds*, 60 TAX LAW. 583 (2007).

<sup>167</sup> There is evidence that private equity funds make such a claim currently with respect to their non-U.S. investors. See, e.g., Polsky, *supra* note 3, at 746, n.32; Lee A. Sheppard, *News Analysis: Are Hedge Funds in a Trade or Business?*, 114 TAX NOTES 140 (2007); Sicular & Sobel, *supra* note 164, at 772–73. The difference if the entire fund moved offshore would be that all the LPs, and not just the non-U.S. LPs, would bear the risk of tax if the position was incorrect. For tax-exempt LPs in particular, this incremental risk could be a substantial negative factor in deciding whether to invest in a particular fund.

<sup>168</sup> See Blanchard, *supra* note 166. This could include promoting the corporation to the market or customers or actively managing loans or financing. See Sicular & Sobel, *supra* note 164, at 773–74.

<sup>169</sup> For example, if the lead member of the consortium were considered to be acting as an agent for the fund in conducting a business. *Id.* at 765.

<sup>170</sup> See, e.g., Kyle D. Logue, *Optimal Tax Compliance and Penalties When the Law is Uncertain*, 27 VA. TAX REV. 241 (2007).

**Northwestern Journal of  
International Law & Business**

29:713 (2009)

level tax, ultimately born mostly by the LPs through reduced after-tax returns in the fund. Presumably, LPs would not be interested in maximizing the tax benefits of the GP at their own risk, even if such risk was relatively small. Contrast this to the current case of carried interest, where the LPs are indifferent for the most part to the taxation of the GP because the only cost to them is the loss of a deduction which is mostly irrelevant to tax-exempt LPs. Thus, even though incentives to cross borders can be a crucially important aspect of adopting any new tax provision, the experience with offshore hedge funds and the business model of private equity make changes to the taxation of carried interest for private equity funds less of a concern than would otherwise be the case.

So far, this analysis is not unique to the holding period proposal—any increase in taxation of the GP on the carried interest would result in the same analysis with respect to the ability of the fund to locate offshore. In addition to these general limitations, however, there are also benefits unique to the holding period proposal. One of the primary benefits would be that GPs would be treated as receiving short-term capital gain with respect to their carried interest independent of the investment profile of the fund. Thus, so long as the GP was located in the United States, the proposal would apply to disallow beneficial rates, regardless of the investment profile of the fund itself.

By way of contrast, many of the other proposals (such as proposed § 710) require some information with respect to the fund investments themselves, so as to identify partnerships with troubling assets and re-characterize them as ordinary income. With respect to domestic partnerships this is not particularly problematic because such entities are required to file informational returns with the IRS and are subject to unified audit procedures.<sup>171</sup> Information collection can prove more problematic for offshore funds not subject to U.S. enforcement jurisdiction,<sup>172</sup> and forcing disclosure of asset classes, investment returns, or other proprietary information may be difficult if not impossible.<sup>173</sup> Thus, any proposal relying on information from the fund would provide an incentive for unscrupulous funds to locate offshore solely in the hopes of denying this information to the IRS.<sup>174</sup> Since the holding period proposal does not require any such information, it does not suffer from this problem and correspondingly does not provide any additional incentive for funds to

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<sup>171</sup> See WILLIS, PENNELL & POSTLEWAITE, *supra* note 40, ¶ 20.02[1].

<sup>172</sup> *Id.* ¶ 21.04[2].

<sup>173</sup> This is precisely the case with respect to offshore hedge funds currently, and is the subject of current proposed legislation. See Stop Tax Haven Abuse Act, H.R. 1265, 111th Cong. § 109 (2009).

<sup>174</sup> Of course, the GP controls the fund and would be subject to U.S. law, and thus could be the subject of enforcement proceedings instead.

*Not All Carried Interests Are Created Equal*  
29:713 (2009)

locate offshore.

This does not end the analysis, however, because in addition to incentives for the *fund* to move offshore, such a proposal must also consider incentives for the *GP* to move offshore as well. Unlike the first issue, this issue is directly relevant to the holding period proposal because it is the *GP* who would be subject to the higher rate of tax by denying holding period for carried interest.<sup>175</sup> Once again, unique factors about the U.S. tax regime and the business model of private equity make this less of a concern than would first appear. In general, unlike most countries, the U.S. taxes the worldwide income of all U.S. citizens and all U.S. residents.<sup>176</sup> As an initial matter, therefore, so long as the *GP* is a U.S. citizen the *GP* would not avoid U.S. tax simply by relocating to another country. This rule places significant pressure on the role of citizenship; since citizenship subjects one to U.S. tax, the tax law creates an incentive to renounce citizenship as a means to avoid paying tax.<sup>177</sup> For many, the tangible and intangible benefits of citizenship likely outweigh any marginal tax savings that could inure from renouncing, including the right to live and work in the United States, which could be especially important for those with family, friends, or other close ties remaining within the United States.<sup>178</sup> The cost-benefit analysis for *GPs* of private equity may differ from most people, if for no other reason than the sheer size of the dollars at issue dwarfs that of most U.S. citizens.<sup>179</sup> As a result, the potential of *GPs* expatriating to avoid an increase in the tax liability of their carried interest must be taken seriously, even if expatriation is not a significant concern with respect to most taxpayers.

Again, this may not necessarily be problematic because it could simply result in taxpayers engaging in transactions for which Congress has clearly established rules. First, Congress recently enacted new rules intended to discourage tax-motivated expatriation by U.S. citizens.<sup>180</sup> Under these rules, the U.S. citizen must pay an “exit tax” upon expatriation by marking all their assets to market and paying tax on any gain as if they had sold all of their assets for the fair market value.<sup>181</sup> This may not be much of an

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<sup>175</sup> Again, this assumes that part or all of the incidence of such tax actually falls on the *GP*. See *supra* note 154.

<sup>176</sup> KUNTZ & PERONI, *supra* note 155, ¶ A1.03.

<sup>177</sup> Michael S. Kirsch, *Taxing Citizens in a Global Economy*, 82 N.Y.U. L. REV. 443 (2007).

<sup>178</sup> *Id.* at 469–75.

<sup>179</sup> Fleischer, *supra* note 1, at 5 (“In 2004, almost nine times as many Wall Street managers earned over \$100 million than did public company CEOs; many of these top earners on Wall Street are fund managers.”).

<sup>180</sup> Heroes Earnings Assistance and Relief Tax (HEART) Act of 2008, Pub. L. No. 110-245 (2008).

<sup>181</sup> *Id.* § 301, codified at 26 U.S.C. § 877A (2008).

**Northwestern Journal of  
International Law & Business**

29:713 (2009)

issue for most U.S. citizens, but GPs in private equity could well, and likely do, have significant holdings in appreciated assets; as a result, an exit tax could act as a significant deterrent on expatriating solely as a means to avoid the holding period proposal on carried interest. Further, these new rules also impose a gift and estate tax liability on any expatriate who gifts or bequeaths significant amounts of property back to beneficiaries in the United States.<sup>182</sup> Thus, not only would the expatriate have to sacrifice the right to permanently live and work near their family or friends, but they would also have to sacrifice passing on their assets to the same, at least without incurring a significant U.S. tax which would defeat the purpose of expatriating. Presumably, this would make expatriation a less viable option than it might otherwise appear at first glance.

Finally, the U.S. tax rules also significantly limit the ability of expatriates to even visit family and friends in the United States without incurring a tax liability, because the United States defines a U.S. resident as anyone who spends 183 days in the United States in any given year.<sup>183</sup> This is a bright-line test, and even de minimis amounts of time in the United States count towards the 183 day limit absent a specific exception.<sup>184</sup> Thus, an expatriate would have to significantly limit their visitation back to the United States to avoid being subject to U.S. tax on their worldwide income.<sup>185</sup> Taken together, these rules impose a substantial personal and financial toll on taxpayers who expatriate solely to avoid a marginal increase in U.S. income taxes.<sup>186</sup>

Due to the operation of these limitations, expatriation seems an unlikely response to adoption of the holding period proposal. As a result, it

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<sup>182</sup> *Id.* § 301, codified at 26 U.S.C. § 2801 (2008).

<sup>183</sup> 26 U.S.C. § 7701(b) (2008).

<sup>184</sup> 26 C.F.R. § 301.7701(b)-3(a) (2008) (“[A]n alien is considered to be present if the individual is physically present in the United States at any time during the day . . .”). See generally KUNTZ & PERONI, *supra* note 155, ¶ B1.02[2][c][iii].

<sup>185</sup> This is in addition to any other non-tax restrictions on expatriates visiting the United States. For example, former citizens who are determined to have renounced their citizenship solely to avoid taxes may be prohibited from returning to the United States at any time. 8 U.S.C. § 1182(a)(10)(E) (2008) (“Any alien who is a former citizen of the United States who officially renounces United States citizenship and who is determined by the Attorney General to have renounced United States citizenship for the purpose of avoiding taxation by the United States is inadmissible.”).

<sup>186</sup> This analysis does not take into account another complicating factor, which is that the expatriate would also need to find another country willing to grant citizenship or permanent residence status. For those with dual-citizenship this would be less of a problem, since the expatriate could return to the other country of citizenship, but there is anecdotal evidence that for those without dual citizenship finding a new home may not be as easy as it sounds, at least for certain high profile individuals. See Sarah Lyall, *Bobby Fischer, Facing Charges in U.S., Seeks Icelandic Citizenship*, N.Y. TIMES, Jan. 28, 2005, available at <http://query.nytimes.com/gst/fullpage.html?res=9FOCE1D7173BF93BA15752C0A9639C8B63&fta=y&scp=2&sq=fischer%20renounce%20citizenship&st=cse>.

*Not All Carried Interests Are Created Equal*  
29:713 (2009)

becomes necessary to consider whether the United States would disadvantage its own private equity fund managers as compared to those located in other countries if the holding period proposal were adopted. The answer to this question requires an investigation into two areas: first, how other countries treat carried interest, and second, the incentives to U.S. taxpayers in light of the proposal.

With respect to the first issue, there is not an obvious single answer. A number of similarly situated jurisdictions, such as the United Kingdom, have also proposed taxing carried interest at higher rates than under current law.<sup>187</sup> In such a case, although the details would differ, U.S. fund managers would not necessarily be at a competitive disadvantage to funds in countries such as the United Kingdom. Other countries, on the other hand, have reportedly promoted the beneficial treatment of carried interest under their law as a means to attract fund managers.<sup>188</sup> As a result, it is difficult to claim that there is any international consensus as to the treatment of carried interest.

It is possible, if not likely, that countries with more established financial centers would be able to impose higher taxes on carried interest because funds would benefit from remaining in such jurisdictions even given the tax (or in other words the location of the funds would be sufficiently inelastic).<sup>189</sup> Although not certain, this would make it more likely that other major financial centers such as the United Kingdom and Japan could also increase the taxation of carried interest, leaving U.S. fund managers in no worse position as compared to their primary competitors than under current law. While U.S. fund managers may be disadvantaged as compared to competitors in other countries, such as Swiss fund managers, this may be less of a concern considering the lack of significant private equity fund manager activity in these jurisdictions.<sup>190</sup> To the extent this is the case, competitiveness would not be a concern; to the extent it is not, however, the concern remains and thus the question would need to be confronted directly.

Directly confronting this question presents the second issue: whether, even if they were taxed more heavily than some competitors, U.S. fund

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<sup>187</sup> Peston, *supra* note 1. See also Lee A. Sheppard, *News Analysis: Hedge Fund Managers' Tax Benefits Compared*, 119 TAX NOTES 243 (2008).

<sup>188</sup> See, e.g., Jean-Baptiste Brekelmans, *Luxembourg's Law on Specialized Investment Funds*, 2007 WTD 115-9 (June 11, 2007); *Switzerland to Clarify Hedge Fund, Private Equity Treatment*, 2008 WTD 175-20 (Sept. 5, 2008).

<sup>189</sup> This is also referred to as "rent extraction." See Rosanne Altshuler & Harry Grubert, *The Three Parties in the Race to the Bottom: Host Governments, Home Governments and Multinational Companies*, 7 FLA. TAX REV. 153 (2005).

<sup>190</sup> This would depend on the relative costs and benefits, which was seen in the case of funds moving to Singapore in light of adverse Japanese tax and regulatory rules. See, e.g., Randall Jackson, *Japan Trying to Woo Back Hedge Funds*, 2008 WTD 18-4 (Jan. 28, 2008).

**Northwestern Journal of  
International Law & Business**

29:713 (2009)

managers would change their behavior or have less incentive to manage or invest in portfolio companies. Such an analysis confronts the well-known tension between the “income effect” and “substitution effect” of the tax laws.<sup>191</sup> Under the income effect, the higher taxes are the more people must work to earn the same after-tax income, while under the substitution effect, higher taxes provide less incentive to choose work over leisure.<sup>192</sup> The literature is divided on which effect should dominate theoretically, or even whether that can be determined.<sup>193</sup> Consequently, the answer turns on whether policy makers believe that private equity fund managers would work less in the face of the holding period proposal, at least relative to other professions.<sup>194</sup> There is no direct empirical evidence on this issue, and the evidence that exists would seem to suggest a contrary conclusion.<sup>195</sup> As a result, it is difficult to justify not adopting the proposal based solely on a claim of tax induced reduction in private equity performance, although it could be a relevant factor in structuring the details of a reform proposal as part of the overall debate.

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<sup>191</sup> Eric M. Zolt, *The Uneasy Case for Uniform Taxation*, 16 VA. TAX REV. 39, 63 (1996). This assumes the incidence falls on the GP and is not shifted to the LPs. See *supra* note 154.

<sup>192</sup> Weisbach, *supra* note 70, at 1653–54.

<sup>193</sup> See Anne L. Alstott, *Equal Opportunity and Inheritance Taxation*, 121 HARV. L. REV. 469, 497 (2007) (“Economic theory cannot predict whether the income effect or the substitution effect will dominate: that is an empirical question.”); Martin J. McMahon, Jr., *The Matthew Effect and Federal Taxation*, 45 B.C. L. REV. 993, 1080–84 (2004).

<sup>194</sup> See *Carried Interest Part II: S. Comm. on Fin. Hearing*, 110th Cong. 2 (July 31, 2007) (testimony of Joseph Bankman, Ralph M. Parsons Professor of Law and Business, Stanford Law School), available at <http://finance.senate.gov/hearings/testimony/2007test/073107testjb.pdf>. Professor Bankman testified that:

In order for the current low rate to be efficient, it would have to be shown not just that fund managers will work less if the tax is increased, but that they are relatively more sensitive to tax than those in other occupations . . . no one has presented any evidence that this is the case.

*Id.*

<sup>195</sup> See McMahon, *supra* note 193, at 1082–83:

Historically, over the long-term in the United States, increasing real wages have led to shorter work weeks, longer vacations, and earlier retirement. This is evidence that the income effect predominates over the substitution effect. Furthermore, there is nothing to indicate that high-income earners behave any differently than anyone else, unless perhaps their labor supply is more inelastic than that of low-income workers because of the nature of their jobs and the reasons that they work . . . . In short, the empirical evidence indicates that those who predict that lower tax rates will increase work effort have made erroneous assumptions about human behavior.

*Not All Carried Interests Are Created Equal*  
29:713 (2009)

From this perspective, one benefit of the holding period proposal in particular is that it focuses solely on the GP and not on the fund itself. This is important, because the competitiveness analysis ultimately turns on the ability of the *funds* to attract investors, not on the treatment of the fund managers. Since the holding period proposal does nothing to change the after-tax return of the fund itself or of the investors in the fund, there is no particular reason to think that it would change the competitive position of U.S. managed funds as compared to those managed in other jurisdictions.<sup>196</sup> Consequently, although difficult issues arise when confronting the treatment of carried interest in an international regime, the competitiveness of U.S. funds as compared to non-U.S. funds does not appear to be a reason for the holding period proposal to be unattractive from a normative standpoint within the existing income tax framework.

#### V. THE POSITIVE CASE FOR CARRIED INTEREST AND HOLDING PERIOD

One major benefit of the holding period proposal to the taxation of carried interest is that it is arguably not only the proper policy answer, but also would be much simpler to integrate into current law. This may seem strange at first, but after a short overview of some provisions of the Code in other contexts, the short term capital gain approach proves much simpler to adopt than most re-characterization proposals.

In general, income, gains, losses, and deductions realized in a partnership are allocated to the partners in accordance with the partners' interests in the partnership.<sup>197</sup> The Treasury regulations provide a detailed set of rules on how to maintain capital accounts and allocate gains and losses so as to comply with this requirement.<sup>198</sup> Under these rules, gains are allocated among the partners so as to make the capital accounts match (eventually) with the economic rights of the partners if the partnership were to liquidate.<sup>199</sup> Further, the character of the gain is determined at the partnership level, and then treated in the same manner by the partner when the gain is allocated to the partner.<sup>200</sup> The general intent of these provisions is to treat the partnership as an entity for purposes of calculating income, gain, loss, and deductions but to end up in the same (or as similar as possible) situation as if the partners had owned a share of the underlying

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<sup>196</sup> The one exception would be to the extent the fund could shift the incidence of the tax to the LPs. As discussed above, to the extent such shifting was possible then competitiveness should be less of a concern, while to the extent it was not then the return for the LPs would not be affected. See *supra* note 154.

<sup>197</sup> 26 U.S.C. § 704(b) (2008).

<sup>198</sup> See generally 26 C.F.R. § 1.704-1(b) (2008).

<sup>199</sup> WILLIS, PENNELL & POSTLEWAITE, *supra* note 40, ¶ 10.01.

<sup>200</sup> 26 U.S.C. § 702(b) (2008).

assets of the partnership directly.<sup>201</sup>

Under § 1092, if a taxpayer enters into an offsetting position with respect to certain capital assets,<sup>202</sup> among other consequences the holding period of the asset stops running.<sup>203</sup> For example, if a partnership which owned stock in a publicly-traded company for less than one year were to engage in an offsetting position with respect to such stock, the partnership would toll the holding period of the stock at such time. In such case, assuming nothing else changes, upon sale of the stock any gain would be short-term calculated at the partnership, and thus would be short-term for the partners to whom it was allocated.<sup>204</sup>

This straightforward example does not address the treatment of partners who enter into offsetting positions with respect to their partnership interests. It would appear at first glance that a partner entering into an offsetting position with respect to the partnership interest would not be in a straddle with respect to an asset owned by the partnership, because they are two distinct assets.<sup>205</sup> This result is contradicted by § 1092(d)(4)(C), however, which provides that, in general, if part or all of the gain or loss with respect to a position held by a partnership would be allocated to a partner, then such position shall be treated as held by the partner.<sup>206</sup> Under

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<sup>201</sup> See generally WILLIS, PENNELL & POSTLEWAITE, *supra* note 40, ¶¶ 10.01–04.

<sup>202</sup> Section 1092 only applies to “personal property of a type which is actively traded.” 26 U.S.C. § 1092(d)(1) (2008). It is likely that the GP’s carried interest would not meet this test since it is a private fund. The stock of the underlying portfolio company is less clear, however. Under their business model, stock of portfolio companies owned by private equity funds are private—that is not actually traded—until a liquidation event. However, § 1092 does not require actual trading to apply. Rather, § 1092 only requires that the stock be *of a type* that is actually traded for it be personal property (emphasis added). Thus, it is possible that portfolio company stock could meet this definition even under current law because a common exit strategy for private equity is a public offering of the portfolio company stock. See Michael Kosnitzky, *The Uncertain Repeal of the Straddle Stock Exception*, 109 TAX NOTES 1458 (2005). Regardless, even if the portfolio company stock was not covered under the current definition of personal property, it is relatively clear that Treasury has the regulatory authority to include it in the definition. 26 U.S.C. § 1092(b)(1) (2008). This may not be sufficient for real estate or other types of non-equity funds, but Congress could add such assets to the list as well if it was considered important or necessary.

<sup>203</sup> See 26 C.F.R. § 1.1092(b)-2T(a) (2008). See generally KEYES, *supra* note 136, ¶ 17.03[2][a].

<sup>204</sup> See 26 U.S.C. § 702(b) (2008).

<sup>205</sup> 26 U.S.C. § 741 (2008).

<sup>206</sup> 26 U.S.C. § 1092(d)(4)(C) (2008). The statute states:

If part or all of the gain or loss with respect to a position held by a partnership, trust, or other entity would properly be taken into account for purposes of this chapter by a taxpayer, then, except to the extent otherwise provided in regulations, such position shall be treated as held by the taxpayer.

*Not All Carried Interests Are Created Equal*  
29:713 (2009)

this approach, the partner would be treated as owning a share of the underlying asset of the partnership. For example, if a partner in partnership ABC, which owned XYZ stock, entered into a put against XYZ stock outside of the partnership, the partner would be considered to have entered into offsetting positions; in this case, the put directly owned by the partner would be considered an offsetting position against the XYZ stock deemed owned by the partner under § 1092(d)(4).<sup>207</sup>

What is less clear is whether an offsetting obligation with respect to the *partnership interest* can be an offsetting position with respect to the *underlying asset* of the partnership, even if such asset is deemed owned by the partner under § 1092(d)(4). This is a difficult question because, under the entity theory of partnerships, the partnership interest is a separate and unique asset from the underlying assets of the partnership. For example, if a taxpayer owned two wholly unrelated assets D and E and entered into an offsetting position with respect to E, this would not cause the taxpayer to be considered to have entered into an offsetting position with respect to D. Similarly, if a partner has an offsetting position with respect to the partnership interest, this should not necessarily impact the partner's deemed ownership of the underlying assets of the partnership. This is purely a legal construct, however; economically, the partnership interest represents the right to share in the underlying assets of the partnership. Thus, the economic realities would support the argument that the taxpayer has entered into an offsetting position with respect to the underlying asset. Nonetheless, the legal answer remains unclear.<sup>208</sup>

Support for the affirmative answer to this question can be found by looking to other provisions of the tax laws. For example, in Prop. Reg. § 1.263(g)-4(c), Ex. 6, a partner who borrows at the partner level to make an investment with respect to a partnership asset is considered to have entered into a straddle.<sup>209</sup> The example concludes that the partner should be

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*Id.* See also 26 C.F.R. § 1.246-5(c)(6) (2008).

<sup>207</sup> An offsetting position for these purposes exists to the extent there is a substantial diminution of the taxpayer's risk of loss with respect to personal property. 26 U.S.C. § 1092(c)(2)(A) (2008). Since these offsetting positions would be deemed to occur outside the partnership, the partnership would not necessarily have to re-characterize the gain solely for that partner or otherwise alter compliance with Subchapter K, although the mechanics can get complicated in more complex situations. See Deborah H. Schenk, *Taxation of Equity Derivatives: A Partial Integration Proposal*, 50 TAX L. REV. 571, 619–22 (1995) (providing detailed examples).

<sup>208</sup> See Kevin M. Keyes, *Proposed Straddle and Hedging Regulations Take Steps in the Wrong Direction*, 850 PLI/TAX 1087, 1094 n.18 (2008) (“[O]ne would not think of a partnership interest as being part of a straddle.”).

<sup>209</sup> 66 Fed. Reg. 4746-01, at 4751 (2001). See also 26 C.F.R. § 1.246-5(c)(6) (2008) (“Positions held by a party related to the taxpayer . . . are treated as positions held by the taxpayer if the positions are held with a view to avoiding the application of this section or § 1.1092(d)-2.”).

treated as entering into an offsetting position with respect to the underlying assets of the partnership, even though the partner only reduced the risk of loss with respect to the partnership interest.<sup>210</sup> Under this interpretation, entering into an offsetting position with respect to the partnership interest could result in a straddle with an asset owned by the partnership. What is interesting about this analysis is that, unlike the situation where the partnership enters into an offsetting obligation, only the partner is deemed in a straddle, not the entire partnership.

It may be difficult to argue that an example in a regulation applying the interest capitalization rules of § 263 could change the definition of a straddle under § 1092 if it otherwise did not cover this type of situation.<sup>211</sup> However, the Treasury and the IRS have consistently taken the position that the regulations interpreting § 263 are meant to be read in concurrence with § 1092; in other words, it is the position of the Treasury and the IRS that a § 1092 straddle must exist before § 263 can apply.<sup>212</sup> Under this approach, at least in the interpretation of Treasury and the IRS, a partner entering into an offsetting position with respect to a partnership interest can be considered to be in a straddle with the underlying property of the partnership.

This position is further supported by the presence of § 7701(f),<sup>213</sup> which provides that Treasury has the authority to enact regulations to prevent the use of a flow-through entity such as a partnership to avoid any provision of the Code related to diminished risk of loss. Among other things, § 7701(f) was intended to give Treasury the authority to prevent corporations from claiming a dividends-received deduction in certain circumstances where the corporation owned stock through a partnership and entered into a position limiting its risk of loss on the partnership interest.<sup>214</sup> The Tax Court has held that the failure to issue regulations under § 7701(f) does not mean that other provisions applying similar rules cannot be applied to taxpayers.<sup>215</sup> Taken together, these support the argument that partners who enter into an offsetting position with respect to a partnership interest can be in a straddle with the assets of the partnership. Even if they did not, § 7701(f) would seem to provide clear authority to Treasury to promulgate

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<sup>210</sup> *Id.*

<sup>211</sup> *See, e.g.,* KEYES, *supra* note 136, ¶ 17.05 n.309.21.

<sup>212</sup> *Id.* ¶ 17.05 n.309.24.

<sup>213</sup> 26 U.S.C. § 7701(f) (2008) (“The Secretary shall prescribe such regulations as may be necessary or appropriate to prevent the avoidance of those provisions of this title which deal with . . . (2) diminishing risks . . . through the use of related persons, pass-thru entities, or other intermediaries.”).

<sup>214</sup> BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATION & SHAREHOLDERS* ¶ 5.05 n.204 (2000).

<sup>215</sup> *Enter. Int’l, Inc. v. Comm’r*, 105 T.C. 71 (1995).

*Not All Carried Interests Are Created Equal*  
29:713 (2009)

regulations to such effect.<sup>216</sup>

Even taking this as true, how does it apply to carried interest? Once again, it requires a return to the embedded loan construct of carried interest. The typical analysis of the embedded loan is that it should be thought of as a nonrecourse loan from the LPs to the GP to acquire a capital interest in the partnership.<sup>217</sup> Although not entirely clear, this appears to be a favored alternative construct of carried interest because it is similar to more familiar situations where the borrower does not bear risk of loss beyond the secured asset—a nonrecourse loan. In particular, since the landmark holdings of *Crane*<sup>218</sup> and *Tufts*,<sup>219</sup> the fact that a taxpayer may not bear the risk of loss when using nonrecourse debt to acquire property has been considered irrelevant to whether the debt is considered true debt, whether the taxpayer is considered the owner of the property, and whether the taxpayer receives basis in such property.<sup>220</sup> Given the overwhelming dominance of *Crane* and *Tufts*, the paradigm in the tax law has generally been to analogize to nonrecourse debt in situations where a borrower does not bear risk of loss on financing, such as with the embedded loan in carried interest.<sup>221</sup>

What has been long recognized in the literature, however, is that nonrecourse debt is economically identical to recourse debt plus a put option on the secured property.<sup>222</sup> Given the dominance of *Crane* and *Tufts*, and the disfavor in the tax laws for deconstructing instruments into constituent parts, the tax law has generally not treated nonrecourse debt as separate recourse debt plus a put option, notwithstanding their economic

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<sup>216</sup> Cf. 26 C.F.R. § 1.246-5(c)(6) (2008).

<sup>217</sup> Fleischer, *supra* note 1, at 40; Weisbach, *supra* note 1, at 734.

<sup>218</sup> *Crane v. Comm'r*, 331 U.S. 1 (1947).

<sup>219</sup> *Comm'r v. Tufts*, 461 U.S. 300 (1983).

<sup>220</sup> See, e.g., Deborah A. Geier, *Tufts and the Evolution of Debt-Discharge Theory*, 1 FLA. TAX REV. 115 (1992); see also *Preslar v. Comm'r*, 167 F.3d 1323 (10th Cir. 1999).

<sup>221</sup> See Schmolka, *supra* note 39. For example, borrowings by disregarded limited liability companies (LLCs) have been analogized to nonrecourse debt of the owner of the LLC under this theory. See Terence Floyd Cuff, *Indebtedness of a Disregarded Entity*, 81 TAXES 303 (2003); see also Stephanie R. Hoffer, *Give Them My Regards: A Proposal for Applying the COD Rules to Disregarded Entities*, 107 TAX NOTES 327 (2005).

<sup>222</sup> See, e.g., Linda Sugin, *Nonrecourse Debt Revisited, Restructured and Redefined*, 51 TAX L. REV. 115, 146 n.21 and accompanying text (1995). For example, assume a person buys a \$500,000 house with no money down with a \$500,000 nonrecourse mortgage. If the house drops in value to \$300,000, due to the nonrecourse nature of the debt the person can simply walk away from the house and owe nothing additional on the mortgage. If the person acquires the same house with a \$500,000 recourse loan but also buys a put on the house for \$500,000 from the same lender, if the house drops in value to \$300,000 the person is technically liable for the additional \$200,000 due to the recourse nature of the loan. In response, the person could exercise the put, sell the house to the lender for \$500,000, and fully satisfy the mortgage. Under either scenario, the person has no liability for the mortgage beyond the risk of losing the house.

equivalence.<sup>223</sup> This paradigm is so strong that it has dominated the carried interest debate. This need not be the case, however. Since the “debt” at issue in carried interest is embedded in the profits interest of the partnership, there is no existing legal instrument to deconstruct, and thus the paradigm to respect nonrecourse debt need not apply. Rather, the law should be able to construct a hypothetical set of facts to most closely match the tax treatment of carried interest with its economic reality.<sup>224</sup>

Perhaps the better approach from this perspective would be for the embedded loan in a carried interest to be thought of as if the GP had borrowed money on a recourse basis from the LPs and at the same time purchased a put on the partnership interest. Under this construct, the GP would have invested capital in the partnership but also would be economically protected from risk of loss on the partnership interest, which would fit perfectly within the interpretation of § 1092 described above. Of course, this is only a legal construct; no real debt exists, would be constructively attributed, or would be actually or constructively bifurcated. Rather, such an approach would merely recognize that the embedded put in an embedded loan of the carried interest could have the economic effect of an “offsetting position” for purposes of § 1092.<sup>225</sup>

Assuming this is correct, then a GP holding a carried interest would be considered to have a reduced risk of loss with respect to the partnership interest of the fund and thus to have entered into a straddle with respect to the stock of the portfolio companies owned by the fund.<sup>226</sup> As a result, the GP would have to toll its holding period with respect to the stock of all portfolio companies owned by the fund.<sup>227</sup> Since the carried interest is issued to the GP at the inception of the fund, the GP would be deemed in a straddle with portfolio company stock at all times, and thus all gain allocated to the carried interest with respect to such investments would be

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<sup>223</sup> See *id.*; see also STEVIE D. CONLON & VINCENT M. AQUILINO, PRINCIPLES OF FINANCIAL DERIVATIVES U.S. & INTERNATIONAL TAXATION ¶ B2.04[5] (2008) (“[T]he tax law as a general matter does not bifurcate a debt instrument into its economic components.”). With respect to straddles, however, on at least one occasion the IRS has shown a willingness to bifurcate an instrument in certain circumstances. See IRS Field Service Advice Memorandum No. 199940007, 1999 WL 801598 (June 15, 1999).

<sup>224</sup> David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 TAX LAW. 235 (1999).

<sup>225</sup> See, e.g., David M. Hasen, *A Realization-Based Approach to the Taxation of Financial Instruments*, 57 TAX L. REV. 397 (2004); David F. Levy, *Towards Equal Treatment of Economically Equivalent Financial Instruments: Proposals for Taxing Prepaid Forward Contracts, Equity Swaps, and Certain Contingent Debt Instruments*, 3 FLA. TAX REV. 471 (1997); Jeff Strnad, *Commentary: Taxing New Financial Products in a Second-Best World: Bifurcation and Integration*, 50 TAX L. REV. 545 (1995).

<sup>226</sup> JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 108TH CONGRESS 485 (2005).

<sup>227</sup> 26 C.F.R. § 1.1092(b)-2T(a) (2008).

*Not All Carried Interests Are Created Equal*  
29:713 (2009)

short-term capital gain.<sup>228</sup>

Whether such an approach can or should be adopted, and if so by either Treasury or Congress,<sup>229</sup> are important questions, but distinct from the positive claim that such an approach fits more easily within the existing tax regime than most of the current carried interest proposals being debated. Under such a positive claim, the short-term capital gain approach would be simpler to adopt and implement within current law than other carried interest proposals, thereby avoiding placing the IRS in the unenviable position of both needing to be near-omniscient in crafting rules within a new regime and near-omnipresent in policing them going forward.

This remedy does not necessarily solve all of the problems raised by carried interest. For example, treating carried interest as short-term capital gain under current law would not subject the carried interest to payroll taxes, to which wage income would be subject.<sup>230</sup> It is difficult to think of a reason why conforming problems such as these would themselves provide the basis for adopting a complex and difficult to administer approach such as proposed § 710; rather, such concerns would seem to further support the adoption of the short-term capital gain approach, but with conforming amendments to the payroll tax rules to include such amounts in the payroll tax base.<sup>231</sup> By more closely fitting the treatment of carried interest within the existing law, such conforming changes would presumably be much simpler to identify and implement than in the situation where a completely

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<sup>228</sup> One problem with this interpretation of current law may be that it proves too much, i.e., if the GP owns a put against the carried interest, then potentially all gain allocated to the GP, even amounts allocated to a real capital investment by the GP, could be subject to the straddle rules of § 1092. Under the identified straddle rules of § 1092(a)(2), however, a taxpayer may identify specific offsetting positions as part of a straddle and thus insulate other positions in similar property from the straddle rules. Thus, one possibility could be for all GPs to identify the carried interest as a straddle and thus insulate any additional capital interest owned by the GP, including reinvested capital, from these rules. Further, since the taxpayer is deemed to engage in the offsetting “put” as of the date of issuance, taxpayers might claim the benefits of the “married put” rules of § 1233, which would cause the carried interest to escape the tolling rules. 26 U.S.C. § 1233(c) (2008). It is likely that if a transaction is a straddle under § 1092, it is not entitled to the benefits of the married put rule, thus mitigating the risk of such an argument. See Report of the Tax Section of the New York State Bar Association, *Comments on Proposed Straddle Legislation*, 87 TAX NOTES 823, 843 (2000) (“The married put rule was in effect eliminated from the code, as it relates to actively traded property, by the straddle rules.”).

<sup>229</sup> For example, it is possible that Treasury pursuant to its existing authority under § 1092(b)(1) and § 7701(f) could accomplish this result solely through regulation.

<sup>230</sup> 26 U.S.C. § 3121(a) (2008).

<sup>231</sup> See James B. Sowell, *Partners as Employees: A Proposal for Analyzing Partner Compensation*, 90 TAX NOTES 375, 391 (2001) (“Given the burgeoning use in today’s business environment of LLCs and other entities that are treated as partnerships for federal tax purposes, it is time for Congress . . . to enact legislation specifically allowing partners to be treated as employees.”).

new regime is adopted as well.

## VI. CONCLUSION

Much has been written recently regarding the proper tax treatment of carried interest. The debate has tended to focus on the distinction between capital income, on the one hand, and services income, on the other. More specifically, the debate has focused on carried interest in private equity funds claiming the benefit of preferential long-term capital gain rates, which raises significant distributional issues due to the large amount of money involved. What generally has been missing in the debate, however, is that the tension in addressing blended investment/services income is unique neither to private equity nor even to private investment funds more generally, but rather has been an embedded feature of the income tax laws since their inception.

What can be learned from the tax treatment of incentive fees for managers of other private funds such as hedge funds is that the proper answer to the taxation of carried interest might not be to re-characterize otherwise capital gain as ordinary income or fundamentally reshape the partnership tax rules, but rather to rely on the rules already in place—the treatment of short-term capital gain—to address such concerns. Looking at the issue of carried interest from this perspective appears to provide both a more satisfying analogy and a more implementable policy answer, at least within the constrictions of current law. In other words, to the extent critics of reform proposals insist that capital gains treatment is normatively correct so long as there is an ordinary/capital distinction in the tax law, the holding period proposal can satisfy such concerns, while to the extent proponents of reform insist on higher rates of tax, the holding period proposal can satisfy their normative preferences as well. Perhaps these conclusions only support the claim that more fundamental reform is necessary, or that the logistical concerns of other proposals may actually be preferable to the result of the holding period proposal. Regardless, any discussions about the taxation of carried interest under current law not taking into account the treatment of short-term capital gains would be incomplete. At a minimum, therefore, treating carried interest as short-term capital gain should be part of the debate if and when Congress and Treasury revisit this issue.