Carried Interest Legislative Proposals and Enterprise Value Tax

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This report examines a pending legislative proposal to change the code's long-standing character-flow-through regime for a service partner who owns a carried interest in a partnership (or limited liability company) engaged in investment or real estate activities. The most recent versions of the House and Senate proposals would add new section 710, taxing a portion (between 50 and 75 percent) of those carried interest allocations as ordinary compensation income.

We first provide a brief description of proposed section 710. Second, we briefly describe several serious flaws in 710, principally stemming from the legislation's staggering complexity; incompatibility with generally applicable tax principles; excessively broad, abstract, and incomprehensible rules, subrules, and definitions; and sweeping grants of regulatory power. And third, we focus on an aspect that is particularly unwise from both a tax and economic policy perspective: 710's treatment of all the gain on disposition of a service partner's carried interest in a partnership engaged in investment or real estate activities as 710 tainted and thus as 50 to 75 percent ordinary compensation income (depending on whether the House or Senate version prevails). This so-called enterprise value tax treats gain on disposition of such an interest in an investment or real estate partnership far more harshly than warranted by the logic for enacting 710 and far more harshly than disposition gain on either (a) a partnership engaged in any other business or (b) a C corporation engaged in any business (including investments or real estate).

If Congress chooses to enact 710 (hopefully only after curing the serious flaws described herein and ensuring that there are no other unintended consequences), the authors propose that 710 taint on gain from the disposition of such a partnership interest be limited (through invocation of expanded section 751 hot asset rules) to the amount of carried interest gain that would be allocated to the interest if the partnership sold its underlying investment or real estate assets at current value.

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Table of Contents

I. **2010 House and Senate Bills** . . . 2
II. **Structure of Investment Funds** . . . 5
A. Single Fund With No Management Entity . 5
B. Single Fund With Management Entity . . . 5
C. Multiple Funds With No Management Entity . . . 5
III. **Sale of P'ship Interest Under Current Law** . . 6
A. Sale of Interest in Management Entity . . . 7
B. Sale of Interest in GP Entity . . . 8
C. Sale of Interest in Super GP Entity . . . 8
IV. **Sale of P'ship Interest Under 710** . . . 9
A. Sale of Interest in Management Entity . . . 9
B. Sale of Interest in GP Entity . . . 9
C. Sale of Interest in Super GP Entity . . . 9
V. **710's Proper Scope on P'ship Interest Sale** . . 9
VI. **710's Enterprise Value Tax Is Bad Policy** . . . 12
A. Entrepreneurs Traditionally Taxed at CG Rate . . . 12
B. 710 Drastically Disadvantages Investment/RE . . . 14

Under long-standing federal income tax rules, when a partnership (or limited liability company)

recognizes profit or loss from operations or asset sales (either directly or through another partnership), the share allocable to each partner (or member), whether or not a service provider, flows through to the partner with the same tax character as in the partnership's hands (for example, ordinary income or loss, dividend income, or long- or short-term capital gain).[1]

To the extent a partner's interest in the partnership's future profits is proportionately larger than his share of the partnership's capital, it is called a profits interest or a carried interest. Such an interest is frequently offered to the partnership's key service providers.

Beginning in 2007, there have been legislative proposals to change the code's long-standing character-flow-through regime for a service partner holding a carried interest in a partnership engaged in investment or real estate activities, on the ground that carried interest constitutes compensation for services. In November 2007, June 2008, and February 2009, the House passed bills (seeking to enact new section 710) that would have taxed as ordinary compensation income 100 percent of carried interest allocable to a service partner from a partnership engaged in those activities. Then in May 2010 the House passed a revised version of 710 so taxing a portion (50 to 75 percent) of that carried interest. However, the Senate did not pass any of these bills.[2]

We first provide a brief description of the most recently proposed (2010) iterations of 710. Second, we describe several serious flaws in 710, principally stemming from the legislation's staggering complexity; its incompatibility with generally applicable tax principles; its excessively broad, abstract, and incomprehensible rules, sub-rules, and definitions; and its sweeping grants of regulatory power. Third, we focus on an aspect that is particularly unwise from both a tax and economic policy perspective: 710's treatment of all the gain on disposition of a service provider's carried interest in a partnership engaged in investment or real estate activities as 710 tainted and thus characterized as 50 to 75 percent ordinary compensation income (depending on whether the House or Senate version prevails). This so-called enterprise value tax treats gain on disposition of such an interest in an investment or real estate partnership far more harshly than warranted by the logic for enacting 710, and far more harshly than disposition gain on either (a) a partnership engaged in any other business or (b) a C corporation engaged in any business (including investments or real estate).

If Congress chooses to enact 710 (hopefully only after curing the serious flaws described herein and ensuring that there are no other unintended consequences), we propose that 710 taint on gain from the disposition of such a partnership interest (that is, the enterprise value tax) be limited (through invocation of expanded section 751 hot asset rules) to the amount of carried interest gain that would be allocated to the interest if the investment or real estate fund sold its underlying investment or real estate assets at current value.

I. 2010 House and Senate Bills

Under the 2010 iterations of the carried interest legislation, a portion of the carried interest flow-through allocation to a service provider from a partnership engaged in investment or real estate activities would be treated as compensation for services, with the balance continuing to receive character-flow-through treatment. The May 2010 House-passed bill[3] (if enacted) would be effective January 1, 2011, and would tax as ordinary compensation income 50 percent of an individual partner's flow-through allocation with respect to an ''investment services partnership interest'' in 2011 and 2012, rising to 75 percent of those allocations in 2013 and subsequent years.[4]

A very similar Senate bill (not yet passed by the Senate)[5] would tax as ordinary compensation income for 2011 and all subsequent years 75 percent of the type of income covered by the House bill.

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[1]Because an LLC is generally taxed as a partnership, all references herein to a partnership include an LLC.

We assume that no partnership discussed herein is a publicly traded partnership or checks the box to be taxed as a corporation or is a disregarded entity owned by one person.

[2]The Obama administration's 2011 budget contains an even broader proposal that would treat as 100 percent ordinary compensation income a service provider's carried interest in any partnership, regardless of the nature of the service partner's activities or the partnership's assets. *See* Department of Treasury, ''General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals,'' at 91-92 (Feb. 2010), *Doc 2010-2363*, *2010 TNT 21-20*.

[3]American Jobs and Closing Tax Loopholes Act of 2010, an amendment to H.R. 4213, offered by House Ways and Means Committee acting Chair Sander M. Levin, D-Mich., 111th Congress, 2d Session, section 412 (the House bill). For the text of the Levin amendment, see 156 *Cong. Rec*. H4130-H4169 (111th Congress, 2d Session, 2010).

[4]Throughout this report we assume that any investment service partnership interest is held by an individual, either directly or through one or more partnerships.

[5]American Jobs and Closing Tax Loopholes Act of 2010, SA 4386, an amendment to H.R. 4213 offered by Senate Finance Committee Chair Max Baucus, D-Mont., 111th Congress, 2d Session, section 412 (the Senate bill). For the text of the Baucus amendment, see 156 *Cong. Rec*. S5324-S5365 (111th Congress, 2d Session, 2010). Baucus introduced a substantially similar carried interest bill in September 2010. *See* Jobs Creation and Tax Cut Act of 2010, S. 3793, 111th Cong. (2010).

However, the Senate bill would recharacterize as ordinary compensation income only 50 percent (for 2011 and all subsequent years) of flow-through allocations attributable to gain from the disposition of assets held at least five years, for example, equity in portfolio companies and section 197 intangibles (generally investment management company goodwill), as further described below.[6]

Under these bills, a partnership carried interest would be an investment services partnership interest (ISPI) covered by 710 if the partner or any related person is reasonably expected to directly or indirectly provide a substantial quantity of any of the following types of services (investment management services) regarding partnership assets:

A. advising on the wisdom of investing in, purchasing, or selling any specified asset;

B. managing, acquiring, or disposing of any specified asset;

C. arranging financing for acquiring specified assets; or

D. any activity in support of those services.

For this purpose, ''specified asset'' means (a) corporate stock; (b) interests in partnerships; (c) debt instruments; (d) notional principal contracts; (e) real estate held for rental or investment; (f) commodities; and (g) specified options, derivatives, and other financial instruments with respect to, and certain hedges of, assets described in (a) through (f).

Thus, 710 would clearly apply to partnership carried interest flow-through allocations to a service partner of a private equity fund, leveraged buyout fund, venture capital fund, mezzanine fund, hedge fund, real estate fund, or other similar investment fund.

To prevent a service partner from avoiding 710 taint by (1) causing an investment fund partnership to distribute appreciated assets in kind or (2) selling his partnership carried interest before a partnership-level recognition event (for example, before a partnership-level asset sale), 710 overrides the long-standing tax treatment of (1) a partnership in-kind asset distribution and (2) sale of a partnership interest. Thus, the 710 taint would apply not only to partnership income flowing through to a carried interest partner, but also to (a) gain inherent in property distributed in kind with respect to an ISPI (generally an amount equal to the in-kind property's inherent appreciation allocable to the carried interest), which would be taxed to a carried-interest partner at the time of the in-kind distribution, and (b) a carried-interest partner's gain on disposition of his ISPI.

We do not address here the many reasons why, as a matter of tax and economic policy, we believe it is not a good idea to treat all or part of carried interest allocations as ordinary compensation income,[7] nor do we debate the portion (for example, 50 to 75 percent or more or less) that should be treated as ordinary compensation income if the long-standing character-flow-through rules are indeed changed. Rather, we simply highlight in Part I several serious flaws in 710, all of which stem from a common source: 710 is excessively broad and overly complex, with 30 pages of abstract and incomprehensible rules, sub-rules, definitions, and sweeping grants of regulatory power, creating huge uncertainties about its scope, including its potential application to income that should not be covered. These flaws and the potential for other serious unintended consequences under 710 provide a powerful argument against enacting it.

The first three flaws stem from the fact that, although 710 is aimed at income from *carried* interest, it sweeps far more broadly[8] because it taints all interests held by a service partner or related person with a narrow carve-out for a ''qualified capital interest.'' This approach produces clearly inappropriate results in several common fact patterns. First, 710 taints income allocated to a service partner's *capital* interest if the capital is obtained by the service partner in connection with a loan from (or guaranteed by) another partner (or a person related to another partner).[9] This treatment may make sense in the context of a nonrecourse, low- or

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[6]The portion of income tainted by 710 and taxed as ordinary compensation income under the bill (50 percent for 2011 and 2012 and 75 percent thereafter for the House bill, and 75 percent — with a cutback to 50 percent for five-year assets — for the Senate bill) is also subjected to the 2.9 percent (increasing to 3.8 percent beginning January 1, 2013) Medicare tax on compensation income, and the portion taxed as capital gain, or dividend or interest income (because not tainted by 710) is subjected to the 3.8 percent Medicare tax on passive investment income (*e.g.*, dividend income and capital gain) beginning January 1, 2013.

[7]One of the authors has testified against changing the long-standing carried interest taxation rules, in part because (1) one of the principal reasons for a lower tax rate on long-term capital gain is to spur American risk capital investments, which then produce jobs and economic growth; and (2) reducing this tax incentive for American risk capital investments would inevitably result in some reduction in those investments, job creation, and economic growth. *See* Carried Interest Taxation: Hearing Before the H. Comm. on Ways and Means, 2007 Leg., 110th Congress, 1st Session, Serial 110-58 (statement of Jack S. Levin, Kirkland & Ellis LLP), Sept. 6, 2007, *Doc 2007-20471, 2007 TNT 174-47*.

[8]Proposed section 710(c) and (d). *See* Martin D. Ginsburg and Jack S. Levin, *Mergers, Acquisitions, and Buyouts*, para. 1502.6.2(3)(d) (Aug. 2010 edition).

[9]Proposed section 710(d)(8). *See* Ginsburg and Levin, *supra* note 9, para. 1502.6.2(3)(f).

no-interest loan to a service partner from an unrelated non-service partner, because such a loan could be structured to mirror the economic effect of a carried interest. However, this treatment does not make any sense when the loan is from (or guaranteed by) a fellow service partner or is full recourse with adequate interest or is from a family member. In these cases, the economics of the loan arrangement simply do not create a disguised carried interest.

Second, although 710 targets a carried interest, it may taint income earned by a family investment partnership with no carried interest, because all partners are related to each other and hence no unrelated capital partner receives substantial similar capital interest allocations as required by 710 to fit within the limited and highly technical qualified capital interest exception.[10] Proposed section 710 does contain a provision that targets a different situation (for example, a partnership in which all partners are service partners), which would allow the IRS also to offer relief to a family partnership through regulations or other guidance,[11] but that relief is likely to be a long time coming and uncertain in ultimate scope. Also, the Senate (but not the House) bill contains a specific family partnership relief clause (that can be overridden by the IRS), but that relief is conditioned on the family partnership not investing any amount in any other partnership (for example, an unrelated hedge fund or private equity fund) that allocates a carried interest to anyone (even to a person wholly unrelated to the family partnership and its partners).[12]

Third, although 710 targets a service provider's carried interest, it still sweeps in a pure investor in the following circumstances: When an upper-tier management partnership holds both a carried interest and a capital interest in a lower-tier fund partnership engaged in investment or real estate activity and the upper-tier partnership's equity owners include one or more service providers (rendering investment management services) and one or more pure investors (rendering no investment management services), the portion of the upper-tier partnership's carried interest allocable to a pure investor is 710 tainted, even though he is not rendering management services. This situation arises, for example, where a large (bell-cow[13]) pure investor invests in a fund through the upper-tier management partnership and is granted a portion of the carried interest. Proposed 710 creates this unexpected result for the pure investor's carried interest because the upper-tier partnership is rendering management services to the lower-tier fund and hence the upper-tier entity's entire carried interest (even the portion allocable to the pure investor) is tainted.

Fourth, although 710 targets partners who manage investment and real estate funds, its broad and opaque language sweeps far more broadly and may taint an interest in a partnership that indirectly (in Example 1 below) or directly (in Examples 2 and 3 below) operates a non-investment, non-real-estate business.[14]

Example 1: A partnership serves as a holding company by owning equity in either a partnership or a corporation that is engaged in an active business (a non-investment, non-real-estate business), so that the holding partnership, which indirectly holds an operating business, is tainted because it holds an equity interest (which is a "specified asset") in the operating partnership or the operating corporation.

Example 2: An operating partnership directly (itself) engaged in an active business (a non-investment, non-real-estate business) also holds a "specified asset" in connection with its business (for example, interest rate or currency swaps used to manage interest rates on borrowed capital or foreign currency fluctuations on foreign sales, or vacant land next to its factory, or an office or factory building with excess space rented out, all of which are "specified assets").

Example 3: An operating partnership is directly (itself) engaged in an active business (a non-investment, non-real-estate business) and also holds a portfolio of investments (for example, stocks and bonds), perhaps purchased with accumulated business profits.

This threat of tainting unintended targets is sufficiently serious that the pending bills contain an exception for a family farm. Unfortunately, owners of thousands of other types of active businesses conducted in the United States are not so lucky.

Fifth, by applying 710 to all the gain from *disposition* of an investment services partnership interest (the enterprise value tax), 710 treats that disposition gain far more harshly than warranted by the logic for enacting 710, and it treats an entrepreneur who builds an investment or real estate business in

[10]*See* Ginsburg and Levin, *supra* note 9, para. 1502.6.2(3)(e).

[11]Proposed section 710(d)(2)(B).

[12]Senate bill, *supra* note 5, proposed section 710(c)(4).

[13]In fund parlance, a bell-cow investor is an early and influential investor who often gets more favorable terms than later, smaller investors.

[14]*See* Ginsburg and Levin, *supra* note 9, para. 1502.6.2(3)(c); Carol Kulish Harvey, James B. Sowell, and Deborah Fields, "I Spy an ISPI: Expansive Breadth of Carried Interest Proposals," *Tax Notes*, Aug. 2, 2010, p. 526, *Doc 2010-15363*, or *2010 TNT 147-9*.

partnership form far more harshly than an entrepreneur (a) who builds any other type of business in partnership form or (b) who builds an investment or real estate business (or any other type of business) in corporate form. The balance of this report focuses on 710's enterprise value tax, concluding that it is bad tax and economic policy and suggesting a fairer and more limited way to protect against avoidance of 710's basic rule.

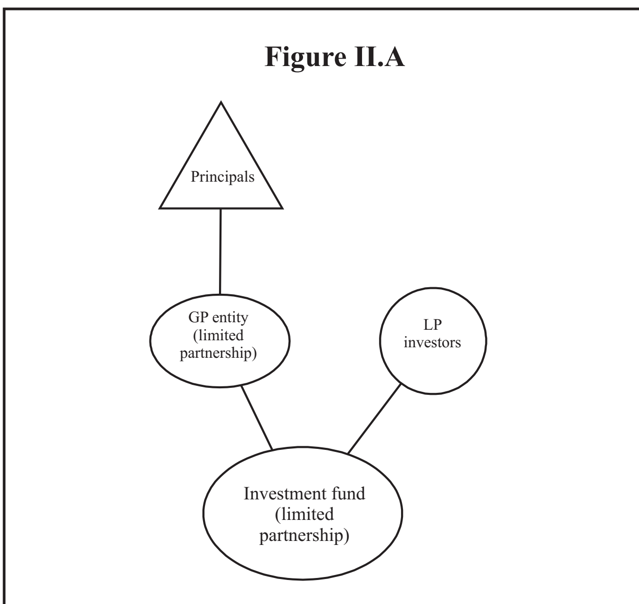
II. Structure of Investment Funds

In evaluating the enterprise value tax, it is essential first to understand the basic structure of an investment fund, which determines the type of partnership interest that a service partner may be able to sell.[15]

A. Single Fund With No Management Entity

In its simplest structure (Figure II.A, below), an investment fund is formed as a limited partnership, with limited partner (LP) investors providing capital, and an entity (typically a limited partnership or LLC) composed of the fund's principals, which serves as the fund's general partner (the GP entity).

Figure II.A

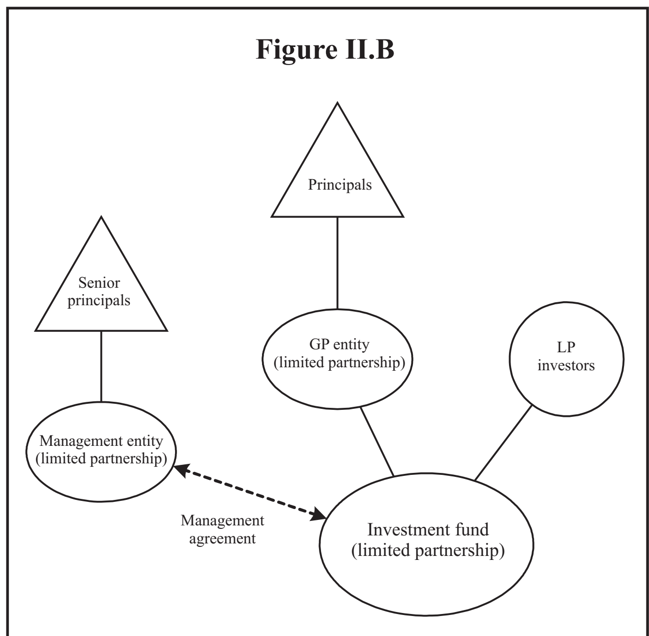


The GP entity, owned by the principals who manage the fund, typically receives from the investment fund a management fee (approximately 2 percent of fund commitments), a return on its invested capital (generally the same as the return on the LPs' invested capital), and a carried interest share of profits (approximately 20 percent of the fund's cumulative net profits, in some cases after a hurdle rate of return is paid to the LPs on their invested capital).

B. Single Fund With Management Entity

In some cases, the principals form a separate management entity (typically a limited partnership or LLC) to manage the fund and receive the management fee from the fund (Figure II.B, below). This is done (1) because the management entity provides services to multiple investment funds formed by the principals, (2) because the carried interest and the management fee (net of fund expenses) are owned by different principals or by the same principals but in different percentages, or (3) for state or local tax planning reasons.

Figure II.B



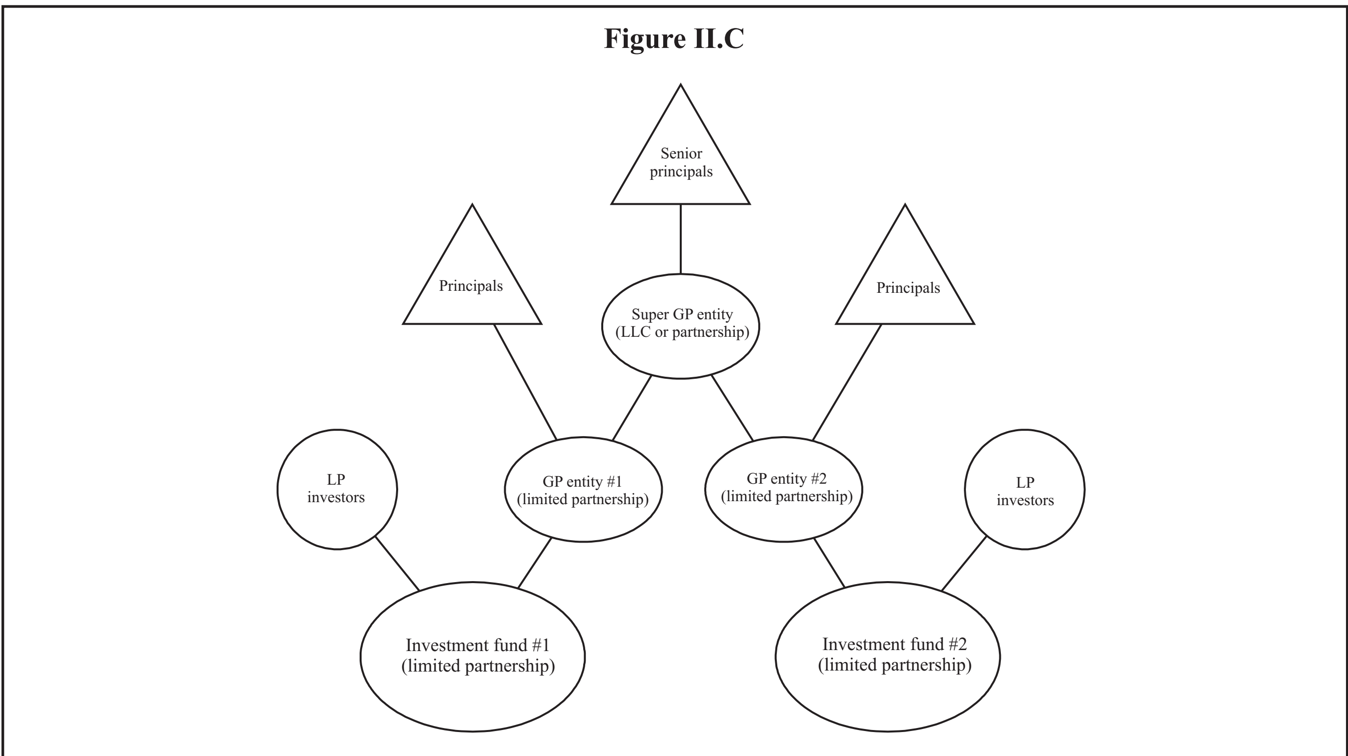
In this case, the management entity is generally not a partner in the fund, receives the management fee from the fund under a management agreement (approximately 2 percent of fund commitments), employs the non-principal employees, and pays the expenses of managing the fund. The GP entity receives from the fund a return on its invested capital (generally the same as the return on the LPs' invested capital) and a carried interest share of profits (approximately 20 percent of the fund's cumulative net profits, in some cases after a hurdle rate of return is paid to the LPs' on their invested capital).

C. Multiple Funds With No Management Entity

When the principals form a series of funds (generally with Fund 2 formed after Fund 1 has invested its capital), the principals often create an entity (a super GP entity) to serve, directly or indirectly, as GP of each GP entity; own the funds' track record,

[15]While we describe below the principal fund structures, in practice many funds adopt variations of these structures.

Figure II.C



name, and other intangibles; employ non-principal employees; provide central administrative services for all the funds; engage in fundraising; control formation of future funds; and control allocation of carried interest among the principals of the various GP entities (Figure II.C, above).

In this case, the GP entities receive from the investment funds a management fee (approximately 2 percent of fund commitments), a return on invested capital (generally the same as the return on the LPs' invested capital), and a carried interest share of profits (approximately 20 percent of a fund's net cumulative profits, in some cases after a hurdle rate of return is paid to the LPs on their invested capital). A portion of the management fees, return on invested capital, and carried interest may be allocated to the super GP entity.

In some cases the principals of a super GP entity might form a separate management entity to manage all the funds and receive all the management fees from the funds, for the reasons described in Part II.B.

III. Sale of P'ship Interest Under Current Law

Under current tax law, the sale of a partnership interest (whether or not the partnership is engaged in investment or real estate activities) is governed by sections 741 and 751. Under section 741, gain or loss on the sale of a partnership interest is capital gain or loss. However, where a partnership owns assets that would produce ordinary income in a partnership-level asset sale (hot assets), section 751 partially overrides section 741 by treating a partner who sells a partnership interest as recognizing the underlying asset-level ordinary income inherent in the hot assets attributable to the partnership interest sold.[16] Hot assets include, among other items, (1) "any rights (contractual or otherwise) to payment for . . . services rendered, or to be rendered"[17]; (2) depreciation recapture[18]; and (3) inventory.[19] When the partnership in which an interest is being sold owns an interest in a lower-tier partnership, a look-through rule applies so that the upper-tier

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[16]Section 751(a). *See* William S. McKee, William F. Nelson & Robert L. Whitmire, *Federal Taxation of Partnerships & Partners*, ch. 17 (2010) for general discussion of the complex operation of section 751. To the extent the selling partner recognizes hot asset ordinary income, his basis in the partnership interest is increased, thus generally substituting ordinary income for an equal amount of capital gain.

[17]Section 751(c). Thus, for example, a partnership's receivables not yet taken into the partnership's ordinary income (*e.g.*, because the partnership uses the cash method of tax reporting) constitute hot assets.

[18]Section 751(c). For example, section 1245 provides that where depreciable or amortizable personal property is sold at a gain, that gain, up to the amount of depreciation/amortization deductions previously claimed with respect to the asset, is treated as ordinary income (thus recapturing the previous deductions).

[19]Section 751(d). Under section 1221(a)(1), inventory is not a capital asset so gain from selling inventory constitutes ordinary income.

partnership is treated as owning its proportionate share of the lower-tier partnership's hot assets.[20]

Thus, under current law, the sale of a partnership interest in a management entity, GP entity, or super GP entity gives rise to capital gain or loss under section 741, except to the extent that the partnership owns hot assets (directly or indirectly through other partnerships, including through an underlying investment fund or an underlying investment fund's flow-through portfolio company). Determining a partnership's hot assets therefore requires a look-through analysis of the assets that make up the value of the partnership interest being sold.[21]

Depending on the entity in which a partnership interest is being sold and the fund's structure (as described in Part II.A, B, and C), the principal components of value are generally one or more of the following items:

1. For an investment fund that is in existence, the value of:

a. the management entity's, GP entity's, or super GP entity's right to receive management fees from the existing fund;

b. the GP entity's or super GP entity's capital interest in the existing fund, based on the current value of the fund's existing investments;

c. the GP entity's or super GP entity's carried interest in the existing fund, based on the current value of the fund's existing investments (the built-in-gain carried interest);

d. the GP entity's or super GP entity's possible additional carried interest, attributable to possible future appreciation in the existing investments of the existing fund; and

e. the GP entity's or super GP entity's possible additional carried interest, based on the possibility that existing funds may invest uncalled capital commitments in the future and those investments may thereafter appreciate.

2. For an investment fund that is not in existence but may be formed in the future, the value of:

a. the management entity's, GP entity's, or super GP entity's possible right to receive future management fees with respect to capital that may (or may not) be raised; and

b. the GP entity's or super GP entity's possible right to receive future carried interest generated by future appreciation in investments that may (or may not) be made with future capital that may (or may not) be raised.

How the tax rules apply to a particular investment fund depends in part on the fund's structure — that is, whether the fund has a management entity separate from the GP entity, whether the interest being sold is in the management entity or in the GP entity, and whether there are multiple funds with a super GP entity on top, as discussed immediately below.

A. Sale of Interest in Management Entity

The value of an interest in a management entity (structured as discussed in Part II.B) is generally attributable to (i) management fees from existing investment funds (1.a above) and (ii) depending on the facts, potential management fees from investment funds to be formed in the future (2.a above). A separate management entity generally does not own either a capital interest or a carried interest in the investment funds it manages.

The right to receive management fees under a management agreement may be a hot asset under section 751, that is, a ''right . . . (contractual or otherwise) to payment for . . . services rendered, or to be rendered.'' The courts have generally held that a contract that may be canceled on short notice is not a hot asset on the ground that there is no ''right'' to payment.[22] Thus, the management fee arrangement should generally not be considered a hot asset if the investment fund LPs have the right, in the case of a private equity fund, to terminate the fund and the related management fee without cause on short notice (generally referred to as a no-fault divorce clause) or, in the case of a hedge fund, to withdraw their capital.

The possibility that a management entity may receive management fees from a fund to be formed in the future should not be a hot asset, because there are no existing rights (contractual or otherwise) to receive those management fee payments.[23] The

[20]Section 751(f).

[21]A management entity, GP entity, or super GP entity may also own tangible property, including computers, office furniture and equipment, leasehold improvements, etc. For purposes of this report, we generally ignore these items even though they may generate depreciation recapture (and hence are hot assets) because they are typically of small value compared with the financial assets and intangibles discussed in text.

[22]*See* McKee et al., *supra* note 17, para. 17.03[1] and the cases cited therein.

[23]Reg. section 1.751-1(c)(1)(ii).

value is a future expectancy in the nature of goodwill, and it should receive capital gain treatment under section 741.

As a result, under current law, when a partner sells an interest in a typical investment fund management entity, his gain should be capital gain, except to the extent that the value of the interest sold is attributable to rights to management fees under management agreements with existing funds that are not cancelable on short notice. When management fee rights are a hot asset, the value of those rights is determined after taking into account the management entity's future cost to provide the management services and the time value of money.[24]

B. Sale of Interest in GP Entity

The value of an interest in a GP entity (structured as discussed in II.A, B, or C above) is generally attributable to (i) management fees from an existing investment fund (if the management fees are not payable to a separate management company) (1.a above), (ii) its capital interest in the existing investment fund (1.b above), (iii) its carried interest in the existing investment fund based on the current value of the fund's existing investments (1.c above), and (iv) the possibility that it may receive additional carried interest from future appreciation in existing investments (1.d above) or from future investments not yet made (1.e above). An existing GP entity generally does not derive value from the possible formation of future funds (2.a and 2.b above), since the principals generally form a new GP entity for each subsequent investment fund.

As discussed above in connection with the sale of an interest in a management entity, the GP entity's management fee rights in the fund should generally not constitute a hot asset in the GP entity's hands to the extent those rights are cancelable by the fund on short notice. Also, management fee rights held by a GP entity apparently do not constitute hot assets for another reason: The GP entity's rights to receive management fees from the fund constitute a section 707(c) guaranteed payment and thus should be viewed as part of the GP entity's partnership interest in the underlying investment fund,[25] rather than as a right (contractual or otherwise) to payment for services rendered, or to be rendered.

The GP entity's partnership interest in the investment fund would constitute a hot asset in part only to the extent that the underlying fund's assets on a look-through basis include hot assets (for example, a flow-through portfolio company with receivables, depreciation recapture, or inventory) under section 751(f) (which views an upper-tier partnership — here the GP entity — as owning, for hot asset purposes, its share of the assets in a lower-tier partnership — here the investment fund and its flow-through portfolio companies), thus indicating that the GP entity's partnership interest in the fund (including the right to receive a guaranteed payment) is not itself a hot asset.

Similarly, the possibility that carried interest could be earned with respect to future appreciation in existing investment fund assets (1.d above) or appreciation in assets to be acquired by the fund in the future (1.e above) does not relate to any existing value of hot assets at the fund level, but rather is a future expectancy in the nature of goodwill and hence should receive capital gain treatment.

Thus, under current law, when a principal sells an interest in a GP entity, the gain should be capital gain, except (i) gain attributable to the GP's capital interest and carried interest in flow-through portfolio companies held by the investment fund to the extent that those operating partnerships own hot assets and (ii) gain attributable to the GP's right to management fees from the fund when those rights are not cancelable on short notice and also are not treated as part of the GP entity's partnership interest in the fund.

C. Sale of Interest in Super GP Entity

The value of an interest in a super GP entity (structured as discussed in II.C above) may be attributable to all the elements of value discussed in 1 above related to one or more existing investment funds and in 2 above related to possible future investment funds.

To the extent that the value of an interest in a super GP entity is attributable to an interest in management fees earned by an underlying GP entity that earns management fees from an existing investment fund, the gain should be capital gain, except to the extent that the GP's right to management fees from the fund are not cancelable on short notice and also are not treated as part of the GP entity's partnership interest in the fund. To the extent that the value is attributable to the possibility that the super GP entity may earn management fees from a future investment fund not yet formed (earned through a GP entity also not yet formed), the value should not be a hot asset as discussed above in connection with the sale of an interest in a management entity, because there is no existing right to a payment, but rather a mere future expectancy in the nature of goodwill.

To the extent that the value of an interest in a super GP entity is attributable to a capital or carried interest in an existing investment fund (generally

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[24]Reg. section 1.751-1(c)(3).

[25]Reg. section 1.707-1(c) (with specified exceptions not relevant here, "guaranteed payments are regarded as a partner's distributive share of ordinary income").

held through a GP entity), any gain should be capital, except to the extent the underlying investment fund owns an interest in a flow-through portfolio company owning hot assets (for example, receivables, depreciation recapture, or inventory).

To the extent that the value of an interest in a super GP entity is attributable to carried interest that the super GP may receive from a future investment fund not yet formed (earned through a GP entity also not yet formed), the gain should be capital, because there are no underlying hot assets to which that value relates and thus the value is a mere future expectancy in the nature of goodwill.

IV. Sale of P'ship Interest Under 710

Let's now examine how the conclusions set forth in Part III would change if 710 (as set forth in the 2010 House and Senate bills) were enacted.

A. Sale of Interest in Management Entity

In general, an interest in a management entity that receives management fees from one or more investment funds but does not own an equity interest (either a capital interest or a carried interest) in those funds (as described in Part II.B) does not appear to be an ISPI, because the management entity does not provide any services regarding specified assets owned directly or indirectly by the management company itself.[26]

Thus, in the absence of regulations expanding 710's scope, the sale of an interest in a management entity would not be covered by 710 and would continue to be treated under current law as described in Part III. This makes sense because 710 targets carried interest, and a management company structured as outlined in Part II.B does not own any carried interest.

B. Sale of Interest in GP Entity

An interest in a GP entity (as described in Part II.A, B, or C) would generally be an ISPI under 710 because the holder is a principal who performs investment management services regarding specified assets owned by the fund (and thus indirectly owned by the GP entity).[27]

Under the 2010 bills, all the gain on sale (other than gain attributable to a qualified capital interest at both the GP entity and fund levels) is 710 tainted, so that a portion of the sale gain (between 50 and 75 percent, depending on whether the House or Senate approach prevails) is treated as ordinary compensation income, and the balance of the gain would continue to be treated under current law as described in Part III.

C. Sale of Interest in Super GP Entity

An interest in a super GP entity (as described in Part II.C) would generally be an ISPI under 710 because the holder is a principal who performs investment management services (at the super GP entity level and at the GP entity level)[28] regarding specified assets owned by the underlying investment funds and thus indirectly held by the super GP entity. The tax treatment for sale of an interest in the super GP entity is similar to the treatment of the sale of an interest in a GP entity, discussed immediately above (except that the super GP entity is more likely to own goodwill eligible for the Senate bill's 50 percent five-year rule).

V. 710's Proper Scope on P'ship Interest Sale

A concrete example is useful to assess the extent to which gain on the sale of an ISPI should be tainted by 710.

As depicted in Figure V on next page: Individuals A and B founded an investment firm and formed three investment funds over several years, using the multiple funds structure outlined in Part II.C. Each investment fund raised $10 million of LP commitments and has a GP entity entitled to a 20 percent carried interest in the fund's cumulative net profits.[29] Each GP entity allocates 90 percent of its carried interest to the four principals (founders A and B, and also younger principals C and D) who are providing services to the underlying investment funds and the remaining 10 percent of its carried interest (or 2 percent of fund profits, that is, 10 percent x 20 percent carried interest) to the super GP entity. As founders, A and B own the interests in the super GP entity 50 percent each. The super GP entity employs non-principal employees, leases office space, owns computers and other office equipment used by the principals and employees in managing the investment funds, owns the rights to the funds' track record and name, controls the relationship with the funds' LP investors, has the right to raise new funds, and controls allocation of carried interest at the GP entity level.

Fund 1, the oldest fund, has invested its $10 million of LP commitments in assets that are now worth $30 million. Fund 2 has invested its $10 million of LP commitments in assets that are now worth $20 million. Fund 3, the newest fund, has invested $5 million of LP commitments in assets

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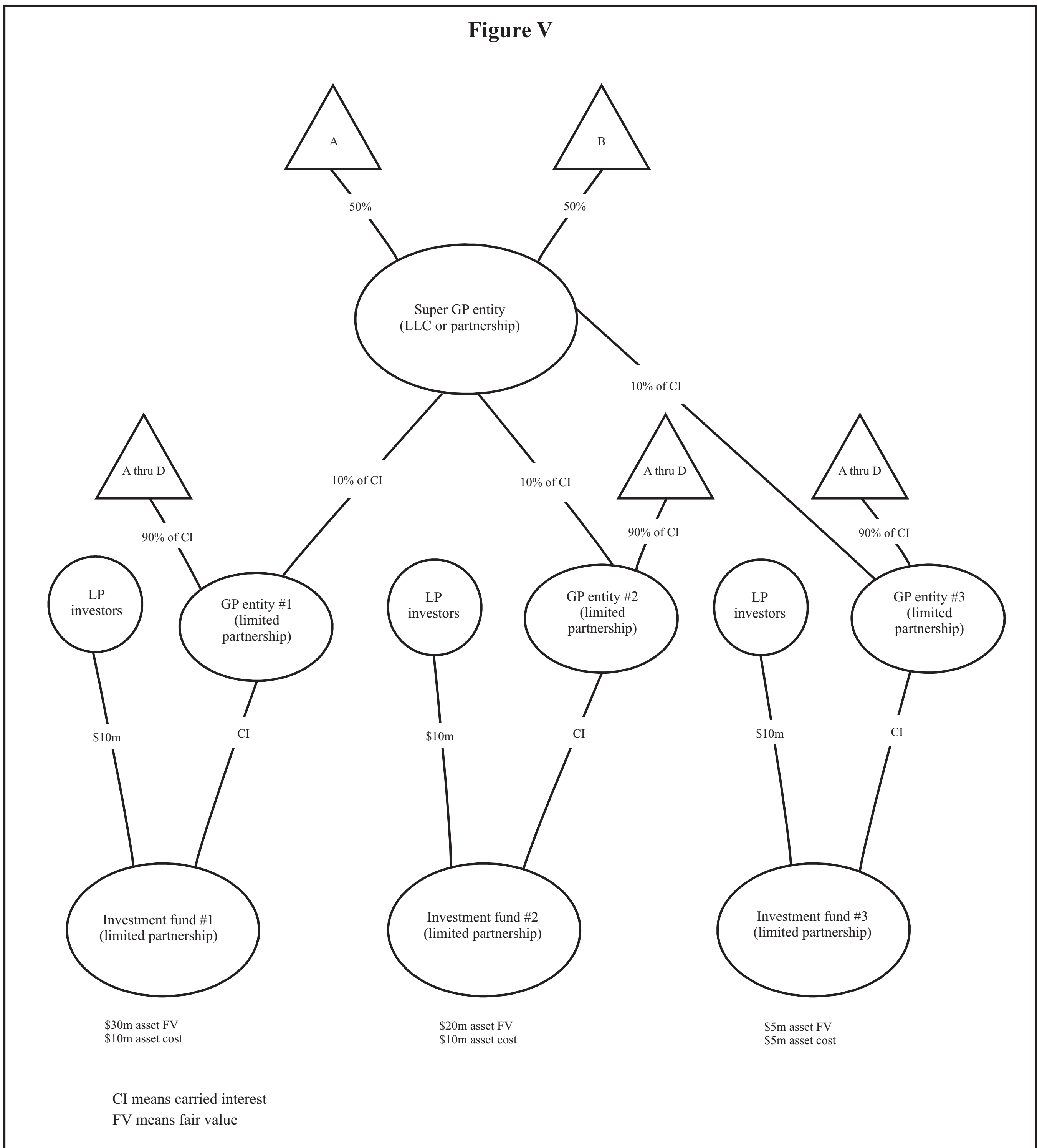
[26]Proposed section 710(c)(1).

[27]*Id.*

[28]Indirect services are counted in determining whether a partnership interest is an ISPI under the Senate bill only to the extent provided by the IRS. Senate bill, proposed section 710(c)(1).

[29]To make the math simpler, we ignore management fees, preferred returns, and GP capital interest.



that are still worth their $5 million cost and expects to identify additional assets in the future in which to invest its remaining $5 million of LP commitments. All of the fund investments are (for simplicity) in stock of C corporations, so that there are no hot assets at the fund level.

Because Funds 1 and 2 have performed well as measured against their peers, A and B expect to raise Fund 4 when Fund 3 completes investing its committed capital, and they expect to continue raising new funds thereafter as each fund invests its committed capital.

If Fund 1 sold its assets ($10 million cost) for their current $30 million value and distributed the proceeds, Fund 1's GP entity would be allocated $4

million of carried interest gain ($20 million fund-level profit x 20 percent carried interest share = $4 million). If Fund 2 sold its assets ($10 million cost) for their current $20 million value, Fund 2's GP entity would be allocated $2 million of carried interest gain ($10 million fund-level profit x 20 percent carried interest share = $2 million). Because Fund 3's assets have not appreciated ($5 million cost and $5 million value), there would be no carried interest share if Fund 3 sold its assets for their $5 million value.

If Congress chooses to tax allocations of carried interest gains recognized at the fund level as part ordinary compensation income under 710, the $4 million carried interest if Fund 1 sold its assets and the $2 million carried interest if Fund 2 sold its assets would be 710 tainted and hence treated as part (50 to 75 percent depending on whether the House or Senate approach prevailed) ordinary compensation income. If Congress makes this choice, we agree that the 710 taint should also apply to some of the gain that the principals recognize if they sell a portion of their interest in a GP entity or in the super GP entity before the funds have realized their asset appreciation. Otherwise, the principals could avoid 710 taint by selling all or part of their interest in the GP entity or the super GP entity before a fund-level recognition event.

However, we believe that 710's version of the enterprise value tax goes well beyond the need to protect the basic fund-level carried interest rule, and as a result taints (and hence subjects to the enterprise value tax) far too much gain on sale of an investment services partnership interest. It thus treats entrepreneurs like A and B who build an investment management business more harshly than entrepreneurs who build other types of businesses. As discussed in Part VI, we believe this is not good tax or economic policy.

We believe a section 751 hot asset approach to taxing the gain on sale of an investment services partnership interest (or the sale of a partnership interest in a partnership that owns an investment services partnership interest) would be far more appropriate and consistent with existing code principles. Under this approach, the amount of gain or loss that would be treated as ordinary compensation income in the above example if each underlying fund sold its investment or real estate assets at their value at that time (that is, the built-in gain carried interest multiplied by the percentage treated as ordinary income by 710) would be treated as a section 751 hot asset with respect to the sale of an interest in a GP entity. In a tiered partnership situation, the rule would be applied by looking through any partnership that is an investment management partnership or an investment or real estate fund. Any gain not covered by 710 would be governed by existing law as set forth in Part III and would generally be capital gain under section 741.

Assume A, B, C, and D (in the above example) sell their interests in the GP entity and the super GP entity to a financial institution. If Funds 1, 2, and 3 had sold their investment assets for their then value ($30 million, $20 million, and $5 million, respectively), the three funds would have recognized an aggregate of $30 million gain ($20 million for Fund 1, $10 million for Fund 2, and $0 for Fund 3). In that case the GP entities and the super GP entity would be allocated $6 million of carried interest gain ($30 million x 20 percent). Thus $6 million is the amount of gain recognized by A, B, C, and D on sale of their partnership interests to the financial institution that should be tainted by 710 to reach the same result as if the funds had sold their investment assets. The portion of the $6 million that would be taxed as ordinary compensation income under 710 in the event of a fund-level asset sale (50 to 75 percent, depending on whether the House or Senate approach prevails) would be treated as a hot asset and taxed as ordinary compensation income in connection with the sale of the interests in the GP entities and the super GP entity.

Any additional amounts that the principals (A, B, C, and D) can convince the financial institution buyer to pay them for their partnership interests is because the financial institution buyer hopes that additional carried interest will be earned in the future, either from additional appreciation in existing funds or from new funds to be formed in the future. Hence, under our hot assets approach, the balance of the principals' gain relates to future expectancy in the nature of goodwill and would be taxed under current rules, generally resulting in capital gain.

This approach imposes 710 taint on any built-in gain carried interest at the time of a sale, so that principals cannot avoid 710 taint by selling an interest in a GP entity or super GP entity. Consistent with the general approach of the tax law, however, it does not taint gain attributable to future expectancy (that is, income from future appreciation in existing funds and from future funds) that is in the nature of goodwill.

At the same time, it does so in a manner that is significantly simpler than the Senate bill's 50 percent five-year approach. There is no need for special rules to separately value goodwill and other intangibles (backed by harsh penalties). Taxpayers and the IRS must merely value the underlying investment assets at the time of a partnership interest sale, something that investment funds have long been required to do periodically (generally quarterly) in

preparing their generally accepted accounting principles financial statements.[30]

This approach makes clear that gain attributable to the built-in value of a carried interest (as described in III.1.c above) is subject to 710 taint, whether recognized in a fund-level asset sale, recognized by an in-kind asset distribution by the fund, or recognized by selling an interest in a GP entity or super GP entity. Gain attributable to the possibility of future carry that does not exist at the time of sale — value from possible future appreciation in existing investments (III.1.d above), gain from possible appreciation in future investments that may be purchased in the future by existing funds with uncalled committed capital (III.1.e above), and gains from possible funds to be formed in the future (III.2.b above) — would not be tainted and would generally constitute capital gain under current rules.[31]

VI. 710's Enterprise Value Tax Is Bad Policy

Even if Congress does enact 710 to treat a portion (for example, 50 to 75 percent) of an investment or real estate partnership's flow-through carried interest allocations as ordinary compensation income, it does not follow that all of an investment entrepreneur's gain on sale of the enterprise — including goodwill — should be 710 tainted (and taxed 50 to 75 percent as ordinary compensation income). Entrepreneurs in other industries do not have ordinary compensation income when they sell stakes in their businesses, organized as partnerships or LLCs, even when the business generates ordinary income (except to the extent of the business's hot assets at the time of sale) and even when the value of the business is attributable in whole or in part to services provided by the equity owners.

As discussed in Part V, should Congress choose to taint carried interest allocations recognized by an investment or real estate partnership as a result of fund-level asset sales (and in-kind distributions) by treating 50 to 75 percent of gain from those dispositions as ordinary compensation income, we believe a sale of an investment services partnership interest should be similarly tainted only to the extent of 50 to 75 percent of the built-in gain carried interest (that is, the carried interest gain that would result if the underlying funds sold their investment or real estate assets at then-current value).

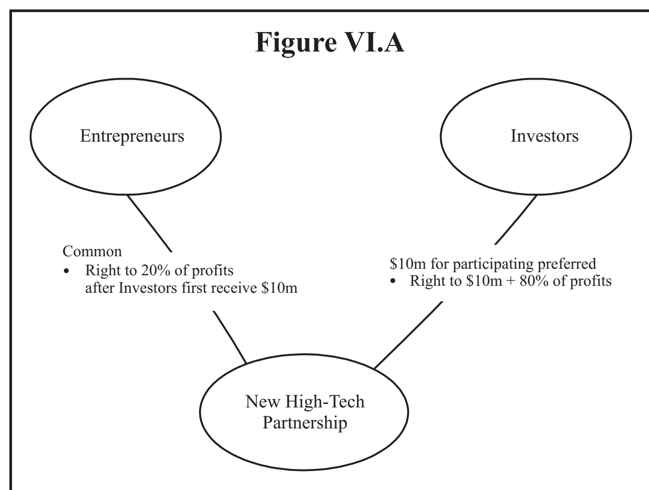
That taint would protect 710's basic fund-level carried interest rule so that an investment manager could not avoid ordinary gain by selling an interest in a fund, a GP entity, or a super GP entity before a fund-level asset realization. Any further taint punishes investment or real estate activities compared with other businesses, constitutes a clear departure from long-standing federal income tax norms, and is unnecessary, unwise, and unfair.

A. Entrepreneurs Traditionally Taxed at CG Rate

Under current law, an entrepreneur who forms a business as a partnership and later sells all or part of the partnership interest is entitled to capital gain treatment under section 741, except to the extent the partnership has hot assets (receivables, depreciation recapture, and inventory) under section 751. This is true even if the underlying business generates mostly or entirely ordinary income, even if the founder's services contributed to the increase in value of the founder's equity (so-called sweat equity), and regardless of the nature of the underlying business.

Consider some examples. Entrepreneurs hoping to be the next Bill Gates and Paul Allen form a new Microsoft-like enterprise; entrepreneurs hoping to be the next Steve Jobs and Steve Wozniak form a new Apple-like enterprise; and entrepreneurs hoping to be the next Sergey Brin and Larry Page form a new Google-like enterprise, in each case with a view to developing important new technological advances for America and creating high paying jobs for Americans.

Figure VI.A



As depicted in Figure VI.A above: Assume that each set of entrepreneurs raises $10 million from

[30]*See* Financial Accounting Standards Board Accounting Standards Codification, para. 946-10-15-2.

[31]If Congress narrows 710's enterprise value tax by adopting a hot asset approach as suggested herein, a clarification would be desirable in the portion of 710 dealing with a 710-tainted partnership's *asset* sales. The portion of 710 that governs asset sales should be clarified so that in the highly unusual case in which there is a sale of an investment or real estate partnership's business and assets (rather than a sale of its partnership interests) for more than the investment or real estate assets' value (*i.e.*, because of goodwill and other intangibles), the 710 taint would apply only to built-in gain in the partnership's investment or real estate assets.

investors in exchange for participating preferred partnership interests, giving the investors the right to a return of their $10 million in capital plus an 80 percent share of the business's profits and appreciation. The founders receive a common partnership interest in exchange for their know-how, talent, and sweat equity, entitling them to 20 percent of the business's profits and appreciation after the return of the investors' $10 million capital. In each case, the founders' hard work and talent is critical to the business's success.

New Microsoft Partnership develops and sells computer software, generating ordinary income. New Apple Partnership develops computers and other high-tech electronics, generating ordinary income. New Google Partnership provides Internet services and ads, generating ordinary income.

The value of each business and its partnership equity is based on the expectation that the business will continue to generate ordinary income, partly based on existing products and partly based on the expectation of developing future products — the expectation that New Microsoft will develop and sell new software, New Apple will invent more i-gadgets, and New Google will create new Internet services and revenue.

When the founders ultimately sell their partnership interests, they recognize capital gain (except to the extent of underlying hot assets, that is, receivables, depreciation recapture, and inventory), even though their hard work (sweat equity) in the form of services to the partnership contributed enormously to the value of their partnership interests, and even though the business's future profits will constitute ordinary income.

Now assume that A and B instead form an entrepreneurial investment or real estate business in partnership form, as described in Part V, that successfully raises a series of funds, develops special expertise in specific industries, hires many employees for the fund, opens many offices, creates and expands a myriad of operating companies in which it invests, and develops a reputation and track record which attracts additional investors to its new funds and enables a new round of investments in operating portfolio companies.

Like the high-tech entrepreneurs discussed above, A and B ultimately may want to sell the firm they have created. Under current tax law, A and B are taxed under the same rules applicable to the high-tech entrepreneurs discussed above. They recognize capital gain on a sale of partnership interests, except to the extent the partnership owns hot assets (receivables, depreciation recapture, and inventory), including those it owns indirectly as a result of fund-level investments in operating portfolio companies formed as partnerships.

How does 710 change things? For the high-tech entrepreneurs, the result should be the same as under current law, since we believe Congress does not intend 710 to apply to operating partnerships. Thus, they should recognize capital gain on the sale (except to the extent that a partnership business holds hot assets). Unfortunately, as noted in Part I, 710 is drafted so broadly and ambiguously that it could be interpreted to reach interests in operating companies, depending on the facts and structure, inappropriately extending the enterprise value tax to the sale of interests in such operating partnerships. It is hard to imagine Congress wanting to do so, especially in the current economic environment when job creation is so crucial.

However, for A and B, 710 clearly results in dramatic change. A portion (50 to 75 percent, depending on whether the House or Senate approach prevails) of their gain on sale of an interest in the GP entities or the super GP entity is 710 tainted and thus treated as ordinary compensation income. While we agree that, should Congress choose to enact 710, a portion of their built-in gain carried interest (based on the then-current value of underlying investment and real estate assets) should be taxed (under a hot asset approach) as ordinary compensation income, it is inappropriate to apply 710 taint to A and B's gain in excess of the built-in gain carried interest, since this additional gain is purely a future expectancy in the nature of goodwill and thus should be taxed as capital gain as it would be for any other entrepreneurial business.

If the high-tech entrepreneurs and the investment management entrepreneurs discussed above choose to form their businesses as C corporations rather than as partnerships, each would (under both current tax law and under 710 if enacted) receive the same capital gain treatment on an ultimate sale of the C corporation's stock, even though the founders' sweat equity in the form of services to the corporation contributed enormously to the stock's value.

We recognize that there are significant differences between corporations — which are subject to the American double tax system — and partnerships — which are subject to a single level of taxation with character-flow-through. But these are differences between the tax treatments of two different forms of business organization, each of which has long been available under our tax system to any entrepreneur regardless of the underlying industry.

The important point is that founders' equity generally receives capital gain treatment in the C corporation context, whether the underlying business involves investment or real estate activities or any other type of activities.[32]

Thus, we see no rationale for converting to ordinary compensation income (under 710's enterprise value tax) any portion of gain in the nature of goodwill from disposition of a partnership investment management or real estate business while continuing to afford lower capital gain treatment to disposition gain from (a) the sale of any other type of partnership business and (b) the sale of all corporate businesses (including an investment or real estate business). In sum, we see no reason to use the enterprise value tax to so drastically discourage formation of a partnership investment management or real estate business.

B. 710 Drastically Disadvantages Investment/RE

One of the most important reasons the capital gains tax rate has almost always been lower than the ordinary income rate is to spur American entrepreneurs to risk their capital by seeking to build companies that produce jobs and economic growth. The current and long-standing tax preference afforded to capital gain has led to tremendous innovation in the United States that is the envy of the world.

If, as noted in Parts I and VI.A, 710 applies to an operating partnership in some situations (that is, where it has a tiered ownership structure or holds some specified assets in its business), the enterprise value tax will also apply to a sale of an interest in such an operating partnership in the same situations. Discouraging entrepreneurs from forming new operating businesses by applying the enterprise value tax would be bad policy in general and particularly bad policy at a time when job growth is urgently needed in our economy. We strongly doubt that Congress intends this unfortunate result.

Even if Congress clarifies 710 to carve out operating partnerships and the sale of interests in operating partnerships, we still believe the 710 enterprise value tax as currently proposed for investment and real estate partnerships is badly flawed because it taints more gain on sale than necessary to protect 710's basic purpose. We see no tax or economic policy reason why Congress should extend this taint beyond the built-in appreciation in investment and real estate assets, and hence so thoroughly discourage formation of investment management partnerships by subjecting entrepreneurs like A and B to an enterprise value tax imposing far harsher taxation on a sale of an interest in their investment management or real estate business than would apply to sales by entrepreneurs in other industries.

Fund managers will, of course, respond to an increase in taxation in a manner similar to other entrepreneurs. If taxes are dramatically increased on sale of an investment management or real estate business (versus sale of any other business), fewer will be formed. Harsher taxation will also create incentives for fund sponsors to go offshore.

Investment and real estate activities by private funds are clearly beneficial for our country's economy:

- Professional management of money by private funds is good for investors (including pension funds and endowments) and provides access to assets that many could not buy on their own.
- Venture capital funds provide capital to innovative start-up businesses.
- Growth-equity funds provide capital at a later stage in a company's development, helping to grow businesses.
- Buyout funds provide liquidity for family companies and others seeking to sell businesses. Entrepreneurs and companies are more likely to form a new enterprise if there are sources of liquidity (in addition to the public markets) for ultimate sale of the business.
- Private equity fund principals provide professional business and financial expertise to companies in which they invest, helping them to expand and prosper.
- Real estate funds supply capital and expertise to real estate projects that might not otherwise be developed.
- Hedge funds create and enhance liquidity in markets of all kinds.

It is important to note that private investment funds, as a group, were not the source of, nor even a significant contributing cause of, the recent financial meltdown. To the extent that an extremely small number of individual funds were involved in undesirable activities, an enterprise value tax applied to the entire industry is not an effective or appropriate response. Rather, regulation targeting those undesirable activities would be far more effective.

Of course, Congress could choose to apply higher ordinary income rates to all founders' shares, sweat equity, and profits interests in all business entities

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[32]It is true that a service provider entrepreneur who receives common stock in a start-up enterprise recognizes ordinary income under section 83 to the extent that the service provider pays less than the stock's front-end fair market value. However, founders' stock is generally received early in the enterprise's life when its value is low or even nominal, so that most of the ultimate appreciation is capital gain despite section 83. Indeed, such stock is often received tax free under section 351 in exchange for the founder's contribution of (*e.g.*, intellectual) property.

— C corporations as well as partnerships — and in all industries. That would avoid singling out for harsher treatment investment and real estate businesses and operating businesses that happen to hold specified assets (and hence may fall within 710). However, this would be bad tax and economic policy, particularly when our economy desperately needs enhanced growth to create jobs.

We caution against justifying the 710 enterprise value tax based on large gains earned by a few venture capital, private equity, real estate, and hedge fund principals in a few select years before onset of the 2006-2009 deep recession. It is bad policy to twist the tax system by changing longstanding tax rules to punish perceived success, particularly when outsized success may be transitory and attributable to one-time events — for example, the venture capital/tech stock bubble (which burst in 2001) or the private equity/leveraged buyout bubble (which burst in 2007-2008). If Congress were to develop a pattern of singling out for harsh taxation any business activity that produces significant profits (subjectively viewed by Congress as excessive), even for only a brief period, what entrepreneur would feel safe working hard to build a business?