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## TAXING INVESTMENT FUND MANAGERS USING A SIMPLIFIED MARK-TO-MARKET APPROACH

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### INTRODUCTION

In the throes of the worst recession since the Great Depression,<sup>1</sup> private investment funds (such as hedge funds and private equity funds) find themselves alternately vilified and lionized.<sup>2</sup> One day, hedge funds are accused of causing systemic risk.<sup>3</sup> The next, their high-frequency trading is credited with adding liquidity and stability to the stock market.<sup>4</sup> Some see hedge funds as rip-off artists, out to fleece investors (and, incidentally, to wreak havoc on non-investors), while others see them as an “oasis” in the world of Bernie Madoff and huge portfolio losses.<sup>5</sup>

It seems strange that investment funds could elicit such visceral but opposing reactions. After all, an investment fund is just a privately owned investment vehicle through which (wealthy) people can pool their money and have it invested by a professional investment fund manager. But with an estimated \$2 trillion invested in hedge funds alone at the beginning of 2008,<sup>6</sup> there is a

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1. Edmund L. Andrews, *Forget Aloof, Bernanke Goes Barnstorming*, N.Y. TIMES, July 27, 2009, at A1.

2. Note that when this Article refers to investment funds, it is referring to private and unregulated investment funds, including hedge funds and private equity funds as well as certain real-estate partnerships, but is not referring to mutual funds or any other investment fund regulated by the U.S. government.

3. Chris Dillow, *Why Aren't Hedge Funds Failing as Fast as Banks?*, TIMES (London), Sept. 17, 2008, at 32 (“Before the credit crunch started, countless experts warned us that hedge funds were a source of ‘systemic risk’. They were wrong.”).

4. *In Praise of Fast Trades*, N.Y. TIMES DEALBOOK, Aug. 3, 2009, <http://dealbook.blogs.nytimes.com/2009/08/03/in-praise-of-fast-trades/> (“Rather than destabilizing the markets, Mr. Niederauer said, high-frequency trading adds liquidity to the marketplace and so probably does the opposite, reducing market volatility.”). *But see* Paul Krugman, Op-Ed., *Rewarding Bad Actors*, N.Y. TIMES, Aug. 3, 2009, at A21.

5. Louise Story, *Just a Little off the Top*, N.Y. TIMES, Mar. 25, 2009, at B1.

6. *See* Louise Story, *Hedge Funds, Unhinged*, N.Y. TIMES, Jan. 18, 2009, at BU1.

popular perception that when an investment fund sneezes, the markets catch a cold.<sup>7</sup>

The same sense of irreconcilable duality that exists as to whether investment funds are good or evil also plays out in discussions of the taxation of investment fund managers.<sup>8</sup> A large portion of an investment fund manager's income is paid in the form of "carried interest." Carried interest is an investment fund manager's principal ownership interest in an investment fund. The investment fund manager receives carried interest in exchange for her work managing the fund, not in exchange for contributing money to the fund. The carried interest entitles the investment fund manager to a portion of the fund's profits; although the percentage can vary, depending on the particular investment fund, investment fund managers generally receive a 20% share of the investment fund's profits as their carried interest.<sup>9</sup>

Generally, compensation is treated as ordinary income for tax purposes, taxable at a maximum marginal rate of 35%.<sup>10</sup> But because investment funds are generally treated as partnerships for tax purposes, under current law the carried interest is treated as

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7. This may not be the case in the current economic downturn. *See supra* note 3. But the fear certainly is not unfounded. In 1998, the collapse of the hedge fund Long-Term Capital Management nearly paralyzed the banking system, and the fund had to be bailed out. *See, e.g.*, Tyler Cowen, *Was an Old Bailout a Bad Precedent?*, N.Y. TIMES, Dec. 28, 2008, at BU5 ("The financial crisis is a result of many bad decisions, but one of them hasn't received enough attention: the 1998 bailout of the Long-Term Capital Management hedge fund."); Joe Nocera, *Hedge Fund Manager's Farewell*, N.Y. TIMES, May 16, 2009, at B1 ("They still remembered Long Term Capital Management, a hedge fund that a decade earlier had, indeed, brought the financial system to the brink because of its extreme leverage.").

8. *See* Philip F. Postlewaite, *Fifteen and Thirty Five—Class Warfare in Subchapter K of the Internal Revenue Code: The Taxation of Human Capital upon the Receipt of a Proprietary Interest in a Business Enterprise*, 28 VA. TAX REV. 817, 851 (2009) ("If the intent is to prevent excessive benefits for the super rich, thereby targeting investment structures solely on the size of the return, the goal must be questioned. . . . However, if the concern is broader, i.e., the proper theoretical taxation of a compensatory receipt of a profits interest in a partnership, such concerns arise with respect to any receipt of a profits interest.").

9. *See* Henry Ordower, *Demystifying Hedge Funds: A Design Primer*, 7 U.C. DAVIS BUS. L.J. 323, 346 (2007).

10. I.R.C. § 1(a), (i)(2) (2006). After 2010, the maximum tax rate is set to revert to its pre-2001 level of 39.6% unless Congress extends the lower rates currently in place. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 901(a)(1), 115 Stat. 38, 150 (codified as amended in scattered sections of 26 U.S.C.). The Obama administration has indicated that it will allow the top two tax brackets to revert to their higher pre-2001 levels. Ron Lieber & Tara Siegel Bernard, *Braced for a Higher Tax Bill, Some May Dodge the Bullet*, N.Y. TIMES, Feb. 27, 2009, at A1 ("The top two federal income tax brackets would rise to 36 percent and 39.6 percent from 33 percent and 35 percent, respectively.").

income from a partnership interest. As income from a partnership interest, carried interest is taxed to the investment fund manager in the same manner as it is taxed to the passive investors and is potentially subject to tax at the 15% long-term capital gains rates.<sup>11</sup>

Investment fund managers can be very handsomely compensated. In 2006, James Simons, one of the leading investment fund managers, made \$1.7 billion. By way of comparison, Lloyd Blankfein of Goldman Sachs, the highest-paid Wall Street executive in 2006, earned \$54.3 million.<sup>12</sup> That certain very wealthy people could pay taxes on the majority of their income at a 15% rate seemed intuitively unfair; even the very wealthy seemed to understand the intuitive unfairness. Warren Buffett said that it was wrong that investment fund managers could pay taxes at a lower rate “than our receptionists do or our cleaning ladies.”<sup>13</sup> And Representative Sander Levin, among others, has introduced legislation to raise taxes on carried interest, not, he asserts, in order “to soak the rich,” but “to find tax equity.”<sup>14</sup>

Investment fund managers reply that carried interest should continue to be taxed at capital gains rates.<sup>15</sup> They argue that carried interest *is* capital gain, not compensation income, and should be treated as such.<sup>16</sup> Furthermore, they argue that increasing the tax on carried interest will decrease investment fund managers’ appetite for long-term risky investments and that raising the taxes on carried interest will ultimately hurt economic growth in the United States.<sup>17</sup> Some legislators argue that ultimately, raising taxes on carried interest will not just hurt the wealthy, but will hurt middle-class people too.<sup>18</sup>

The debate over the appropriate taxation of investment fund managers has also played out in the academic literature, with some commentators arguing that the taxation of carried interest needs to be reformed,<sup>19</sup> and others arguing that the status quo best reflects

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11. Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 14–15 (2008).

12. Jenny Anderson & Julie Creswell, *Make Less Than \$240 Million? You’re off Top Hedge Fund List*, N.Y. TIMES, Apr. 24, 2007, at A1.

13. Andrew Ross Sorkin, *Putting a Bull’s-Eye on a Tax Loophole*, N.Y. TIMES, Mar. 10, 2009, at B1.

14. Jenny Anderson & Andrew Ross Sorkin, *‘Tax Equity’ Is Battle Cry in New Bill*, N.Y. TIMES, June 23, 2007, at C1.

15. Sorkin, *supra* note 13.

16. *See id.*

17. *Id.*

18. Eric Cantor, Op-Ed., *Don’t Hike Partnership Taxes*, USA TODAY, Dec. 6, 2007, at 17A.

19. *See, e.g.*, Noël B. Cunningham & Mitchell L. Engler, *The Carried Interest Controversy: Let’s Not Get Carried Away*, 61 TAX L. REV. 121, 121 (2008); Fleischer, *supra* note 11, at 49; Mark P. Gergen, *Reforming Subchapter K: Compensating Service Partners*, 48 TAX L. REV. 69, 103 (1992).

the economics inherent in the allocation of carried interest.<sup>20</sup> Generally, the academic analysis has revolved less around the question of whether it is fair for high-wealth individuals to be taxed on the bulk of their income at long-term capital gains rates and more around the question of what, economically, carried interest most resembles. Supporters of the status quo argue that carried interest is a risky bet, with little economic difference from the investments of others in the investment fund.<sup>21</sup> Supporters of reform argue on the other hand that carried interest most closely looks like compensation for managing the portfolio<sup>22</sup> or like an interest-free loan from the passive investors to the investment fund manager.<sup>23</sup>

Lost in the back and forth, however, is any significant discussion of *why* capital gains are taxed at a lower rate than other forms of income. Because taxing some income at a 15% rate and other income at a 35% rate, depending on the income's source, introduces complexity into the tax code and can affect investment decisions, preferential tax rates should only be applied where there is a compelling justification.<sup>24</sup> Prior to determining whether carried interest is more like compensation or is more like investment income, it is valuable to look to the policy justifications for preferential capital gains rates and to apply those justifications to carried interest. If the case for taxing capital gains at a lower rate applies to an investment fund manager's carried interest, then it would make sense to tax carried interest at the lower rates. If, however, the case for taxing capital gains at a lower rate does not apply to carried interest, carried interest should be taxed at ordinary rates, absent some compelling non-tax justification. If the underlying tax policy justifying reduced tax rates on capital gains also applies to carried interest, carried interest should be taxed at preferential capital gains rates, and it becomes unnecessary to determine the best economic equivalent. Similarly, if the tax policy justifications do not apply, carried interest should be taxed at ordinary rates, and, again, it is unnecessary to determine the closest economic equivalent.

This Article argues that the policy arguments for taxing capital gains at lower rates are not compelling when applied to carried

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20. See, e.g., Howard E. Abrams, *Taxation of Carried Interests: The Reform That Did Not Happen*, 40 LOY. U. CHI. L.J. 197, 198 (2009); 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, 425 (2008); Postlewaite, *supra* note 8, at 821; David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 VA. L. REV. 715, 715 (2008).

21. See *infra* Part IV.A.

22. See *infra* Part IV.B.1.

23. See *infra* Part IV.B.2.

24. See Daniel Halperin, *A Capital Gains Preference Is Not EVEN a Second-Best Solution*, 48 TAX L. REV. 381, 382 (1993).

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interest. Moreover, those arguments that do weakly support taxing carried interest at long-term capital gains rates can be neutralized by a simple reform: if investment fund managers were required to pay taxes on carried interest on a simplified mark-to-market basis—that is, if investment fund managers were taxed on the amount of the fund’s appreciation allocated to them, whether realized or unrealized, every year—there would remain no justification for taxing carried interest at a preferential rate.

This Article will progress in the following manner: Part I will discuss the structure of investment funds and the types of compensation investment fund managers receive. Part II will discuss how carried interest is currently taxed and the bill pending in Congress that would change the taxation of carried interest. Part III will discuss the justifications for taxing capital gains at lower rates than those applicable to ordinary income.

Although analyzing whether policy justifications underlying preferential tax rates apply to carried interest is enough to decide whether to tax carried interest at capital or ordinary rates, Part IV will analyze the arguments regarding economic equivalents of carried interest. In doing so, this Article will demonstrate that, even absent the capital gains analysis, the case for treating carried interest as compensation is as strong as the case for treating it as investment income. As such, there is not a compelling reason for taxing carried interest at capital gains rates.

Finally, Part V will lay out in detail the proposal for taxing investment fund managers on their carried interest on a simplified mark-to-market basis. This Part will discuss how such taxation would work, the problems it would solve, and why it would be fair to investment fund managers and investment fund investors.

## I. INVESTMENT FUND BASICS

### A. *The Structure of an Investment Fund*

The structure of investment funds has been laid out in great detail elsewhere.<sup>25</sup> Because this Article will focus on the tax treatment of carried interest, it will only briefly describe the structure of investment funds. In addition, because concerns about the taxation of carried interest do not arise in the context of foreign investment funds, the discussion of investment funds in this Article

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25. For a broad explanation of the regulatory and tax structure of investment funds, see Ordower, *supra* note 9. For another excellent overview of investment fund structures, see Melone, *supra* note 20, at 425–31. I would disagree with Professor Melone’s use of the term “hedge fund” as overbroad to describe the world of hedge funds, private equity funds, venture capital funds, and buyout funds. In this Article, I will use the term “investment fund” or “unregulated investment fund” instead. Aside from that minor terminological quibble, however, his description of investment funds is right on the money.

will be limited to those that are treated as partnerships for U.S. tax purposes.<sup>26</sup>

Private investment funds are generally organized as limited partnerships.<sup>27</sup> Both hedge funds and private equity funds are investment vehicles in which wealthy investors pool their money in order to obtain an investment return. Although their structures are similar, there are certain differences between hedge funds and private equity funds,<sup>28</sup> most of which result from the fact that hedge funds generally invest in publicly traded securities and other liquid investments, whereas private equity funds generally make illiquid investments in private companies.<sup>29</sup> Generally hedge funds require a significant initial investment from potential investors, while private equity funds require a significant capital commitment.<sup>30</sup> The minimum initial investment or capital commitment can often be \$1 million or more.<sup>31</sup> Once they have put their money into the investment fund, investors have limited opportunities to withdraw their money from the fund. Hedge fund investors can generally

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26. While there are interesting tax issues that arise in the context of offshore investment funds, such funds are not structured as partnerships, so there is no question of their passing through capital gains to the investment fund manager.

27. See KEITH H. BLACK, *MANAGING A HEDGE FUND: A COMPLETE GUIDE TO TRADING, BUSINESS STRATEGIES, RISK MANAGEMENT, AND REGULATIONS* 114 (2004). Although the investment fund manager is the general partner, and thus retains all liability with respect to the fund, the investment fund manager is often organized as an entity that has limited liability but has pass-through tax treatment. *Id.* at 114–15.

28. For a more general look at differences between hedge funds and private equity funds, see Adam H. Rosenzweig, *Not All Carried Interests Are Created Equal*, 29 *NW. J. INT'L L. & BUS.* 713, 716–21 (2009).

29. See Douglas Cumming, Andrej Gill & Uwe Walz, *International Private Equity Valuation and Disclosure*, 29 *NW. J. INT'L L. & BUS.* 617, 618–19 (2009).

30. One of the significant differences between hedge funds and private equity funds is that an investor in a hedge fund puts in all of her money up front. She can invest more money in the future if she decides to, but she has no obligation to do so. Private equity investors, on the other hand, commit to investing a specified amount of money but need not give it to the fund immediately. Instead, as the investment fund manager finds potential investments, the manager will “call” a portion of the investors’ capital commitment, at which point investors are obligated to provide the money to the fund.

31. See, e.g., Riva D. Atlas, *A Hedge Play for Anyone with \$10,000*, *N.Y. TIMES*, Nov. 22, 2005, at C1 (“Highbridge typically requires a minimum investment of \$10 million for the fund, and annual fees of 2 percent of assets and 25 percent of any profits, according to the U.S. Offshore Funds Directory, which lists the performance of hedge funds.”); Saul Hansell, *A Primer on Hedge Funds: Hush-Hush and for the Rich*, *N.Y. TIMES*, Apr. 13, 1994, at A1 (“If that’s not enough to create the presumption of some sort of conspiracy in the minds of people who do not have \$1 million required for the minimum investment, hedge funds have been blamed for many of the recent traumatic events in world financial markets, including the collapse of Europe’s plan for stable currency rates and the recent slide in the stock and bond markets.”).

withdraw money only on specified dates, and those dates rarely occur more frequently than monthly. In some hedge funds, investors can only withdraw their money once a year.<sup>32</sup> Private equity investors are not generally permitted to redeem their interests until the termination of the fund, often more than ten years after their original investment.<sup>33</sup>

Private investment funds are not regulated and therefore can borrow more and pay their investment managers more than regulated investment funds such as mutual funds.<sup>34</sup> Because they are unregulated, there is limited publicly available information about the structures and strategies of investment funds.<sup>35</sup> Investors often sign nondisclosure agreements with respect to the investment funds in which they invest.<sup>36</sup>

The investment fund manager generally invests in the fund as the general partner. The investment fund manager may, but is not required to, contribute a nominal amount of money to the fund in exchange for this general-partner interest.<sup>37</sup> Other investors contribute money to the fund in exchange for limited-partner interests. The investment fund manager invests the fund's money (including borrowed money), generally in some combination of public and private securities, commodities, and financial instruments, in order to provide a return on investors' money.<sup>38</sup>

It is important that investment funds be treated as partnerships for tax purposes. The tax law treats a partnership as a pass-through entity. This means that partners are taxed on their proportionate share of the partnership's income, whether or not such income is actually distributed to them. The income has the same character to the partners as it did in the partnership's hands.<sup>39</sup>

Investment funds keep track of the amount of money investors have in the fund through "capital accounts." A capital account is essentially a record of each investor's interest in the investment fund. An investor's capital account is increased by, among other things, the amount of money the investor contributes to the fund and by the investor's proportionate share of the investment fund's gain or income. The investor's capital account is decreased by, among other things, the investor's proportionate share of fund losses and by any amounts withdrawn by or otherwise distributed to the

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32. Ordower, *supra* note 9, at 328.

33. Thomas J. Brennan & Karl S. Okamoto, *Measuring the Tax Subsidy in Private Equity and Hedge Fund Compensation*, 60 HASTINGS L.J. 27, 40 (2008).

34. Ordower, *supra* note 9, at 324.

35. *Id.* at 325.

36. Melone, *supra* note 20, at 428.

37. DOUGLAS L. HAMMER ET AL., U.S. REGULATION OF HEDGE FUNDS 92 (2005).

38. Melone, *supra* note 20, at 425.

39. I.R.C. § 702 (2006).

investor.<sup>40</sup> Investment funds do not generally make spontaneous distributions to their investors, even when they sell assets. Instead, they “allocate” gains and losses by increasing or decreasing the value of the investors’ capital accounts and reinvest gains in new investments. The only way an investor can get money from the investment fund is by withdrawing money from her capital account.

This Article will periodically use variations on the following hypothetical investment fund in order to clarify or explain a concept: Abby, an investment fund manager, forms a new hedge fund. She takes a general-partner interest in the hedge fund but does not invest any of her own money. Instead, she markets the hedge fund to Ben and Christy, who each invest \$50. Initially, Abby’s capital account is worth \$0, and Ben and Christy each have a capital account of \$50. Abby uses the \$100 to purchase one share of IBM stock. One year and one day after purchasing the stock, it is worth \$110, and Abby causes the partnership to sell the IBM stock and purchase two shares of Microsoft for \$110. No money is distributed to Ben or Christy, but both will be taxed on \$5 of long-term capital gains.

By investing in an investment fund, investors are able to pool their funds with other investors, which allows them a simpler way to diversify their portfolios.<sup>41</sup> In addition, investors are able to take advantage of the investment expertise of the investment fund manager.<sup>42</sup> However, by investing through a tax partnership, investors are able to avoid an additional level of tax that would be imposed if they invested in an entity taxed as a corporation.<sup>43</sup>

### B. *How Investment Fund Managers Are Compensated*

Engaging the investment fund manager’s investment expertise is not free—the investment fund manager is compensated for her work. Her compensation generally consists of two components. First, the investment fund manager receives a management fee,

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40. See, e.g., Simon Friedman, *Partnership Capital Accounts and Their Discontents*, 2 N.Y.U. J.L. & BUS. 791, 793–94 (2006). An investment fund “allocates” gains and income to the partners, not necessarily by transferring money or property to the partners, but instead by recording that a partner’s capital account has increased by the partner’s proportionate share of the fund’s gain. In order to monetize her portion of the fund’s gain, a partner would have to withdraw a portion of her capital, subject to the limitations discussed above. See *supra* text accompanying notes 32–33.

41. Melone, *supra* note 20, at 428 (“Various factors have contributed to the growth of such funds. . . . Developments in modern portfolio theory have emphasized the benefits of diversification . . .”).

42. Fleischer, *supra* note 11, at 20 (“The growing adoption of portable alpha strategies among institutional investors helps explain the increased demand for the services of private investment fund managers.”).

43. See I.R.C. § 11 (2006).



which is a percentage (often 2%) of the value of the fund's assets.<sup>44</sup> The management fee is taxed to the investment fund manager as ordinary income, and this treatment is uncontroversial.<sup>45</sup>

In addition to the management fee, the investment fund manager will receive an allocation of carried interest. The carried interest is a "profits interest" in the investment fund that entitles the investment fund manager to a percentage of the investment fund's profits, even if the investment fund manager has not invested any of her own money in the fund.<sup>46</sup> A profits interest is a type of partnership interest that provides certain rights in the investment fund but that has no current liquidation value,<sup>47</sup> meaning that if the investment fund were liquidated immediately, the holder of the profits interest would not receive any money. By way of contrast, the investors in an investment fund own a capital interest in the fund, which has rights in the partnership and has current liquidation value.<sup>48</sup> Although the amount of the carried interest can vary depending on the investment fund, it is often 20% of the profits.<sup>49</sup>

Hedge funds generally allocate carried interest based on both realized and unrealized growth in the market value of the fund's assets.<sup>50</sup> That is, the investment fund manager earns carried interest on all of the appreciation of the hedge fund's assets, whether or not the fund has sold an asset and realized the gain on the asset. Returning to Abby's hedge fund, assume that Abby receives a standard 20% carried interest in the fund. At the end of the year, the value of the fund's IBM stock has increased from \$100 to \$110. Even though the fund has not sold the IBM stock, on the fund's books, Ben and Christy are each allocated \$4 of gain (so their capital accounts are each worth \$54), and Abby is allocated \$2 (so she has a capital account of \$2).

Investment funds use carried interest as a tool to align the investment fund manager's interests with the interests of the investors.<sup>51</sup> Because the investment fund manager will share in all of the fund's appreciation without a cap, it is in the investment fund manager's economic interest to provide the best possible return on

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44. Ordower, *supra* note 9, at 346.

45. Fleischer, *supra* note 11, at 9–10 ("The management fee is treated as ordinary income to the GP, included in income as it is received on an annual or quarterly basis.")

46. *See id.* at 3.

47. *Id.* at 11.

48. *See id.*

49. Ordower, *supra* note 9, at 346.

50. *See id.* at 347.

51. Robert C. Illig, *The Promise of Hedge Fund Governance: How Incentive Compensation Can Enhance Institutional Investor Monitoring*, 60 ALA. L. REV. 41, 71–72 (2008).

the investors' money.<sup>52</sup>

## II. TAXATION OF CARRIED INTEREST

### A. *The Current Taxation of Carried Interest*

The current taxation of carried interest is advantageous to investment fund managers in two ways: the character of income realized and the timing of taxation.

#### 1. *Character of Income*

Carried interest is paid with respect to an investment fund manager's profits interest in the fund. Because she is the general partner of the investment fund, the investment fund manager pays tax on her carried interest in the same manner as other investors. Because of the partnership tax rules, the investment fund manager can, like other investors in the fund, essentially treat the fund as if it did not exist. Instead, she is taxed as if she owned 20% of the investment fund's assets directly. As such, the investment fund manager receives the benefit of the characterization of the income in the fund's hands. If, during a year, half of the investment fund's income is from short-term capital gains and half is from long-term capital gains, half of the carried interest will be taxed to the investment fund manager as short-term capital gains and half as long-term capital gains. If the fund were to realize only long-term capital gains, all of the carried interest allocated to the investment fund manager would be long-term capital gains, taxable at a 15% rate.<sup>53</sup>

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52. *See id.* Note, however, that the alignment of interests may not be perfect: in a declining market, it is possible that the incentive allocation structure could cause an investment fund manager to expend her time and effort seeking new investors rather than providing a profit for existing investors. Ordower, *supra* note 9, at 348. The investment fund manager generally only receives an incentive allocation to the extent that the fund has profits in excess of a high-water mark. If, for example, Ben had invested \$50 in Abby's fund and, in year one, his capital account was worth \$55, Abby would receive 20% of his \$5 profit. If, in year two, Ben's capital account were to lose \$10, Abby would not receive any carried interest for that year (although she would not be required to return the \$1 she was allocated in year one as carried interest). Moreover, she would not receive any carried interest from Ben until after his capital account had earned back the \$10. If, on the other hand, Dave were to come in on the first day of year three and invest \$45, Abby would earn an incentive allocation on the first dollar of Dave's profits. *See id.* If the fund were to earn enough to allocate \$9 each to Ben and Dave in year three, Abby would not get any incentive allocation from Ben but would be allocated \$1.80 from Dave's gain. Because of this disconnect, if a hedge fund has lost too much, it is more valuable for the investment fund manager to spend time marketing the fund to new investors than to try to make up the loss for old investors.

53. *See* Fleischer, *supra* note 11, at 14–15.

## 2. *Timing of Taxation*

The public debate about the taxation of carried interest has focused principally on the fact that it can be taxed at a capital rate.<sup>54</sup> At least as valuable to investment fund managers as the character of the carried interest, but less well understood, is when the investment fund manager is taxed on the carried interest. Because tax is generally imposed when gain is realized (typically when an appreciated asset is sold), the investment fund manager is not taxed on her carried interest when it is allocated to her. Instead, she defers the tax until the investment fund sells the appreciated assets.<sup>55</sup>

Appreciation in the fund's assets will be allocated to the investment fund manager whether or not the assets are sold, increasing her capital account. Because of the allocation of appreciation, the investment fund manager has economic income whether or not the assets are sold. If the fund holds the appreciated assets rather than selling them, the investment fund manager has economic income without being required to pay any tax.<sup>56</sup> And the income is not just theoretical—the investment fund manager generally has the right to withdraw money from her capital account.<sup>57</sup> In any event, the investment fund manager's increased capital account represents a real accession to wealth even though there is no tax imposed until a realization event occurs.<sup>58</sup>

We return again to Abby's hedge fund. As before, the fund's investment in IBM has appreciated from \$100 to \$110. Abby has been allocated \$2 of gains and Ben and Christy have each been allocated \$4 of gains. However, because the fund has not sold its IBM stock, no realization event has occurred for tax purposes, and Abby, Ben, and Christy have no tax liability.

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54. See *infra* Part II.B (describing proposed I.R.C. § 710, which would modify the character, but not the timing, of taxation of carried interest).

55. See Fleischer, *supra* note 11, at 11.

56. See Samuel D. Brunson, *Taxing Investors on a Mark-to-Market Basis*, 43 LOY. L.A. L. REV. (forthcoming 2010) (manuscript at 28), available at <http://ssrn.com/abstract=1426402>. For more discussion, see *infra* Part V.B.

57. See Ordower, *supra* note 9, at 358. Hedge funds traditionally invest largely in liquid assets, meaning that if the investment fund manager were to withdraw money from her capital account, the fund could sell assets in order to have cash to distribute. See Kate Litvak, *Governance Through Exit: Default Penalties and Walkaway Options in Venture Capital Partnership Agreements*, 40 WILLAMETTE L. REV. 771, 777 (2004).

58. Mary Louise Fellows, *A Comprehensive Attack on Tax Deferral*, 88 MICH. L. REV. 722, 724 n.4 (1990) ("An unrealized gain occurs when a taxpayer retains property that has appreciated in value. The Code taxes this appreciation only when the taxpayer enters into a realization event by disposing of the property.").

### 3. *When Carried Interest Is Not Taxed*

In order to understand how radically the current rules defer tax, it is instructive to look at when tax could be imposed on the carried interest. Theoretically, the most appropriate time to tax the investment fund manager is in the year she receives the profits interest pursuant to which she will be paid carried interest. It is settled law that a partner who receives a capital interest in a partnership in return for performing services is taxable on the receipt of the interest.<sup>59</sup> Although it is less clear whether the receipt of a profits interest is a taxable event, it would make sense to tax a partner who receives a profits interest in exchange for services when the profits interest is received. The tax code does not state whether the receipt of a profits interest is taxable, and the courts have come to different conclusions. In *Campbell v. Commissioner*,<sup>60</sup> the Eighth Circuit Court of Appeals stated in dicta that it doubted that a taxpayer could be taxed upon receipt of a profits interest in exchange for services performed by the taxpayer.<sup>61</sup> On the other hand, the Seventh Circuit Court of Appeals had previously held that such a receipt of a profits interest in exchange for services was taxable.<sup>62</sup> Courts, whether or not they find the receipt of a profits interest to be a taxable event, have generally recognized that there may be a practical problem in valuing the profits interests received.<sup>63</sup>

In response to the uncertainty over whether or not the receipt of a profits interest was taxable, the Internal Revenue Service ("IRS") issued Revenue Procedure 93-27.<sup>64</sup> The IRS did not attempt to resolve the question of the taxability of the receipt of a profits interest. Instead, it stated that it would not treat the receipt of such an interest as a taxable event, either for the partner or for the

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59. Treas. Reg. § 1.721-1(b)(1) (as amended in 1996) ("The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61.").

60. 943 F.2d 815 (8th Cir. 1991).

61. *Id.* at 823 ("Thus, we doubt that the tax court correctly held that Campbell's profits interests were taxable upon receipt.").

62. *Diamond v. Comm'r*, 492 F.2d 286, 291 (7th Cir. 1974) ("But in the absence of regulation, we think it sound policy to defer to the expertise of the Commissioner and the Judges of the Tax Court, and to sustain their decision that the receipt of a profit-share with determinable market value is income.").

63. *See, e.g., Campbell*, 943 F.2d at 823 ("More troubling, however, is Campbell's argument that the profits interests he received had only speculative, if any, value. We fully agree with this contention and we reverse the tax court."); *Diamond*, 492 F.2d at 291 ("Do the disadvantages of treating the creation of the profit-share as income in those instances where it has a determinable market value at that time outweigh the desirability of imposing a tax at the time the taxpayer has received an interest with determinable market value as compensation for services?").

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

partnership, unless the profits interest could be easily valued.<sup>65</sup> Carried interest is not easy to value, so because of the safe harbor provided by the IRS, investment fund managers have not had to worry about whether they owe taxes when they receive carried interest.

Because the right to receive carried interest in the future is a property right received in exchange for investment management services, it would make theoretical sense to tax an investment fund manager up front on the receipt of the profits interest.<sup>66</sup> However, the IRS's safe harbor protects investment managers from tax upon receipt, and there has been no serious attention paid to proposals to impose tax at such a time.<sup>67</sup> Moreover, it is impractical to impose tax on the receipt of a profits interest. The value of a profits interest would be the present value of all of the future carried interest to be received by the investment fund manager. Although calculating that value is theoretically possible, practically, it is virtually impossible to assign a value to a profits interest upon receipt.<sup>68</sup> Therefore the safe harbor of Revenue Procedure 93-27 will—and should—continue to stand. Still, not taxing carried interest until appreciated assets are sold results in a significant deferral of tax.

#### *B. Reforms That Have Been Proposed in Congress: Section 710*

In 2007, while attempting to find revenue to offset the cost of patching the alternative minimum tax,<sup>69</sup> Congress noticed the tax-advantaged treatment of carried interest.<sup>70</sup> Raising the rate of tax on carried interest seemed like an ideal way to pay for the

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65. *Id.* at 344.

66. Fleischer, *supra* note 11, at 10 (“When a GP receives a profits interest in a partnership upon the formation of a fund, that receipt is not treated as a taxable event. This treatment seems counterintuitive. The GP receives something of value at the moment the partnership agreement is signed.”).

67. Weisbach, *supra* note 20, at 733 (“The overwhelming consensus is that taxing profits interests on receipt is not desirable, and such proposals have received little attention in the current round of discussions.”).

68. *Id.* at 733–34.

69. The alternative minimum tax, originally passed in order to make sure that the wealthiest Americans could not entirely escape paying taxes, was not indexed to inflation when originally passed. Therefore, every year, it reached more taxpayers. Its exemption levels are set at an amount that easily reaches middle-class taxpayers, which is politically untenable. But the revenue raised is attractive, and the tax cost of repealing the alternative minimum tax entirely is sufficiently high that there have been no successful attempts to actually repeal it. Instead, Congress passes annual one-year “patches” raising the exemption level for that year. *See, e.g.,* Wesley Elmore, *Grassley Proposes AMT Safe Harbor for Estimated Tax Payments*, 116 TAX NOTES 11, 13 (2007).

70. Meg Shreve & Dustin Stamper, *Ways and Means Approves AMT Patch, Extenders Package*, 117 TAX NOTES 551, 551 (2007) (“The House Ways and Means Committee last week approved in a 22-13 party-line vote a one-year alternative minimum tax patch and ‘extenders’ package mainly offset by deferred compensation and carried interest provisions.”).

alternative-minimum-tax patch: not only were investment fund managers some of the highest-paid people in America,<sup>71</sup> but Congress could capitalize on the apparent unfairness of wealthy investment fund managers paying taxes at almost half the rate of ordinary wage earners.<sup>72</sup> Moreover, the projected revenue from taxing carried interest at ordinary rates was significant: the Joint Committee on Taxation estimated that taxing carried interest at ordinary levels would increase tax revenue by \$14.689 billion over the first five years and \$25.624 billion over ten years.<sup>73</sup>

Since 2007, several members of Congress have introduced legislation that would change the taxation of carried interest, adding a new section 710 to the Internal Revenue Code ("I.R.C.").<sup>74</sup>

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71. In 2006, James Simons, one of the leading investment fund managers, earned \$1.7 billion. By way of comparison, Lloyd Blankfein of Goldman Sachs, the highest-paid Wall Street executive in 2006, earned \$54.3 million in salary, cash, restricted stock, and stock options. Anderson & Creswell, *supra* note 12.

72. See I.R.C. § 1(h) (2006). For a more in-depth discussion of the historic taxation of carried interest, see *supra* Part II.A. While in the real world, any given allocation by an investment fund would most likely consist of a mixture of long-term capital gains, short-term capital gains, and ordinary income, in the interest of simplicity, this Article will treat all allocations as consisting of purely long-term capital gains.

73. JOINT COMM. ON TAXATION, 110TH CONG., ESTIMATED REVENUE EFFECTS OF THE CHAIRMAN'S AMENDMENT IN THE NATURE OF A SUBSTITUTE TO H.R. 3996, THE "TEMPORARY TAX RELIEF ACT OF 2007," SCHEDULED FOR MARKUP BY THE COMMITTEE ON WAYS AND MEANS ON NOVEMBER 1, 2007, JCX-105-07 (2007), available at <http://www.jct.gov/x-105-07.pdf>. The Joint Committee's revenue estimates are total dollars raised, not the present value of the revenue. It is worth noting that, in the aftermath of the current recession, it has become clear that taxing investment fund managers at ordinary rates is not a cure-all for U.S. budgetary woes—although many investment fund managers are still earning breathtaking amounts of income, many more private investment funds are collapsing. See, e.g., Peter Lattman, *Bill Aims for Disclosure by Private Equity: Senate Legislation Would Require Firms to Register with SEC, Release Details on Investors*, WALL ST. J., Feb. 4, 2009, at C3 ("Ironically, the industry's increased scrutiny comes at a time when private-equity profits have evaporated. After a credit-boom buying binge in which private-equity-owned companies issued more than \$1 trillion in debt to fund leveraged buyouts, today many of those companies are choking on all that debt."); Story, *supra* note 5 (stating that in spite of the rough economy, in 2008, James Simons earned \$2.5 billion for the year). The Joint Committee on Taxation's most recent estimates of the revenue from taxing carried interest as ordinary income is down sharply to \$10.456 billion over the first five years (a decline of 29%), while the ten-year estimate is \$23.064 billion (a decline of 10%). JOINT COMM. ON TAXATION, 110TH CONG., ESTIMATED BUDGET EFFECTS OF THE REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2010 BUDGET PROPOSAL AS DESCRIBED BY THE DEPARTMENT OF THE TREASURY, MAY 2009, JCX-28-09 (2009), available at <http://www.jct.gov/publications.html?func=startdown&id=3558>. Carried interest no longer represents the revenue panacea that it appeared to be in 2007, and there is no guarantee that it will represent material tax revenue in the future.

74. See H.R. 3970, 110th Cong. § 1201 (2007) (containing proposed I.R.C. § 710).

On December 9, 2009, the House of Representatives passed the Tax Extenders Act of 2009.<sup>75</sup> In order to prevent the bill from increasing the federal deficit, the House of Representatives offset its cost by including a number of revenue-raising provisions, among them section 710.<sup>76</sup> The principal effect of section 710 on investment fund managers would be to recharacterize carried interest as ordinary income rather than capital gains.<sup>77</sup> In addition, if an investment fund manager were to sell her profits interest, she would be taxed at ordinary rates rather than capital gains rates on any gain from the sale.<sup>78</sup> Section 710 would provide investment fund managers with a small escape from taxation at ordinary rates, though: an investment fund manager could be taxed at capital gains rates on a portion of her interest in the fund to the extent that she owned the interest as a result of investing her own capital and provided that the investment fund reasonably allocated its gains and losses between that portion of the investment fund manager's interest resulting from actual capital contribution and that portion resulting from the carried interest.<sup>79</sup>

Section 710 has been criticized both by those who see no need for change in the current taxation of carried interest and by those advocating reform. Professor Howard E. Abrams, who supports the status quo, argues that section 710 overreaches, treating as ordinary income some amount of income that represents a risk premium.<sup>80</sup> Professor Matthew A. Melone argues that it causes capital gains income to disappear and that it creates double taxation.<sup>81</sup>

Professors Noël B. Cunningham and Mitchell L. Engler, who support reform, have three objections to section 710's recharacterization rule. First, they agree with Professor Abrams that treating the entire carried interest as ordinary income goes too

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75. H.R. 4213, 111th Cong. (2009).

76. Press Release, Representative Sander Levin, House Passes Tax Relief Extensions (Dec. 9, 2009), [http://www.house.gov/apps/list/press/mi12\\_levin/PR120909.shtml](http://www.house.gov/apps/list/press/mi12_levin/PR120909.shtml) ("The legislation does not add to the deficit and offsets the tax relief by putting a stop to billions of dollars worth of tax abuse through overseas tax havens and ending the special preferential tax treatment for carried interest given to fund managers as compensation.").

77. See H.R. 4213, 111th Cong. § 602 (2009) (containing proposed I.R.C. § 710(a)(1)). For a more detailed explanation and analysis of the terms of section 710, see Howard E. Abrams, *A Close Look at the Carried Interest Legislation*, 117 TAX NOTES 961 (2007).

78. See H.R. 4213, 111th Cong. § 602 (2009) (containing proposed I.R.C. § 710(b)).

79. See *id.* (containing I.R.C. § 710(c)(2)).

80. Abrams, *supra* note 77, at 971 ("There is no perfect way to distinguish the third, entrepreneurial component from the two compensation components . . ."); Abrams, *supra* note 20, at 225 ("But proposed Section 710 makes no allowance for adjusting the definition of a 'reasonable' allocation on capital for distributions even if this distribution increases Y's claim on all future distributions.").

81. Melone, *supra* note 20, at 479.

far.<sup>82</sup> Next they argue that funds could avoid the results of section 710 by restructuring the carried interest as a loan from the partners.<sup>83</sup> Finally they argue that section 710 will produce a lock-in effect, distorting the investment fund manager's incentives to make the best investment decisions on behalf of the fund.<sup>84</sup>

### III. POLICY BASES FOR TAXING CAPITAL GAINS AT PREFERENTIAL RATES

Whether capital gains should be taxed at preferential rates is, itself, a controversial question,<sup>85</sup> and it has been a controversial question nearly since the inception of the income tax.<sup>86</sup> Although it is beyond the scope of this Article to join the debate on whether capital gains should be subject to a preferential tax rate in comparison with ordinary income, it is necessary to review the justifications for such a preferential rate in order to know the criteria to apply to carried interest. Scholars generally agree that preferential rates on capital gains are not optimal, adding unnecessary complexity and gamesmanship to the tax code,<sup>87</sup> and should be avoided unless necessary to resolve distortions in taxpayer incentives.<sup>88</sup> Unless taxing carried interest at a preferential rate is necessary in order to solve a similar distortion inherent in carried interest, then the tax system should minimize complexity and distortions associated with preferential rates and tax carried interest at ordinary rates.<sup>89</sup> These distortions arise, in general,

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82. Cunningham & Engler, *supra* note 19, at 133 (“[Section 710] goes too far by treating the entire carried interest return as ordinary income, rather than limiting the compensation inclusion to an interest rate return.”).

83. *Id.* at 135–36.

84. *Id.* at 136–37.

85. See, e.g., Noël B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319, 320 (1993) (“We found all arguments favoring the [capital gains] preference wanting.”); Halperin, *supra* note 24, at 381 (“I would reject a capital gains preference as a tolerable solution . . . at all.”); Daniel N. Shaviro, *Uneasiness and Capital Gains*, 48 TAX L. REV. 393, 394 (1993) (“My own view is that, as the maximum statutory rate for tax on ordinary income increases, at some point the argument for the preference becomes irresistible, despite the danger that Congress will set the preferential capital gains rate well below the point of revenue maximization.”).

86. Walter J. Blum, *A Handy Summary of the Capital Gains Arguments*, 35 TAXES 247, 247 (1957) (“The issue is almost as old as the income tax itself.”).

87. *Id.* at 262 (“Preferential treatment for capital gains is the main source of complexity in our income tax.”).

88. See Cunningham & Schenk, *supra* note 85, at 321 (“Although complexity attributable to the preference is a significant offsetting factor, the preference might be efficient if it resulted in taxation of capital income at the revenue-maximizing rate.”).

89. See, e.g., Halperin, *supra* note 24, at 382 (“Since a capital gains differential can affect choices between one investment and another, such a route is justifiable only if one thinks that the tax system improperly discriminates against some types of investments, or that affirmative encouragement of



because tax is imposed when gains are realized rather than when they arise.<sup>90</sup>

Professors Noël B. Cunningham and Deborah H. Schenk have broken down the arguments for taxing capital gains at a preferential rate into seven categories: (1) capital gains are not income, (2) consumption, and not income, should be taxed, (3) bunching, (4) double taxation of corporate earnings, (5) inflation, (6) risk, and (7) the lock-in effect.<sup>91</sup> Each of these arguments purports that it is necessary to tax capital gains at a lower rate than that to which ordinary income is subject in order to rectify the imperfect treatment of capital gains under current law.<sup>92</sup> Professors Cunningham and Schenk reject each of these arguments in favor of a capital gains preference as the best solution to the distortions caused by realization accounting.<sup>93</sup> Moreover, they reject a capital gains preference as even a second-best solution to all the problems it purports to solve except for the lock-in effect.<sup>94</sup>

In response to the argument that capital gains are not income, they reply that this argument relies on an unsophisticated understanding of what constitutes income and ignores the Haig-Simons definition of income broadly used today. There is no reason why capital gains income is inherently different from other income.<sup>95</sup>

The argument that consumption, rather than income, should be taxed (with its corollary that capital gains are not consumption and therefore should not be taxed) is beside the point. Congress has chosen to impose an income tax and, in an income tax, the fact that capital gains are not consumption does not argue for a preferential rate on the taxation of capital gains.<sup>96</sup>

The bunching argument is that realization causes income that has accrued over a number of years to be taxed in a single year.<sup>97</sup> That is, if Ben were to purchase his interest in the fund for \$50 and sell it two years later for \$100, he would be taxed on \$50 of gain in the second year. Some portion of his gain, however, is attributable to the first year he held the fund. This is only a problem for Ben,

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particular types of investment is desirable.”).

90. Cunningham & Schenk, *supra* note 85, at 322 (“There are at least four major ways in which the current treatment of capital gains diverges from this ideal—all attributable to the realization requirement.”).

91. *Id.* at 319. For a more detailed summary of arguments in favor of a preferential capital gains rate, see Blum, *supra* note 86, at 248–61.

92. *Id.* at 322.

93. *Id.* at 320.

94. *Id.* at 320–21.

95. *Id.* at 326. Under Haig-Simons, “personal income” is defined as the sum of consumption plus the change in value of assets. Brunson, *supra* note 56 (manuscript at 6 n.11). The Haig-Simons definition of income has become the generally accepted definition of income, acting as a basis for most income-tax theory. *Id.*

96. Cunningham & Schenk, *supra* note 85, at 326–27.

97. *Id.* at 328.

however, if he is in a higher tax bracket in the second year than he was in the first and is, therefore, taxed on the first year's appreciation at a higher rate than he would have been if he had paid taxes on that appreciation in the first year.<sup>98</sup> Even if he is in a higher tax bracket, however, the higher rate of tax is offset to some degree by the benefits to Ben of deferring the payment of the tax.<sup>99</sup>

Proponents of a preferential rate on capital gains argue that it reduces the impact of inefficiencies created by the double taxation of corporate income.<sup>100</sup> Corporate income is subject to at least two levels of tax: first, when earned by the corporation and second, when paid as a dividend to shareholders, causing distortions in corporations' investment choices.<sup>101</sup> While Professors Cunningham and Schenk argue that there is little or no distortion caused by corporations' retained earnings (which are essentially the capital gains realized by a shareholder upon her sale of the stock),<sup>102</sup> other commentators argue that distortions caused by double taxation of corporations are, in fact, a significant justification for preferential rates.<sup>103</sup> Whether or not the double-taxation argument is a good argument for preferential capital gains rates, however, is essentially irrelevant to the question of whether carried interest should be taxed at capital gains rates. If valid, the double-taxation argument supports preferential rates for corporate stock but does nothing to support capital gains treatment derived from a partnership interest.<sup>104</sup>

Inflation is primarily a problem with short-term gains; as an asset is held longer, inflation generally represents a smaller and smaller portion of the gain on an asset.<sup>105</sup> The way capital gains are currently taxed, however, short-term gains (i.e., gains on capital assets held for one year or less) are taxable at ordinary rates, while long-term gains (i.e., gains on capital assets held for more than one year) are taxed at preferential rates.<sup>106</sup>

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98. *Id.* ("Bunching is a potential problem only in a system with graduated tax rates and only if the taxpayer is in a higher bracket on the disposition date than she was when the income accrued.").

99. *Id.*

100. *Id.* at 331.

101. *Id.*

102. *Id.* at 332.

103. Shaviro, *supra* note 85, at 395 ("I regard the double taxation of corporate income as a far more serious problem than [Professors Cunningham and Shenk] do.").

104. Cunningham & Schenk, *supra* note 85, at 336 ("This integration rationale supports a preference only for stock in C corporations and no other assets.").

105. *Id.* at 338.

106. Only a "net capital gain" is taxed at the preferential 15% rate. I.R.C. § 1(h)(1)(C) (2006). "Net capital gain" is defined as the excess of a taxpayer's net long-term capital gain for a taxable year over the taxpayer's net short-term capital loss. I.R.C. § 1222(11) (2006). President Obama's fiscal year 2010

Broadly speaking, then, there are two justifications that would support taxing carried interest at a preferential long-term capital gains rate. First, the lower rate of tax increases the rate of return on entrepreneurial risk, thus encouraging risk taking.<sup>107</sup> Second, the reduced rate of tax diminishes the so-called lock-in effect of the realization method of accounting.<sup>108</sup>

Although the lock-in argument provides nominal support for taxing carried interest at capital gains rates, the simplified mark-to-market proposal laid out in this Article deals with lock-in in a way that neutralizes it as a problem, and the risk arguments are effectively rendered moot by non-tax incentives and are inapplicable to a profits interest.

#### A. *The Lock-in Effect*

Because appreciation on capital assets is only taxed upon a realization event, such as the sale of the asset, and because gains are not taxed at death, investors are reluctant to sell appreciated assets and incur a tax that can be deferred or eliminated entirely by continuing to hold the asset.<sup>109</sup> Commentators generally agree that a preferential rate on capital gains ameliorates the lock-in problem.<sup>110</sup>

With investment funds, the lock-in problem can potentially be even more acute. The investment fund manager's capital account is increased both by realized and unrealized gain; under both the current treatment of carried interests and under proposed section 710, however, the investment fund manager only pays tax when the investment fund sells the appreciated asset or otherwise realizes the appreciation. Moreover, to the extent that the investment fund manager can withdraw money from her capital account, she does not need to sell the asset in order to monetize the unrealized

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revenue proposals appear to propose ending the preferential rates on capital assets held for longer than five years, which, if enacted, would suggest that the government is at least considering inflationary concerns in its design of the preferential rates. See DEP'T OF THE TREAS., GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2010 REVENUE PROPOSALS 77 (2009), available at <http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf> ("The reduced rates on gains on assets held over 5 years would be repealed.")

107. While Professors Cunningham and Schenk acknowledge that the risk issue potentially presents a legitimate distortion, they argue that a preferential capital gains rate is a poor second-best solution to a problem that could better be solved by eliminating limitations on the deduction of losses. Cunningham & Schenk, *supra* note 85, at 343. Nonetheless, because such limitations on deduction do exist, this Article will treat risk as a potentially legitimate argument in favor of preferential rates and will evaluate whether the risk argument supports a preferential rate for carried interest.

108. Abrams, *supra* note 20, at 219–20.

109. Cunningham & Schenk, *supra* note 85, at 344.

110. *Id.* at 350.

appreciation.<sup>111</sup> If she were subject to a 35% rate of tax on realization, she would have a strong incentive to hold onto an appreciated asset, even if it would be in the other investors' best interest for the fund to sell the asset and invest the proceeds from that sale in something else.

Preferential rates are, however, a second-best solution to the lock-in problem. Even at a 15% tax rate, the investment fund manager has an incentive to cause the fund to hold appreciated assets rather than to sell them. If, instead, appreciation were taxed to the investment fund manager, who makes the decision of when to sell assets, on a mark-to-market basis, the distortions creating the lock-in effect would be eliminated.<sup>112</sup> Under a mark-to-market system, the investment fund manager would be taxed on any gain in her capital account, whether or not the appreciated assets had been sold. While implementation of a mark-to-market system on investments in general is unlikely,<sup>113</sup> marking the investment fund manager's carried interest to market would eliminate the lock-in effect. Because the investment fund manager would be taxed on her carried interest annually, she would be indifferent, from a tax perspective, as to whether to sell any appreciated assets.<sup>114</sup>

#### B. *Encouraging Investment in Risky Assets*

The other argument for taxing carried interest at preferential rates is that such a preference encourages risk taking by the investment fund manager.<sup>115</sup> In a purely proportional tax world, where investors are taxed on their gains and are able to deduct their losses fully, the tax rate would not materially affect an investor's risk tolerance.<sup>116</sup> However, the current U.S. tax system in some cases limits the deductibility of losses.<sup>117</sup> Suppose that Abby's hedge fund invests \$100 in IBM stock. Abby expects that in one year the stock will either be worth \$150 or \$50. If she were taxed at a 35%

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111. See *supra* Part II.A.2.

112. Cunningham & Schenk, *supra* note 85, at 346; see also Abrams, *supra* note 20, at 220 ("[I]f the realization doctrine were eliminated either directly or indirectly, [the lock-in effect] would disappear.").

113. See Brunson, *supra* note 56 (manuscript at 3) ("In spite of the theoretical superiority of mark-to-market accounting, however, it is unlikely to supplant realization accounting."); Cunningham & Schenk, *supra* note 85, at 346 ("The consensus, however, is that the cost of implementing an accrual system would be so high as to make it infeasible.").

114. An approximate marking of the carried interest to market is central to this Article's proposal. For a more detailed discussion, see *infra* Part V.

115. Abrams, *supra* note 20, at 219.

116. In fact, Professors Cunningham and Schenk argue that, in such a world, an investor's appetite for risk may *increase*. Cunningham & Schenk, *supra* note 85, at 341. Where losses are fully deductible, although an investor's potential upside is reduced, her potential loss is reduced by the same amount—the amount of the tax. *Id.*

117. *Id.* at 342.

rate, a gain would be worth \$32.50 after taxes.<sup>118</sup> If losses were fully deductible, she would only face an after-tax loss of \$32.50.<sup>119</sup> If, however, her full gain will be taxed, but she can only deduct, for example, 80% of her losses, the tax system has increased the downside risk of an investment relative to the potential gain. She still can only expect \$32.50 of after-tax gains, but she faces \$36 of after-tax losses.<sup>120</sup> Because the projected loss is greater than the projected gain, the tax treatment of losses serves to discourage Abby from making the risky investment. At a lower rate of tax, however, this distortion in the amount of risk is diminished.<sup>121</sup>

This justification for preferential capital gains rates is not convincing in the carried interest area, however, for at least two reasons. First, the investment fund manager has non-tax reasons to make risky investments. In order to attract investors, and therefore to increase the size of the investment fund (and the investment fund manager's compensation), the investment fund needs to demonstrate that it has strong returns. Riskier investments provide for more potential upside than less risky investments.<sup>122</sup>

Moreover, the carried interest is a profits interest. If the investment fund loses money in any given year, the investment fund manager is not allocated any carried interest. But, because the carried interest is a profits interest, she does not absorb 20% of the fund's loss. With respect to her carried interest, the investment fund manager is in the same position if the fund loses 10% or 50% of its value.<sup>123</sup> As such, the investment fund manager is indifferent to whether the loss is or is not deductible. In fact, because the investment fund manager has no risk of loss with respect to her carried interest, she should be willing to make riskier investments, in hopes of a larger payoff, than an individual investor investing for herself would make.

Sometimes proponents of the status quo invoke a different

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118. That is, she would have a gain of \$50 and pay taxes of \$17.50, leaving her with \$32.50.

119. That is because the \$50 loss would give rise to a deduction of \$17.50, reducing the amount of tax she would otherwise have to pay.

120. If she can only deduct 80% of her losses, she can only deduct \$40 of her \$50 loss. At a 35% marginal rate, that gives Abby a deduction of \$14, rather than the \$17.50 she would have without the limitation.

121. At a 15% rate, Abby could expect to pay \$7.50 in taxes on a gain, leaving her with \$42.50 after taxes, and would have a \$6 deduction on a loss, leaving her with an after-tax loss of \$44. The diminution of loss is not eliminated by using a lower rate of tax, but it is decreased.

122. JAE K. SHIM & JOEL G. SIEGEL, *FINANCIAL MANAGEMENT* 133 (3d ed. 2008) ("All financial decisions involve some sort of risk-return trade-off; the greater the risk, the greater the return expected.").

123. Note, however, that, with respect to her capital account (that is, any of her own money that she has invested and any carried interest that was allocated to her in a previous year that she did not withdraw), the investment fund manager is subject to losses.

concept of entrepreneurial risk, standing alone and divorced from any concept of the deductibility of losses, as the reason why carried interest should be taxed at capital rates.<sup>124</sup> In essence, the argument goes that profits interests are inherently risky—if the fund does not make a profit, the investment fund manager is not compensated. Therefore, the carried interest must be a return from capital, not from labor.<sup>125</sup> But the proponents of this theory of entrepreneurial risk do not explain why, from a tax-policy perspective, a risky return should be taxed at capital rates. In fact, return from labor can be risky—people who are paid on commission (including salespeople and real-estate brokers) are often paid only if they close their sales. Moreover, other employees receive bonuses tied to individual performance, market conditions, and other factors at least partly out of their own control. Even though it is risky, however, their compensation is unquestionably treated as ordinary income for tax purposes.<sup>126</sup> Likewise, the fact that the amount, if any, of carried interest to be allocated to the investment fund manager in a given year is subject to risk is not, of itself, a sufficient justification for preferential capital gains rates.

#### IV. ECONOMIC EQUIVALENTS OF CARRIED INTEREST

The principal argument commentators make in support of the current tax treatment of carried interest revolves around what carried interest most resembles economically. Defenders of the status quo argue that analogizing the investment fund manager to a service provider (who would be taxed at ordinary rates on service income) is a poor match for the economic reality of the investment fund manager's role.<sup>127</sup> Instead, they argue, carried interest represents legitimate return on capital, and it is irrelevant that the investment fund manager is providing labor rather than capital. The most accurate analogy for the investment fund manager is that of an investor who should be treated on the same footing as the limited partners.<sup>128</sup> Those who favor reform argue that carried

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124. See, e.g., Jenny Anderson & Andrew Ross Sorkin, *Congress Weighs End to Tax Break for Hedge Funds*, N.Y. TIMES, June 21, 2007, at A1.

125. Melone, *supra* note 20, at 488 (“Critics of the current tax treatment of carried interests do not call for a broad-based effort to identify the labor component in the myriad situations in which it is embedded in capital income. Nor do they assert that the particular duties performed by the service partners in a fund disqualify the income as capital because the same duties are performed by individual investors without a similar fuss being raised.”).

126. Chris William Sanchirico, *The Tax Advantage to Paying Private Equity Fund Managers with Profit Shares: What Is It? Why Is It Bad?*, 75 U. CHI. L. REV. 1071, 1152 (2008).

127. See, e.g., Melone, *supra* note 20, at 487.

128. See, e.g., Abrams, *supra* note 20, at 218 (“Those who say that the capital gain/ordinary income distinction draws a sharp line between returns to capital and returns to labor treat these exceptions as anomalies, but perhaps they are

interest is more akin to compensation, and therefore should be taxed at ordinary rates.<sup>129</sup> Ultimately, this question of whether carried interest is a return to capital or to labor is beside the point; as demonstrated, carried interest is outside of the justifications for preferential capital gains rates. However, because the debate has so far focused on whether carried interest is a return to capital or to labor, it is worth looking to see how well carried interest fits in the paradigm of returns to capital.<sup>130</sup>

#### A. *Defending the Status Quo*

It is clear that an investor trading securities on her own behalf will realize capital gains on the sale of her securities.<sup>131</sup> Supporters of the status quo argue that the investment fund manager is, in essence, doing just this: trading securities on her own behalf.<sup>132</sup> The investment fund manager is a partner in the investment fund and, by virtue of the long history of partnership taxation, it is more appropriate to tax her as such.<sup>133</sup> Because partnerships are used to obtain tax treatment for partners as if they are individually performing the activities of the partnership, the argument continues, the investment fund manager should be treated as if she

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not so anomalous if the line is drawn differently.”); Melone, *supra* note 20, at 487–88 (“Moreover, a fundamental premise of partnership taxation is to tax the partners in a fashion similar to that in which they would have been taxed had they undertaken their activities in their individual capacities. It is beyond dispute that had the investment income been earned directly by the service partner, the income would have been capital in nature . . .”); Weisbach, *supra* note 20, at 749 (“[T]he right distinction is between a partner and someone who works for the partnership but is not properly treated as engaged in partnership business. Although this line is hard to draw, private equity sponsors would clearly be treated as partners under both current law and reform proposals.”).

129. See, e.g., Victor Fleischer, *Taxing Blackstone*, 61 TAX L. REV. 89, 105 (2008) (“The Code thus treats carried interest distributions—the bread and butter of fund manager compensation—as a return on low-taxed investment capital rather than as high-taxed labor income.”). Professor Rosenzweig, on the other hand, argues that this binary view of the tax character of carried interest—as either ordinary income or long-term capital gains—is too narrow; instead, he advocates looking for a third way, such as taxing carried interest as short-term capital gains. Rosenzweig, *supra* note 28, at 741–42.

130. The point of this Part is not to demonstrate that carried interest is better thought of as a return to capital, but rather that either classification is problematic and that it is not unreasonable to analogize carried interest to a return to labor.

131. See I.R.C. § 1221(a) (2006).

132. Melone, *supra* note 20, at 487–88 (“It is beyond dispute that had the investment income been earned directly by the service partner, the income would have been capital in nature, despite the fact that numerous labor intensive activities are performed in generating such income.”).

133. See, e.g., Weisbach, *supra* note 20, at 754 (“The long history of the development of the partnership tax rules and the many policy proposals for their reform indicate the strong preference for taxing partners as if they engaged in partnership activity directly.”).

actually *is* trading on her own behalf.<sup>134</sup>

But is the investment fund manager trading securities on her own behalf? To the extent that the investment fund manager has contributed money to the investment fund, yes. And horizontal-equity concerns suggest that the investment fund manager's tax treatment on returns generated by her contributed capital should be treated the same as returns generated by other partners' contributed capital.<sup>135</sup> But the investment fund manager may provide little to none of the fund's capital.<sup>136</sup> While the investment fund manager's return from her invested capital should certainly be treated as capital gains, there is no reason why the rest of the fund should be treated as being traded on the investment fund manager's own account.<sup>137</sup> As regards that much larger portion of the investment fund, the investment fund manager is buying and selling securities on behalf of others, and, if she were an investment advisor, would be taxed on any income paid her by the other investors at ordinary rates.

Moreover, there is no question that the investment fund manager is a service provider. Payments for services provided to a partnership by a partner are treated as payments made to a nonpartner.<sup>138</sup> Nobody argues that the management fee should be treated as an allocation to a partner in her capacity as such, and that it should therefore be treated as capital gains.<sup>139</sup> While carried interest can be analogized to many things, including a return on a nonrecourse loan<sup>140</sup> and a nonqualified stock option,<sup>141</sup> in its simplest form, investors pay carried interest to the investment fund manager in order to align her economic interest with theirs.<sup>142</sup> As such, there

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134. See Melone, *supra* note 20, at 488.

135. See *infra* Part V.C–D.

136. See *supra* note 37 and accompanying text.

137. In a related vein, Professor Weisbach argues that, rather than funding the investment fund by selling equity, the investment fund manager could borrow the money and invest it; because the investment fund manager could receive capital gains treatment on its leveraged investment, it would be wrong to treat the manager of an equity-funded investment fund differently. Weisbach, *supra* note 20, at 741–42. I find this argument unconvincing for the same reasons I find unconvincing the argument that the investment fund manager should be treated as borrowing money to make a 20% investment in the fund. See *infra* Part IV.B.2.

138. I.R.C. § 707(a) (2006); Treas. Reg. § 1.707-1(a) (as amended in 1983).

139. See *supra* note 45 and accompanying text.

140. See Fleischer, *supra* note 11, at 51.

141. *Id.* at 25.

142. A tale is told, perhaps apocryphally, about an investment bank that had an internal hedge fund for the bank's employees. The fund charged a management fee but, because it was for employees, there was no carried interest. Once employees had invested in the hedge fund, though, the investment fund manager sat on the assets without trading or otherwise seeking any return. The investment bank loved the investment fund manager's strategy, because the investment fund manager was earning the 2% fee for the



is no overwhelming reason why carried interest cannot be analogized to compensation income.<sup>143</sup>

*B. Proposals for Reform*

Commentators who believe that the current taxation of carried interests at pass-through rates is inappropriate have proposed types of reforms that, broadly, fall into two categories. Under the first, the character of the taxable income would be changed. Under the second, the grant of the profits interest would be treated as an interest-free loan from the investors to the investment fund manager allowing the investment fund manager to purchase a 20% interest in the fund. Each proposal solves some of the problems with the current taxation of carried interest, but each also presents additional difficulties.

*1. Recharacterization*

Recharacterizing carried interest as ordinary income rather than capital gains is the most intuitively appealing reform. Essentially, this is the approach proposed section 710 takes.<sup>144</sup> It is appealing largely because of its apparent simplicity—instead of taking into account the character of the income underlying the investment fund manager's carried interest, all carried interest would be characterized as ordinary income.

Other than recharacterizing carried interest, section 710 would not make any significant changes to the current taxation of carried interest. Notably, the investment fund manager would continue to defer any taxation of her carried interest until the underlying

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bank every year. The employees, on the other hand, felt cheated because not only was their money not growing, it was actually shrinking by virtue of the annual management fee. Whether or not such a fund existed, the story illustrates why investors would want the amount of the investment fund manager's compensation to be linked to the fund's performance. (And why, in this story, would the employees not just pull their money out? Most hedge funds limit the frequency with which withdrawals can be made and, sometimes, the amount that can be withdrawn on any withdrawal date.)

143. For example, the management fee could be treated as base salary and the carried interest as a performance bonus. Professor Weisbach objects to the use of analogical reasoning in determining the proper taxation of carried interest because, he says, an analogy can be made equally well for treatment as capital income or treatment as services income and because generally the comparison criteria are deployed without explaining why they matter. Weisbach, *supra* note 20, at 741. While I agree that analogies do not create a *prima facie* case for treating carried interest as ordinary income or as capital gains, they can be useful for thinking about the basket in which carried interest belongs. Ultimately, carried interest, like any other investment income, is *sui generis*, but it must be categorized somehow, and it is useful to see that it has similarities to other types of income in the basket in which it is placed.

144. H.R. 4213, 111th Cong. § 602 (2009) (containing proposed I.R.C. § 710(a)(1)).

appreciated assets were sold.

Although section 710 is simple, commentators have pointed out a number of problems with this approach, including the availability of planning options to avoid it<sup>145</sup> and the fact that it causes capital gains income to disappear.<sup>146</sup>

What has not been discussed, but is perhaps more important, is that section 710 aggravates the lock-in problem discussed above.<sup>147</sup> If the investment fund manager will be taxed at a 35% rate, but only when the investment fund realizes the income, the investment fund manager has an even stronger incentive to continue to hold any appreciated assets rather than sell them, potentially to the detriment of the other investors.<sup>148</sup> Because its enactment would increase the lock-in effect of investment funds, section 710 would strengthen the policy justifications for taxing carried interest at preferential capital gains rates.

## 2. *Cost-of-Capital Approach*

Professors Fleischer, Cunningham, and Engler have all suggested variations on a second type of treatment of carried interest, one they call a “cost-of-capital” (or “interest charge”) approach.<sup>149</sup> Simplified and summarized, their proposals would continue to treat carried interest in the same manner as it is currently treated. However, the cost-of-capital approach would create a deemed loan from the investors to the investment fund manager sufficient to allow the investment fund manager to purchase a 20% interest in the investment fund.<sup>150</sup> The deemed loan would be treated as an interest-free loan to the investment fund manager. Presumably, if this loan were made in an arm’s-length transaction, the investors would have charged interest at the market rate. Because there is no interest, the investors would be deemed to forgive the interest, and the investment fund manager would be taxed, at ordinary rates, on the interest deemed forgiven.<sup>151</sup> As such, the investment fund manager would be treated as having some amount of ordinary income every year, whether or not she was allocated any carried interest, but her portion of the fund’s gains could continue to be treated as capital gains.

Although an elegant solution, Professor Melone has criticized it

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145. Fleischer, *supra* note 11, at 51. *But see id.* at 57 (“But there is nothing offensive about [restructuring to avoid the tax].”).

146. Melone, *supra* note 20, at 479.

147. *See supra* Part III.A.

148. *See supra* Part III.A.

149. Cunningham & Engler, *supra* note 19, at 128; Fleischer, *supra* note 11, at 6.

150. Cunningham & Engler, *supra* note 19, at 126; Fleischer, *supra* note 11, at 40.

151. Cunningham & Engler, *supra* note 19, at 127; Fleischer, *supra* note 11, at 40.

on a number of grounds, including that it would not significantly change the results of current law, that a loan on the terms imputed to the carry would not be recognized as a loan under current tax law, and that the transaction is not a loan and, therefore, should not be treated as a loan.<sup>152</sup>

Not only is the carried interest not a loan, but there is no evidence that, from a business perspective, the investors would be willing to make such a loan to the investment fund manager. If the investors were willing to do so—and the loan were respected for tax purposes—there is no reason why investment fund managers could not structure their funds to include a loan from the investors to the manager. In fact, Professor Fleischer recommends that something similar to section 710 be enacted as a baseline rule, which would allow funds to structure the investment fund manager's compensation as a loan rather than as carried interest if that is their preferred tax treatment.<sup>153</sup>

Ultimately, it is not clear that the economic similarities between carried interest and an interest-free loan are compelling enough to add the complexity that the cost-of-capital approach would introduce into the tax system. Although such a loan would achieve the same economics as carried interest, it is not a better description of the business deal. The investors do not think of themselves as making a loan to the investment fund manager, and the economic similarities are not so compelling as to favor treatment as a loan over treatment as a partnership allocation.

#### V. THE SIMPLIFIED MARK-TO-MARKET PROPOSAL

Any proposal to tax carried interest as ordinary income must not only determine whether carried interest is more like services income or investment income; it must also take into account whether the policies underlying the capital gains preference would apply to carried interest.

This Article proposes a simplified mark-to-market regime imposed on carried interest. A mark-to-market system of taxation departs radically from the current realization system: under mark-to-market, a taxpayer pays tax every year on all appreciation in her assets, without regard to whether those assets have been sold. Under this Article's simplified mark-to-market proposal, an investment fund manager would pay taxes annually on the amount of carried interest allocated to her, irrespective of whether the fund had sold assets, and would pay taxes on that amount at ordinary rates. This simplified mark-to-market approach shares the basic idea underlying section 710, that is, to tax carried interest at ordinary rates, but differs in ways that accommodate the capital

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152. Melone, *supra* note 20, at 472–73.

153. Fleischer, *supra* note 11, at 57.

gains analysis.

A. *Taxing Carried Interest Under a Simplified Mark-to-Market Regime*

Under the simplified mark-to-market approach, an investment fund manager would be taxable every year on the amount of carried interest allocated to her, without regard to whether the fund had sold the appreciated assets and realized the gain. She would pay tax on the carried interest at ordinary rates. Upon paying taxes, the investment fund manager would be deemed to have contributed the amount of the carried interest to the investment fund, and her capital account would increase by the amount of the carried interest.<sup>154</sup> Any gain or loss realized as a return on the investment

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154. The deemed contribution does not represent a change from current law. Under current law, undistributed profits earned pursuant to a profits interest in a partnership (including carried interest in an investment fund) transform the next year into a capital interest in the partnership. Postlewaite, *supra* note 8, at 845.

It is necessary to note that the deemed contribution by the investment fund manager would cause the investment fund's outside basis to differ from its inside basis. Very simply, tax basis represents the amount of after-tax money used to purchase an asset. In this case, the asset is both the fund itself and the securities in which the fund has invested. Generally, an asset's basis is the cost of the asset. I.R.C. § 1012 (2006). Basis is used to calculate taxable gain or loss on the sale or exchange of an asset. *Id.* § 1001(a). "Outside basis" is the sum of each partner's tax basis in the fund, whereas "inside basis" is the fund's tax basis in its assets. Joseph M. Dodge & Jay A. Soled, *Debunking the Basis Myth Under the Income Tax*, 81 IND. L.J. 539, 553 n.73 (2006) ("Outside basis is the equity holder's basis in her tax partnership interest; inside basis is the predistribution basis of an asset, the ownership of which is held by the tax partnership."). If Ben and Christy each contributed \$50 to Abby's hedge fund, there is a total outside basis of \$100 in the hedge fund. The fund purchases assets for \$100, so the fund also has an inside basis of \$100. During its first year of operation, the hedge fund earns \$10, \$2 of which is allocable to Abby. Under the simplified mark-to-market approach, Abby would be taxed on the \$2 and would receive \$2 of basis in the fund. Because it has not sold any assets, the fund would continue to have an inside basis of \$100. However, there would be an outside basis of \$102 (both Ben and Christy would have a basis of \$50 in the fund, and Abby would have a basis of \$2).

During the life of the fund, this disconnect should not make any difference to the investors, who will be allocated gain according to their capital accounts. On liquidation, any difference between inside and outside basis will resolve itself: if investment assets are distributed, an investor will take the assets with a basis equal to her outside basis in the fund. I.R.C. § 732(b) (2006). If Abby's hedge fund were to liquidate after the first year and distribute its assets, Ben and Christy would each receive assets worth \$54 and would each have a basis of \$50 in those assets. The \$4 difference between the value of the assets and their basis would represent the untaxed appreciation. Abby, on the other hand, would receive assets worth \$2 and would have a basis in those assets of \$2. Because she was already taxed on the appreciation when she was allocated her carried interest, the rule of section 732(b) prevents her from being taxed on that appreciation a second time.

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fund manager's deemed contribution would take a pass-through character, as capital gain or loss.

This approach is not strictly taxation on a mark-to-market basis. Most notably, the simplified mark-to-market approach does not require an investment fund to value its assets accurately and objectively. Instead, an investment fund would be permitted to continue to value its assets using whatever system it has used in the past. Allowing investment funds to continue to determine the value of their assets reduces the administrative costs that adopting a new valuation calculation would impose. Such costs would ultimately be borne by the funds' investors, reducing their returns. Because this simplified mark-to-market taxation can tax investment fund managers in a fair manner, there is no need to impose extra costs.

This simplified mark-to-market approach accomplishes a number of objectives that commentators critical of the current system of taxing carried interest seek. First, it treats the carried interest as ordinary income, which is both the apparently fair result as well as the result mandated by the capital gains analysis performed above. The simplified mark-to-market approach also eliminates certain distortions that cause the investment fund manager's incentives to differ from the investors' desires, and it eliminates deferral of the investment fund manager's inclusion of gain. At the same time, it allows pass-through treatment for the investment fund manager's economic investment in the fund.

*B. Why the General Objections to Mark-to-Market Taxation Do Not Apply to the Simplified Mark-to-Market Approach*

As discussed above, a proposal such as section 710, which changes the tax character of carried interest while continuing to tax the carried interest only when income is realized, aggravates the already extant lock-in problem. However, the issues with lock-in would be ameliorated if the investment fund manager were taxed on a mark-to-market basis. By taxing the allocation of carried interest without regard to underlying realization, the investment fund manager's compensation would no longer be subject to deferral. Instead, she would be taxed as income accrued to her.

Although mark-to-market taxation best reflects Haig-Simons income, there are two practical impediments to requiring people to pay taxes on a mark-to-market basis. The first is valuation. Commentators have argued that taxing carried interest on a mark-to-market basis "could not function" because of valuation concerns and concerns that the investment fund manager would manipulate the value of portfolio investments.<sup>155</sup> The second is liquidity. The

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155. Fleischer, *supra* note 11, at 38–39. These arguments are especially strong with private equity funds, which invest in private companies for which there is no market and therefore no reliable method of valuation. They are less

fact that an investor's assets have appreciated does not mean that the investor has cash available to pay the tax; mark-to-market taxation could potentially force an investor to sell an appreciated asset in order to have the money to pay the tax, even if she would prefer to continue to hold the asset. Under the simplified mark-to-market approach to taxing carried interest, however, the investment-fund manager would not face either a valuation or a liquidity problem.

### 1. Valuation

The simplified mark-to-market approach being proposed in this Article would not require investment funds to value their assets separately for tax purposes. Rather, the amount of an investment fund manager's tax would be based on the fund's financial accounting.

Because financial accounting and tax accounting have different goals (to provide useful information to interested parties and to provide for equitable collection of revenue, respectively), there is no "presumptive equivalency" between financial accounting and tax accounting.<sup>156</sup> Still, there is an incessant assertion that tax accounting should follow financial accounting.<sup>157</sup> At the very least, advocates of financial accounting for tax purposes argue that if tax accounting followed financial accounting, corporations understating their tax liabilities would also be required to understate their profits, making shareholders unhappy.<sup>158</sup> Ultimately, though, calculating income for tax purposes under financial-accounting standards is arguably a bad idea and is unlikely to happen—the government is unlikely to cede authority to determine taxable income to anybody else.<sup>159</sup>

For purposes of implementing the proposed simplified mark-to-market taxation of carried interests, however, it makes sense to calculate the amount of carried interest based on an investment fund's financial accounting. Investment funds already value their assets in order to provide both investors and creditors with the

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compelling for plain-vanilla hedge funds that invest principally in publicly traded securities.

156. *Thor Power Tool Co. v. Comm'r*, 439 U.S. 522, 542–43 (1979).

157. Deborah A. Geier, *The Myth of the Matching Principle as a Tax Value*, 15 AM. J. TAX POL'Y 17, 19–20 (1998) ("Accountants typically argue that tax accounting should simply follow financial accounting. Even some tax lawyers, policymakers, and judges (and justices), insufficiently conscious of the tax values that should inform tax accounting and with no formal background in financial accounting, are often lulled into agreement with the rhetoric of the financial accountants.")

158. Calvin Johnson, *GAAP Tax*, 83 TAX NOTES 425, 426 (1999).

159. *See, e.g., id.* ("Tax accounting . . . [is] too important to be left to the accountants.")

information they require.<sup>160</sup>

For hedge funds, the amount subject to mark-to-market taxation would be the amount of carried interest allocated to them every year for financial-accounting purposes. At least annually, a hedge fund must determine the amount the fund's assets have increased in value, 20% of which it allocates to the investment fund manager and the remainder of which it allocates proportionally to its limited partners. Under the simplified mark-to-market approach, the investment fund manager would be treated as in fact receiving the amount allocated to her and would be taxable on that amount at ordinary rates.

Because private equity funds invest in illiquid assets for which there is no public market, the valuation on the public equity side is a little bit trickier. In addition, private equity fund managers are not allocated their carried interest until the fund sells an investment and receives the money. Nonetheless, private equity funds create financial statements to provide to investors and creditors, and the simplified mark-to-market system would use the valuations in those financial statements in order to determine the amount of carried interest subject to tax.

Admittedly, relying on the fund's valuation of its own assets could invite manipulation of those values in order to reduce the investment fund manager's tax bill. The investment fund manager could, for example, choose to carry all investments at purchase price until their sale, in which case the investment fund would only calculate appreciation when assets were sold. If the investment fund were to defer calculating appreciation, the investment fund manager could defer any tax on carried interest under the simplified mark-to-market proposal as long as it does under current law. Alternatively, the investment fund manager could undervalue its assets until sold, thereby deferring some portion of its tax until realization.

Even if an investment fund manager were to defer all or a portion of the tax on her carried interest, she would still be subject to tax no later than she is taxed under current law. However, she would be taxed at ordinary rates rather than at capital gains rates. Because the policy considerations underlying preferential tax rates on capital gains do not apply to carried interest, this still provides a minor improvement over the current treatment of carried interests.

However, there are non-tax incentives for investment fund managers not to understate the value of their assets. Although, as privately held firms, investment funds are not subject to mandatory financial reporting rules, most nonetheless rely on U.S. Generally Accepted Accounting Principles.<sup>161</sup> These incentives are slightly

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160. See Cumming, Gill & Walz, *supra* note 29, at 621.

161. *Id.*

different for hedge funds and for private equity funds and are laid out below.

Hedge funds have two main non-tax incentives to value their assets generously. First, hedge fund managers are not allocated any carried interest for financial-accounting purposes until the hedge fund takes gains into account.<sup>162</sup> When the hedge fund takes its realized and unrealized gains into account, the hedge fund manager's capital account is increased, which represents a real increase in the manager's net worth, gain that the manager can then withdraw from the fund. If the fund defers the allocation of gains, any increase in the hedge fund manager's wealth is also deferred.

Second, by deferring the allocation of unrealized gain, the investors' capital accounts do not increase. In order to keep current investors happy, and in order to market the fund to other potential investors, it is presumably better to show a consistent increase in the fund's assets and in investors' capital accounts. Moreover, if the hedge fund were to fail to allocate appreciation to investors on a regular basis, new investors who enter the fund after the appreciation has occurred but before it is allocated to the old investors would receive a portion of the appreciation that occurred prior to their investing in the fund.<sup>163</sup> Such a result would be unacceptable to early investors and, therefore, any hedge fund that anticipates bringing in investors after the initial round of investors would not, as a business matter, defer allocating unrealized appreciation.

Private equity fund managers do not receive their carried interest until the fund sells an asset.<sup>164</sup> In addition, a private equity fund generally does not bring in additional investors after an initial investment period.<sup>165</sup> However, private equity fund managers often form additional private equity funds for which they need to raise

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162. Illig, *supra* note 51, at 70–71.

163. As an example, let us return to Abby's investment fund. *See supra* Part I.A. For the sake of this example, we can ignore any payments to Abby. Assume that at the end of the year, the IBM stock has appreciated from \$100 to \$110, but the \$10 of appreciation is not allocated to Ben and Christy. On January 1 of Year 2, Dave invests \$50, which is used to purchase another \$50 of IBM stock (meaning that the fund owns \$160 of IBM stock). Because the appreciation was not allocated to Ben and Christy, their capital accounts have remained at \$50, and all three are equal partners. If the fund were to liquidate the next day, Ben, Christy, and Dave would each receive \$53.33, in spite of the fact that the \$10 of appreciation occurred before Dave purchased his interest. If done correctly, the \$10 of appreciation would have been allocated to Ben and Christy on December 31 of Year 1, so each of them would have a capital account of \$55. If Dave bought his interest on January 1 of Year 2 and the fund were to be liquidated on January 2, Ben and Christy would each receive \$55 and Dave would receive his \$50 back.

164. Brennan & Okamoto, *supra* note 33, at 40.

165. *See id.* at 39–40.



capital before the termination of existing funds. In order to market the new funds both to existing and new investors, private equity fund managers have incentives to overvalue their illiquid investments that have not yet been sold.<sup>166</sup> As with hedge funds, such business incentives to overvalue assets are in tension with any tax incentives to undervalue assets.

Because of this tension between tax and non-tax incentives, it seems unlikely that investment fund managers will significantly undervalue their assets, even faced with a mark-to-market regime on unrealized appreciation. Therefore, in spite of the valid arguments for not basing tax accounting on financial-accounting standards, in the case of imposing a mark-to-market system on carried interest, it makes sense to use the financial-accounting system an investment fund already uses in order to value its assets.

## 2. *Liquidity*

Although the simplified mark-to-market proposal does not require an objective valuation of an investment fund's assets, the investment fund manager does require cash to pay the annual tax. Therefore, the simplification does not, itself, solve the general liquidity concerns associated with mark-to-market taxation.<sup>167</sup> Nonetheless, the simplified mark-to-market proposal would not create liquidity issues for investment fund managers because, by the nature of an investment fund manager's compensation, investment fund managers always have sufficient liquidity to pay taxes imposed on carried interest.

In general, the management fee alone would provide sufficient cash to the investment fund manager to pay tax at ordinary rates on any allocation of carried interest.<sup>168</sup> Return again to Abby's hedge fund. It has \$100 of invested capital and, for 2009, has a shockingly good year, earning an 18% return (i.e., \$18 of profit). The fund charges investors a 2% management fee and 20% of the fund's profits as carried interest. Abby will receive a management fee of \$2 and will be allocated \$3.60 of carried interest. Assuming that both the management fee and the carried interest are subject to tax at a 35% rate, she will owe \$0.70 of taxes on her management fee and \$1.26 of taxes on her carried interest, for a tax bill of \$1.96. After taxes, she will have \$0.04 of cash left from the management fee (in addition to the \$3.60 by which her capital account in the fund has increased).<sup>169</sup>

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166. Cumming, Gill & Walz, *supra* note 29, at 629.

167. See Brunson, *supra* note 56 (manuscript at 9).

168. Fleischer, *supra* note 11, at 37 ("Nor is liquidity a concern; the annual management fees earned by private equity funds would provide more than enough cash to pay the tax on an annual basis.")

169. Although only having \$0.04 in cash left after taxes seems a miniscule amount, an actual investment fund would begin with exponentially more assets

Theoretically, there could be situations in which the management fee was insufficient to cover the investment fund manager's taxes. If Abby's hedge fund were to make slightly better investments, increasing the fund's return by two percentage points—a 20% profit—her total tax bill would be \$2.10, \$0.10 more than the management fee she earned. Even in this situation, however, Abby would have the liquidity to pay her tax bill. Although the carried interest is just an allocation, if the investment manager needs cash for whatever reason, she can cause the fund to redeem a portion of her interest in the fund.<sup>170</sup>

*C. The Simplified Mark-to-Market Approach Is Straightforward and Comports with the Parties' Understanding of the Structure of Carried Interest*

One problem with the cost-of-capital approach is that, while it reflects the economics of carried interest, it adds steps and complexity to the structure of the transaction.<sup>171</sup> While under the tax law, the government may disregard a taxpayer's chosen form,<sup>172</sup> and although these added steps may accurately reflect one version of the economics of the compensation of the investment fund manager, the fact remains that the investment fund manager and the investors have not chosen to adopt those steps. Moreover, while the additional steps reflect the economics of carried interest, so do other analogies, and there is no compelling reason why the cost-of-capital analogy, with its added steps (i.e., a loan from the investors to the investment fund manager, a contribution by the investment fund manager to the fund, and the forgiveness of interest), should replace the current treatment, which does not require any steps to be imputed.

The simplified mark-to-market proposal, on the other hand, merely eliminates the realization requirement.<sup>173</sup> Because there is

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and, therefore, Abby would be left with exponentially more cash. If we were to assume that Abby's fund had \$100 million of invested capital, she would be left with \$40,000 cash after taxes, as well as an additional \$3.6 million in her capital account.

170. Ordower, *supra* note 9, at 358. Because a significant portion of a hedge fund's assets are liquid, if the investment fund manager were to withdraw money from her capital account, the fund could sell assets in order to have money to distribute.

171. See *supra* Part IV.B.2.

172. See *Kuper v. Comm'r*, 533 F.2d 152, 155 (5th Cir. 1976) ("As a general rule, the incident of taxation depends on the substance rather than form of the transaction.").

173. Perhaps it is audacious to say that the proposal "merely" eliminates the realization requirement, which has been a fundamental part of the U.S. tax law since before the enactment of the modern income tax. See David M. Schizer, *Realization as Subsidy*, 73 N.Y.U. L. REV. 1549, 1551 n.2 (1998) ("The [realization] rule is as old as the income tax itself."). But the realization requirement is merely a tax accounting tool; it is not an actual transactional

no realization requirement, it is necessary to impute a contribution by the investment fund manager to the fund in order to account for the fact that the carried interest remains invested in the fund. But this imputed step comports with the transaction in which the investment fund manager and the investors understand themselves to be engaged. Moreover, taxing a taxpayer on income, even when undistributed, and creating a deemed recontribution has a significant history in corporate taxation, including in the taxation of mutual funds.<sup>174</sup>

Because carried interest is an allocation of profits to the investment fund manager, there is no physical distribution of cash or other property to the investment fund manager. Instead, the investment fund manager contributes her labor in exchange for an interest in the fund. If the investment fund manager wishes to receive cash for her labor instead of an interest in the fund, she must cause the investment fund to make a distribution to her out of her capital account.<sup>175</sup> Under the simplified mark-to-market proposal, rather than requiring the investment fund manager to take a distribution from her capital account, she is essentially treated as first receiving a distribution (i.e., the carried interest) in exchange for her labor and then contributing the cash to the fund in exchange for an interest in the fund.

The tax law has no objection to treating investors as if they received a distribution and then recontributed the money, even where no cash changed hands. Mutual funds generally allow their shareholders to participate in dividend-reinvestment plans. Under a dividend-reinvestment plan, a shareholder can elect to receive shares of the mutual fund in lieu of receiving a cash dividend.<sup>176</sup> Although the mutual fund investors may not feel like they have realized any income,<sup>177</sup> they are treated as if they were in constructive receipt of the dividend.<sup>178</sup> Effectively, then, a mutual fund shareholder who elects not to receive distributions of cash in favor of receiving additional shares of the mutual fund is taxed on a mark-to-market basis.

Although a dividend-reinvestment plan applies to corporations, there is no material difference between what happens in the mutual fund context and what is happening in the partnership context—rather than receiving a cash distribution of 20% of the fund's profits,

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step. Thus, eliminating the realization requirement does less damage to the form of the transaction than imputing steps.

174. See Terrence R. Chorvat, *Perception and Income: The Behavioral Economics of the Realization Doctrine*, 36 CONN. L. REV. 75, 119–20 (2003).

175. Ordower, *supra* note 9, at 358.

176. Chorvat, *supra* note 174, at 121–22.

177. *Id.* (“It is likely that individuals therefore do not view these increases in portfolio wealth as they would the receipt of cash.”).

178. Treas. Reg. § 1.305-2(a)(1) (1973); Rev. Rul. 78-375, 1978-2 C.B. 130, 132.

the investment fund manager has chosen to receive additional interest in the fund. While the treatment of dividend-reinvestment plans is not—and should not be—dispositive of the tax treatment of carried interest, it demonstrates that the tax law is able and willing to impute the single step of reinvestment to a transaction.

*D. The Simplified Mark-to-Market Proposal Preserves Horizontal Equity Between the Investment Fund Manager and the Investors*

The simplified mark-to-market proposal effectively bifurcates the investment fund manager's return. Allocations of carried interest would be taxed annually at ordinary rates. However, after being taxed, the carried interest would be treated as invested directly in the fund, and any gains or losses on that amount would get the pass-through character, and could potentially be long-term capital gains.<sup>179</sup> As has already been discussed, though, the reasoning behind the simplified mark-to-market proposal is that the justifications for a preferential capital gains rate do not apply to the investment fund manager's receipt of carried interest. Why, then, should such preferential rates apply to other partnership allocations made to the investment fund manager?

First, unlike the carried interest, once the appreciation is part of the investment fund manager's capital account, it is legitimately subject to risk; if the value of the fund's assets fall, the investment fund manager's capital account will shrink, and she will suffer a loss. Because the investment fund manager is subject to risk of loss as well as potential for gain after being allocated the carried interest, part of the justification for a preferential capital gains rate applies to the investment fund manager with respect to her capital account: she may not get to treat her losses in an equal and opposite way from the way she treats her gains.

Second, horizontal-equity concerns weigh strongly in favor of the investment fund managers being treated the same as the other investors with respect to allocations of gain and loss resulting from her capital account. Essentially, she is in the same position as the passive investors: she has contributed (or been deemed to have contributed) cash to the fund, which has increased the size of her capital account.<sup>180</sup> And this investment by the investment fund manager is made on an after-tax basis, just like the investments of

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179. Even this comports with certain current mark-to-market rules. A securities dealer subject to the mark-to-market rules of section 475 of the Internal Revenue Code can opt out of such treatment for "any security held for investment." I.R.C. § 475(b)(1)(A) (2006).

180. There are certain differences. For example, the investment fund manager can generally withdraw capital from her capital account at any time. Ordower, *supra* note 9, at 358. However, the investors can generally only redeem their shares at certain times. Depending on the fund, it may be as frequently as monthly or as infrequently as annually. *Id.* at 328.

any other taxable investor.<sup>181</sup>

Third, and related to the first two points, is that the investment fund manager could easily avoid a rule that taxed all partnership allocations to her as ordinary income, irrespective of whether the allocation was carried interest or investment interest. In order to avoid the rule, all she would have to do would be to withdraw her full capital account every time carried interest was allocated. Then she could invest directly in the assets owned by the fund or she could invest in another investment fund that she did not manage.<sup>182</sup> By investing directly or by investing through an alternative investment fund, the investment fund manager would be subject to the realization rules and capital rates applicable to other investors.<sup>183</sup>

To the extent that the tax law encouraged the investment fund manager to take her money out of the fund, the other investors would be hurt. In order to have the cash available to make distributions to the investment fund manager, the fund would have to sell certain assets that it might otherwise prefer not to sell. Losing the investment fund manager's money would also shrink the fund's assets, diminishing the advantages that inhere in having a large capital base. Furthermore, while allocations of carried interest encourage the investment fund manager to make as much profit for the fund as possible, where the fund has lost money, carried interest may not provide sufficient incentive for the investment fund manager to make up the loss.<sup>184</sup> Where the investment fund manager's capital account has shrunk alongside the capital accounts of the other investors, however, she is in the same boat as the limited partners; having her own money in the fund improves the alignment between the investment fund manager's interests and the interests of the other investors.

Ultimately, once the investment fund manager has paid taxes in respect of the allocation of carried interest, whatever she leaves in

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181. Tax-exempt investors, of course, invest on a pretax basis. One objection to the current treatment of carried interest (which would also apply to section 710) is that it would effectively allow an investment fund manager to purchase interest in the fund using pretax dollars, because tax is only imposed upon realization. See Fleischer, *supra* note 11, at 24 ("Rather than contribute after-tax dollars to buy a capital interest, GPs can, instead, convert management fees, on a pretax basis, into investment capital.").

182. The second option would appear to be less appealing than the first because in another fund she would have to pay a management fee and incentive allocation. She could, however, negotiate with the fund to reduce or exempt her from the management fee and incentive allocation applicable to her investment (possibly in return for doing the same for the investment fund manager of that investment fund).

183. See Rosenzweig, *supra* note 28, at 727 ("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.")

184. See Ordower, *supra* note 9, at 346-48.

the fund represents a bona fide investment. There is no compelling reason to treat that investment differently than the investment of any other person.

*E. The Simplified Mark-to-Market Approach Is Invisible to Passive Investors*

Although investment fund managers would be subject to changed character and timing in the taxation of carried interest, the changes made by the simplified mark-to-market approach would be invisible to the investors. Because the simplified mark-to-market proposal would make no changes to the taxation of other investors, it would not add any administrative burden to computing their taxes. Moreover, it would be administrable from their perspective, because they would not be required to do anything different from what they currently do. Because it is invisible to the other investors, they should have no objection to enacting the simplified mark-to-market proposal.

From the perspective of passive investors in an investment fund, after the enactment of the simplified mark-to-market approach, 20% of the fund's gains would continue to be allocated to the investment fund manager. Professor Melone criticizes this result on the grounds that it causes capital gains income to disappear.<sup>185</sup> Professor Mark P. Gergen's proposal would solve this disappearance problem by treating compensatory allocations as salary, which would be income to the investment fund manager and an expense to the investment fund.<sup>186</sup> The investment fund would then allocate to the investors gains (including the 20% currently allocated to the investment fund manager) and, in addition, would allocate to the investors their pro rata portion of the salary expense.

The following illustrates the difference between Professor Gergen's approach and the simplified mark-to-market approach:<sup>187</sup> Assume that Abby's fund earns and realizes \$100 of long-term capital gains. Under the modified mark-to-market approach, Abby would be allocated \$20, which she would take as ordinary income, and Ben and Christy would each be allocated \$40 of long-term capital gains. Under Professor Gergen's approach, on the other hand, Abby would receive \$20 of salary, treated as ordinary income. Ben and Christy would each be allocated \$50 of long-term capital gains and \$10 of compensation expense. Professor Melone finds the recharacterization of \$20 of capital gains as ordinary income to be "anomalous because it is clear that capital gain has been generated. If the service partner traded for her own account, the gain would be

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185. Melone, *supra* note 20, at 478–79.

186. Gergen, *supra* note 19, at 103.

187. See also Melone, *supra* note 20, at 479 (demonstrating the difference between I.R.C. § 710 and Professor Gergen's approach).

characterized as capital gain. If the service partner is not allocated capital gain, it should be allocated to someone else—it should not disappear.”<sup>188</sup>

It is not clear, however, why the capital gains should not disappear. If preferential capital gains rates exist in order to correct distortions otherwise created by the imposition of tax, where the distortions do not exist, there is no reason why capital gains are inherently different from other income and no reason why they must always be preserved. Moreover, under current law, capital gains can and do disappear. If, for example, the investment fund manager (or, for that matter, any other investor) had made an election under section 475(f) of the I.R.C. to be taxed on a mark-to-market basis, any gains allocated to the investment fund manager (or electing investor) would be treated as ordinary income, notwithstanding the character of the income being passed through.<sup>189</sup> And for a dealer in securities, ordinary treatment is mandatory, irrespective of whether the dealer’s counterparty treats the income as capital or ordinary.<sup>190</sup>

Nonetheless, by taxing the carried interest as ordinary income, the simplified mark-to-market proposal is essentially treating carried interest as salary. So why should the tax law not go all the way and adopt Professor Gergen’s approach? First, although the carried interest is arguably closer to compensation for services than it is to a partnership allocation, the fact remains that it is structured as a partnership interest. Although the tax law can disregard a taxpayer’s chosen form in deciding how to tax a transaction,<sup>191</sup> such line drawing adds complexity to the tax code. Where the proper result can be achieved without adding that complexity, it makes sense to use the simpler approach. There is a long history of investment funds treating carried interest as an allocation to the investment fund manager; it is an administrable rule, and the principal justification for changing it from an allocation to a salary (i.e., so that capital gains do not disappear) is not so compelling as to demand the change be made, with the attendant complexity added to the tax code.<sup>192</sup>

In addition, continuing to treat carried interest as an allocation presents certain advantages to the passive investors. Because the change is transparent to them, it does not involve any administrative burden beyond what is already required of them. Also, because it is an allocation, for tax purposes, investors are

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188. *Id.*

189. I.R.C. § 475(d)(3)(A)(i), (f) (2006).

190. *Id.* § 475(a)(1).

191. *Id.* § 1259(c) (treating certain nonsale transactions as “constructive sales” for tax purposes).

192. It is important that changes to the taxation of carried interest not be made irresponsibly or hastily, inasmuch as “any change to the taxation of carried interests could affect a large number of sectors in the economy.” Weisbach, *supra* note 20, at 727.

treated as never having received that 20% of the investment fund's profits, and are not taxed on it. While it is true that they would also have an ordinary deduction for the salary paid to the investment fund manager, their ability to take the deduction could be limited if the fund is not engaged in a trade or business for tax purposes.<sup>193</sup> And determining whether an investment fund is engaged in a trade or business requires the investment fund to evaluate its activities against a standard that is not completely clear. Moreover, it is possible, depending on its activities, for an investment fund to be engaged in a trade or business one year and not the next.<sup>194</sup>

Beyond simplicity and following the form, treating passive investors in a favorable (though fair) manner may be advantageous to the enactment of carried interest reform. In spite of broad agreement that something needs to be done about the taxation of carried interests, until now, no reform has been passed.<sup>195</sup> Though it is not clear why reform has failed so far, it is clear that investment funds have opposed proposed reforms.<sup>196</sup> Among other things, funds have asserted that, if the tax rate on carried interest were raised, the additional tax cost would be passed on to passive investors.<sup>197</sup> If the added tax costs were passed on to the investors,<sup>198</sup> they

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193. If the fund is engaged in a trade or business, the deduction for salary paid would be fully deductible by the fund under section 162 of the I.R.C. The deduction would pass through to partners, who would be able to deduct fully their pro rata share of the salary expense. I.R.C. §§ 162, 702(a)(7) (2006); Treas. Reg. § 1.702-1(a)(8)(i) (1960). However, if the fund were not engaged in a trade or business, the expense would, instead, be deductible under section 212 of the I.R.C. I.R.C. § 212 (2006). It would still be passed through to the investors, but, as a miscellaneous itemized deduction, would be subject to several limitations. *Id.* §§ 67–68.

194. See Brunson, *supra* note 56 (manuscript at 23).

195. See Darryll K. Jones, *The Taxation of Profit Interests and the Reverse Mancur Olson Phenomenon*, 36 CAP. U. L. REV. 853, 880 (2008) (“Ultimately, efforts to reform the taxation of profit interests failed, despite having initially been welcomed as necessary and long overdue.”).

196. See Abrams, *supra* note 20, at 227 (“[I]t could be that private equity outfoxed reform-minded academics.”); Jones, *supra* note 195, at 878 (“Obviously, fund managers seek to maintain the *status quo ante* by which their compensation income may be taxed at capital gains rates.”); Andrew Ross Sorkin, *A Professor’s Word on a Buyout Tax Battle*, N.Y. TIMES, Oct. 3, 2007, at H8 (“The Private Equity Council has done a great job using sound bites to shape the debate. It started out as a debate about the tax rates that wealthy fund managers pay. Now it’s about whether tax reform would hurt pensioners, minorities, and destroy capitalism as we know it.” (quoting Professor Fleischer)).

197. See, e.g., Jones, *supra* note 195, at 879 (“These arguments were essentially that if Congress actually reformed the law, fund managers would either restructure their compensation arrangements to nevertheless obtain the conversion which by that point would be clearly unintended, or would expatriate themselves from the United States in order to avoid the tax.”).

198. Note that it is far from clear that investment funds would (or even that they would be able to) increase the rate of carried interest they charge



presumably would also oppose any change in the treatment of carried interests. If, however, investment funds were presented with two proposals, one of which would add administrative burden, income, and possibly a limited deduction to their taxes and the other of which would be substantially invisible to them, those investors may, if not support, at least not oppose legislation enacting a simplified mark-to-market taxation of carried interest.

*F. Practical Objections to Taxing Carried Interest at Ordinary Rates*

Even though taxing carried interests at ordinary rates rests on a sound tax-policy footing, there are at least two unfavorable, albeit non-tax-related, consequences that may occur. First, it is possible that investment funds would leave the United States, taking both their profits and their jobs with them.<sup>199</sup> Second, some argue that the incidence of a tax increase would not fall on the investment fund managers, but would, instead, be passed on to investors, decreasing their return.<sup>200</sup> If these objections are of any concern, empirical research would be necessary to evaluate their truth and their scope. Intuitively, however, neither appears to be a significant problem.

It seems unlikely that raising the rate of tax on investment fund managers would drive funds offshore. Although this Article has treated investment fund managers as if they were individuals, they are generally entities, often limited-liability companies, that are taxable as partnerships.<sup>201</sup> Still, for the tax rate of carried interest to matter, the ultimate recipient must be an individual who is subject to U.S. taxes. Corporate taxpayers pay the same rate of tax on ordinary income and long-term capital gains.<sup>202</sup>

Although the investment fund manager could restructure itself as a non-U.S. entity in reaction to an increased rate of tax on carried interest, as long as the investment fund manager is taxable as a

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investors. *See infra* Part V.F.

199. *See* Raymond Hernandez & Stephen Labaton, *In Opposing Tax Plan, Schumer Supports Wall Street over Party*, N.Y. TIMES, July 30, 2007, at A1 (“[Senator Schumer] said a tax increase on private equity and hedge fund executives could lead to an exodus of jobs and companies from New York, and even from the country.”); *see also* Jenny Anderson, *For Schumer, the Double-Edged Sword of Cozying Up to Hedge Funds*, N.Y. TIMES, June 22, 2007, at C6 (“From that perspective, Mr. Schumer should logically be opposed to tax increases on an industry that is already complaining it is losing ground to overseas markets (yet making more money than it has ever made, but that’s another story).”).

200. *See* Sarah Lueck, *Minority Group Fights Carry Tax Increase*, WALL ST. J., Sept. 5, 2007, at A3 (“For example, the industries have argued that raising taxes on managers would reduce returns for public pension funds that invest in private-equity and hedge funds.”).

201. Andrew W. Needham, *A Guide to Tax Planning for Private Equity Funds and Portfolio Investments (Part 1)*, 95 TAX NOTES 1215, 1225 (2002).

202. I.R.C. § 11 (2006).

partnership, its members would continue to be subject to higher rates of tax imposed by reform. Even if the members wanted to expatriate, they would be subject to U.S. taxation for ten years following the loss of their citizenship.<sup>203</sup> Moreover, recent amendments to the I.R.C. are aimed to prevent investment fund managers from deferring their income through offshore entities.<sup>204</sup> Although certain administrative jobs may move offshore if investment fund managers were to restructure as non-U.S. entities, there would ultimately be minimal difference with respect to U.S. jobs or U.S. tax revenues.

It is possible that if an investment in U.S.-based investment funds were to cost more (thus reducing investors' returns), investors would instead invest in non-U.S. funds. But the modified mark-to-market proposal would not, in itself, raise the costs or lower the return for investors. The only way their costs would be raised would be if the investment fund managers were to raise the management fee or rate of carried interest in order to recoup some or all of the increased taxes they paid. And it is not a foregone conclusion that investment funds would pass the cost of a tax increase on to their investors. If an investment fund manager wanted to pass the cost of a tax increase to her investors, she could do so by raising the management fee or the amount of carried interest. But if an investment fund manager believed that raising the management fee or the rate of carried interest would drive investors to invest in foreign investment funds, raising fees or carried interest would be irrational.

Assuming that all of an investment fund's income was long-term capital gains, the fund would have to increase the carried interest from 20% to approximately 26% (so that it could maintain an after-tax return of 17% of the fund's profits).<sup>205</sup> There is no reason that, assuming there is robust competition between investment funds for some finite amount of investment capital, some

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203. *Id.* § 877(a)(1).

204. See Martin J. McMahon, Jr., Ira B. Shepard & Daniel L. Simmons, *Recent Developments in Federal Income Taxation: The Year 2008*, 9 FLA. TAX REV. 275, 340 (2009) ("Hammering employees whose deferred compensation comes from offshore, i.e., hedge fund managers. The Emergency Economic Stabilization Act of 2008 added new Code § 457A, which provides that any nonqualified deferred compensation . . . under a plan of a nonqualified entity must be included in gross income in the first year in which there is no substantial risk of forfeiture.").

205. Under current law, if an investment fund earns \$100 of long-term capital gains in a year and allocates a 20% carried interest to its manager, the manager would be allocated \$20 before taxes. Because long-term capital gain is taxable at a 15% rate, the investment fund manager would pay \$3 in taxes ( $\$20 \times 0.15 = \$3$ ) and would have \$17 ( $\$20 - \$3$ ) in after-tax profit. If carried interest were taxed instead at a 35% rate, the investment fund manager would have to be allocated carried interest of approximately 26% in order to have the same \$17 of after-tax profit.  $\$26 \times 0.35 = \$9.10$ ;  $\$26 - \$9.10 = \$16.90$ .

investment funds would not maintain 20% carried interest in order to undercut their competition and attract more investors. If the fund could attract more investors and more invested capital, it could increase its after-tax profit through volume rather than higher carried interest. A fund with \$100 of invested capital, a 10% return, and 26% carried interest would be allocated \$2.60 of carried interest pre-tax and, at a 35% rate, would have \$1.69 of carried interest after taxes. In order to earn the same \$1.69 after tax on the same 10% return, assuming 20% carried interest, the fund would have to have \$130 of invested capital. It is at least feasible that, by imposing carried interest that was 23% lower (especially if it provided a comparable return), an investment fund could attract 30% more invested capital.

It is true, however, that there have not been any significant number of investment fund managers entering the current market in order to undercut the rate of carried interest currently being charged. It is not clear whether this is because of information asymmetries, cartelization, or some other reason.<sup>206</sup> However, it is not readily apparent that investors would continue to accept whatever fees and carried interest investment fund managers charge if the rate of carried interest were suddenly radically raised. As their returns have faltered, investment funds have lost some of the mystique that may have convinced investors to accept their terms unquestioningly in the past; there are already signs that, in the future, investors may not accept higher carried interest just because the investment fund managers want to charge higher rates.<sup>207</sup>

If investors were to accept higher fees or carried interest, though, presumably it would be because they felt the investment fund manager's services were worth the additional six percentage points. Any change would be transparent. If investors felt that the investment fund manager's services were worth more than they currently pay, it would be a fair and arm's-length change.<sup>208</sup>

#### CONCLUSION

It appears likely that Congress will change the taxation of carried interests. The current preferential rates seem intuitively

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206. See Sanchirico, *supra* note 126, at 1151.

207. See, e.g., Louise Story, *Hedge Fund Glory Days Fading Fast*, N.Y. TIMES, Sept. 12, 2008, at C1 ("A prolonged downturn might prompt some investors to rethink these investments or demand lower fees from managers, who typically collect annual management fees of 2 percent and then take a 20 percent cut of any profits.").

208. That is to say, there is no compulsion in the investment market. An investor in an investment fund could invest her money directly, for example, if she felt that she could get a better return than the return (subtracting fees and other costs) she gets through the investment fund.

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unfair, especially when the people receiving carried interest are among the highest-paid people in the world. But to base a change solely on the fact that investment fund managers can be wildly financially successful, where there is no policy justification for such change, would be to do violence to the tax code.

Previous commentary advocating a change in the taxation of carried interest has largely been based on finding economic equivalents to carried interest and taxing carried interest in accordance with the equivalent. However, any analogy that suggested that carried interest should be taxed as ordinary income could be countered by an analogy that demonstrated that investment managers were, in fact, investors in the fund and deserved to be treated as such.

This Article has provided an alternate basis for reforming the taxation of carried interest. Because the justifications underlying the taxation of capital gains at preferential rates do not apply to carried interest, it is unnecessary to determine what analogy is best; provided that carried interest is taxed on a (simplified) mark-to-market basis, there is no reason why it should be taxed at preferential rates.

Analyzed closely, the practical objections to raising the rate of tax on carried interest do not appear to significantly affect the policy considerations. Although it is possible that some investment fund activity will shift overseas and that some investors will pay more in order to invest through funds, it is not clear that either will result from raising the tax. And, to the extent either happens, investors will be fully informed of both the fact that the change is occurring and the consequences of the change.