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The Taxation of Carried Interest and Its Effects upon Cities

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THE TAXATION OF CARRIED INTEREST AND ITS EFFECTS UPON CITIES

Joseph Ferrone[*]

INTRODUCTION

As the adage goes, in this world, nothing can be said to be certain, except death and taxes. Although this invariably proves to be true, tax reform remains a central aspect of every election. With the 2020 election approaching, the public should expect to hear more about the taxation of carried interest, as it remains a major point of controversy

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within the world of tax law.[1] Specifically, carried interest is a portion of the profits of a private investment fund that is distributed to fund managers as compensation for a fund reaching a certain threshold of profitability.[2] Controversially, if fund managers hold the underlying asset for a minimum of three years, the resulting carried interest is currently taxed as a long-term capital gain at a maximum rate of 20%.[3] If fund managers hold the underlying asset for less than this three-year holding period, the resulting carried interest is taxed as a short-term capital gain at a rate of approximately 40%.[4] Yet, commentators claim all carried interest should be taxed as ordinary income, which is taxed at a maximum rate of approximately 40%.[5]

President Donald Trump made fixing this "tax loophole" a central promise of his 2016 campaign.[6] Despite passing ground-breaking tax reform in the 2017 Tax Cuts and Jobs Act, however, the carried interest loophole remains largely untouched.[7] The only significant reform occurred in Section 1061 of the Internal Revenue Code, which increased the holding period requirement from one year to a minimum of three years, in order for carried interest to qualify for long-term capital gains tax treatment.[8] Not surprisingly, private investment fund managers have utilized and designed various structures to circumvent this requirement.[9] Moreover, even under the assumption that the Internal Revenue Service (IRS) would challenge such structures, the three-year holding requirement does not affect hedge fund or private equity fund managers. Specifically, hedge funds generally hold assets for less than one year, so carried interest distributed to hedge fund managers was not receiving preferential long-term capital gains tax

1. *See The Taxation of Carried Interest: Hearing Before the H. Comm. on Ways & Means*, 110th Cong. 7 (2007) [hereinafter *The Taxation of Carried Interest*] (statement of Peter R. Orszag, Director, Congressional Budget Office).

2. *See id.*

3. I.R.C. §§ 1, 1061 (2019).

4. *Id.* §§ 1, 1061.

5. *Id.* § 1; *The Taxation of Carried Interest*, *supra* note 1, at 7.

6. Alan Rappeport, *Trump Promised to Kill Carried Interest. Lobbyists Kept it Alive*, N.Y. TIMES (Dec. 22, 2017), https://www.nytimes.com/2017/12/22/business/trump-carried-interest-lobbyists.html [https://perma.cc/QE2D-XLUT].

7. *See id.*

8. I.R.C. § 1061.

9. *See generally* Scott Dolson et al., *2019 Update — How to Deal with Section 1061's Three Year Holding Period Requirement for Carried Interests*, FROST BROWN TODD: TAX L. DEFINED BLOG (June 14, 2019), https://www.lexology.com/library/detail.aspx?g=9a5f0c8e-983d-491f-99ae-ee0dde192696 [https://perma.cc/8MWQ-DWWS].

treatment under the previous law.[10] Furthermore, private equity funds generally hold assets for far longer than three years, making Section 1061 ineffective for private equity fund managers.[11]

Although arguments present strong points in favor or against amending the relevant laws, carried interest should not be taxed solely as a long-term capital gain or as ordinary income. Specifically, Section 1061 should be tightened to more effectively limit the ability of fund managers to gain long-term capital gain tax treatment, but also allow such treatment in certain circumstances. An increase in the minimum holding period requirement from three years to a five- to seven-year period, an expansion in the definition of "related parties," and bringing other types of investments into its purview would make Section 1061 more effective. This additional tax revenue would amount to billions of dollars and would have a significant effect on many indebted urban areas.[12] Yet, legislators must keep in mind that private investment funds bring jobs, philanthropic endeavors, and economic growth to American cities, especially New York City.[13] Thus, a properly drafted revision should continue to incentivize fund formation and allow private investment funds to continue to help urban economies thrive.

Part I of this Note provides an overview of carried interest and analyzes Section 1061's stipulations and its resulting industry-wide effects with a focus on hedge funds and private equity funds. Part II discusses the arguments in favor of and against taxation of carried interest as a long-term capital gain. Part III argues that carried interest should not be taxed solely as a long-term capital gain or as ordinary income, and that Section 1061 should be altered to further limit such preferential tax treatment while properly incentivizing fund formation. Part III concludes by illustrating how a properly drafted revision to Section 1061 is significant to New York City.

10. *See* Scott Dolson, *How New IRC § 1061 Impacts Carried Interests*, FROST BROWN TODD: LEGAL UPDATE (Feb. 26, 2018), https://frostbrowntodd.com/how-new-irc-%C2%A7-1061-impacts-carried-interests-2/ [https://perma.cc/8WUF-MCEL].

11. *See id.*

12. CITIZENS BUDGET COMM'N, NYC DEBT OUTSTANDING: FISCAL YEARS 2002–2018 (2018); Victor Fleischer, *How a Carried Interest Tax Could Raise $180 Billion*, N.Y. TIMES (June 5, 2015), https://www.nytimes.com/2015/06/06/business/dealbook/how-a-carried-interest-tax-could-raise-180-billion.html [https://perma.cc/V9DQ-S5KB] [hereinafter Fleischer, *Carried Interest Tax*].

13. Charles Swenson, *Economic Impact Analysis: Proposed New York State Tax Increases on Carried Interest of the Private Funds Industry*, AM. INV. COUNCIL 3, 5 (2019).

I. CARRIED INTEREST: AN OVERVIEW

A. Carried Interest and I.R.C. Section 1061

Carried interest is the primary means by which private investment fund managers are compensated.[14] Private investment funds are typically organized as limited partnerships with investors as the limited partners and fund managers as the general partners.[15] The fund managers determine investments that the fund makes, and the fund generates gains or losses through the operation of the investments made by fund managers.[16] As per partnership tax law, the resulting gains or losses flow through to the partners.[17] Carried interest is distributed to fund managers if the fund reaches a certain threshold of profitability.[18] If fund managers do not hold the underlying investment for a minimum of three years, the resulting carried interest is being taxed as a short-term capital gain at a maximum rate of approximately 39.6%.[19] However, if fund managers hold the underlying investment for a minimum of three years, the resulting carried interest is currently taxed as a long-term capital gain at a maximum rate of 20%.[20] In response to critics, the Tax Cuts and Jobs Act addresses this issue in I.R.C. Section 1061.[21] Tax planning strategies and the general nature of certain private investment funds reveal that Section 1061's new three-year holding period requirement is relatively ineffective.[22]

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14. Daniel Feldman, *Carried Interest: "That Is Pure Poppycock!"*, 12 RUTGERS J.L. & PUB. POL'Y 513, 513–14 (2015).

15. In a limited partnership, general partners typically control major business decisions and face unlimited personal liability. On the other hand, limited partners are usually passive investors and only liable up to the extent of their investments. Thus, limited partnerships allow fund managers to maintain control over investment decisions and also allow limited partners to invest without fear of unlimited liability. *See id.* at 516; Colleen DeBaise, *Forming a Partnership*, WALL ST. J. (Mar. 8, 2010), https://www.wsj.com/articles/SB10001424052748704869304575109770640885814 [https://perma.cc/99VM-WLN4].

16. *See* Feldman, *supra* note 14, at 516.

17. I.R.C. § 704(b) (2019).

18. *See The Taxation of Carried Interest*, *supra* note 1, at 7.

19. I.R.C. §§ 1, 1061 (2019).

20. *Id.* §§ 1, 1061.

21. *See id.* § 1061; Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 35 (2008) [hereinafter Fleischer, *Two and Twenty*] (exemplifying how Professor Victor Fleischer has been a significant critic of the preferential tax treatment of carried interest and advocates for reform in this area); Rappeport, *supra* note 6.

22. *See* Dolson et al., *supra* note 9.

Hedge fund and private equity fund managers are some of the wealthiest people in the world.[23] The taxation of their compensation arrangements is an area of constant debate and a major controversy in tax law.[24] Private investment funds typically follow what is known as a "two and twenty" compensation structure.[25] The 2% refers to the minimal portion of their income that is composed of a management fee.[26] Specifically, this annual management fee is guaranteed in the partnership agreement and is taxed as ordinary income.[27] The 20% refers to the portion of a fund manager's income that is deemed a profits interest.[28] The profits interest is not guaranteed, as it is incentive-based.[29] Under a typical arrangement, a fund manager usually sets a certain threshold of profitability that he must surpass and, upon reaching the threshold, is able to garner a share of the profits.[30] Subject to some slight restrictions, this profits interest can be taxed as a long-term capital gain at a maximum rate of 20% with an additional 3.8% surtax of net investment income tax.[31] For example, if a private investment fund manager formed a fund and investors made an initial total investment of $1,000,000, under a two and twenty compensation structure, the manager would be allocated a management fee of 2% or $20,000.[32] If the fund performs over a designated threshold, such as a profit of $500,000, the manager would get 20% of the profit or $100,000.[33]

Since some investment funds invest relatively aggressively, these fees can reach extraordinarily high amounts, but such aggressive investments also run the risk of generating losses for investors.[34] The

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23. *See* Tom Maloney, *The Best-Paid Hedge Fund Managers Made $7.7 Billion in 2018*, BLOOMBERG (Feb. 15, 2019), https://www.bloomberg.com/news/articles/2019-02-15/the-10-best-paid-hedge-fund-managers-made-7-7-billion-in-2018 [https://perma.cc/3PFJ-VMMJ].

24. *See* Rappeport, *supra* note 6.

25. *See* Feldman, *supra* note 14, at 513–14.

26. *See id.*

27. I.R.C. §§ 1, 1061 (2019); *Feldman*, supra note 14, at 513–14.

28. *See* Feldman, *supra* note 14, at 513–14.

29. *See id.* at 516.

30. *The Taxation of Carried Interest*, *supra* note 1, at 7.

31. I.R.C. §§ 1, 1061; David Rae, *What Are the New Capital Gains Rates for 2020?*, FORBES (Jan. 13, 2020), https://www.forbes.com/sites/davidrae/2020/01/13/new-capital-gains-rates-for-2020/#71c09ef843eb [https://perma.cc/YK3J-9FVP].

32. *See* Anne Sraders, *What Is a Hedge Fund and How Do They Work?*, THESTREET (July 23, 2019), https://www.thestreet.com/personal-finance/education/what-is-a-hedge-fund-14662109 [https://perma.cc/5JAA-DLSG].

33. *See id.*

34. *See id.* The potential for large losses was especially evident in the collapse of Tiger Management. Before its eventual closing, the hedge fund suffered losses of 19%

preferential tax treatment of carried interest is so significant that investment fund managers often forfeit a portion of their annual management fee in exchange for a higher amount of carried interest.[35] These fee waivers have become very common and allow fund managers to forego the typical 2% management fee that would be taxed as ordinary income.[36] Instead, these fund managers can, therefore, earn a higher rate of carried interest with its potential tax benefits.[37] Moreover, since fund managers typically invest their own money into the fund, the profits distributed based upon a fund manager's invested capital is often treated as a capital gain, subject to some slight restrictions.[38]

Due to the significant amount of wealth involved, a constant debate surrounds the preferential tax treatment of carried interest.[39] Proponents of the preferential tax treatment claim that carried interest is based upon the vicissitudes of the markets and is not guaranteed, making long-term capital gains treatment most logical.[40] Moreover, these proponents rely on other various taxation-based arguments and public policy rationales.[41] On the other hand, critics of the current tax treatment of carried interest liken carried interest to a bonus, and affirm that it most logically should be taxed as ordinary income at a maximum rate of approximately 40%.[42] Similarly, these critics rely on a variety of other taxation and public policy-related arguments.[43]

Congress has previously attempted to reform the taxation of carried interest.[44] These proposals have ranged from the full taxation of carried interest as ordinary income to approaches categorizing carried interest as a blend of ordinary and capital gains income.[45] In 2007,

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in 1999 alone. *See* Gregory Zuckerman et al., *Fallout of Tiger Management's Collapse on Asian Markets Should Be Limited*, WALL ST. J. (Mar. 31, 2000), https://www.wsj.com/articles/SB954443007478201408 [https://perma.cc/A5HZ-38VW].

35. *See* Feldman, *supra* note 14, at 518–19.

36. *See id.*

37. *See id.*

38. I.R.C. § 1 (2018); Sraders, *supra* note 32.

39. DONALD MARRON, URB. INST. & BROOKINGS INST.: TAX POL'Y CTR., GOLDILOCKS MEETS PRIVATE EQUITY: TAXING CARRIED INTEREST JUST RIGHT 1 (2016), https://www.urban.org/research/publication/goldilocks-meets-private-equity-taxing-carried-interest-just-right/view/full_report [https://perma.cc/2GB6-EQ93].

40. *Id.* at 2.

41. *Id.*

42. *See id.* at 1; I.R.C. § 1.

43. MARRON, *supra* note 39, at 1.

44. *See* Feldman, *supra* note 14, at 526–27.

45. DONALD J. MARPLES, CONG. RESEARCH SERV., RS22689, TAXATION OF HEDGE FUND AND PRIVATE EQUITY MANAGERS 4 (2014).

Representative Charles B. Rangel introduced a tax reform bill — H.R. 3970 — that would have been included in the Temporary Tax Relief Act of 2007.[46] Specifically, this bill proposed I.R.C. Section 710, which would have effectively changed the taxation of any "investment services partnership interest."[47] The proposed Section 710 would have treated the distributive share of carried interest as compensation income and, therefore, would have taxed fund managers at the applicable ordinary income rates.[48]

Specifically, Section 710(a)(1), as proposed by Representative Rangel, would have treated the net income arising from investment service partnership interests as ordinary income regardless of the character of the underlying asset.[49] This proposed version of Section 710 would have only applied to partnerships focused on investing in securities, commodities, or real estate and to a partner providing substantial services consisting of investment advice or asset management.[50] This type of partnership was referred to as an investment services partnership and the described investment services were intended to cover the activities of private investment fund managers.[51] The proposed Section 710 did not characterize as ordinary income the portion of a partner's distributive share that consisted of the partner's invested capital.[52] To avoid such recharacterization, the bill required such invested capital allocations to be reasonable.[53] To be deemed reasonable, an allocation to invested capital of a partner providing investment services could not be in excess of the amount allocated to the partners not providing such services.[54]

Representative Rangel's proposed Section 710 has not yet been passed,[55] and received significant criticism from tax experts.[56] Professor Howard E. Abrams criticized the proposed Section 710,

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46. Howard E. Abrams, *Taxation of Carried Interests: The Reform That Did Not Happen*, 40 LOY. U. CHI. L.J. 197, 211–12 (2009) [hereinafter Abrams, *Taxation of Carried Interests*].

47. *See id.*

48. *See id.*

49. *See id.*

50. *See id.*

51. *See id.*

52. *See id.* at 213.

53. *See id.*

54. *See id.*

55. *See id.*

56. *See id.* at 223*; see also id.* at 198, 212 (citing Howard E. Abrams, *A Close Look at the Carried Interest Legislation*, 117 TAX NOTES 961, 970–71 (2007) [hereinafter Abrams, *A Close Look*]).

emphasizing the great difficulties surrounding the recharacterization of a portion of carried interest as ordinary income without considering the underlying investment.[57] Moreover, Professor Abrams claimed that the proposed bill was an overly simplistic solution to a complicated issue. Professor Abrams felt such arbitrary re-characterization of income was directly contrary to the rudimentary principle that the tax law should treat partners equally. Furthermore, it is advantageous that income passes from a partnership to partners without any tax modifications.[58]

In 2007, Senator Sander Levin introduced a tax reform bill to Congress within the Temporary Tax Relief Act of 2007.[59] This bill proposed to treat income received by general partners for the performance of investment management services as ordinary income regardless of the character of the underlying assets.[60] This bill was drafted very broadly, applying to investment services partnerships and to entities not classified as investment services partnerships.[61] Congress did not support this proposal, as it was introduced in the House of Representatives and ultimately was not passed.[62]

In 2009, Senator Levin introduced a bill as part of the Job Creation and Tax Cuts Act of 2010.[63] This bill proposed to set a fixed percentage of partnership distributions distributed to fund managers of investment management partnerships as ordinary income and a fixed percentage as capital gains income.[64] Under this proposed Section 710, a fixed percentage of carried interest would be taxed at ordinary income rates, notwithstanding the original character of the income and if it would have been treated as capital gains.[65] Moreover, a fixed percentage would keep pass-through capital gains character.[66] In an effort to compromise with proponents of the current tax treatment of carried

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57. Professor Abrams emphasized the difficulties of recharacterizing carried interest regardless of the character of the underlying investments by saying that "the current manner of taxing carried interests is more consistent with general principles of taxation than is admitted by its critics . . . ." Abrams, *Taxation of Carried Interests*, *supra* note 46, at 198; *see also* Abrams, *A Close Look*, *supra* note 56, at 970–71.

58. Abrams, *A Close Look*, *supra* note 56, at 970–71; Abrams, *Taxation of Carried Interests*, *supra* note 46, at 198–99.

59. *See* Feldman, *supra* note 14, at 526–27.

60. *See id.*

61. *See id.*

62. *See id.*

63. *Id.*

64. *See id.*

65. *See id.*

66. *See id.*

interest, the bill proposed a 75/25 split, meaning 75% of a carried interest would be treated as ordinary income and 25% would retain pass through capital gains character.[67]

Tax experts criticized Senator Levin's 2009 proposal because it directly conflicted with the basic principle of Schedule K — that partnership income flows through to partners without any changes.[68] Moreover, scholars indicated that the bill was far too simple of a solution to an extraordinarily complex issue.[69] Like the 2007 bill proposed by Senator Levin, this bill was introduced in the House of Representatives and died in a House Subcommittee.[70]

The 113th Congress's S. 268 and President Obama's FY2014 Budget Proposal also proposed relatively significant reforms in the taxation of carried interest.[71] Both proposals sought to tax carried interest as ordinary income, but made exceptions for enterprise value.[72] The value of private investment funds is partially composed of goodwill, which is typically referred to as enterprise value.[73] There is no clear way to tax enterprise value, as scholars indicate that it has both ordinary and capital gains characteristics.[74] Both proposals recognized the dual nature of enterprise value and sought to allow enterprise value that is unrelated to providing investment services and distinct from other types of partnership value to be taxed as capital gains.[75] Moreover, each proposal would have taxed the remainder of carried interest resulting from investment partnerships at ordinary income rates.[76] According to the Joint Committee on Taxation, Congress's proposal would have raised $3.1 billion in tax revenues from 2014 to 2023.[77] Furthermore, President Obama's proposal would have raised $17.4 billion in tax revenues from 2014 to 2023.[78] Like other attempts at carried interest tax reform, S. 268 was introduced in the Senate and

67. *See id.*

68. *See id.*

69. Tax scholars have argued that simply recharacterizing carried interest would alter the fundamental principle of the pass-through taxation of partnerships and would carry significant consequences. *See* Feldman, *supra* note 14, at 527.

70. *See id.*

71. *See* MARPLES, *supra* note 45, at 6.

72. *See id.* at 6–7.

73. Goodwill is typically described as the excess of a partnership's value over its physical assets and future income streams. *See id.*

74. *See id.*

75. *See id.*

76. *See id.* at 5.

77. *See id.*

78. *See id.*

died, and President Obama's carried interest proposal was not included in the budget.[79]

Throughout his 2016 presidential campaign, then-candidate Donald Trump consistently pledged to close the hedge fund "tax loophole," in reference to the preferential tax treatment of carried interest.[80] During the finalization of the 2017 Tax Cuts and Jobs Act, White House economic advisor Gary Cohn pushed for significant reform in the area, attempting to have the Act treat carried interests as ordinary income.[81] By contrast, Treasury Secretary Steven Mnuchin emphasized preserving the current tax treatment as much as possible but adding small revisions.[82] In the end, Mnuchin prevailed, and the 2017 Tax Cuts and Jobs Act did little to address the issue.[83] The new statute — Section 1061 — is the major revision related to carried interest.[84]

Section 1061 was signed into law on December 22, 2017 and is effective for tax years beginning after 2017.[85] In part, Section 1061 states:

> (a) In general. If one or more applicable partnership interests are held by a taxpayer at any time during the taxable year, the excess (if any) of —
>
> > (1) the taxpayer's net long-term capital gain with respect to such interests for such taxable year, over
> >
> > (2) the taxpayer's net long-term capital gain with respect to such interests for such taxable year computed by applying paragraphs (3) and (4) of sections 1222 by substituting "3 years" for "1 year",

79. *See* Hunter Walker, *Obama Still Wants to Kill Wall Street's Favorite Tax Loophole*, BUS. INSIDER (Mar. 3, 2014, 8:00 PM), https://www.businessinsider.com/obama-fiscal-year-2015-budget-2014-3 [https://perma.cc/MN84-BMHA].

80. President Trump "called hedge fund managers 'paper pushers' who were 'getting away with murder' partly because of measures including the carried-interest provision that he said allowed them to shield their wealth and to minimize their tax burdens." Tiffany Hsu, *Trump Vowed End to Key Wall St. Loophole. G.O.P. Tax Plan Leaves It Intact*, N.Y. TIMES (Nov. 3, 2017), https://www.nytimes.com/2017/11/03/business/trump-carried-interest-tax-loophole.html [https://perma.cc/2QU5-VWT4].

81. Dolson et al., *supra* note 9.

82. *Id.*

83. *Id.*

84. *See id.*

85. *2017 Tax Reform Enacts a Three-Year Holding Period Rule for Carried Interests*, BAKER TILLY (Mar. 30, 2018), https://www.bakertilly.com/insights/2017-tax-reform-enacts-a-three-year-holding-period-rule-for-carried-interes/ [https://perma.cc/C4SD-TNV3] [hereinafter *2017 Tax Reform*].

> shall be treated as short-term capital gain, notwithstanding section 83 or any election in effect under section 83(b).[86]

In comparison to the previous law, Section 1061 imposes a more significant holding period requirement before carried interest receives preferential long-term capital gains tax treatment.[87] For example, previously, funds only needed to hold the underlying asset for a minimum of one year before the resulting carried interest would be taxed at long-term capital gains rates.[88] However, given the changes of Section 1061, the underlying asset would need to be held for a minimum of three years for the resulting carried interest to be treated as a long-term capital gain.[89] If the underlying asset was not held for three years, the carried interest would be taxed at the higher short-term capital gains rates.[90]

Section 1061(c)(1) defines an applicable partnership interest to mean "any interest in a partnership which, directly or indirectly, is transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any applicable trade or business."[91] Thus, a fund manager's management and structuring of the fund fits within this definition of applicable partnership interest.[92]

Furthermore, the term "applicable trade or business" is defined to mean:

> [A]ny activity conducted on a regular, continuous, and substantial basis which, regardless of whether the activity is conducted in one or more entities, consists, in whole or in part, of –
>
> (A) raising or returning capital, and
>
> (B) either —
>
> > (i) investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition), or
> >
> > (ii) developing specified assets.[93]

Specifically, the "applicable trade or business" designation delineates what types of businesses fall within the purview of Section

86. I.R.C. § 1061 (2019).
87. *See id.*
88. *See id.*
89. *See id.*
90. *See id.*
91. *Id.*
92. Dolson et al., *supra* note 9.
93. I.R.C. § 1061.

1061.[94] Since Section 1061(c)(1) provides that Section 1061 applies to raising capital and investing in specified assets, the continuous and substantial work of managing a private investment fund qualifies as an "applicable trade or business."[95] Section 1061 also defines "specified assets" as securities, commodities, real estate held for rental or investment, cash, and options or derivative contracts with respect to any of these assets.[96] Thus, Section 1061 clearly addresses the taxation of carried interest,[97] and its three-year holding period requirement applies to capital gains realized by the partnership regardless of when the individual acquired the applicable partnership interest.[98]

Although Section 1061 modified the traditional treatment of carried interest, the statute has a major inadequacy.[99] Specifically, it contains an exception that removed almost all of the teeth of the new rule.[100] In part, Section 1061 states "the term 'applicable partnership interest' shall not include . . . any interest in a partnership directly or indirectly held by a corporation."[101] The legal community quickly noticed that the corporation exception did not explicitly say it was solely for C corporations.[102] Thus, private investment fund managers quickly began forming S corporations to take advantage of the corporation exception and to continue to receive preferential tax treatment of carried interest.[103] In Notice 2018-18, however, the IRS fixed this loophole by stating that Section 1061 does apply to S corporations.[104] Therefore, private investment fund managers, who formed S or C corporations are likely subject to Section 1061.[105]

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94. *Id.*

95. Dolson et al., *supra* note 9.

96. I.R.C. § 1061.

97. Private investment funds invest in securities and commodities, and a range of other similar financial products. Since carried interest is given to fund managers as a form of compensation, Section 1061(c)(1)'s definition of specified assets clearly encompasses fund managers' carried interests. *See id.*; Dolson et al., *supra* note 9; Sraders, *supra* note 32.

98. *2017 Tax Reform*, *supra* note 85.

99. *Id.*

100. *Id.*

101. I.R.C. § 1061.

102. *See 2017 Tax Reform*, *supra* note 85.

103. Richard Rubin, *Treasury Issues Tax Guidance Limiting Carried-Interest Provision*, WALL ST. J. (Mar. 1, 2018), https://www.wsj.com/articles/treasury-issues-tax-guidance-limiting-carried-interest-provision-1519921428 [https://perma.cc/KZ8B-XRUK].

104. I.R.S. Notice 2018-18, 2018-12 IRB 443.

105. *See id.*

B. Private Equity Funds

A Private Equity (PE) fund is an investment vehicle in which a fund manager pools investors' capital and invests the fund's assets.[106] PE funds are extremely significant to the global economy.[107] In 2017, PE funds raised $453 billion,[108] and in 2017, PE funds had over $2.8 trillion of assets under management.[109] PE funds are relatively hands-on in the context of private investment funds, as they typically take a controlling interest in an operating company, commonly referred to as a portfolio company, and engage actively in the management of the business.[110] In general, PE funds invest in private companies and focus on improving operations or cutting unnecessary expenses.[111] PE fund managers strive to increase the value of businesses in order to profit off of a later sale.[112] Like other private investment vehicles, a PE fund is managed by a fund manager, who is typically compensated according to the two and twenty compensation structure.[113] Thus, PE fund managers earn most of their income from carried interest and are an intended target of Section 1061.[114]

Despite its seemingly significant three-year holding period requirement, Section 1061 has very little practical effect for funds that invest long-term, like PE funds.[115] The very nature of a PE fund's investments involve a long-term focus, and sales made by PE fund managers may not occur until many years after the initial investment.[116] In fact, only 27% of investments by PE funds fell under the three-year

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106. J.B. Maverick, *Hedge Fund vs. Private Equity Fund: What's the Difference?*, INVESTOPEDIA (July 15, 2019), https://www.investopedia.com/ask/answers/121614/what-difference-between-hedge-fund-and-private-equity-fund.asp [https://perma.cc/AA9A-6SHU].

107. *See generally* Andrew Metrick & Ayako Yasuda, *The Economics of Private Equity Funds*, 23 REV. FIN. STUD. 2303 (2010).

108. Cardell McKinstry, *Private Equity and Venture Capital Firms Still Digesting Trump Tax Reform*, ATLANTA BUS. CHRON. (May 29, 2018), https://www.bizjournals.com/atlanta/news/2018/05/29/private-equity-and-venture-capital-firms-still.html [https://perma.cc/6JYP-TA6E].

109. URBAN INST. & BROOKINGS INST., TAX POLICY CTR., WHAT IS CARRIED INTEREST, AND SHOULD IT BE TAXED AS CAPITAL GAIN? (2016), https://www.taxpolicycenter.org/briefing-book/what-carried-interest-and-should-it-be-taxed-capital-gain [https://perma.cc/5HSY-NZ7C].

110. Maverick, *supra* note 106.

111. *See id.*

112. *See id.*

113. *See* Feldman, *supra* note 14, at 514.

114. *See id.*; I.R.C. § 1061 (2019).

115. *See* Rubin, *supra* note 103.

116. *See id.*

holding requirement in 2017.[117] Thus, the three-year minimum holding requirement of Section 1061 is largely irrelevant for PE funds, as they typically hold investments for more than five years.[118]

Moreover, relatively straightforward tax planning nullifies the effects of Section 1061 for PE funds.[119] In its definition of "specified assets," Section 1061 does *not* include operating businesses.[120] Thus, if a PE fund invests in various operating business joint ventures and issues a carried interest, it will likely not fall within the purview of Section 1061.[121] Specifically, Section 1061(c)(3) requires an examination of the activities of the joint venture to determine if the issuer of the carried interest is in possession of a specified asset.[122] Thus, if a PE fund solely invests in joint ventures only engaged in operating businesses, any resulting carried interest should not be subject to Section 1061.[123]

Furthermore, a PE fund might be able to structure its investments in such a way as to further minimize the effects of Section 1061.[124] Holders of carried interest — especially PE fund managers — might acquire stock in a particular company, commonly referred to as a platform company.[125] When considering Section 1061's three-year holding period requirement, the investor will want to meet this three-year threshold as quickly as possible.[126] One area that might cause problems is the issuance of new stock.[127] Specifically, the issuance of new stock would trigger a new holding period under Section 1061 and reset the three-year clock.[128] Thus, investors might be able to pay for additional capital for add-on investments with pro-rata capital contributions instead of the traditional issuance of additional stock.[129] If pro-rata capital contributions are impractical, investors might be

117. Gregg Coughlin, *Carried Interest Post-TCJA: Impact on Hedge Funds, Private Equity, and Real Estate*, MICH. BUS. & ENTREPRENEURIAL L. REV. (Apr. 3, 2019), http://mbelr.org/carried-interest-post-tcja-impact-on-hedge-funds-private-equity-and-real-estate/ [https://perma.cc/4X8K-M3SA].

118. *See* URBAN INST. & BROOKINGS INST., *supra* note 109.

119. Dolson et al., *supra* note 9.

120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.*

124. *Id.*

125. *Id.*

126. *Id.*

127. *Id.*

128. *Id.*

129. *Id.*

able to avoid issuance of new stock by funding additional capital needs with debt.[130]

One potential structure would be to designate an LLC or LP as a holding company over the particular corporate portfolio company.[131] In the event that additional funding is necessary for an add-on investment at the portfolio company, private investment fund managers could structure such funding at the holding company level.[132] This structure would allow fund managers to contribute funds to the capital of the corporate portfolio company without issuing any new stock and triggering a new three-year holding period requirement.[133] Thus, provided that the stock complies with the three-year holding period requirement, the capital gain on the sale of the portfolio stock would flow through to the holding company's owner and a PE fund would be able to sell the stock without Section 1061 implications.[134]

An even simpler planning technique, especially applicable to PE funds with blocks of portfolio company stock, is the strategic timing of sales.[135] Specifically, if there are blocks of such investments, funds can choose to time the sale or redemption of the stocks to ensure that stocks are not sold until they satisfy the three-year holding period requirement.[136] This strategy would be relatively straightforward, as PE funds typically hold assets for longer than three years.[137] Therefore, such a strategy would not require extensive tax planning.

C. Hedge Funds

A hedge fund is an investment vehicle in which a hedge fund manager pools investors' capital and invests in a variety of securities and equities to generate a positive return.[138] Investors include institutions like pension funds, high-net-worth individuals, or even the managers themselves.[139] In 2018, hedge funds had approximately $3.2 trillion under management, making them a significant force in the

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130. *Id.*
131. *Id.*
132. *Id.*
133. *Id.*
134. *Id.*
135. *Id.*
136. *Id.*
137. URBAN INST. & BROOKINGS INST., *supra* note 109.
138. *See* Sraders, *supra* note 32.
139. Kimberly Amadeo, *Hedge Fund Investors*, BALANCE (June 25, 2019), https://www.thebalance.com/who-invests-in-hedge-funds-and-why-3306239 [https://perma.cc/J39T-FQRG].

global economy.[140] Similar to PE fund managers, hedge fund managers are typically compensated according to the two and twenty structure.[141] Thus, the 20% of fund managers' compensation that consists of carried interest is potentially subject to Section 1061.[142]

Section 1061 fails to address carried interest distributions from hedge funds.[143] Since hedge funds usually hold investments for less than one year, hedge fund managers typically were not receiving preferential tax treatment of carried interest under the previous tax law.[144] However, for those few hedge funds that hold investments for longer periods, Section 1061 is still easy to circumvent.[145] One relatively straightforward tax planning strategy that might minimize Section 1061's effects upon hedge funds involves transferring carried interest to "unrelated parties."[146] Specifically, Section 1061 states that:

> (2) Related person. For purposes of this paragraph, a person is related to the taxpayer if —
>
> > (A) the person is a member of the taxpayer's family within the meaning of section 318(a)(1), or
> >
> > (B) the person performed a service within the current calendar year or the preceding three calendar years in any applicable trade or business in which or for which the taxpayer performed a service.[147]

Section 318(a)(1) defines "related parties" as an individual's "spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance) and his children, grandchildren, and parents."[148] Thus, the related party definition in Section 1061 does not include attribution from partnerships, estates, trusts, and corporations.[149] Solely including immediate family members and current or recent fund management colleagues without attribution rules creates a very significant tax planning consideration for private investment fund managers.[150]

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140. Matt Egan, *Hedge Funds Assets Plunged by $88 Billion in 2018*, CNN (Jan. 25, 2019), https://www.cnn.com/2019/01/25/investing/hedge-funds-2018-markets/index.html [https://perma.cc/8CQB-RRGW].

141. *See* Sraders, *supra* note 32.

142. *See* I.R.C. § 1061 (2019); Coughlin, *supra* note 117.

143. Dolson et al., *supra* note 9.

144. *See* I.R.C. § 1061; Dolson, *supra* note 10.

145. Dolson et al., *supra* note 9.

146. *See id.*

147. *See* I.R.C. § 1061.

148. *Id.* § 318.

149. *See id.* §§ 318, 1061; Dolson et al., *supra* note 9.

150. Dolson et al., *supra* note 9.

These related party classifications allow private investment fund managers to utilize tax planning strategies to avoid Section 1061's three-year holding requirement.[151] Specifically, a distribution would only trigger Section 1061 if it was transferred directly to a related party.[152] Since the attribution rules of Section 318(a)(2) are clearly omitted from the statute, a fund manager might be able to transfer carried interest to an entity owned by a related party and the related party would be able to avoid the three-year holding requirement.[153] Importantly, the transferee-entity would need to be regarded as a taxpayer in a manner that is separate from the particular related party.[154] Although the related party classifications will capture some transactions, these classifications are clearly narrow and enable private investment fund managers to avoid the restrictions of Section 1061.[155]

Under Section 1061, hedge fund managers and all private investment fund managers may avoid the three-year holding requirement by distributing appreciated partnership assets as a form of carried interest.[156] The fund manager would then be free to sell the appreciated assets and avoid Section 1061's three-year holding requirement.[157] These various tax planning strategies make it clear that Section 1061 will likely not have a significant effect upon the taxation of carried interest, especially when considering that private investment fund managers have access to some of the most capable attorneys and accountants.[158] Section 1061 fails to achieve a substantive revision of the taxation of carried interest because elementary tax planning allows fund managers to avoid any restrictions imposed.[159] The preferential tax treatment of carried interest remains controversial, as both critics and proponents of this preferential tax treatment present strong arguments in favor of and opposing tax reform in this area.[160]

151. *See id.*
152. *See id.*
153. *See id.*
154. *See id.*
155. *See id.*
156. *See id.*
157. *See id.*
158. *See id.*
159. *See id.*
160. *See* Marron, *supra* note 39, at 1–2.

II. THE GREAT TAX DEBATE

Given the trillions of dollars of assets under management and extraordinarily high income flowing to fund managers, it is unsurprising that the taxation of carried interest is highly controversial within tax law.[161] When evaluating an aspect of tax law, it is helpful to evaluate tax policy, fiscal policy, and general public policy.[162] The primary tax policy considerations include vertical equity, horizontal equity, economic neutrality, and administrability.[163] Vertical equity is based upon the idea of taxing different taxpayers progressively, meaning taxing individuals at higher rates relative to income.[164] Horizontal equity focuses upon taxing similar earners uniformly.[165] Economic neutrality concentrates upon avoiding the influence of taxpayer preferences due to taxation.[166] Lastly, administrability focuses upon the practicability — the difficulty of implementation and enforcement.[167] Furthermore, the four primary fiscal policy considerations include economic growth, economic stability, raising revenue for expenditures, and increased employment.[168] As discussed in the Sections below, both critics and proponents of the current tax treatment of carried interest make arguments based on these factors,[169] and raise strong points and help to illustrate the importance of the taxation of carried interest to tax law in general.

A. The Critics of the Preferential Tax Treatment of Carried Interest

Critics of the preferential tax treatment of carried interest are quite vocal regarding their dissatisfaction with the current tax law. For example, when discussing the need to reform the taxation of carried interest, President Obama pointed out that "the top 25 hedge fund managers made more than all the kindergarten teachers in the country."[170] Furthermore, President Trump referred to hedge fund managers as "paper pushers" and claimed they were "getting away

161. Fleischer, *Two and Twenty*, *supra* note 21.
162. *See* Feldman, *supra* note 14, at 522–23.
163. *Id.* at 523.
164. *See id.*
165. *See id.*
166. *See id.*
167. *See id.*
168. *See id.* at 524.
169. *See id.*
170. President Barack Obama, *Conversation on Poverty at Georgetown University*, YOUTUBE (May 12, 2015), https://www.youtube.com/watch?v=vaGnNQ6Jr_8 [https://perma.cc/NT5A-NZFN].

with murder," partly due to the preferential tax treatment of carried interest.[171] Moreover, Professor Victor Fleischer declared that "the status quo treatment of a profits interest in a partnership is no longer a tenable position to take as a matter of sound tax policy."[172]

Critics primarily rely upon a variety of tax policy rationales in claiming that carried interest should be taxed as ordinary income.[173] They argue that taxing carried interest as ordinary income would increase vertical equity, as the extremely wealthy investment fund managers would pay tax at a higher rate; this higher tax rate is more appropriate for their high income levels under a progressive tax model.[174] Moreover, these wealthy investment fund managers are financially able to pay this higher rate of taxation because of their significant compensation packages.[175] This idea of taxing higher income earners at a higher tax rate is the basis of our progressive income tax system, and vertical equity clearly points to carried interest tax reform.[176]

Similarly, critics also claim that taxing carried interest as ordinary income aligns with horizontal equity.[177] Specifically, taxing carried interest as ordinary income would put fund managers on the same basis as other similarly situated service-providing taxpayers.[178] Critics adopt what is called the "labor services view," in which carried interest should be taxed as ordinary income, as it most closely resembles wages.[179] Economists consider most of carried interest to be performance-based compensation for the general partners rather than a return of previously invested capital as the tax code currently treats it.[180] Carried interest is paid to private investment fund managers as an incentivization device similar to the bonus-heavy compensation structure in investment banking.[181] Investment bankers and other professionals pay ordinary income tax rates on their salaries and bonuses.[182] Furthermore, for most service providers, their income is

171. Hsu, *supra* note 80.
172. Fleischer, *Two and Twenty*, *supra* note 21, at 59.
173. Marron, *supra* note 39, at 1–2.
174. *See* Feldman, *supra* note 14, at 523.
175. *See id.*
176. *See id.*
177. *See id.*
178. *See id.*
179. *See* Marron, *supra* note 39, at 1–2.
180. *See The Taxation of Carried Interest*, *supra* note 1, at 1.
181. *See id.* at 7.
182. *See id.* at 5.

treated as ordinary income and taxed at the applicable rates.[183] Thus, critics believe carried interest should be treated as ordinary income, notwithstanding that the underlying investments generate capital gains.[184]

Moreover, commentators also argue that taxing carried interest as ordinary income would be best for economic neutrality.[185] Specifically, critics claim that the preferential tax treatment of carried interest is persuading individuals to become investment fund managers instead of pursuing other careers as potential doctors, lawyers, and scientists, for example.[186] Thus, commentators argue that this is problematic on an economic neutrality basis, as the tax law should not have such a significant impact upon taxpayer decision-making, and there is no need to encourage individuals to become investment fund managers.[187]

Commentators also argue the ease of administrability and enforcement shows that carried interest should simply be taxed as ordinary income.[188] Specifically, commentators can claim that taxing carried interest as ordinary income would be relatively easy for the government.[189] If carried interest is simply treated as ordinary income, the government would no longer need to track investment holding periods related to carried interest taxation or request as much investment information for investment fund managers' individual tax returns.[190] Moreover, there would be no need to determine which portion of carried interest constitutes labor income and investment income as required by various proposals.[191] Carried interest would simply be categorized and taxed as ordinary income without any of these additional steps.[192]

Critics also rely on a variety of fiscal policy rationales to show the benefits of treating carried interest as ordinary income.[193] Specifically, commentators who criticize the current law claim that taxing carried interest as ordinary income would raise significant tax revenues.[194] It is estimated that private investment funds currently have over $2

183. *Id.*
184. *Id.* at 1.
185. *See* Feldman, *supra* note 14, at 523.
186. *See id.*
187. *See id.*
188. *See id.* at 524.
189. *See id.*
190. *See id.*
191. *See id.*
192. *See id.*
193. *See* Fleischer, *Carried Interest Tax*, *supra* note 12.
194. *See id.*

trillion under management.[195] Thus, the gains made upon such a large principle have significant tax revenue implications. It is very difficult to ascertain the tax revenue implications of treating carried interest as ordinary income, as carried interest is based upon fund performance relying on numerous economic factors.[196] By some estimates, taxing carried interest as ordinary income would raise as much as $180 billion over ten years.[197] Critics identify public programs that could be funded or governmental debt that could be paid down with such an increase in tax revenues.[198]

Critics also rely on general public policy-based arguments. Specifically, critics emphasize the public outrage of the preferential tax treatment of carried interest.[199] Famed investor and philanthropist Warren Buffet, has made public comments emphasizing the ramifications of the preferential tax treatment of carried interest.[200] Buffet found it absurd that private investment fund managers might pay taxes at a lower effective tax rate "than our receptionists do or our cleaning ladies."[201] Critics also point to general morality and distributive justice-based arguments.[202] Distributive justice-based arguments focus on the apportionment of goods in consonance with the best interests of society.[203] Thus, critics point to the distributive justice concerns that the tax law allows some of the world's wealthiest individuals to pay a lower effective tax rate than middle-class earners.[204] Critics claim such a reality is both untenable and unfair.[205]

B. The Proponents of the Current Carried Interest Tax Law

Proponents of the tax treatment of carried interest as long-term capital gains rely on their own tax policy, fiscal policy, and general

195. Fleischer, *Two and Twenty*, *supra* note 21, at 35.
196. Fleischer, *Carried Interest Tax, supra* note 12.
197. *See id.*
198. *Id.*
199. *See* Feldman, *supra* note 14, at 515.
200. *See id.*
201. *See id.*
202. Fleischer, *Two and Twenty*, *supra* note 21, at 5.
203. *See Distributive Justice*, MERRIAM-WEBSTER DICTIONARY, https://www.merriam-webster.com/dictionary/distributive%20justice [https://perma.cc/H2GQ-EVS3] (last visited Mar. 7, 2019) ("[T]he justice that is concerned with the apportionment of privileges, duties, and goods in consonance with the merits of the individual and in the best interest of society.").
204. Fleischer, *Two and Twenty*, *supra* note 21, at 5.
205. *See id.* at 4–5.

public policy-related arguments.[206] In terms of tax policy, proponents of the current tax law claim that treating carried interest as a long-term capital gain satisfies horizontal equity.[207] Specifically, proponents of the current tax law advocate for the "entrepreneurship view" that carried interest serves as a reward for fund managers who help new ventures prosper, businesses improve, and create greater business value.[208] Proponents emphasize the similarity of managing a private investment fund to the work of entrepreneurs that start new businesses and treat a portion of their returns as capital for contributing "sweat equity."[209] Specifically, since it is so difficult to measure the performance of sweat equity, the American tax system usually allows labor income to be converted to capital.[210] Thus, proponents claim carried interest should be treated as long-term capital gains, like the gains of angel investors and entrepreneurs who risk financial capital and sweat equity in businesses.[211]

Proponents, including fund managers themselves, make another horizontal equity-based argument by claiming that carried interest is more appropriately taxed as a long-term capital gain because it is completely dependent upon the vicissitudes of the markets.[212] If a fund manager does not make the right investments and as a result does not reach the agreed upon profitability threshold, he or she will not receive carried interest.[213] Unlike an attorney's or banker's compensation, carried interest has this commonality with sales of securities and other transactions treated as capital gains.[214] Although bonuses and certain salary agreements are not always guaranteed, carried interest's additional and significant reliance upon market forces renders it more appropriately taxed as a capital gain.[215]

Furthermore, proponents of the current carried interest tax law claim that any perceived horizontal inequity resulting from the taxation of carried interest stems from the preferential tax treatment of long-

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206. *See* Feldman, *supra* note 14, at 523–24.
207. *See id.* at 523.
208. Marron, *supra* note 39, at 2.
209. *Id.*
210. URBAN INST. & BROOKINGS INST., *supra* note 109.
211. *See id.*
212. Gerry Langeler, *Another View: In Defense of Carried Interest*, N.Y. TIMES (May 20, 2010), https://dealbook.nytimes.com/2010/05/20/another-view-in-defense-of-carried-interest/ [https://perma.cc/JB6G-AM45].
213. *See id.*
214. *See id.*
215. *See id.*

term capital gains.[216] Specifically, proponents claim that carried interest taxation is simply an application of the tax code to a particular situation.[217] The large tax savings derived from the current system should not be dealt with by adjusting carried interest tax law. Instead, the issue should be addressed by revising the tax treatment of long-term capital gains generally.[218] Thus, proponents claim that dealing with preferential capital gains tax rates directly would be more effective and efficient than disturbing existing carried interest tax law.[219]

Proponents of the current tax law also emphasize the ease of administrability and enforcement of simply leaving carried interest taxation alone.[220] Specifically, these proponents claim that treating carried interest as a long-term capital gain does not put any extreme logistical strain on the IRS.[221] Proponents emphasize that the current tax treatment of carried interest avoids any intensive factual analysis requiring research and fact gathering.[222] Therefore, treating carried interest as a long-term capital gain avoids the need to differentiate between labor and investment income or to deduce which income was generated by investment services partnerships or other types of partnerships.[223]

Proponents of the preferential tax treatment of carried interest also rely upon the basic principles of partnership taxation.[224] Specifically, proponents claim that the basic principles underlying Subchapter K clearly support the preferential tax treatment of carried interest.[225] As codified in Subchapter K, partnership tax law as a whole is designed to tax partners in a manner similar to which they would be taxed at the individual level.[226] If general partners of private investment funds directly invested in portfolio companies, or purchased and sold shares

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216. *See* David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 VA. L. REV. 715, 763 (2008).

217. Tax experts claim that the tax savings associated with carried interest is simply an application of the broader capital gains tax law. Therefore, the preferential tax treatment of carried interest should be addressed by reforming capital gains taxation as a whole, rather than by reforming capital gains taxation as it applies to carried interest. *See id.*

218. *See id.*

219. *See id.*

220. *See* Feldman, *supra* note 14, at 524.

221. *Id.*

222. *See id.*

223. *See id.*

224. *See id.* at 545–47.

225. *See id.*

226. *See id.*; I.R.C. § 701 (2019).

of public companies for a profit, it is clear that any profits received would be characterized as capital gains.[227] For example, if instead of raising capital by receiving contributions from limited partners, general partners simply borrowed money from limited partners and then used these loans as contributions to the fund, it is likely that any profits generated would be treated as capital gains.[228] Proponents claim that since the general partner would be viewed as the owner of the borrowed funds, any investments made would be viewed as direct investments by the general partner and any profits would be characterized as capital gains.[229]

Furthermore, proponents emphasize that the flow-through taxation of partnerships can be a significant advantage and fundamental reason for choosing to form a partnership.[230] Moreover, proponents state that partnership tax law is designed to permit investors to conduct businesses, including investment-related businesses, in a flexible arrangement without any additional entity level tax.[231] Proponents claim these fundamental principles indicate that any investment income earned by private investment fund managers must keep its capital characterization regardless of any labor performed to produce such returns.[232]

Proponents also rely on an array of fiscal policy rationales to maintain the current tax treatment of carried interest.[233] In terms of economic growth, proponents emphasize that higher taxes generally impede economic growth by stifling economic investment and entrepreneurship.[234] Moreover, proponents claim applying a higher tax rate to carried interest would be far above the revenue maximizing tax rate.[235] These proponents argue that private investment funds help fuel businesses, help businesses become more efficient, and create jobs.[236] Thus, proponents claim that changing the preferential tax

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227. *See* David A. Weisbach, *The Taxation of Carried Interests in Private Equity* 2 (John M. Olin Program in Law and Econ., Working Paper No. 365, 2007).

228. *See id.* at 26–27.

229. *See id.*

230. The flow-through taxation of partnerships allows partners to be taxed at the individual level and can offer significant tax advantages, such as recognizing gains at individual income rates. *See* I.R.C. § 701; Feldman, *supra* note 14, at 546–47.

231. *See* Feldman, *supra* note 14, at 546–47.

232. *See id.*

233. *See id.* at 524.

234. *See id.*

235. *See id.*

236. *See* Swenson, *supra* note 13, at 5.

treatment might cause funds to relocate or close, which will hurt economic growth.[237]

Proponents also emphasize that the current tax treatment of carried interest enhances economic stability.[238] Specifically, proponents emphasize that billions of dollars are contributed into private investment funds each year,[239] and moreover, investment funds have trillions of dollars under management.[240] Increasing the tax rate on carried interest could cause private investment fund managers to invest less into funds.[241] Furthermore, an increase in the taxation of carried interest might cause private investment fund managers to charge a higher rate of carried interest to offset higher taxes, causing investors to invest less to avoid these higher fees and a decrease in contributions might decrease returns to investors.[242] Thus, proponents claim that reformation of the current carried interest law would create significant economic instability, as the increase in taxation of carried interest might cause an overall reduction in contributions to private investment funds.[243]

Furthermore, proponents also claim that taxing carried interest as ordinary income would not significantly raise tax revenues.[244] Specifically, they point to studies performed by the Joint Committee on Taxation, which estimate that such a tax change would only raise about $14 billion from 2019 through 2028.[245] Moreover, with a national debt of $22 trillion, these proponents emphasize that such small revenues would have a minimal practical effect on the national budget.[246] Furthermore, proponents go even further by claiming that increasing the taxation of carried interest would actually *decrease* tax revenues.[247] Specifically, these proponents claim that tax reform in this

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237. *Id.* at 23.

238. *See* Feldman, *supra* note 14, at 524.

239. *See id.*

240. Fleischer, *Two and Twenty*, *supra* note 21, at 35.

241. *See* Feldman, *supra* note 14, at 524.

242. *See id.* at 524–25.

243. *See generally id.*

244. *See* CONG. BUDGET OFFICE, TAX CARRIED INTEREST AS ORDINARY INCOME (2018), http://www.cbo.gov/budget-options/2018/54795 [https://perma.cc/B5M3-9DRH].

245. *Id.*

246. *See generally id.*; *see also* Bill Chappell, *U.S. National Debt Hits Record $22 Trillion*, NAT'L PUB. RADIO (Feb. 13, 2019), https://www.npr.org/2019/02/13/694199256/u-s-national-debt-hits-22-trillion-a-new-record-thats-predicted-to-fall [https://perma.cc/P39E-3NT3].

247. *See* Feldman, *supra* note 14, at 524.

area would disincentivize fund investment activity and lead to less tax revenues due to decreased fund revenues.[248]

Proponents of the current tax treatment of carried interest also claim that tax reform in this area would reduce employment in the American financial sector.[249] Since an increase in taxation would potentially reduce the amount of capital contributed to private investment funds, the funds available to maintain employment levels would also be reduced.[250] Thus, proponents claim that carried interest tax reform would potentially lead to an outsourcing of jobs to foreign nations that have more favorable tax codes, decreasing employment and tax revenues in the process.[251]

Lastly, proponents of the current tax treatment of carried interest highlight the issue of investor fairness.[252] Investors and private investment fund managers negotiate these fee arrangements, which are often very extensive and likely involve high agency costs.[253] A central aspect of the fee arrangement involves the current preferential taxation of carried interest.[254] Proponents claim altering this significant area of tax law will assign risk to investors who have already negotiated these agreements, fundamentally altering the economic relationships of investors and managers.[255] Specifically, since agreements usually involve clawback and tax distribution provisions, proponents claim a change in the taxation of carried interest might cause fund managers to make riskier investments.[256] Therefore, a change in the taxation of carried interest would essentially cause a shifting of risks to investors without any consideration.[257] Proponents claim altering the current tax

248. *See id.*
249. *See id.* at 524–25.
250. *See id.*
251. *See id.*
252. *See id.* at 547–48.
253. *See id.*
254. *See id.*
255. *See id.*
256. *See id.* Fund agreements typically include clawback provisions. A clawback provision indicates whether and how much of a carried interest a private investment fund manager must return to the fund if early distributions of carried interest exceed the profit to which the manager was ultimately entitled. This is one of the most significant economic provisions in a fund agreement. Moreover, funds also typically include tax distribution provisions. Specifically, tax distribution provisions are made to certain partners in an amount to enable a partner to pay tax on income allocated to that partner. These distributions are extremely significant and usually are prioritized over other distributions. Heather M. Field, *The Return-Reducing Ripple Effects of the "Carried Interest" Tax Proposals*, 13 FLA. TAX REV. 1, 13, 33 (2012).
257. *See* Feldman, *supra* note 14, at 547–48.

treatment of carried interest would produce unintended and indirect economic consequences to parties who contracted under the current tax law.[258]

III. Moderate Reform and Its Importance to Urban Areas

Although both critics and proponents of the preferential tax treatment of carried interest make strong arguments, a compromise is clearly necessary. Carried interest should be neither solely taxed as a capital gain nor as ordinary income. A moderate revision of Section 1061 would allow legislators to effectively balance the incentivization benefits of the preferential tax treatment of carried interest, while also taxing more carried interest at ordinary income rates. An increase in the holding period requirement from three years to a period in the range of five to seven years, a more expansive definition of "related parties," and bringing other investment types under its purview are potential avenues to consider.[259] Furthermore, the importance of private investment funds is especially evident in urban areas. Thus, legislators must be especially cognizant of the economic growth that funds bring to cities and states, such as New York City and New York.[260]

A. Section 1061: A Balancing Act

While both sides of the debate on the carried interest taxation law present strong arguments, neither side is completely correct. If carried interest is solely taxed as a capital gain, the government will lose tax revenues and public outrage would continue to be significant.[261] Yet, if carried interest is taxed as ordinary income, individuals might not enter the industry or invest in certain urban areas.[262] Thus, instead of solely taxing all carried interest as ordinary income or completely retaining the preferential tax treatment, the appropriate middle ground would be to strengthen Section 1061 by increasing its holding period requirements, expanding its definition of related parties, and bringing different investment types under its purview.

The three-year holding period requirement of Section 1061 must be increased to have any significant effect upon private investment fund

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258. *See id.*
259. *See generally* I.R.C. § 1061 (2019).
260. *See* Swenson, *supra* note 13, at 3.
261. *See* Fleischer, *Two and Twenty*, *supra* note 21, at 5.
262. Swenson, *supra* note 13, at 14–15.

managers, especially PE fund managers.[263] Legislators, however, must also weigh the potential disincentivizing effects that a long holding period requirement may have upon fund managers.[264] A potential solution would balance the public benefits of a longer holding period requirement with the drawbacks and incentivization issues associated with a longer holding period.[265] Since PE fund managers generally hold investments for much longer than three years, the current version of Section 1061 is virtually ineffective.[266] Although it is difficult to calculate an optimal holding period requirement, a holding period of five to seven years would be sufficient, as it is sufficient time to capture certain activities of fund managers, but it is not overly restrictive.[267] For example, in 2017, only 27% of PE fund investments were held for less than three years[268] — the median holding period of PE fund investments was around 5.2 years.[269]

Therefore, a five- to seven-year holding period would bring certain PE and hedge fund managers under the purview of Section 1061, allowing the statute to have a meaningful impact upon the taxation of carried interest.[270] Nonetheless, PE fund managers who hold investments longer than the five- to seven-year holding period would still be rewarded with the preferential tax treatment of carried interest.[271] Moreover, for hedge funds, a holding period of five to seven years would continue to have a small effect upon hedge funds that focus upon very short-term investments (such as less than one year), as these fund managers already fall under the purview of Section 1061.[272] Yet, a five- to seven-year holding period requirement would affect hedge fund managers who hold investments for an intermediate period of time (five to seven years).[273] Furthermore, such a holding period would still allow hedge fund managers who hold investments for longer than

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263. *See* Coughlin, *supra* note 117 (discussing the shortcomings of the three-year holding period requirement).

264. *See* Swenson, *supra* note 13, at 14.

265. *See id.*

266. Coughlin, *supra* note 117.

267. *See generally id.* (discussing the advantages of holding periods longer than three years).

268. Adam Lewis, *3 Ways US Tax Reform Will Impact Private Equity*, PITCHBOOK (Mar. 1, 2018), https://pitchbook.com/news/articles/3-ways-us-tax-reform-will-impact-private-equity [https://perma.cc/5DX8-ZCZQ].

269. *Id.*

270. *See generally* Coughlin, *supra* note 117.

271. *See id.*; I.R.C. § 1061 (2019).

272. I.R.C. § 1061; *see* Coughlin, *supra* note 117.

273. I.R.C. § 1061; *see* Coughlin, *supra* note 117.

five to seven years to enjoy the preferential tax treatment of carried interest.[274]

The definition of "related parties" in Section 1061 should also be revised to explicitly bring in the Section 318(a)(2) attribution rules to define a "related party."[275] Section 1061 currently opens the door for fund managers to avoid Section 1061 by having relatives or colleagues create certain legal entities.[276] Specifically, because the attribution rules from partnerships, estates, trusts, and corporations are currently absent from Section 1061, a private investment fund manager can distribute carried interest directly to a business entity owned by a related party and, thus, avoid Section 1061's holding period requirements.[277] If the Section 318(a)(2) attribution rules from partnerships, estates, trusts, and corporations applied, then fund managers could not contribute their carried interests to such entities.[278]

Additionally, due to the sophistication of fund managers, legislators should consider further expanding the definition of "related parties" to include "siblings," "aunts," and "uncles."[279] Moreover, revising Section 1061's "related party" section to include persons who performed a service within the preceding ten calendar years would make Section 1061 more effective.[280] Section 1061's "related parties" section only includes former colleagues of the previous three years, allowing fund managers to have former colleagues assist them in avoiding the restrictions.[281] Thus, classifying all colleagues within the previous ten calendar years as "related parties" would avoid this possibility by requiring a longer period to pass before such transactions would be considered to be at arm's length.[282] The "related parties" definition in Section 1061 should not leave any options open for fund managers to circumvent Section 1061 by employing such tax planning strategies.[283]

An additional, necessary revision to strengthen Section 1061 involves bringing direct investments in operating businesses under its

274. I.R.C. § 1061; *see* Coughlin, *supra* note 117.
275. I.R.C. §§ 1061, 318; Coughlin, *supra* note 117.
276. I.R.C. § 1061; Dolson et al., *supra* note 9.
277. I.R.C. § 1061; Dolson et al., *supra* note 9.
278. I.R.C. §§ 1061, 318; Dolson et al., *supra* note 9.
279. I.R.C. §§ 1061, 318.
280. *Id.* § 1061.
281. *See id.*
282. *See id.*
283. *See id.*; Dolson et al., *supra* note 9.

purview.[284] Specifically, an operating business produces goods or services, whereas a holding company only owns assets.[285] Currently, the specified assets of Section 1061 do not include investments in operating businesses,[286] allowing private investment fund managers to avoid Section 1061 by solely investing in joint ventures engaged in operating businesses.[287] Since governments want to encourage investing in operating businesses for job creation purposes, a similar balancing act would be required. Categorizing investments in operating businesses as specified assets under Section 1061 would not be overly effective, as many private investment funds hold investments in operating businesses for long periods (i.e., more than three years) to improve operations before an eventual sale.[288] Therefore, these investments would easily satisfy the holding period requirements under the current version of Section 1061.[289] Yet, adding operating business investments into Section 1061's specified assets would cover any opportunities for fund managers to purchase an operating business for a quick sale.[290] Thus, categorizing investments in operating businesses as specified assets along with the aforementioned holding requirement of five to seven years would effectively balance tax revenue considerations with potential incentivization issues.[291]

Another potential revision that would strengthen Section 1061 while maintaining certain incentivization benefits is designating a specified percentage of carried interest as ordinary income and a specified percentage as capital gains.[292] Senator Sander Levin's 2009 proposal attempted to strike such a balance.[293] In what was planned to become I.R.C. Section 710, a fixed percentage of any partnership distribution to private investment fund managers was characterized as ordinary income notwithstanding the original character of the income or

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284. I.R.C. § 1061; Dolson et al., *supra* note 9.

285. Fraser Sherman, *What Is the Difference Between an Operating Company and a Holding Company*, CHRON (Feb. 5, 2019), https://smallbusiness.chron.com/difference-between-operating-company-holding-company-10752.html [https://perma.cc/G2EA-JM4K].

286. I.R.C. § 1061; Dolson et al., *supra* note 9.

287. I.R.C. § 1061; Dolson et al., *supra* note 9.

288. *See* Dolson, *supra* note 10, at 1.

289. I.R.C. § 1061 (d)(2)(B).

290. *See id.*; Dolson et al., *supra* note 9.

291. I.R.C. § 1061; *see* Dolson et al., *supra* note 9.

292. *See* Feldman, *supra* note 14, at 528.

293. H.R. 1935, 111th Cong. (2009). Senator Levin's 2009 proposal would have been part of the Job Creation and Tax Cuts Act of 2010. *See id.*

whether it led to preferential long-term capital gains tax treatment.[294] Similarly, it would have allowed a certain percentage of carried interest to retain its pass-through capital gains character.[295] The 2009 Levin Bill proposed a 75/25 split, where 75% of profits allocated to private investment fund managers based on profits interest would be taxed at the higher ordinary income rates and 25% would maintain pass-through capital gains tax treatment.[296]

Although Section 710 received great criticism, utilizing a revised fixed-percentage treatment in Section 1061 would be effective.[297] Considering the failure of the 2009 Levin Bill, a more politically acceptable breakdown could be a 50/50 split.[298] Under this structure, 50% of profits allocated to private investment fund managers based on profits interest would be taxed as ordinary income, and a maximum of 50% would retain the preferential long-term capital gains tax treatment, if applicable.[299] Specifically, the potential capital gains portion should solely be characterized as a long-term capital gain if it would be considered a long-term capital gain under Section 1061's three-year holding period requirement.[300] Thus, this revision would establish a proposed *maximum* portion of the carried interest that could potentially be treated as a long-term capital gain if an interest has been held for at least three years.[301] Any remainder under the 50% ceiling not held for a minimum of three years would be taxed as ordinary income.[302] As a result, the federal government would gain additional tax revenues, and private investment fund managers would retain significant tax advantages.[303]

B. New York City: The Private Investment Funds Capital

Although private investment funds are primarily focused upon generating returns for investors and managers, their investment activities also have positive impacts on cities and localities.[304] The presence of private investment funds is most significant in New

294. *See* Feldman, *supra* note 14, at 528.
295. *See id.*
296. *See id.*
297. *See id.*
298. *See generally id.*
299. *See generally id.*
300. I.R.C. § 1061(d)(2)(B) (2019); s*ee* Feldman, *supra* note 14, at 530.
301. *See* Feldman, *supra* note 14, at 527.
302. *See* I.R.C. § 1061; Feldman, *supra* note 14, at 527.
303. *See* Fleischer, *Carried Interest Tax*, *supra* note 12.
304. Swenson, *supra* note 13, at 3.

York.[305] Estimates indicate that 40% of all hedge fund managers are based in New York State.[306] Moreover, these New York-based hedge funds manage 60% of all assets under management worldwide.[307] To illustrate the significance of such an amount, hedge fund managers in Connecticut, often referred to as the hedge fund capital of the world, manage only 8% of assets under management worldwide.[308]

Private investment funds directly employ 134,000 New York State residents.[309] Direct employees include fund managers, research analysts, investor relations personnel, compliance teams, in-house legal counsel, tax teams, information technology teams, and many other positions.[310] Since the investment fund industry requires outside services, it has a "ripple through" effect, including the employment of third parties that the fund hires to perform tasks.[311] Specifically, investment funds require outside consultants, lawyers, accountants, analysts, etc.[312] Thus, when factoring in these indirectly-created jobs, the investment fund industry employs an additional 236,000 New Yorkers with an average salary of over $200,000.[313] In total, the investment fund industry accounts for more than 370,000 jobs and $4.5 billion in compensation.[314] These salaries are then spent, invested, and saved, creating even more economic growth in the Empire State.[315]

Private investment funds also contribute significantly to state and local tax revenues.[316] Specifically, the industry accounts for a significant amount of New York state and local taxes paid.[317] These state and local taxes include a variety of different taxes.[318] High earners employed by investment funds usually pay high individual income tax rates.[319] Similarly, if corporations are paid, these entities

305. Charles McGrath, *New York, The Hedge Fund Capital of the Universe*, PENSIONS & INV. (Feb. 15, 2018), https://www.pionline.com/article/20180215/INTERACTIVE/180219915/new-york-the-hedge-fund-capital-of-the-universe [https://perma.cc/MK6A-BRGF].

306. *See id.*

307. *See id.*

308. *See id.*

309. Swenson, *supra* note 13, at 3.

310. *See id.* at 5.

311. *See id.*

312. *Id.*

313. *Id.* at 3.

314. *See id.* at 5.

315. *See id.*

316. *See id.* at 7.

317. *Id.*

318. *See id.*

319. *See id.*; *see also* I.R.C. § 1 (2018).

also pay income taxes to states and localities.[320] Furthermore, private investment funds also pay sales taxes, property taxes, social insurance taxes, and any other necessary fees.[321] These amounts are very significant to state and local budgets, as research suggests that the private investment funds industry contributes almost $4.5 billion per year to New York state and local tax revenues.[322]

Moreover, private investment funds also invest directly into many New York companies, such as Nature's Bounty Company and Carestream.[323] PE funds invest in many of these New York-based businesses, help to improve management and efficiency, and make the businesses more profitable.[324] In fact, American Investment Council research suggests that PE funds invested about $343.11 billion in New York companies from 2008 to 2018.[325] Perhaps more importantly, these companies employed over 200,000 citizens.[326]

Furthermore, private investment funds can earn above-market returns for investors.[327] This is especially significant to states and cities given that pension funds account for 47% of private equity fund investors.[328] In fact, the New York State Common Retirement Fund and the New York City Public Pension Fund, two of the State's largest public pension funds, have invested $26 billion in PE funds.[329] Moreover, out of all of the New York State Common Retirement Fund's asset classes, private equity investments are the highest returning asset class over both the short and long term.[330] In 2019, the New York State Common Retirement Fund enjoyed an 18.7% return on private equity investments.[331] The evidence suggests that private investment funds are helping city residents retire and save.[332]

In addition to these more obvious benefits of private investment funds, there are other less readily recognizable benefits.[333] For example, New York State's tech sector accounts for a significant

320. Swenson, *supra* note 13, at 7.
321. *See id.*
322. *See id.*
323. *See id.* at 8.
324. *See id.*
325. *See id.*
326. *See id.*
327. *See id.* at 9.
328. *See id.*
329. *Id.*
330. *Id.*
331. *Id.*
332. *See id.*
333. *See id.* at 22.

portion of the State's economy and has supported the development of newer and larger companies.[334] An important reason for the rise of tech in New York City is access to capital, primarily from New York's various private investment funds.[335] Carried interest tax reform might cause private investment funds to leave the United States, which might lead these tech companies to also relocate to nations with more access to capital.[336] Moreover, carried interest tax reform might also lead to new funds choosing to locate elsewhere.[337] Thus, the now bountiful tax base from carried interest and businesses could decrease dramatically, leaving New York State and New York City deprived of billions of dollars of tax revenues.[338]

Furthermore, private investment fund managers have grown to become not only some of New York City's highest income earners, but also the City's biggest philanthropists.[339] The competitive nature for which the industry is known has led investment fund managers to invite colleagues and competitors into philanthropic efforts and has created a competitive cycle.[340] Not only do fund managers try to outperform one another in the workplace, but they also strive to out-give one another, which has led charities to raise record amounts.[341] As uber-wealthy private investment fund managers look for charitable causes, many are attracted to local causes in New York City.[342] Moreover, these private investment fund managers are looking to be involved and take a hands-on approach to helping charities grow.[343] Thus, this leads them to turn to more community-based charities.[344]

Private investment fund managers founded and maintained some of the most well-known and influential New York City charities.[345] The Robin Hood Foundation, which is famous for fighting poverty in New

334. *See id.*
335. *See id.*
336. *See generally id.*
337. *See id.* at 23.
338. *See id.*
339. *See* Jenny Anderson, *Fund Managers Raising the Ante in Philanthropy*, N.Y. TIMES (Aug. 3, 2005), https://www.nytimes.com/2005/08/03/business/fund-managers-raising-the-ante-in-philanthropy.html [perma.cc/V939-CPRE].
340. *See id.*
341. *See id.*
342. *See id.*
343. *See id.*
344. This goes for other major cities as well. Rob Davis, founder of Hedge Fund Cares, emphasized the importance of local areas to fund managers' charitable endeavors by saying "if you live in San Francisco and you participate, don't you want to know that the Bay Area will be served by that?" *See id.*
345. *See id.*

York City, was founded by Larry Robbins, founder of Glenview Capital Management.[346] The Robin Hood Foundation's charity galas have included 4000 guests and raised up to $32 million.[347] Robin Hood supports New York City's Brooklyn Kindergarten Society, which helps New York parents get involved at a daycare center, and Abraham House Providing, which provides educational services to the children of incarcerated individuals in the Bronx.[348]

As the private investment fund industry grows, its other charitable endeavors continue to focus on helping New York City residents.[349] In 2005, Dan Stern, who runs Reservoir Capital, organized a charity event at Lincoln Center for the Hedge Fund Council featuring Jon Stewart, then-host of *The Daily Show*. The event attracted many well-known private investment fund managers, and in total, it raised $1.4 million for Lincoln Center.[350] Private investment fund managers have also created philanthropic organizations through industry groups, such as Hedge Fund Cares, which has donated more than $15 million to organizations fighting child abuse.[351]

Despite these various benefits of investment funds, many of the nation's most significant states and cities are in debt and in dire need of tax revenues.[352] Specifically, New York State is currently $56.3 billion in debt, according to the full accrual accounting method under Generally Accepted Accounting Principles (GAAP).[353] Moreover, in 2018, New York City's debt burden grew to $119 billion.[354] New York's debt has a compounding factor because it has led to higher debt service costs.[355] In fact, for city-supported debt, debt service costs alone were nearly 11% of city tax revenues in 2018.[356] Thus, initiating a higher tax

346. *See id.*; *Board of Directors*, ROBIN HOOD, https://www.robinhood.org/about-us/governance/ [https://perma.cc/74SQ-SL9Z] (last visited Mar. 8, 2019).

347. *See* Anderson, *supra* note 339.

348. *See id.*

349. *See id.*

350. *See id.*

351. *See id.*

352. *State and Local Government Debt in the United States as a Percentage of Gross Domestic Product in the 2017 Fiscal Year, by State*, STATISTA (Dec. 17, 2019), https://www.statista.com/statistics/246337/state-debt-in-the-us-as-a-percentage-of-gsp/ [https://perma.cc/C6H5-QR95]; *see, e.g.*, OFFICE OF THE N.Y. STATE COMPTROLLER, 2018 FINANCIAL CONDITION REPORT (2018), https://www.osc.state.ny.us/finance/finreports/fcr/2018/debt.htm [https://perma.cc/NUW3-G42K].

353. *See* OFFICE OF THE N.Y. STATE COMPTROLLER, *supra* note 352.

354. *See* CITIZENS BUDGET COMM'N, *supra* note 12.

355. *See id.*

356. *See id.*

upon carried interest might seem tempting to not only federal, but also New York State and New York City governments.

Given the variety of benefits which private investment funds bring to New York State and New York City and corresponding debt levels, the taxation of carried interest will continue to be a significant concern for not only national, but also state and local governments.[357] When legislators reform the current tax treatment of carried interest, they will need to balance the benefits that private investment funds provide to New York State and New York City, as well as the need to pay down rising debt levels.[358] Thus, the taxation of carried interest is especially relevant to New York State and New York City, and this debate will continue for years to come.

CONCLUSION

Private investment fund managers are some of the wealthiest people in the world.[359] Fund managers are usually compensated according to a two and twenty compensation arrangement.[360] The 2% of the compensation is deemed a management fee and is taxed as ordinary income at a rate of approximately 40%.[361] The 20% component is composed of a profits interest and is colloquially referred to as carried interest.[362] Carried interest can rise to extremely high amounts.[363] If fund managers hold the underlying asset for less than three years, the resulting carried interest is taxed as a short-term capital gain at a maximum rate of approximately 40%.[364] Controversially, if fund managers hold the underlying asset for more than three years, it is currently taxed as a long-term capital gain at a maximum rate of around 20%.[365]

In response to years of public outrage, the IRS implemented Section 1061, which requires private investment fund managers to hold carried interests for three years to qualify for long-term capital gains tax

357. *See* OFFICE OF THE N.Y. STATE COMPTROLLER, *supra* note 352; Swenson, *supra* note 13, at 3.

358. *See* CITIZENS BUDGET COMM'N, *supra* note 12; OFFICE OF THE N.Y. STATE COMPTROLLER, *supra* note 352; Swenson, *supra* note 13, at 3.

359. *See generally* Maloney, *supra* note 23.

360. *See* Feldman, *supra* note 14, at 513–14.

361. *Id.* at 517; *see also* I.R.C. §§ 1, 1061 (2018).

362. *See* Feldman, *supra* note 14, at 514.

363. *See id.* at 518.

364. *See* I.R.C. §§ 1, 1061.

365. *See id.* §§ 1, 1061.

treatment.[366] If this three-year holding period is not met, the carried interest is taxed at the higher short-term capital gains rate.[367] Although Section 1061 includes this increased holding period requirement, the revision is not without its flaws.[368] Some relatively straightforward tax planning strategies and the general nature of certain private investment funds to hold assets for far longer than three years make the statute relatively insignificant.[369]

Instead, legislators should revise Section 1061 to make it more effective.[370] Increasing the holding period requirement from three years to a period in the range of five to seven years would make Section 1061 more effective.[371] An increased holding period might capture investments of private investment funds known for holding investments for long terms, such as PE funds.[372] Moreover, legislators should expand Section 1061's definition of "related parties," particularly by adding the attribution rules of Section 318(a)(2), which disallows easy tax avoidance strategies.[373] Legislators should also consider categorizing investments in operating businesses as specified assets under Section 1061, as such a revision would bring more PE fund managers into its purview.[374] Furthermore, legislators should categorize a certain percentage of a carried interest as ordinary income and a certain maximum percentage as long-term capital gains income.[375] Specifically, legislators should allow a predetermined percentage of carried interest to be taxed as long-term capital gains provided that the manager satisfies Section 1061's three-year holding period requirement for an amount up to a maximum of 50% of the carried interest.[376] This potential 50/50 split would classify a meaningful amount of carried interest as ordinary income, but such a

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366. *Id.* § 1061.

367. *See id.* §§ 1, 1061.

368. *See* Dolson et al., *supra* note 9 (arguing "[t]he holder of the carried interest may not be able to catch-up if investments sold after the three-year holding period is achieved fail to provide the necessary amount of profits to fund the catch-up").

369. *See id.*

370. *See generally id.*

371. *See id.*; URBAN INST. & BROOKINGS INST., *supra* note 109.

372. *See* URBAN INST. & BROOKINGS INST., *supra* note 109.

373. *See* I.R.C. §§ 318, 1061 (2019); Dolson et al., *supra* note 9 (stating carried interests are typically nontaxable at time of issuance and can participate in the pass-through of long-term capital gains and be sold as a capital asset, in each case avoiding employment taxes).

374. *See* I.R.C. § 1061; Dolson et al., *supra* note 9.

375. *See* Feldman, *supra* note 14, at 527.

376. *See id.*; *see also* I.R.C. § 1061.

moderate reform would still preserve some preferential tax treatment to continue to incentivize fund managers.[377]

Despite the potential benefits of taxing carried interest at higher rates, legislators must still consider the many benefits that private investment funds bring to urban areas. New York City is home to some of the world's largest private investment funds.[378] The private investment funds industry creates substantial economic growth in New York State.[379] These private investment funds create jobs, pay taxes, and make large charitable donations to many of the City's significant charities.[380] Nonetheless, national, state, and city debt levels have risen, and there is a need for more tax revenues, which can potentially be generated by carried interest tax reform.[381]

The debate on the taxation of carried interest will continue in the coming years. Both critics and proponents of the current tax treatment of carried interest raise strong arguments.[382] As in many areas of tax law, there may not be a clear answer in the carried interest taxation debate.[383] The public needs lawmakers to address the various issues and consider all options.[384] To successfully reform the taxation of carried interest, legislators should revise Section 1061 in a way that balances the needs of society.[385] Section 1061 should do a more effective job of taxing carried interest at ordinary income tax rates, while also incentivizing private investment fund formation and its many societal benefits.[386]

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377. *See* I.R.C. § 1061; Feldman, *supra* note 14, at 527.

378. *See generally* McGrath, *supra* note 305.

379. *See* Swenson, *supra* note 13, at 3.

380. *See id.*; Anderson, *supra* note 339.

381. *See* OFFICE OF THE N.Y. STATE COMPTROLLER, *supra* note 352; Chappell, *supra* note 246.

382. *See* Feldman, *supra* note 14, at 522–26.

383. *See id.*

384. *See id.*

385. *See id.*; *see also* I.R.C. § 1061 (2019); URBAN INST. & BROOKINGS INST., *supra* note 109.

386. *See* I.R.C. §§ 1, 1061; Anderson, *supra* note 339; Dolson et al., *supra* note 9; Feldman, *supra* note 14, at 522–26; Swenson, *supra* note 13, at 3.