June 27, 2013

Carried Interest Reform for Hedge Fund Managers

John Ye

Available at: https://works.bepress.com/john_ye/5/
Carried Interest Reform for

Hedge Fund Managers

Submitted by

John Ye

2608 Woodedge Road
Silver Spring, MD  20906
(202) 210-4546
johnye@hotmail.com

Anticipated Graduation:  Spring 2013 (JD)

Tax Policy

Estrada

c/o U. of Baltimore
Graduate Tax Program
1420 North Charles Street
Baltimore, Maryland  21201-5779
(202) 622-3504
TaxPolicy@hotmail.com

Date Submitted:  May xx, 2013
I. Introduction ..................................................................................................................... 2
II. Separate Hedge Funds Tax Reform from Private Equity Reform ................................... 5
III. Economics Defense to the Tax Reform ........................................................................ 9
IV. Accounting Difficulties ............................................................................................... 13
V. New Approach is Needed for Proposed Section 710 .................................................... 17
VI. Hedge Funds Accounting Supports the Economic Reality ......................................... 19
VII. Mark-to-market Accounting Eliminates Interest on Deferred Carried Interest ........... 21
VIII. Hedge Funds Liquidity Supports the Tax Collection in Mark-to-market ..................... 22
IX. Counter Arguments on Taxing Hedge Fund Managers at Ordinary Income Rates ....... 23
X. Hedge Funds Carried Interest Cost/Benefit Analysis .................................................... 24
XI. Conclusion .................................................................................................................. 27
I. Introduction

Private investment managers’ compensation has been a hot topic since the 2012 presidential campaign. Candidate Romney’s tax returns were highly publicized by the media. Romney’s effective tax rate for his recent 2011 tax year was a paltry 14%.\(^1\) Compared to the notional tax rates on ordinary income from 10% to 40%, this would seem too low for a well-off member of our society who made over $13 million in 2011.

Romney’s response was simply that it was not unfair because most of his income was derived from his investments. To discuss fully about the rationale behind why our tax system ends up giving a preferential treatment for investment income would not necessarily make clear the real issue brought up by some of the more focused critics. The real issue is Romney’s investment income is derived from his share in Bain Capital, which is an active manager in the private equity space. In critics’ eyes, Bain Capital is nothing more than a service provider - because it gets paid for its service, not because it is an investor that putting its own capital at risk.

In general, the two dominant players in private investment - private equity and hedge funds, are operating similarly in the compensation structure.\(^2\) They generally charge 2% based on the invested capital annually as management fees.\(^3\) They also charge a

---


performance based compensation called “carried interest”. It is usually a 20% premium based on the actual profit.4

The tax convention for the 2% management fees is that, because fund managers will draw salaries and expenses from them, they will be taxed as ordinary income for that portion received. But the lion’s share of the carried interest is currently taxed at the favorable capital gains rates. That is because for federal income tax purposes a partnership is not a taxable entity. Instead, items of partnership income, gain, deductions, and losses are passed through to the partners.5

As we know, the majority of the private investment manager compensation comes from the 20% carried interest. Characterizing one’s compensation as investment income is why our critics are so vehement about, including President Obama.6 They cry out that ordinary citizens pay ordinary income rate for going to work every day, why should investment managers be any different?7 So if the carried interest reform in the proposed Section 710 is carried out, then not only carried interest is taxed at ordinary rate, it is also treated as compensation for the purposes of the Social Security and Medicare taxes under Section

4 Id.
6 Obama Questions ‘Carried Interest’ Tax Break, CNBC, (February 3, 2013, 5:33 pm), http://www.cnbc.com/id/100429960/Obama_Questions_039Carried_Interest039_Tax_Break (“President Barack Obama said on Sunday more tax revenue would be needed to reduce the U.S. deficit and signaled he would push hard to get rid of loopholes such as the ‘carried interest’ tax break enjoyed by private equity and hedge fund managers.”).
7 Should Carried Interest Be Taxed as Ordinary Income, Not as Capital Gains? The Wall Street Journal (May 14, 2012), http://online.wsj.com/article/SB100014240527023048113045777370062392150338.html (“That bit of alchemy is just what managers of private equity and some hedge firms enjoy. But there is no justification for applying the 15% capital-gains rate to the money they make for managing companies and selling them at a profit.”) (quoting Michael Graetz, a professor of tax law at Columbia Law School, who participated in the WSJ Debate topic).
1402(a).\(^8\) Despite the simplicity of the fairness argument, many tax veterans do not necessarily agree on how the 20% carried interest should be taxed.\(^9\) This is further complicated by the fact that most of these investment entities are organized under the partnership structure, and the fact that acting as a commitment for their work as a general partner, managers contribute some small portion of capital themselves.\(^10\)

This paper will try to give a closer look to some of the arguments made from both the supporters\(^11\) like Steven Rosenthal and Michael Graetz, and opponents\(^12\) like David Tuerck and Douglas Holtz-Eakin. As a high level argument, this paper will propose separating tax reform in hedge funds from private equity to avoid some of the complex issues that led to the failures of previous reform.\(^13\) Next, this paper will look at the economics behind carried interest. Then this paper will go back to the tax code to see how much work would be to recharacterize carried interest. Then this paper will take a look at the estimate on how


\(^9\) The Wall Street Journal, *supra*, ("The fuss over what Warren Buffett and Mitt Romney pay in taxes threatens to give new life to the bad idea of changing the way carried interest is taxed.") (quoting David Tuerck, executive director of the Beacon Hill Institute and a professor and chairman of the economics department at Suffolk University in Boston).

\(^10\) Abrams, Howard E., *TAXATION OF CARRIED INTERESTS*, 116 Tax Notes 183, § The Big Picture, (2007) ("Third, the adviser partner also gets a share of the final 8 percent in proportion to the relative cash contributed by the adviser partner . . . .") (hereinafter Abrams1).

\(^11\) Steven Rosenthal, Visiting Fellow at the Tax Policy Center; Victor Fleischer, Professor of University of Colorado Law School; Michael Graetz, a professor of tax law at Columbia Law School.

\(^12\) David Tuerck, executive director of the Beacon Hill Institute and a professor and chairman of the economics department at Suffolk University in Boston; Douglas Holtz-Eakin, AMERICAN ACTION FORUM; Matthew A. Melone, Professor of Lehigh University, Department of Finance and Law.

\(^13\) Professor Victor Fleischer has written a wonderful policy paper on tax reform in private equity called *TWO AND TWENTY: TAXING PARTNERSHIP PROFITS IN PRIVATE EQUITY FUNDS*, 83 N.Y.U. L. Rev. 1 (2008). In it, he proposed Congress should adopt a drastic “Cost-of-Capital” method for taxing carried interest as ordinary income, similar to taxing implied interest income in debt instruments. I would suggest that this could be a useful secondary analysis but different from the tax reform in hedge funds.
much benefit can be derived from taxing the carried interest as ordinary income. Along the way, this paper will continue to explore if there could be any new problems created. At the end, this paper will sum up the benefits and costs.

II. Separate Hedge Funds Tax Reform from Private Equity Reform

As mentioned earlier, hedge funds are similar to private equity funds in terms of organization, operation and profit sharing, but with a big difference in the assets makeup and investment duration. Hedge funds traditionally invest in liquid assets such as stocks, bonds and financial derivatives with short term investment cycle.\textsuperscript{14} Private equity funds on the other hand, invest in early stage companies - they buy portfolio companies as a whole in hope to sell them later.\textsuperscript{15} As for duration, unlike a private equity fund, which has a clear cycle of 10-15 years from formation to exit\textsuperscript{16}, a hedge fund is typically open-ended, meaning it continues operating as long as investors keep investing in the fund.

By following the partnership accounting rules and keeping the capital accounts up-to-date, each hedge fund investor knows how much is for him to realize at any given time. As each investment is brought and sold, profit and loss are reflected in his capital account. He can pull out from the hedge fund and his investment will be returned based on the capital account amount. Therefore, although the actual partnership accounting could be complicated, a hedge fund investor has considerable freedom to come and go without causing too much problem for the fund to continue to function.

\textsuperscript{15} See Id.
\textsuperscript{16} See infra note 20-22.
Although at this point, one would wonder if hedge funds are simple, then how much more difficult could it be if we also tackle private equity. The answer lies on the fact that our tax system currently has one set of rules for both industries. We cannot push through reform without considering how that would affect the two. That is what the opponents have been concerned about. There is a considerable added level of difficulty in tax reform for private equity funds. First, private equity funds typically form as investment partnerships with a small set of investors. They form by a group of investors putting capital into a partnership, then the partnership buys a number of portfolio companies, which are usually promising companies in their early stage. These portfolio companies would then go through the cycle of investment, growth, and at the end, if they are still in business, would become investment grade companies for the general public. They would either be brought by acquisitions from their competitors, or would go IPO. This is called the exit by the private equity funds. Private equity funds do not usually use capital accounts for the purpose of distribution on each portfolio’s exit. That is because private equity funds normally use the “waterfall” agreement, which is a custom made agreement that dictates how to divvy up the cash. As each portfolio is cashed out, cash would be returned first to investors to pay back their investment plus interest. Next, if there is still cash left as profit, then the profit will be shared 20/80 between fund manager and investors. There are no opportunities for new investors to come in, or for existing investors to pack up and leave early. This is because the investment horizon for private equity funds is usually 5-6 years.

---

17 See Fleischer, supra, note 23, at 8 (“As part of the private equity fund’s portfolio of investments, the companies acquired by private equity funds are commonly known as ‘portfolio companies.’”).
18 See id., at 9-10.
to buy companies to completely liquidate. The actual performance of the fund is unknown until all the way at the end.

Opponents like David Tuerck would argue that, don’t reform the rules because it is easy to do with hedge funds – but also look at the differences in private equity funds. If we recharacterize hedge fund manager compensation to ordinary income due to the short term nature, then how could we use the same rationale to recharacterize private equity manager compensation? That is because with 10-15 years investment horizon, it would be unfair to say it is not investment - because they might not see a dime until the very end, in case it is still profitable.

It is clear that at this point that the one size fits all approach would not work. Hedge funds are different from private equity. The ambitious attempts of tax reform under the proposed Section 710 demonstrated this point:

The basic thrust of proposed section 710 is that distributive share of partnership income should be treated as compensation income to the extent

---

21 Id. at 122.
22 The average holding period varies depending on market conditions. See A Boom in Bust-Ups, Economist, Sept. 29, 2007, at 92 ("Carlyle's boss, David Rubenstein, told a recent private-equity conference that the average holding period is likely to rise to four to six years, far above today's levels.").
23 See The Wall Street Journal, supra, ("The role of a private-equity firm is to take upon itself the job of doing the sweating that investors would have to do were they to manage the start-up or turnaround themselves.") (quoting David Tuerck).
it is attributable to the contribution of a “substantial quantity” of investment activity services to the partnership. The crucial term “investment services partnership interest” is defined in proposed section 710(c)(1) to mean a partnership interest if the partner provides to the partnership any of the following services: (1) advising as to the advisability of investing in, purchasing, or selling any “specified asset”; (2) managing, acquiring, or disposing of any “specified asset”; or (3) arranging financing with respect to acquiring “specified assets.” In this context, a “specified asset” includes securities, commodities, and real estate. Under the general rule of proposed section 710(a)(1), the net income with respect to an “investment services partnership interest” must be treated by the partner as ordinary income without regard to the character of the partnership’s activity.25

For the purpose of Section 710 analysis, we will assume that private equity funds are targeted because they could invest in securities and Chairman Rangel confirmed that was the intention.26

In an analysis of the proposed Section 71027 that took dozens of pages, Professor Howard Abrams took considerable efforts to bring out the complexity of plugging in the proposed Section 710 to the partnership subchapter K accounting rules. The details were so exhaustive in part because Section 710 tried to wring out investment return from the carried interest. But no matter how much pains it will take to approximate accounting principles with the goal to wring out investment return from the carried interest, it is impossible to reconcile with the economics of private equity. That is because private equity funds do not use capital accounts for distribution. Instead, they use the proprietary “waterfall” agreements. Again, I am not advocating to completely letting go on the idea on

26 See CHARLES B. RANGEL, Stop the Middle-Class Tax Raid, The Wall Street Journal, October 30, 2007, available at http://online.wsj.com/article/SB119370139740175633.html (“In order to achieve broad tax relief without increasing the national debt, this legislation restructures benefits provided at the upper income levels. The bill would also end the preferential and lucrative tax treatment currently enjoyed by private equity and hedge fund managers.”).
27 Id.
taxing Mr. Romney a higher rate for the portion that he would earn as a hardworking man and not as a collateral investor. I think it is just not worth it by drawing private equity into the fight with rules that are so inconconsiderate of the economics. Instead, if we just impose the rules on only hedge fund types of investment entities, by virtue of using the capital accounts for allocation, distribution and liquidation, we are already compatible with what it needs to tax hedge fund managers on the portion that is other than return on capital.

III. Economics Defense to the Tax Reform

To win tax reform, taxation must follow the economics. As the preceding section alluded to, supporters of tax reform cannot avoid talking economics, especially in the midst of economics muddle. Perhaps sensing long ago that their carried interest could be scrutinized under the microscope, investment managers came up with an ingenious way to deflect the assault. They started contributing a small amount of capital into the funds to become credible investors themselves. Even the amount is usually small, about 1%, the ramification is profound. Coupled with the flexible partnership structure, this 1% of investment becomes the basis for receiving the 20% of profit by way of carried interest. Even the term “carried interest” has certain connotation of legitimacy in that the interest is carried over from the partnership. Nowhere in the partnership rules says a partner cannot receive more allocation than other partners. That is especially true in service partnerships,

---

28 For a detail economics attack, see Holtz-Eakin, et al., The Tax Treatment of Carried Interest, AMERICAN ACTION FORUM, JUNE 2010, available at http://americanactionforum.org/files/TaxTreatmentCarriedInterest_0.pdf. (Simply stating that the carried interest is compensation for services ignores the economic relationship of the partners in the partnership.)
29 Abrams, supra, 116 Tax Notes 183, at § Carried Interests (“Carried interests can arise in almost limitless ways, and the owner of a carried interest often owns a capital interest as well.”).
30 Harvard Law Review Association, supra, 124 Harv. L. Rev. 1773, 1796 (2011) (“The GP often contributes a small amount of capital to the partnership as well. See Fleischer, supra note 9, at 8 (noting that LPs prefer the GP to have some “skin in the game” for incentive purposes (internal quotation marks omitted)). In fact, the GP was once required to contribute at least 1% of the starting capital to an investment partnership.”).
given that the general partner not only contributes his service to manage the partnership, but also taking unlimited liability. Also, investment managers would argue that having a stake in the game is good for the funds. That is because in order to align the interest of the principal (in this case, the investors) and agent (the managers), agent must be on the hook for loss as well. Therefore, the capital contribution is not just a nicety, but a necessity.\textsuperscript{31}

Supporters of reform like Victor Fleischer\textsuperscript{32} then argue that just like their close cousins the mutual funds managers, private investment managers should be taxed ordinary income. On the surface, that is a good argument. It is true that all of the mutual fund management fees and bonus would be taxed as ordinary income. But the private investment industries are special. Inherently there is a higher risk in the nature of their investments. Unlike mutual funds, which only invest in low risk, lower yield instruments, and whose performance depends largely on the overall economic condition,\textsuperscript{33} private investments are on the hook for big losses if they do not significantly outperform the risk.\textsuperscript{34} Therefore, detractors\textsuperscript{35} would say, precisely because of the economics, it is OK that the majority of the private investment compensation is in the form of profit interest, which is truly a risk

\textsuperscript{31} Cf. Victor Fleischer, Regulatory Arbitrage, 89 Tex. L. Rev. 227, 278 (2010) (principals designing of agents’ compensation would have taken regulatory costs into account, by unifying their common interest).

\textsuperscript{32} Cf. Victor Fleischer, Taxing Blackstone, 61 Tax L. Rev. 89, 100 (2008) (“That statute establishes detailed rules for the operation of mutual funds and other investment vehicles. The 1940 Act defines ‘investment company’ broadly to include, among other things, any issuer engaged primarily in the ‘business of investing, reinvesting, or trading in securities . . . [t]his point is easier to understand by thinking of Blackstone as a diversified financial services firm similar to Citigroup or Goldman Sachs, not an investment vehicle like a Fidelity mutual fund.”)

\textsuperscript{33} See Mutual Fund, Wikipedia, available at http://en.wikipedia.org/wiki/Mutual_fund (“The four main categories of funds are money market funds, bond or fixed income funds, stock or equity funds and hybrid funds.”).

\textsuperscript{34} See John Rutledge, Analysis of the Impact of Increasing Carried Interest Tax Rates on the U.S. Economy, Part II 19 (2007), available at http://www.uschamber.com/reports/analysis-impact-increasing-carried-interest-tax-rates-us-economy-0 (“The GP may face more risk than the LPs because he must clear a hurdle rate before seeing any partnership profit at all.”). Although one could argue that lawyers on contingent fees are facing just as much risk and still pay ordinary income tax - but without capital outlay, it is distinguishable from investment risk because lawyers risk their fees, not their capital in that regard.

\textsuperscript{35} See supra, note 12, at 4.
adjusted investment return.\textsuperscript{36} In addition, some of the distribution agreements call for total investor's return first. That means if there is a loss, fund managers could lose their own capital investment. It would be hard to image investors would hand over their money to private investment if their managers would structure their compensation to have a much lower risk profile than they do. Using the same principal/agent paradigm argument, it would be too harsh to tax an agent at the ordinary income rate, and at the same time, tax the principals at a lower rate. Again, hedge funds don't have all of these problems because they follow capital account rules.

Steve Rosenthal, a Visiting Fellow at the Tax Policy Center, suggests a radical argument in proposing taxing everyone, including the investors, at ordinary income rate for their investment.\textsuperscript{37} His argument goes, just like the real estate portfolio partnerships that invest, fix up and resell their portfolio real estate, as the ordinary business activities, private investments are no different. In comparison, private investments would buy companies, rehabilitate them, and resell them much like other lines of business. If real estate portfolio partnerships pay ordinary income rate, why not tax private investment partnerships ordinary income rate?

There is no question about the correctness of this analogy, especially given Mr. Rosenthal's prestigious affiliation with the Tax Policy Forum and over 25 years of

\textsuperscript{36} “The management fee finances the day to day operations of the PE firm, including employee salaries and office rent. The typical management fee has been falling from two to 1.4 percent recently, as fund sizes have grown and as PE has become more competitive. Appropriately, investors want PE firms to be more dependent on generating returns than on fees.” Public Value: A Primer on Private Equity, Private Equity Council (2007), available at http://www.privateequitycouncil.org/wordpress/wp-content/uploads/pec_primer_layout_final.pdf.

experience in tax policy. On the other hand, even a third year law student could come up with an opposite argument to this simplification. Do we really want to go down the path of taxing ordinary rate on every investment activity that has the investing, holding and reselling components? Because at some point, one would have to ask what is the purpose of having a preferential rate on investment after all?

Almost all investments would have some active participation involved. If one buys some company's stocks, spends time reading their quarterly reports, goes to the shareholders meetings, doing enough to be properly labeled as a shareholder activist, would that mean we are going to tax him at ordinary rate when he sells his stocks? If that is not enough of a business purpose, what if he does it for two or three times? Maybe there should not even be a special capital gains rate given that in Tax Reform Act of 1986, such capital gains rate was made the same as ordinary income rate. But if we assume there is a good cause to encourage investment activities through a special capital gains rate, then we should stick with it for now and leave such debate to society and policy makers.

A final argument that could be made to all critics like Mr. Rosenthal is that, just look at the bigger picture in the deferred employment benefits, such as stock options. After all, Steve Jobs did not make most his money from his salaries. He made most of his money from the stock options. He was certainly in the business of investing, building, and selling the

---

40 "Although Jobs earned only $1 a year as CEO of Apple, Jobs held 5.426 million Apple shares worth $2.1 billion, as well as 138 million shares in Disney (which he received in exchange for Disney's acquisition of Pixar) worth $4.4 billion. Jobs quipped that the $1 per annum he was paid by Apple was based on attending one meeting for 50 cents while the other 50 cents was based on his performance. Forbes estimated his net wealth at $8.3 billion in
Apple Company. In fact, he probably did so for quite a few companies.\textsuperscript{41} Almost anyone who
has employee stock option is in the active business of investing, building and selling a
portion of a business.

Hedge funds stand between private equity and mutual funds in terms of economics. As
explained in II, supra, hedge funds tax reform should be separated from private equity in
order to justify the economic differences.

The goal of carried interest reform requires one be able to separate the fund manager’s
capital return from the total profit interest.\textsuperscript{42} One has to decide how much return should be
allocated for the capital investment. In our case, should the manager’s capital investment
be entitled for market capital return? And how much capital return should be allocated out
of the total distribution? These two questions are critical because capital gains should be
taxed at capital gains rate. Given the discussion of the economics up till now, a sensible
answer would be yes, the manager’s capital investment should be entitled for capital return,
and such capital return rate should be at the same rate as that of investor partners.

\textbf{IV. Accounting Difficulties}

As a conceptual matter, the carried interest return is composed of three distinct
elements: (1) the initial (and hard to value) fair market value of the services provided; (2)

\textsuperscript{41} Id.

\textsuperscript{42} “However, proposed Section 710 does not recharacterize as compensation that portion of a partner’s
distributive share reasonably allocated by the partnership to the “invested capital” of the partner owning an
“investment services partnership interest.” For this purpose, an allocation will not be considered reasonable if it
results in an allocation of income to the ‘invested capital’ of a partner providing investment services in excess of
the amount that is allocated to the same amount of ‘invested capital’ of any other partner not providing
investment services. “Invested capital” includes the amount of cash contributed by a partner as well as the fair
market value of other property contributed by the partner (measured as of the date of contribution of the
property).” Abrams3, \textit{supra}, at III.
an interest element reflecting deferred payment on the initial value of the services provided; and (3) a risk premium reflecting the willingness of the service partner to invest his return on the continued success of the venture.43

To understand the frustration on the inaction for carried interest reform, one has to understand that what a challenging task it would be to distinctively tax carried interest as ordinary income in the context of partnership taxation. As a conclusively stated assessment, because private investment entities are built on the foundation of partnership taxation, the two are inextricably linked by the intricacy of partnership taxation. To phrase it differently, if we can’t extricate the private investment industry from the maze of partnership taxation altogether, to apply the new partnership rules in the proposed Section 710 specifically to the private investment industry is to burden the industry unnecessarily.

The basic capital account principles that govern investment portfolio management are in the partnership subchapter K § 704 provisions.44 Under § 701, there is no partnership level taxation.45 Under § 702, investment incomes/losses pass through from partnership level to partners not necessary at the same time of distribution, and carry the characters with them into the hands of partners.46 The overall goal in partnership tax regime is to promote freedom of business association and formation, without the overhead of a formal corporation structure. It is a suitable structure for business associates having a comparable sophistication or complimentary contribution.

43 Abrams3, supra, 117 Tax Notes 961 at V.
Partnership taxation recognizes that partners come together to do business together not because they need a uniformity in their contributions or rewards, but they come together because each one has a unique contribution that would benefit all in the aggregate. Therefore, it is not hard to imagine partners do not see unequal contribution and distribution as an issue. To the opposite, a negotiated partnership agreement at arm’s length would facilitate the convergence of diversified business assets needed to conduct a business, at the same time, recognize the flexibility needed in the divergence of business assets when business comes to an end. Because partnership taxation does not burden the formation of business, in return, partnership taxation requires partners to follow a set of complicated rules. How can partnership taxation guard against the abuses from mixing assets and reallocating taxation attributes in the distribution for no purpose other than to minimize the aggregate taxation? A simple answer is, at each step of the way, there is a specific set of rules to follow based on economics.

Hedge funds are the best examples to illustrate this approach. In a hedge fund, high net worth investors come together to form an investment partnership. Starting a partnership requires a legitimate and substantial business purpose. In this example, a hedge fund provides individual investors with diversification in investment, economic of scale, and above all, the service of a professional investment manager. Next, partnership taxation requires a partnership agreement on how to form the partnership. In the case of a typical hedge fund, a limited partnership is formed. The general partner would be the manager,

---

47 See Harvard Law Review Association, supra, at 1777 ("The GP is often called the ‘service partner’ because he brings little to the table besides his management expertise and labor,26 and the LPs are often called the ‘capital partners’ because they contribute capital to the partnership and then have almost no involvement in its operation until they receive their money back.").
who has managing responsibility, and unlimited liability. Investors would be the limited partners. They have no management responsibility or authority, and at the same time, they have no liability beyond what they have in the partnership, i.e., their investment capital.

The fund partnership agreement dictates that a minimum contribution of capital. The contribution can be in a form of cash, marketable securities, or even personal properties. For efficiency, contribution of property is not a taxable event and the character of the contributed property at the partnership’s hands would be the same as at the contributed partner’s.48 But partnership taxation requires that capital accounts to be maintained. So we will have two accounts set up for each partner, namely the tax capital account, which records the tax basis (inside basis) for the share of partnership interest, and the book capital account, which “reflect the FMV of assets at the time of contribution and distribution”.49 “The book capital accounts thus accurately show the partners’ economic interests in the partnership and track their ‘business deal.’”50 “Analysis of the book capital accounts is intended to reveal the contribution obligations and the liquidation rights of the partners.”51 “If a partnership satisfies the primary economic effect test, then upon liquidation, a partner is entitled to any positive amount in his/her capital account balance or is obligated to restore a deficit capital account.”52

---

50 Id.
52 Id.
These tax and book capital accounts are maintained by the partnership.\(^{53}\) The corresponding partner outside tax basis would be maintained by the partners for tax purposes when selling the partnership interest.

In each day of operation, accounting complexities arise due to many activities. Some of these activities are: new investment contributions, new investor partners, purchase of investment assets (ordinary and capital), selling of investment assets (ordinary and capital), receiving income from investment (ordinary and capital), distribution to partners, liquidation of partners, revaluation of assets, etc.

At the end of each year, or on liquidation of investors, each investor would give 20% of profits from his capital account to the manager. As we can see, dealing with recharacterization of income attributes requires recharacterization analysis of each transaction at the hands of partnership. Instead of rewriting the partnership tax codes for private investment as a new entity, the proposed Section 710 took a shortcut by overlaying incompatible new rules on top of partnership codes.\(^{54}\)

V. New Approach is Needed for Proposed Section 710

The proposed Section 710 rules also have an execution flaw with respect to the accounting rules in subchapter K. The flaw is that it introduced too many new terms and new methods of accounting, and would significantly increase the complexity of the existing subchapter K rules and regulations. Other parts of the legislation went even further in the

\(^{53}\) See id. at 1779 ("Hedge funds often estimate the value of assets annually (mark-to-market), while private equity partnerships do not readjust capital accounts or allocate the GP’s carry until eventual realization events.").

\(^{54}\) Section 710 "Investment Services Partnership Interest" includes the ambiguity in the term "substantial quantity"; "Special Assets" does not have a proportional test; "Invested Capital" does not include "Purchased Interest"; "Invested Capital" does not account for changes in relative capital resulting from distributions made by the partnership; etc. See the list of 15 incompatibilities in Abrams\(^{3}\), supra, 117 Tax Notes 961 at II.
wrong path, calling for the abandonment of subchapter K accounting principles, and taxing 75% wholesale of all carried interest as ordinary income, by introducing the complex recharacterization rules to fit in the 75% figure.\textsuperscript{55}

Accounting difficulties were certainly one of the main causes in the failed carried interest reforms before. But accounting difficulties could be avoided in part if manager’s capital gets returned at the same rate as investors’ capital return. This is needed so that by the time a manager receives his profit interest, there is no ambiguity as to what part of the profit interest is for capital return and what part is for carried interest. And it would also help tremendously if the realization to manager is annual and distribution is all cash. Of course, one cannot impose such requirement without needing an accounting intervention.

Simplifying the accounting rules by forcing hedge fund managers to recognize gain each year would be my recommendation to solve all the problems in teasing out the three elements: (1) the initial (and hard to value) fair market value of the services provided; (2) an interest element reflecting deferred payment on the initial value of the services provided; and (3) a risk premium reflecting the willingness of the service partner to invest his return on the continued success of the venture.

Given the proposition explained earlier that hedge fund manager’s compensations should be taxed at the ordinary income rate, there are several technical advantages to accomplish this goal using the mark-to-market accounting method. First, as pointed out

\textsuperscript{55} See H.R. 4213 (Introduced Dec 07, 2009 (111th Congress, 2009–2010)). The carried interest provision was twice rejected by the Senate. The provision called for in the first two years (2011-2012) 50 percent of such income is taxed as ordinary income at the 39.6 percent rate and the remainder at the 20 percent capital gains rate. Beginning on January 1, 2013 and thereafter, 75 percent of such income is taxed at the ordinary income rate of 39.6 percent and 25 percent is taxed at the 20 percent capital gains rate.
earlier, carried interest reform should aim at private investment entities that follow the
convention of using capital account in liquidation, e.g. hedge funds. Second, because forcing
annual recognition of income requires mark-to-market accounting, only hedge funds would
be suitable. Third, hedge funds liquidity supports the collection of taxes. The following
detail analysis is for the support of these points.

VI. Hedge Funds Accounting Supports the Economic Reality
Economics are the major obstacles in all of the previous reform efforts. As surveyed in
the many scholarly written opposition papers, the common theme in opposing taxing
private equity manager’s compensation as ordinary income is that private equity managers
act more like investors than wage earners. On the other hand, hedge fund managers,
although also perform investment duties on behalf of the investors - they perform the
investment activities at a capacity more similar to those of mutual funds managers. They
don’t own any companies, they don’t participate in creating equity for anyone except the
partnership. It is easier to equate their carried interest to that of bonuses paid to mutual
funds managers. Even if hedge fund managers make capital contribution, or choose to
reinvest existing capital, the accounting logic should not change because their return of
capital would be accounted for just as regular investors’ return would, all before carried
interest is recharacterized.

Hedge funds operate in the technical trading space, and are marketed to return profits
even in a down market. Although each trade on its own could be risky, the overall risks of
the fund would be minimized by performing many trades and using many financial
instruments that mutual funds could not. As a generalized analogy, hedge funds work like
tidal stream generators. They make money by capturing the friction in the market movement, either up or down. Assets held by hedge funds are those liquid, short-term, and diversified. Hedge fund managers market their expertise based on technicality more than the objectivity normally associated with being a prudent investor. Therefore, economically, there is no excuse why partnership accounting would not precisely follow the economic effects. There should be no second guessing that at any given time a hedge fund manager would not know exactly where he stands economically.

Because we want to give proper capital return to a hedge fund manager’s invested capital, hedge funds accounting, therefore, would support the precise allocation between capital return and carried interest. At step 1, we calculate the amount of return to the manager’s capital account based on the same rate as the investors would get. At step 2, we subtract the total compensation by the capital return to derive at the allocation of carried interest. This amount would be taxed at ordinary rate. Although hedge funds could also have a hurdle rate (minimum rate of return) before the hedge fund manager gets the profit interest, our rule should be flexible to operate only when manager actually gets the profit interest. Even if managers use their capital accounts to indemnify investor loss, there is no accounting conflict because it would be all capital (there is no netting of ordinary income from prior years and current year capital loss because we use mark-to-market rules). It should also be clear that after taxation of carried interest, the fully taxed amount would

---

56 For an example, “some performance fees include a ‘hurdle’, so that a fee is only paid on the fund’s performance in excess of a benchmark rate (e.g. LIBOR) or a fixed percentage. A ‘soft’ hurdle means the performance fee is calculated on all the fund’s returns if the hurdle rate is cleared. A ‘hard’ hurdle is calculated only on returns above the hurdle rate. A hurdle is intended to ensure that a manager is only rewarded if the fund generates returns in excess of the returns that the investor would have received if they had invested their money elsewhere.” *Hedge Fund*, Wikipedia, available at [http://en.wikipedia.org/wiki/Hedge_fund](http://en.wikipedia.org/wiki/Hedge_fund), (date accessed March 16, 2013) (hereinafter Hedge Fund Wikipedia).
increase the tax basis in manager’s capital account, and the outside basis. This would obviously avoid further taxation at later time when the already taxed capital is distributed.

VII. Mark-to-market Accounting Eliminates Interest on Deferred Carried Interest

To avoid the complexity in the case where deferred carried interest could become a contested issue, we should adopt a mark-to-market accounting rule specifically for the manager’s account. Because the proposed Section 710 treats carried interest as compensation for the purposes of the Social Security and Medicare taxes under Section 1402(a), we should eliminate the possibility of letting the interest component getting in the way - because the interest component should not be treated as compensation. There is also a more salient point to make, that is, mark-to-market for hedge fund manager is fair to every wage earner. Because we said hedge fund managers are wage earners, there should be no economic advantage for them to defer the taxation on their current income. David A. Wisbach has written a wonderful analysis on a partial mark-to-market tax system.57 Although Wisbach’s idea would generally apply to all investors, for the purpose of this analysis, we only concern the benefit of mark-to-market in the context of hedge fund manager’s annual income.

57 Weisbach, David A., A Partial Mark-to-market Tax System, 53 Tax Law Review 95. In this analysis, Mr. Wisbach proposed carving out a partial mark-to-market regime in addressing the problems in the current one-size-fits-all realization based system. As pointed out by many scholars before, the Haig-Simons taxation principle is too ideal when it comes to investment income. Given the time value of deferral, two similar tax payers could face different tax burdens if they hold similar investments but for the fact that circumstances of the timing when they depart with their investments. In a one-size-fits-all recognition system, taxation of wealth is measured at the time of the departure, not when wealth is accreted. Mr. Wisbach contents that there could be a middle ground at least when it comes to certain liquid assets when they are readily evaluable at the yearend for tax purposes. Such a partial mark-to-market system would have the benefits of low cost to maintain and high certainty to tax the wealth at the time of matching wealth accretion.
VIII. Hedge Funds Liquidity Supports the Tax Collection in Mark-to-market

It is possible that opponents of carried interest reform would say that taxing private investment managers before realization of carried interest would be unfair because it burdens the managers to come up with cash while holding investment interest that would be economically unattractive to be liquidated in time. This argument was extensively discussed by David Wisbach in his analysis on a partial mark-to-market tax system. The conclusion was that the mark-to-market tax system was doable without too much work because the targets of the mark-to-market regime would be those holding liquid assets.

This paper adopts Mr. Wisbach’s findings because hedge fund managers are particularly well suited to be taxed before realization - they normally sell assets throughout the year. As profits are recognized annually, it takes only a little math to figure out the minimum cash reserve for tax purpose. The maximum cash needed to cover the manager’s distribution for taxes would be 20% (carried interest) times 40% (income tax rate) equals 8% of the annual profit of the fund. As an example, if the fund’s initial capital is $10,000,000, and over the year, assuming a 10% return or $1,000,000 profit is achieved if all assets are sold at least once (100% turnover rate), then $80,000 cash is needed to pay taxes. Further assuming our fund manager is below average, only sold 80% of the holding at the end of year (a generous assumption as compared to 130% average in the hedge funds industry\(^5^8\)), and out of the $1,000,000 theoretical profit, $800,000 is realized and $200,000 is unrealized, then the partnership would still need $80,000 cash on hand to distribute from manager’s capital account ($160,000 balance).

to cover his taxes. In this example, we clearly see that cash flow for manager’s tax would not be a big problem for the hedge fund because it is only 0.72% of the total asset. Any reasonable hedge fund manager would be able to forecast the cash flow to have 0.72% cash on hand at the end of the year. Therefore, there is no risk of changing the general economic significantly from the exiting partnership agreement - only a small cash distribution provision is needed just in case to help out a cash starving manager.

**IX. Counter Arguments on Taxing Hedge Fund Managers at Ordinary Income Rates**

Opponents of carried interest reform could argue that if theoretically we tax private investment managers compensation as income, then that would mean capital partners should be entitled to deduct the same amount as expense - then there would be no tax benefit in the reform efforts.

The logic of this theoretical argument is, if we tax hedge fund managers at a higher ordinary income rate, sure Uncle Sam would get more tax revenue from managers, but the higher tax revenue from managers would be offset by the same amount from the lower tax revenue collected from the capital partners’ ordinary income. Therefore, opponents have a valid argument that the tax reform is nothing but shifting revenue collection between capital partners and fund managers.

I agree that there is no realistic good counter point that I could make, other than the fact that tax policy is no match for the political will. I find that is the case in the proposed Section 710. While it mandates investment managers pay ordinary income rate and Social Security and Medicare taxes, it does not allow capital partners to deduct what they pay
investment managers as expense. I also do not want to dilute the force the opponents have, but only to direct them to other instances of the disappearing deductions, such as the personal deductions. And even if we retain some special itemized deductions, we have to take a 2% Adjusted Gross Income haircut with those deductions (in the case of medical expenses, 7.5%).

X. Hedge Funds Carried Interest Cost/Benefit Analysis

Because we deny a corresponding expense deduction to hedge funds capital partners, the proposed Section 710 would become viable to generate some additional tax revenue.\(^{59}\)

As of April 2012, the estimated size of the global hedge fund industry was $2.13 trillion.\(^ {60}\)

One good news about hedge funds compensation reform is, in contrast to the funds themselves, investment managers are primarily located onshore. The United States remains the largest center of investment, with US-based funds managing around 70% of global assets at the end of 2011.\(^ {61}\) As of April 2012, there were approximately 3,990 investment advisers managing one or more private hedge funds registered with the Securities and Exchange Commission.\(^ {62}\) New York City and the Gold Coast area of Connecticut are the leading locations for US hedge fund managers.

According to *Absolute Return + Alpha*, in 2011 the mean total compensation for all hedge fund investment professionals was $690,786 and the median compensation was

\(^{59}\) See Private Equity Council, *supra*, at 11.


$312,329.63 The same figures for hedge fund CEOs were $1,037,151 and $600,000, and for chief investment officers were $1,039,974 and $300,000.64 In 2011, the top manager earned $3,000 million, the tenth earned $210 million and the 30th earned $80 million.65 In 2011, the average earnings for the 25 highest compensated hedge fund managers in the United States was $576 million.66

Given the impressive size of the tax base that hedge funds reform can reap benefits from, the drafters of proposed Section 710 nonetheless should cautiously proceed to estimate the actual tax revenue increase. It is a worry that in order to estimate the tax revenue effect, the risk of hedge funds industry restructuring itself effectively to avoid the blunt of the reform needs a second look. It is noted that the drafters of proposed Section 710 generally understand that a big portion of the capital partners are tax exempt entities such as endowment funds, pension funds and charities, they would not have any benefit from deduction anyway.67 Together with corporate investors, who do not need to care because income and capital gains are taxed at the same rates, they comprise of 80% of all investors.68 Therefore, there are still the 20% wealthy individual investors out there might find motivation to defeat the deduction denial provision. It is entirely possible that these wealthy individual investors could elect to pay managers additional fees instead of profit

63 Id.
67 See Michael S. Knoll, supra, at 160.
68 See Private Equity Council, supra, at 11.
interest, therefore, effectively get back the deduction benefits.\textsuperscript{69} It is also possible that some of the hedge fund managers would go offshore, and avoid the proposed Section 710 altogether.

Michael S. Knoll, professor University of Pennsylvania Law School, conclude that the expected present value of additional tax collections would be between 1 percent and 1.5 percent of capital invested in private equity funds, or between $2 billion and $3 billion a year.\textsuperscript{70} That estimate, however, makes no allowance for changes in the structure of such funds or the composition of the partnerships, which might substantially reduce tax revenues below those estimates.\textsuperscript{71} In his analysis, citing a similar \textsuperscript{72} estimate from the Joint Committee on Taxation, Knoll points out that the JCT estimates seemed to imply that the JCT believes there will be substantial restructuring or composition changes that will reduce tax collections.\textsuperscript{73} Because we are interested in only hedge funds reform benefit, we will use Knoll’s 1 percent to 1.5 percent of capital invested as a guideline for the present value of additional tax revenue.

Given the size of the invested capital of $2.13 trillion for the whole industry, and 70% of that is managed by US based managers, the estimated present value benefit would be $15 billion to $22 billion over 10 years. That is an annual average of $1.5 to $2.2 billion. Given

\textsuperscript{69} See Michael S. Knoll, supra, at 160 (“Thus, the JCT estimates seem to imply that the JCT believes there will be substantial restructuring or composition changes that will reduce tax collections.”).

\textsuperscript{70} See id., at 116.

\textsuperscript{71} Id.


\textsuperscript{73} Michael S. Knoll, supra, at 160.
that in 2011, US Individual Income Tax revenue is $1.91 trillion,⁷⁴ it is 0.78% to 1.15% additional revenue. Economically, it is a sound policy, especially given that only about 4,000 individuals are affected.

XI. Conclusion

Carried interest reform has been under the radar of the media and policy makers alike for years. Public support for carried interest reform is overwhelming. The idea is so simple that even a lay person would understand. The current reform impasse demonstrated on Capitol Hill has been largely the result of policy makers being too ambitious. We should not use a one-size-fits-all approach because leaving out private equity would make sense both in economics and in technicalities. In summary, private equity funds operate in a real investment paradigm. Any impairment to private equity could have ripple effects in the current delicate economic recovery. Hedge funds, on the other hand, make money from market inefficiency. Not only they are less well known, but also they contribute almost nothing to the economy in employment. Hedge fund managers are about 4,000 in numbers, and are required to register with the SEC, so enforcement efforts are not difficult. Also, hedge funds accounting is simple because they carry mostly liquid assets and follow the partnership accounting rules. Hedge funds accounting could be made even simpler by the mark-to-market rules, if they are not already used.