

Taxing PE Funds and Their Partners: A Debate on Current Law

By Steven M. Rosenthal and
Andrew W. Needham

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The following is the text of a debate that occurred between Rosenthal and Needham at the May meeting of the American Bar Association Section of Taxation in Washington regarding the proper tax treatment of private equity funds and their partners under current law. The introduction should be attributed solely to Rosenthal. The views expressed by Rosenthal are his own and do not necessarily reflect the views of the Tax Policy Center, the Urban Institute, or the Brookings Institution. The text of the debate has been edited for purposes of clarity and print.

Steven M. Rosenthal and Andrew W. Needham, "Taxing Private Equity Funds as Corporate 'Developers,'" ABA tax section May meeting, May 10, 2013, Washington.

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Introduction

For years, the battle over carried interest has focused on how to tax the compensation of private equity managers. But, I believe, a careful reading of current law suggests that all of the business profits of the funds, not just the pay of their managers are ordinary income, and should be taxed that way.

Our tax laws generally treat the profits of taxpayers that develop and sell property in the course of a trade or business as ordinary income. For example, real estate developers often take many years to buy, develop and resell property, and they report their profits as ordinary income. So, why should private equity funds that buy, develop and resell companies (or their stock) treat profits as capital gains?

Some believe that funds are not in a trade or business, their managers are. But the managers are

engaged to act on behalf of the funds, so the activities of the managers must be attributed to the funds. And those activities establish the funds' trade or business.

Others believe the funds invest a large amount of capital, so the funds' returns should be capital gains. But private equity funds are the same as other businesses, in that they deploy capital, labor, and other inputs to make their profits. And business profits should be taxed as ordinary income.

As the transcript of the debate shows, Mr. Needham disagrees with my interpretation of current law.

Debate

Needham: First, let me just start by saying this is not a traditional panel. It's not 'nuts and bolts of X' or 'hot topics in Y', but about a rather provocative article that Steve published in *Tax Notes* in January¹ that's getting a lot of attention. Since then, I suspect Steve has become about as popular in private equity circles as, I don't know, Michael Moore is with the NRA. That's one of the perks, by the way, of working at a think tank in academia. You can say exactly what you think. I unfortunately have clients.

In Steve's article, which is included in your handouts, he argues that the government and the tax bar just have it all wrong with regard to how the Internal Revenue Code actually taxes private equity funds and their participants. Just to be clear, he is *not* making a policy argument about what the law ought to be, but rather what the law is and recommends that Treasury clarify current law by regulation.

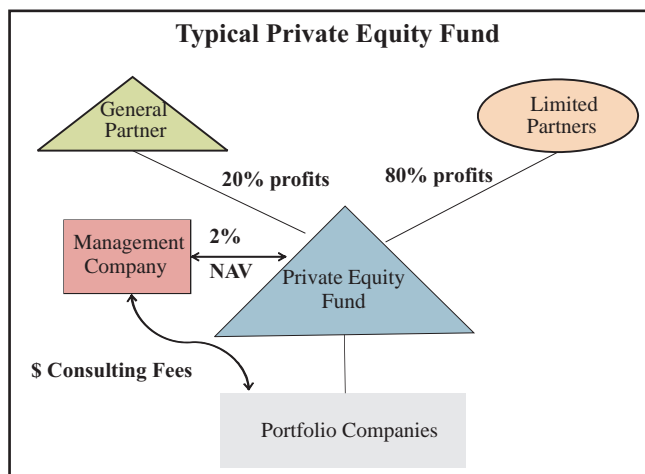
Rosenthal: I think my argument is a little more nuanced than that. I think that both law and policy support my view. And if you look to my article, I acknowledge that there have been many members of the private equity community, maybe even some government staffers, who have misunderstood the tax law. And because I'm a nice guy, I suggested the IRS write regulations to clarify the law in the way that I believe it currently does and should read. But it's a little more nuanced than simply asserting that everyone is wrong. But I could take that position, too, if that helps frame the debate easier.

¹Steven M. Rosenthal, "Taxing Private Equity Funds as Corporate 'Developers,'" *Tax Notes*, Jan. 21, 2013, p. 361.

Needham: Okay. Fair enough. I can tell already this is going to be an interesting discussion. So the way this is going to work, I believe, is Steve will present his case based along the lines of his article and then I'll respond to it. As you'll see, he and I have very different views on the issue.

But before I turn it over to Steve, I thought (actually both of us thought) it might be a good idea to start with just a general overview of private equity funds, what are they, what do they do, and how they are taxed.

One simple way to describe one is a group of investors who pool their capital, hand it over to some money managers to invest on their behalf, all subject to an agreement on how to split the profits. But, that describes hedge funds, mutual funds and other types of entities as well. So let me try to be a little more precise. For purposes of this presentation, we'll assume a very plain vanilla structure like the one that's depicted up on the screen.



We could have presented a structure that had five times the number of entities but if we had done that, I think it would have added more heat than light.

A private equity fund, that's the big triangle right in the middle, invests in private companies. The fund may be an angel fund, a venture capital fund, a mezzanine fund, an LBO fund, all very different in their own way, but all the same in one fundamental respect. They all pool private capital from institutional and other investors and invest it in portfolio companies at various stages of development; these are the portfolio companies represented by the big rectangle at the bottom of the screen. They hold the company for a period of time, whip management into shape, generate some revenue growth, and with any luck, sell the company at a big gain. Meanwhile, during that period, the investors (these are the LP's on the right of the screen), have no liquidity at all and therefore bear a level of

market risk far greater than the risk borne by holders of publicly traded stocks and securities.

In most funds, the investors fall into three broad categories. You have U.S. investors, you have tax exempt investors, and you have foreign investors. Okay? Are there any other key participants? Absolutely. The general partner and the management company. These two entities are the service providers to the fund. For these services, the first receives a 20 percent carried interest and the second receives the base management fee. The fee is usually two percent of the capital commitments to the fund. The GP calls capital on a staggered basis over a five to six year investment period and invests it in various portfolio companies. When it later sells the portfolio companies, it distributes the proceeds out to the various partners pursuant to a pre-agreed distribution waterfall.

Note that both the fund and the general partner are partnerships for tax purposes. Okay. Now, why is that? I'm going to ask Steve just to indulge me for just a moment. The reason is that the gains are capital gain. Almost all fund income is capital gain. If you hold stock as a capital asset and sell it at a gain, the gain is capital. As a result, with regard to tax exempt investors, it's exempt from U.S. tax. With regard to foreign investors, it's usually exempt from U.S. tax. With regard to U.S. investors, and that includes the members of the general partner, it's taxed at a 20 percent rate. So character is absolutely critical in private equity: for U.S. investors, it establishes how much tax you have to pay and for foreign and tax exempt investors, it establishes whether you pay tax at all.

Now, the focus of most of the attention of the government in recent years with regard to private equity, as I'm sure you all know, has been on the carried interest, in particular whether the carried interest ought to be taxed as service income. We've had bills pending in various stages of development going back to 2007 that would do exactly that. And as far as I can tell, they appear to be going nowhere.

By the way, my own view is that that's likely to become the real elephant in the room this morning. Can I just get a show of hands in the audience? How many of you think it would be a good idea for Congress to pass the carried interest legislation? Okay. How many of you think it would be a bad idea? Okay. And for those of you who think it would be a bad idea, is it because you think fund managers ought to be taxed at a 20 percent rate or because the carried interest legislation is just so complex that it's likely to be unadministrable? The first? The second? Very interesting. If this had been a room consisting of people other than tax lawyers or accountants, I think I would have gotten a very

different show of hands. Well, as you're about to hear, Steve has a very different take on all of this.

Rosenthal: I solved that problem for you. Right?

Needham: Yes.

Rosenthal: Not 20 percent and very simple.

Needham: Yes. He says, hey, wait a minute, forget about the carried interest legislation, forget about Congress, you're missing the forest for the trees. Focus on the fund, not the general partners. Funds are not investors at all, they're more like intermediaries or middle men. As such, the stock they hold is not a capital asset. So Treasury should write regulations clarifying this point.

Now, if Steve is right, again, I don't think he is, but if he's right, the implications of that are really quite profound: first and foremost, ordinary income to the general partner and the U.S. investors; second, U.S. taxing jurisdiction over the tax exempt and foreign investors.

So with that introduction, I'm now going to turn it over to Steve. I'm going to let him make his case. After that, I'm going to try my best to poke some holes in his argument with some questions. My hope is that will lead to a lively debate. So Steve?

Rosenthal: Thank you, Andy. Let's start with the structure slide. I just want to highlight a few things that are key to our discussion. Andy is correct that you look to the green triangle, 20 percent of profits. That's a partnership interest that allows the managers, including Mitt Romney, to take 20 percent of the profits of the private equity fund, with the balance going to the limited partners. And as Andy suggests, I believe that the gains or losses of the private equity funds from disposition of their stock, are ordinary income or loss. And so I would recast that 20 percent as ordinary, as well as that 80 percent that goes to the limited partners.

The funds hold the portfolio companies three to five years on average. Sometimes you'll find funds telling potential investors in the prospectus a shorter period, sometimes a longer period. Of course, market conditions matter.

But just to give you a feel for this: the funds buy a company, turn the company around in three to five years, and sell it. How many companies are they turning around? Maybe a dozen for a typical fund. I think Andy was telling me maybe more or less depending on the size of the fund.

This is a very rich business for the general partner and the management company. You notice a green triangle and a red rectangle, which separate their duties and responsibilities. It turns out the general partner only holds the profits interest. And the management company has the employees, the office space and the like. I don't think there's any significance to the separation, other than some

funny New York City tax stuff. So this particular triangle and box I don't think matters. You can view these interchangeably.

Needham: It's really state and local tax planning in the vast majority of cases.

Rosenthal: But these structures are always complicated. I'm just trying to highlight for you what could be important and what is not. Green triangle, red box is not so important. I think we're going to disagree as to whether green triangle/red box or that blue triangle matters. But at least these green and red geometric shapes don't matter.

The 2 and 20's, that could be pretty rich. It could be 3 and 30 or 1 and 30, who knows. But 2 and 20 is conventional, let's say that. Consulting fees also are received by the general partner and the management company for services rendered to the portfolio companies, directly from the portfolio companies. That money is, in effect, turned over to the private equity fund, as a fee offset.

What are the funds doing for their money? I described improving operations, governance, capital structure, and strategic position of their portfolio companies. Well, the management company itself can have hundreds, or as Lee Sheppard once described, thousands of employees. They send them in waves, a battalion sometimes. Of course, one fund differs from another. The funds have a board representative. They often replace an officer or a CEO or have people on site monitoring and managing the operations of the business. A very extensive, integrated operation between the general partner/managing company and the portfolio companies. They boast about their extensive operations in private placement memos. That's the magic that justifies Mitt Romney's large fees. He's rendering something very valuable by operating these companies and turning them around.

And now I'll share with you how I see this situation. And let me say for years there's been a battle over carried interest, focusing on how to tax the compensation of private equity managers. People say, wow, why is Mitt Romney paying 15 percent on hundreds of millions of dollars and he's just rendering management services. What's that all about? No capital invested. What's going on? And is that fair?

I think, if you step back and look at the statutes and the early case law that explain why we have capital gains and capital losses and ordinary income and ordinary losses, you find that, in fact, Mitt Romney never should have had any capital gains to start. The gains from this kind of operation are profits from the normal course of a trade or business, which should be ordinary. Real estate developers who take property, improve it, develop it, and then sell it, they have ordinary profit. Why would

corporate developers, private equity funds that investigate, acquire, improve, and then sell businesses have capital gains?

So the comparison to real estate is what launched me down this path. I started thinking about this problem last summer when Greg Mankiw wrote a piece in *The New York Times*. He described Carl the carpenter who was in the carpentry shop in the week, and on weekends he had bought houses and he was repairing them on his own, and he was selling them off and making a nice capital gain, 15 percent. And Greg Mankiw said that's exactly what private equity funds do, they take those companies, they patch them up, and sell them off. They deserve the same 15 percent. And I was scratching my head and I'm thinking, gosh, I wonder if Carl the carpenter actually pays for tax advice, because if he did, this is not the tax advice I think most traditional lawyers would give. If you hold property for sale to customers in the course of a trade or business to customers, then gains are going to be ordinary, and the case law is fairly clear on that. And it launched me to thinking about, what is the scope of capital assets, and why are private equity funds claiming capital treatment?

In 1921, the capital asset definition first came into the code. World War I had ended. Top tax rates were 73 percent. And Congress saw that there was a horrible lock-in effect: Investors were not selling their assets. And so Congress set a rate of 12½ percent as an incentive to sell assets. Congress added the definition of capital asset, which basically was all property except inventory. Congress didn't want inventory, a form of property, to be eligible for a preference rate. For example, widgets that are sold as a normal course, ordinary. But everything else pretty much was given capital. Interestingly, the holding period then was two years, not one year. Later we'll talk about, well, gosh, doesn't a private equity fund hold those portfolio companies for three to five years? And holding, that must mean something important. I don't think it means much. We can have that argument later.

In 1924, Congress realized that real estate developers were subdividing land, selling land, and claiming capital gains, 12½ percent. Development was a pretty big business, back in the 1920s. And Congress thought that buying land, subdividing it, improving it, selling it, should be ordinary income. Even though the real estate developers at the time were holding the property for 9, 10, and 11 years. So Congress also excluded property primarily held for sale in a trade or business from capital asset. As a result, real estate developers had ordinary income, not capital gains.

Well, that worked for a little while until the great crash of the 1920s. And Andrew Mellon and a whole bunch of fat cats on Wall Street claimed trade or business losses on selling stock in their portfolios. And when they took their losses as ordinary, they zeroed out their dividend income, their interest income, their huge CEO compensation, which resulted in no tax and outraged the American public. And, of course, the Great Depression left lots of stock under water, so they had a nice selection of these stocks to sell.

In 1934, Congress addressed this situation by narrowing the prior exclusion to property primarily held for sale *to customers* in a trade or business. Now stock traders, generally, had capital losses, even though stock traders were in a trade or business, because they didn't have customers. They were selling through an anonymous exchange. They were trying to make their profit from market movements, not from developing property and selling it or middleman activity of a dealer or a market maker who buys stock and resells it.

So what we're left with, when you look back at the definition of capital asset and how it evolved in the '20s and early '30s, it served two purposes, a preference for capital gains and a limitation on selective recognition of losses. But Congress, when you look at what they were trying to do, always kept their eye on the ball: that profits and losses arising from the every day operation of a trade or business are ordinary.

That's generally the legal framework. So normally when we think of stock, we think of, the taxpayer's relationship to stock: a dealer, a trader, or an investor. Dealers hold stock as inventory. They create a stock of securities to meet future buying orders from customers. Traders, well, they trade stock sufficiently that they're in a trade or business, but they're going to get capital gains and losses. Even though they're in a trade or business, they do not have customers. And investors are people who merely devote managerial attention to their stock. They have no trade or business. That's where most people stop in this analysis. They say dealer, trader, investor, that's it.

Now, let's look at private equity funds: Are they dealers? They don't have inventory and are not trying to build a stock of securities to satisfy future demand from potential buyers. Traders, they're not selling stock often enough. They don't turn it over. They're not looking for quick market movements. They're trying to make their money, if you read their placement memos, in a much different way. Or investors? Well, that's the default, the catchall. People think if a private equity fund is not one of the first two, it must be the third. And I consulted

Andy's *Tax Notes* article.² He's told me he's written a longer discussion in BNA and is updating that. But his earlier analysis was conclusory: If a private equity fund is not a dealer, not a trader, it must be an investor. And we'll talk about what that means and what the implications are in the context of our exchange.

But I actually started thinking more intently on this issue, recalling Carl the carpenter who was actively nailing away at those shingles and those planks of wood and thinking about active Mitt Romney and his brethren, who were wiping the sweat from their forehead as they churned out the numbers on-site to turn these companies into profitable enterprises. And I said, well, wait a second, there's a fourth category here, as you look to the structure of the definition of capital asset, it says property and then a bunch of exceptions, and one of the exceptions is for inventory. But if you read on, it also says or property primarily held for sale to customers in the ordinary course of trade or business.

And when is property "primarily held for sale to customers in the ordinary course of a trade or business"? Well, the words were added to deal with real estate developers and more generally the developing and selling of property. That was the circumstance that led Congress to draft the definition in the way that it did, making sure that property in a trade or business would be ordinary and then cutting back a little to make sure those stock speculators who were merely trading on market movements were not getting ordinary losses.

From my research I concluded the statute requires a facts and circumstance inquiry. For that I apologize. Sometimes the tax law is hard, and you've got to know it when you see it, and you have to draw lines and stick to them and the like. But private equity operations, in my view, cross that line. This is not a hard case. So you have to consider: Is there a customer? And is there a trade or business?

Is there a customer? If you look to the controlling precedent and the legislative history as to how we added the words "to customers." It's not the person who wanders into the corner grocery store looking for a loaf of bread. There is no requirement of regular and repeated transactions. The notion of customer, the early case law, the *Farr* case, which is

almost contemporaneous to the 1934 Act, when the words "to customers" were added. That case says you've got to look at the business of the vendor, not the vendee. And the *Kemon* case, which we all look at when we're trying to figure out whether we have a dealer versus a trader, also says you're looking for an intermediation role to find customers, some middleman activity, again, a focus on the activity of the vendor, not the purchaser, not the person we would typically think in terms of a customer.

And so when you step back, the words "to customers" must be a low bar, which may be hard to accept. But for real estate developers, there is a wide range of customers. They develop their real estate. They sell to the first newlywed couple that wants to be part of the development. That's a customer. This developer is never going to see this newlywed couple again. Or a market maker buying and selling stock through the electronic exchanges, they have customers. They're buying anonymously — they have no idea who is on the other side of these exchanges. So I understand the reluctance to accept my assertion, because I had a little time getting my mind around what is a customer. But if you stop and think, the only plausible explanation is by looking at the business of the vendor, the seller, and not who the purchaser is.

In my view, the trade or business is established by so much activity by the private equity fund. The fund adds so much value through finding companies. They raise and return capital. They acquire, develop, and sell businesses. The funds have huge fees, immense profits from these activities. The management companies, the employees that are sent in to turn around these companies, have hundreds of employees, these are huge operations. By the way, these employees, when they go into the operating companies, they're still employees of the general partner/management company. They don't become employees of the portfolio company. They effectively take over the management of the company and try to turn it around. These operations, in my view, are just so extensive that I think they readily satisfy the test for trade or business.

There's an issue which sort of surprised me after I wrote my article, which is who's doing what on behalf of whom. And if you go back to the original structure, you can see the general partner/management company has all these employees and computers and office equipment. The private equity fund, it doesn't have anything. It only has stock certificates and contractual rights from the general partner. And so I've been surprised to find that a lot of people push back and say, the private equity fund, that's merely a passive investor, it's a pool of capital. How can a pool of capital be in a trade or business? And the answer to that is pretty simple. A

²Andrew W. Needham, "A Guide to Tax Planning for Private Equity Funds and Portfolio Investments (Part 1)," *Tax Notes*, May 20, 2002, p. 1215; "A Guide to Tax Planning for Private Equity Funds and Portfolio Investments (Part 2)," *Tax Notes*, May 27, 2002, p. 1381.

legal entity, a partnership, a corporation, cannot do anything on its own, it needs flesh and blood to do something for it. And the case law is quite clear that any corporation, any partnership, any individual, can arrange for its activities and its trade or business to be executed through a variety of employees, representatives, and agents. That's how an entity carries out a trade or business. It does not need warm bodies in the shell there. It just needs to have the right contractual arrangements in place.

And it turns out that the right contractual arrangements are in place. The private equity fund has a general partner that promises to deliver a range of services to help develop those portfolio companies, turn them around. And the activities of the general partner should be attributed to the fund, the principal.

So I will end by saying a whole bunch of bad things can happen to private equity funds that are engaged in a trade or business. Some bad things only occur if it's a trade or business, whether or not there are customers. Some bad things occur if there's both a trade or business and customers. And as a result, I think we're going to focus next on our views, competing views as to whether there's a trade or business and whether a customer exists.

Needham: Okay. Very good. Thank you, Steve. We have less than 20 minutes left, so I'm a little concerned that we won't be able to get through even half of my questions. Let me just say that I disagree with much of what you said for a number of reasons. But in the interest of time, I'm going to just focus on the two basic building blocks of your argument.

The first is that the fund is engaged in a trade or business on a regular and continuous basis; to get there, you would attribute either the trade or business of the general partner or perhaps only the acts of the general partner to the fund based on agency principles.

The second is that the particular trade or business we're talking about is holding stock primarily for sale to customers, based on the view that the funds are basically intermediaries or developers of the portfolio companies for fees. And because that's what they do, the buyers that they sell to in M&A transactions are their customers.

I may have oversimplified, but I think that's broadly accurate.

So I've got a bunch of questions starting with the downward attribution. But before I get to that, since we are talking about current law, and because my own view is that stock is about the most capital of capital assets that one can imagine, let me just open with this. You say in your article that merely providing capital does not automatically make something a capital asset because capital invested

in a bank is ordinary. Now, my question is, why is that an apt analogy and can you cite a single case involving someone who was not a developer, who held stock, sold it at a gain and provided all of the capital where the gain was held to be ordinary?

Rosenthal: A typical New York stock exchange floor specialist, a market maker, invests its capital, holds stock as inventory. That inventory is held for a dealer type markup, middle man mark-up. They buy the stock —

Needham: I meant not a dealer. Other than a dealer.

Rosenthal: Market maker, other than a dealer. Or somebody who develops or promotes stock, who buys stock, turns around the company and sells it, that's also ordinary. There's a long line of cases involving promoters.

Needham: I'm asking you to cite a particular authority that stands for that proposition in the 91 years that we've had a capital gain preference.

Rosenthal: Okay. *Giblin*, which is cited by the U.S. Supreme Court in *Whipple*. *Giblin* was —

Needham: That's a bad debt case.

Rosenthal: But why would it matter? Section 23(e) was added at the same time 23(k) was added.

Needham: It matters a great deal. There's a long line of bad debt cases and in the vast majority of them, the taxpayer loses on the basis that it was an investor, not a trader. The business promotion cases don't turn on the question of whether the asset is a capital asset. Somebody can claim a bad debt loss on a loan he makes to his own company without converting the stock into a non-capital asset.

Rosenthal: Well, let's focus on what we're talking about here. I thought we were talking about is there a trade or business, and then is there a customer. The bad debt cases examine the question of whether a trade or business exists. Promoting or developing a company is a trade or business, under *Higgins* and *Whipple* and the cases they cite. *Giblin* is a bad debt case, but there is a trade or business. That starts the analysis. And then you look for whether or not there is a customer.

So let's just stipulate. Are we saying that there is a trade or business for promoters? Would you agree with the line of cases that the U.S. Supreme Court has recognized?

Needham: I'm just asking a very narrow question, which is, is there a case that you can cite where somebody purchased stock and that person was not a dealer, not a market maker, sold it at a gain, where the court ruled that the gain was ordinary?

Rosenthal: *Katz* is one.

Needham: Okay. Let's talk about *Katz*.

Rosenthal: Is this a test — come up with one? But here's the structure. Is there a trade or business or not? And given the wide activities of the private

equity fund which are undertaken by its agent, and I think even you acknowledge that you attribute the activities of an agent to the fund.

Needham: Well, I'm going to come to that.

Rosenthal: Okay.

Needham: Again, I want to make clear that we're talking about current law. This is not a debate about what the law ought to be. You mentioned Mitt Romney and other fund managers who are taxed at a 15 percent rate while the person who empties their trash cans is taxed at a 35 percent rate. That's the basis for the carried interest legislation. I'm sympathetic to that argument. But that's not what we're talking about this morning. We're talking about current law.

Rosenthal: Right. Well, you find current law in a statute. The statute says capital asset is property excluding inventory and property primarily held for sale to customers. That's current law.

Needham: Okay. So let's talk about the *Katz* case. You mentioned real estate development. The *Katz* case was very much like that except that it wasn't real estate; it was luncheonettes. You had a taxpayer who, with a group of other people, formed eight new companies. They were all shell companies; the taxpayer caused each of the companies to lease some space and to construct a luncheonette. And in every single case, before construction even commenced, the taxpayer started approaching prospective buyers. They would draw up plans, the buyers would look at the plans, comment on the plans, and then they would enter into an agreement to sell the stock.

The average holding period of the stock was nine months in *Katz*. And the only reason for that was that there were no luncheonettes to sell during that period. They first had to be constructed. And in seven of the eight cases, the luncheonettes did not open for business before the closing. And they couldn't have anyway because they had no working capital. The working capital for the business was to be provided by the buyers. So in *Katz*, the taxpayer really was a dealer. That's tantamount to a real estate developer.

So look, it's possible I missed a case, but that's the only case that I'm aware of where you had somebody who is not technically a dealer who funded the capital where the gain was treated as ordinary, and appropriately so, because none of it was attributable to capital appreciation, all of it was services. Private equity funds don't do that. They don't invest in shell corporations and start new businesses. They invest in existing businesses.

Okay. All right. That aside, what I want to move to now is the trade or business question, in particular, downward attribution.

Let's say, for example, that I'm one of these LP's, and I put up a million dollars, and I agree to pay a management fee and surrender 20 percent of my profits. Let's agree that the general partner is engaged in a trade or business. That's clearly your view, which is probably right. Let's also agree that the general partner is an agent so that the acts of the agent are attributed to the principal. Now, Steve, you say in your article that it's not just the acts of the agent, but the trade or business itself that gets attributed to the fund. But we've spoken since then and I just want to be clear. Is it just the acts of the general partner that get attributed to the fund or is it the trade or business itself?

Rosenthal: It's the acts.

Needham: Okay. I agree with that. But I still see a problem with that analysis. I think a good way to frame the issue is by comparing two cases. Let's say I want to open a new restaurant, so I lease some space, I hire busboys, dishwashers, waiters, a maitre d', a restaurant manager. They're all my agents, so all of their acts are imputed to me, and because those acts together constitute the running of a restaurant business, I'm engaged in the business of running a restaurant, even if all I do is sit on my butt all day and watch ESPN. So that's the first case. Now let's come back to our case. Again, I'm an LP, I put up a million dollars for the general partner to invest on my behalf, and I pay a carried interest.

In the restaurant example, the agents were all providing services to third parties, and those parties were acting on my behalf. So if you attribute those acts, the acts of providing services to third parties to the principal, well, the trade or business is just naturally going to follow because the act of providing any service for a fee is a trade or business. But in the limited partner case, the service recipient is me, or more precisely, the fund. So just as my hiring a lawn mower doesn't make me a lawn mower, my hiring the general partner as my money manager doesn't make me a money manager. It makes me an investor, and investing is not a trade or business.

Rosenthal: Okay. Help me out here. I'll work with your example. We got Moneybags that gives money to buy dishes, silverware, dishwashing equipment, I hire workers. And I love managing restaurants. In fact, I think *Giblin* did some of this stuff. A lawyer went into the restaurant managing business, loves doing this stuff, hires a bunch of workers, says thank you for the capital, that's really wonderful. He forms a limited partnership to operate these new restaurants.

Yeah, there's capital, labor, and other inputs in this business. There's a trade or business going on. And you figure out that there's a trade or business going on by what the limited partnership is doing. I think in *Giblin*, it was — Stags Bar was the name of

the restaurant that he had set up. *Giblin* is, of course, the U.S. Supreme Court case that *Whipple* cited, and the U.S. Supreme Court said was promoting businesses. But in any event, he sets up this restaurant, he runs the restaurant. That's a trade or business.

Needham: I agree. I'm distinguishing the restaurant case where the agent is providing services to third parties from the LP case, where the agent is providing services directly to the principal.

Rosenthal: Shall we put the structure diagram back up?

Needham: Sure.

Rosenthal: Don't you see? When the general partner/management company is acting on behalf of the private equity fund, to turn around these portfolio companies, those are services externally focused to improve the value of those portfolio companies. And by the way, this is not a coincidence. Andy says, well, do you have any cases. What's going on here in the private equity world is a little unusual.

If you remember the Mitt Romney story, Mr. Bain comes to Mitt Romney, says we've been making a lot of money consulting, going into these companies, turning them around. We're in a big trade or business, lots of profits. But we can make even more, Mitt. What we want to do is, bring some capital to the table, and when we combine capital, with some outside investors, with our consulting, our extensive, outwardly focused, directed services, we'll make even more money.

What the general partner and the managing company are promising the private equity fund, as their agents, is they're going to devote extensive operations, hundreds and thousands of employees ongoing, continuous, regular, to turn those operating companies around and make a lot of money.

Needham: Okay. I don't mean to cut you off. I really don't. We only have five minutes left.

It just seems to me that every activity that you're describing as the reason a private equity fund is engaged in a trade or business — it's a broker, it's a middle man, it's a promoter, it's a developer, it's like a dealer, all for big fees — were the very activities cited in the *Dagres* case as the reason that the *general partner*, not the fund, was engaged in a trade or business.

In the *Dagres* case, for those of you who are not familiar with it, a member of the general partner of a venture capital fund made a loan to a guy who used to feed deals to the fund and then the guy wasn't able to pay the loan back. So the member claims a business bad debt deduction on the basis that it was in a trade or business because the general partner was in a trade or business. The court agreed, allowing an ordinary deduction on the loss. As I read the case it was the status of the private

equity fund as an investor that was fundamental to the holding. What the court said, and I'm going to quote from the decision here, is, "similar to any bank or brokerage firm that invests other people's money, the manager of venture capital funds provides the service that is the investment mechanism for the customer [that's referring to the fund] but that is the trade or business of the manager." That's the very argument that I'm making here. The general partner is in the trade or business of investing other people's money, not developing or being an intermediary. So the general partner is a money manager, that's a trade or business. But the private equity fund is still an investor.

Rosenthal: Well, help me out. I want to build a house and I want to start selling houses, and I don't know much about building houses, so I get an electrician, I get a drywall guy, I get a general contractor. I ask my brother for some money to help buy some lumber, okay. And I don't do anything. As my wife will tell you, I'm really inept. I start building these houses, and selling them, profitably. Each one of the guys is in their own business. The electrician is in the electrical business. The drywall guy is in the drywall business. I agree with you. The general partner is in a trade or business.

But, like me, the fund itself tapped into the trade or business of others, asked them to develop and sell companies on its behalf. Okay?

Needham: Okay.

Rosenthal: That doesn't end the story: others also can be in a trade or business. There can be a couple of trade or businesses going on here. But the activities of others are attributed to the fund. It's not the trade or business. And afterwards you should show me where I wrote otherwise in the article. If I did, I was mistaken. I would tell you that this case of whether or not a private equity fund is in a trade or business is now being litigated in the First Circuit, and it's on appeal from the trial court. There was another court in Michigan that found a private equity fund was in a trade or business. But the Massachusetts trial court, in *Sun Capital*, said there was no trade or business.

The reason, according to the Massachusetts trial court, was the PBGC incorrectly attributed the activity of the general partner to the investment fund. The court said that you cannot attribute activities of an agent to the principal for purposes of figuring out whether you have a trade or business of the private equity fund.

Needham: They said you can't — I'm sorry, they said you can't attribute the trade or business of the general partner.

Rosenthal: What does the sentence say? The Appeals Board incorrectly attributed the activity of

the general partner of the invested fund. That's how they got to their analysis.

Needham: Read the second sentence.

Rosenthal: The trade or business does not transfer. They did not —

Needham: The trade or business of the agent is not attributed to the principal.

Rosenthal: Because they refused to attribute any activities of the general partner to the fund, and therefore, the trade or business can't transfer.

Needham: That's right.

Rosenthal: But you've got to attribute activities of an agent to a principal. And this analysis just muddles the issue.

Needham: Okay. Well, Steve, all right, that's fine. But again, both of those cases, as I read them, support the view, in fact, *say* that you don't attribute the trade or business of the general partner to the fund. The fund is the one that provides the capital. And so based on those authorities, I would say that the portfolio company's stock is a capital asset.

But let me move on because we're very, very short on time. I want to come back to your point about the breadth of the definition of a capital asset. You say in your article that the exclusions to the definition of a capital asset should be read broadly, even though the addition of the word "customer" in 1934 actually had the affect of narrowing the exclusions to the definition of a capital asset.

And for that, you cite *Corn Products*, where, in fact, the Supreme Court did say that. But then you say that the same court, in *Arkansas Best*, 33 years later, did not flatly overrule *Corn Products*, and so it remains the case that the exclusions to the definition of a capital asset should be read broadly.

Just for those in the room who are not familiar with these cases, these are both very famous tax cases. In *Corn Products*, you had a taxpayer that bought corn and converted it to starch and other products; it bought corn futures to protect itself against price fluctuations, which it treated it as ordinary. The court held that that was appropriate because the futures were effectively a surrogate for the corn.

In *Arkansas Best*, the taxpayer bought *stock*, not futures, sold it at a loss and reported it as ordinary, citing *Corn Products*. What the court said in *Arkansas Best*, and again, I'm going to quote, is "we conclude that *Corn Products* stands for the *narrow* proposition that hedging transactions that are an integral part of a business' inventory purchase system falls within the inventory exclusion of Section 1221."

It then went on to say that the stock held by the petitioner falls within the *broad* definition of the term "capital asset," and that stock is "naturally viewed as a capital asset". So the taxpayer in that case, at least as I read it Steve, was making *your*

argument that the exclusion should be interpreted broadly, which the Supreme Court flatly rejected.

Rosenthal: No. The taxpayer was not making my argument. In *Arkansas Best*, the taxpayer made an argument that bank stock was property and because the property was purchased in connection with a trade or business should be ordinary. The U.S. Supreme Court says no, no, no, property is interpreted narrowly. Business purpose has no implication for how you read the word "property."

But then the U.S. Supreme Court goes on to say we read *Corn Products* as interpreting exclusions broadly, including a broad reading of the inventory exclusion. And they go on to say business purpose matters to determine the broad exclusions from a capital asset.

And so, likewise, when we're excluding property primarily held for sale to customers, that exclusion should be read broadly. And just like *Corn Products* took a very imaginative view of what was inventory. How many of you guys would have thought corn futures were like widgets? Not many. But you take a broad interpretation of inventory, just like you take a broad interpretation of primarily held for sale to customers in the course of a trade or business, another exception, and that's because we want to tax income from business at ordinary rates and not depart and give capital preference except in unusual circumstances.

Needham: Okay. Amy, it's after 9:00. Do I have time for one more question or should we stop? One more? All right. I'll just ask one more. I'm going to jump ahead. It's a question about services, in particular, remuneration for labors rather than capital appreciation. That strikes me as rather fundamental to your analysis. Let's go back to the *Kemon* case that you cited in particular. It concerns the "merchant" analogy with regard to a dealer. The court said that the reason a dealer is like a merchant is that dealers resell at a mark-up, not because the stock has appreciated in value, but as remuneration for their labors. You say in your article that private equity funds also receive large fees and derive immense profits as remuneration for their labors, in this case, for being a developer.

I would say to that "no", private equity funds don't derive large fees and don't derive immense profits. They *pay* large fees (the management fee) and they *disgorge* large profits (the 20 percent carried interest). So I'm not sure what sort of compensation for labor that you're referring to. It certainly isn't that. Perhaps you're referring to the fees that they get from the portfolio companies.

Rosenthal: Both. So there are two forms of fees here. One is, the profits from selling the portfolio companies, okay. And you say, wow, selling the

portfolio companies and making a profit, you developed them, you promoted them, you went in there, rolled up your sleeves, turned them around. But every investor gets profits from sales. That's just a normal investor return.

No, that is a middle man return, a return that takes you out of the definition of capital asset. The *Whipple* case, you know, talked about this very point, about whether or not to find a taxpayer in a trade or business, you have to think about where they get their fees, as well as the source of supply. But the fees might be promoting corporations for commissions, or might be for profits on the sale of the companies. And that's what the private equity funds do. That's one large piece of their profits, the profit that they get from turning around and reselling their companies, and that can be a trade or business and more than mere passive investment.

The second form of fees is more subtle: the fund collects a lot of fees, directly and indirectly. I disagree that the private equity funds are merely paying out these huge fees. That's not the case. This private equity fund is in a trade or business of turning around companies, making a whole bunch of money, and then dividing that money amongst its partners.

Some of the partners struck good deals. The general partners got this nice 20 percent carry, and don't put much capital in. Some of the limited partners are in for the ride. But this is just a way to divide the profits of the partnership amongst the partners. And there's an element of irony here, maybe even chutzpah, that private equity funds are set up as limited partnerships to facilitate investment and to conduct a business with limited liability protection.

And then when you look closely at the private equity funds, they say no, no, ignore that, ignore that separate entity. This is just the passive investors paying themselves. Well, no, the separate entities are in a trade or business. It's developing companies and selling them. And I'll ask you a question. Where can you think of another circumstance in which we have a trade or business going on in which there's no level of tax? Here we have, by design, a partnership with tax exempt and foreigner investors. They all like having investments with no entity level tax, but then they don't have any UBIT or ECI tax.

Needham: Let me just —

Rosenthal: But there's a whole bunch of stuff happening, they're generating a lot of profits.

Needham: Let me respond to that, and I'm going to keep it very short, and then I think we have to come to a close. By asking me what other type of trade or business can do that, you've assumed the

conclusion. My argument, and I think consistent with current law, is that investing is not a trade or business.

But, Steve, look, your article was very provocative. Believe me, it's getting a lot of attention in private equity circles. As I think I've made clear, I disagree with it. I think it's a much stronger argument in favor of taxing the carried interest at ordinary income rates. But let's just say that you have a different view from my own. I've enjoyed debating with you.

Rosenthal: Oh sure. No, thank you. You've got a nice set of ideas. Let me just end with one thought, which is, I believe there's an element of self-delusion going on with the taxation of private equity funds. Everyone sits around and says private equity funds are merely a passive pool of capital. Nothing is happening. And then they cite to a couple U.S. Supreme Court cases, *Higgins* and *Whipple*, they like to downplay *Groetzinger*, which actually looks to the level of activities. They like to cite to *Higgins*, with some nice language, no matter how active you are in managing your investments, you are still a mere passive investor. But as my colleague back at the Tax Policy Center wrote a number of years ago, it's one thing to manage one's investments in businesses and it's another to manage the businesses in which one invests.³

These funds are actively engaged through their agents to manage and turn around the businesses in which they invest. And if you actually read *Higgins* and *Whipple*, they recognize developing and promoting companies is not passive investment. Here's what *Whipple* said: The presence of more than one corporation, in terms of what would be promoted, supports the finding that the taxpayer was engaged in the regular course of promoting commercial corporations for a fee or commission or for a profit on their sale. It cited *Giblin*, which is the lawyer case I described earlier.

So even the U.S. Supreme Court, when it examines this question of mere investment or a trade or business, stops and says, you've got to look to see whether or not stock is being held and sold for the purposes of making a profit on promoting corporations. That was there from the start, it's still there. The *Dagres* court, you quoted some words from it, and I think you and I disagree on how to read *Dagres*. The one thing I think we can agree on is, those words from *Whipple* and *Giblin* and the like are still alive because three years ago in *Dagres*, all

³Chris W. Sanchirico, "The Tax Advantage to Paying Private Equity Fund Managers With Profit Shares: What Is It? Why Is It Bad?" 75 *U. Chi. L. Rev.* 1071, 1102 (2008).

of those words were cited approvingly. And without going into the facts as to why those words matter — whether it's the GP or the partnership that's in a trade or business — the words are alive.

So for those of you who are practicing in this area, stop and read the cases. Look at my article, it gives you a good start. I do not think I can turn around the whole industry on this. I think the case law will unfold, and I think people are going to say we're shocked, who could believe that. But you heard it here first.

Needham: You certainly did hear it here first. Again, Steve, it's a very, very interesting article and I've enjoyed debating it with you. Thank you everyone.

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