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The Carried Interest Standoff: Reaffirming Executive Agency Authority

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THE CARRIED INTEREST STANDOFF: REAFFIRMING EXECUTIVE AGENCY AUTHORITY

*Dean Galaro & Gregory Crespi**

This Article argues that, if reform is necessary, carried interest taxation should be amended by agency rulemaking and not by Congress. Much has already been said about carried interest, but this Article attempts to look through a new lens—legislative history. Carried interest presents a complicated question about the application of foundational partnership tax principles. It is an issue that has received popular attention only within the last decade. Since then, the face of reform has been efforts in Congress to pass an overly complex bill—Section 710. By looking back through the legislative history of carried interest, we begin to see that the best option for reform would be agency rulemaking. Based on legislative history, doctrine, structure, and practicality, this paper will affirm the power of executive agencies in the context of carried interest.

TABLE OF CONTENTS

I. INTRODUCTION	154
II. LEGISLATIVE AND ADMINISTRATIVE HISTORY OF CARRIED INTEREST	156
A. THE 1954 TAX CODE REORGANIZATION	156
B. TREASURY REGULATION § 1.721-1	159
C. REVENUE PROCEDURE 93-27 AND LATER PROPOSALS .	162
III. CARRIED INTEREST IN ACTION	166
IV. THE FAILURE OF SECTION 710.....	168
A. OUTLINE OF PROVISION	168
B. CONGRESSIONAL HEARINGS	169
C. COMMITTEE REPORTS	170
D. CRITIQUES OF SECTION 710	171
V. WHY TREASURY AND NOT CONGRESS	173
A. EXECUTIVE POWER TO ACT ON CARRIED INTEREST: DOCTRINAL AND STRUCTURAL RATIONALES	173
1. <i>Doctrine</i>	174
2. <i>Structure</i>	176

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B. LESSON LEARNED FROM THE SECURITIES AND EXCHANGE COMMISSION	180
C. POSTSCRIPT: CAPITAL GAINS AT LARGE.....	184
VI. CONCLUSION	185

I. INTRODUCTION

BUT only I know the story, the real story. And it is simple and cruel and true and it should make us laugh, it should make us die laughing. But we only know how to cry, the only thing we do wholeheartedly is cry.¹

Ever since *Holy Trinity Church v. United States* in 1892, legislative history has been an available interpretive tool for courts and academics alike.² Thereafter, there has been much debate about the merits and demerits of endless reams of legislative history produced by Congress.³ Such debate is to be avoided here. The goal in this Article is not to make a normative assessment of the various Internal Revenue Code (I.R.C.) sections at play. Rather, the circuitous history of partnership interests is used in service of highlighting the diffident relationship the Internal Revenue Service (IRS or the Service) has had with the subject.

Laws do not appear out of the ether. Bills must be proposed, passed through committee, accepted by both Houses of Congress, and signed by the President.⁴ Bureaucratic agencies play a role as well, often tackling “first-order implementation questions.”⁵ Since *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, agencies have been given deference in interpreting ambiguous laws that Congress either cannot or will not make clear.⁶ And much can be gleaned from the intent of an agency in interpreting an ambiguous law.⁷

1. ROBERTO BOLAÑO, *BY NIGHT IN CHILE* 106 (2003).

2. See *Holy Trinity Church v. U.S.*, 143 U.S. 457, 458–64 (1892); see also Adrian Vermeule, *Legislative History and the Limits of Judicial Competence: The Untold Story of Holy Trinity Church*, 50 STAN. L. REV. 1833, 1835 (1998). (“Holy Trinity elevated legislative history to new prominence by overturning the traditional rule that barred judicial recourse to internal legislative history.”).

3. Compare W. David Slawson, *Legislative History and the Need to Bring Statutory Interpretation Under the Rule of Law*, 44 STAN. L. REV. 383, 402 (1992) (“[A]gencies and courts use legislative history in order to avoid the responsibility and intellectual labor of making the decisions themselves.”), with Abner J. Mikva, *A Reply to Judge Starr’s Observations*, 1987 DUKE L.J. 380, 383 (1987) (“[F]requently a statute’s plain meaning is not going to be easily discerned, and it is not going to be discerned at all if the judges and courts do not look at the legislative history.”).

4. See WILLIAM N. ESKRIDGE JR., ET. AL., *LEGISLATION AND REGULATION* 2–34 (5th ed. 2014) (telling the story, in great detail, of the Civil Right Act of 1964’s journey through Congress).

5. *Id.* at 936.

6. See *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843 (1984) (“[I]f the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency’s answer is based on a permissible construction of the statute.”).

7. See Lars Noah, *Divining Regulatory Intent: The Place for a “Legislative History” of Agency Rules*, 51 HASTINGS L.J. 255, 282 (2000) (“[I]t is far easier to ascribe an intent to an

The I.R.C. is abstruse, and the IRS has been tasked with administering and interpreting it for almost one hundred years.⁸ Subchapter K, created in 1954, is a series of interwoven rules controlling partnership taxation originally intended to provide a flexible business structure that avoids entity-level taxation.⁹ One of the more vexing aspects of partnership tax is carried interest, a partnership interest in future profits used to compensate investment fund managers in a way that is preferentially taxed as capital gains and not ordinary income.¹⁰

Media coverage, political punditry, and hefty compensation packages have made carried interest a hot topic of discussion both in the news¹¹ and in the academy.¹² While many reform proposals and rebuttals have been penned, the question still remains: if reform is appropriate, whose job is it? For the last nine years, Congress has punted the political football of carried interest back and forth in various bills that never made it past committee markup.¹³ On the other hand, the Department of the Treasury (Treasury) and the IRS have mustered only a handful of furtive explanatory salvos in several decades.¹⁴ Nevertheless, as will become clear below, the Treasury and the IRS retain the authority and expertise to make technical, industry-specific changes to partnership tax law.

This Article will develop in several parts. Part II sets out the legislative history behind the Tax Code provisions affecting carried interest, showing

agency when it issues a rule than to a legislature when it enacts a statute, both because of differences in their decisionmaking [sic] routines and because of the greater reliability of the materials that document the bases for their decisions.”).

8. See *Bob Jones Univ. v. United States*, 461 U.S. 574, 596 (1983) (“Yet ever since the inception of the tax code, Congress has seen fit to vest in those administering the tax laws very broad authority to interpret those laws.”).

9. Treas. Reg. § 1.701-2(a) (as amended in 1995).

10. See Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 8–15 (2008) (explaining what carried interest is and why it puts fund managers in an advantageous tax position); *infra* Part III (showing how various tax provisions allow for carried interest compensation).

11. See, e.g., Paul Solman, *Is carried interest simply a tax break for the ultra rich?*, PBS NEWSHOUR (Oct. 29, 2015, 5:54 PM), <http://www.pbs.org/newshour/making-sense/carried-interest-simply-tax-break-ultra-rich/> [<https://perma.cc/9KSQ-Y4JM>]; Kelsey Snell & Steven Sloan, *The ‘carried interest’ debate*, POLITICO (Feb. 6, 2013, 1:25 PM), <http://www.politico.com/story/2013/02/mitt-romney-style-income-under-tax-scrutiny-again-087260> [<https://perma.cc/Y5B4-KV9L>]; see also Joseph Cotterill, *Private equity execs face bigger tax on ‘carried interest’*, FIN. TIMES (Mar. 31, 2016), <http://www.ft.com/cms/s/0/02e6421c-f73e-11e5-803c-d27c7117d132.html#axzz47FX7338W> [<https://perma.cc/VQB7-994D>] (discussing a similar debate in the United Kingdom).

12. See, e.g., Heather M. Field, *The Return-Reducing Ripple Effects of the “Carried Interest” Tax Proposals*, 13 FLA. TAX REV. 1, 2 (2012); Samuel D. Brunson, *Taxing Investment Fund Managers Using a Simplified Mark-to-Market Approach*, 45 WAKE FOREST L. REV. 79, 81–82 (2010); Shrilaxmi S. Satyanarayana, *Tax Equality: Eliminating the Low Effective Marginal Tax Rates for Private Equity Professionals*, 82 ST. JOHN’S L. REV. 1589, 1589 (2008); Fleischer, *supra* note 10, at 1; Matthew A. Melone, *Success Breeds Discontent: Reforming the Taxation of Carried Interests—Forcing a Square Peg into a Round Hole*, 46 DUQ. L. REV. 421, 422 (2008).

13. See *infra* Part IV (discussing the rickety trajectory of Section 710 through Congress).

14. See *infra* Part II.B–C (discussing regulations, proposals, procedures, and case law that have come and gone since Subchapter K was created in 1954).

how the IRS's woolliness has compounded confusion. Part III will then apply the law as it stands today for investment funds. Part IV will discuss the latest congressional attempt to reform carried interest and explain how and why it failed. Finally, Part V offers structural, doctrinal, and practical reasons why, if reform is in fact needed, agency rulemaking is the proper vehicle.

II. LEGISLATIVE AND ADMINISTRATIVE HISTORY OF CARRIED INTEREST

Since 1932, partnerships have been statutorily defined as "a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on."¹⁵ That definition remains largely unchanged to this day.¹⁶ However, the rules surrounding that definition have undergone decades of reinterpretation. This Part will break down the legislative history of carried interest into several parts, all of which will show the damaging effects of the Treasury's "hands off" approach.

A. THE 1954 TAX CODE REORGANIZATION

As a legislative project, the Internal Revenue Code of 1954 (1954 Act or 1954 Code)¹⁷ took two years to prepare, required half a million hours of work, and spanned 928 printed pages.¹⁸ Such a comprehensive overhaul of the tax code was supposed to "remove inequities, to end harassment of the taxpayer and to reduce tax barriers to future expansion of production and employment."¹⁹ Dreams of simple partnership taxation resulted, as the Tax Court once opined, "in utter failure."²⁰ Nevertheless, many portions of Subchapter K have remained static since 1954.

Before passing the 1954 Act, the House Ways and Means Committee (Ways and Means) and Senate Committee on Finance (Finance Committee) published their respective reports on the massive tax bill. Because most bills are heavily shaped in committee, these reports are essential tools for statutory interpretation.²¹ Both committees understood the monumental task—the House Report called partnership tax "among the most confused in the entire income tax field."²²

While certain sections of the new I.R.C. received long discussions, Sections 721–23 (concerning partner contributions, the nexus of current car-

15. Revenue Act of 1932, ch. 209 § 1111(a)(3), 47 Stat. 169, 289 (1932).

16. See I.R.C. § 761(a) (West current through Pub. L. No. 114-254).

17. Internal Revenue Code of 1954, Pub. L. No. 591-736, 68A Stat. 1, 1 (1954).

18. Russell C. Harrington, *Remarks by Commissioner of Internal Revenue Russell C. Harrington, Before the Section of Taxation of the American Bar Association, Dallas, Texas, August 26, 1956*, 10 A.B.A. BULLETIN 16, 21 (1956).

19. H.R. REP. NO. 83-1337, at 1 (1954), as reprinted in 1954 U.S.C.C.A.N. 4017, 4025.

20. *Foxman v. Comm'r*, 41 T.C. 535, 551 (1964), *aff'd*, 352 F.2d 466 (3d Cir. 1965).

21. See Eskridge, *supra* note 4 at 786 ("Most judges and scholars agree that committee reports should be considered as authoritative legislative history and should be given great weight.").

22. H.R. REP. NO. 83-1337, at 4091.

ried interest debate) received short shrift.²³ Like other areas of the 1954 Code, the contribution sections were designed to retain the common law practices.²⁴ All of Subchapter K was written to retain “the existing scheme of regarding the partnership as merely an income-reporting, and not a taxable, entity.”²⁵ Specifically, Section 721 was meant to make “clear that no gain or loss shall be recognized . . . upon a contribution of property to the partnership in exchange for a partnership interest.”²⁶

Both the House and Senate Reports also agreed on partnership salaries. At the time, fixed payments to a partner were not recognized as salary, but rather a distributive share of partnership earnings.²⁷ Such an approach, concluded Ways and Means, was “unrealistic and unnecessarily complicated.”²⁸ Thus, the 1954 Code included Section 707(c), which treats “payment of a fixed or guaranteed amount” of income as salary.²⁹

The 1954 Act did not disturb partnerships’ treatment as aggregates of the individual partners in most situations.³⁰ In a 1993 report on partnership profits interest, the American Bar Association’s Section of Taxation broke down the pre-1954 tax treatment of partnership interests into three categories: services exchanged for compensation, services exchanged for capital interest, and property exchanged for capital interest.³¹

Partner compensation used to be a non-realization event under the aggregate theory. A partner, wrote the Board of Tax Appeals in 1929, “can not be paid a salary by the firm out of earnings in the sense of compensation for services rendered to an employer.”³² Such payment was merely moving money from one pocket to another.³³ This concept, however, was one of the few changed by the 1954 Act. Section 707, as noted above, makes such payments taxable when the partner is not acting as a

23. See *infra* Part II.B (discussing the Treasury regulation for Section 721 and the confusion it continues to cause); Part III (explaining how various I.R.C. sections affect carried interest taxation).

24. H.R. REP. NO. 83-1337, at 4094.

25. S. REP. NO. 83-1622, at 89 (1954), as reprinted in 1954 U.S.C.C.A.N. 4621, 4722.

26. H.R. REP. NO. 83-1337, at 4367.

27. *Id.* at 68, at 4094.

28. *Id.*

29. I.R.C. § 707(c) (West through Pub. L. No. 114-244); H.R. REP. NO. 83-1337, at 4094.

30. See *United States v. Basye*, 410 U.S. 441, 448 n.8 (1973) (“The legislative history indicates, and the commentators agree, that partnerships are entities for purposes of calculating and filing informational returns but that they are conduits through which the taxpaying obligation passes to the individual partners in accord with their distributive shares.”). As noted previously, the House and Senate Reports make clear that the 1954 Act was codifying preexisting common law. See H.R. REP. NO. 83-1337, at 68, as reprinted in 1954 U.S.C.C.A.N. 4017, 4094.

31. See Charles H. Egerton & Richard E. Levine, *The Tax Consequences of the Receipt of a Partnership Profits Interest for Services*, 46 TAX LAW. 453, 456 (1993). Services exchanged for a profits interest is not in this list because the term “profits interest” was not used until Treasury Regulation § 1.721-1 in 1960. See Treas. Reg. § 1.721-1(d) (as amended in 1996).

32. *Lloyd v. Comm’r*, 15 B.T.A. 82, 87 (1929).

33. *Id.* (“A partner receiving a salary is merely transferring money from one to another of his own pockets.”).

partner.³⁴

Contributions to a partnership in return for a capital interest were handled two ways before 1954. Providing services to a partnership and receiving a capital interest was a taxable event.³⁵ The 1954 Act did not codify this concept, necessitating Treasury regulations.³⁶ On the other hand, providing property to a partnership and receiving a capital interest was not a taxable event (as recognized in 1954 by Section 721). In 1934, when a partner contributed stock into a partnership and the partnership later sold the stock at a gain, the IRS argued that the partner had a tax liability.³⁷ The Second Circuit rejected this view by considering the partnership an aggregate of the partners.³⁸

Rearranging the I.R.C. in this way was not easy. As the House Report suggested, the 1954 Act was “developed through extensive and lengthy study” on how to remove various “tax inequities and tax restraints.”³⁹ Interestingly, the members of Ways and Means who voted against the 1954 bill suggested otherwise: “We frankly admit that we do not fully understand or comprehend many of the changes proposed in the bill. . . . In many instances, we were not even given a draft of the proposed changes in the law until the committee began considering them.”⁴⁰ In reference to excise taxes on distilled spirits, the Ways and Means majority admitted their revisions were limited “[d]ue to a lack of time.”⁴¹ Granted, the heavy lifting had already been done before Ways and Means began deliberating.⁴² But with a bill this large, congressmen were inevitably required to vote on tax reforms they did not (could not) fully digest in time.⁴³

The complexity and girth of the 1954 Act also meant Congress would have to lean on Treasury Regulations. Excise taxes on alcoholic bever-

34. See I.R.C. § 707(a), (c) (West through Pub. L. No. 114-244). Such an acute exception to aggregate treatment was, as the Fifth Circuit found, not meant to bleed into other areas of partnership tax law. See *Pratt v. Comm’r*, 550 F.2d 1023, 1026 (1977) (“Congress . . . created an exception to this general rule to limit the excepted activities to those specifically outlined.”).

35. See, e.g., *Lehman v. Comm’r*, 19 T.C. 659, 661–662 (1953). In that case, the petitioner’s capital account was credited \$5,000 for a year’s services to the partnership. *Id.* at 660. The Tax Court did not consider it “crucial” to decide whether the transfer was really compensation, but regardless concluded: “Surely the increase resulted in a gain or profit to petitioners.” *Id.* at 661.

36. See Treas. Reg. § 1.721-1 (as amended in 1996); *infra* Part II.B (discussing the development of the regulations for Section 721).

37. *Helvering v. Walbridge*, 70 F.2d 683, 684 (2d Cir. 1934).

38. *Id.* at 685 (“By his transfer the partner ceases to be sole owner of what he contributes and thereafter holds jointly.”).

39. H.R. REP. NO. 83-1337, at 4025.

40. *Id.* at 4600.

41. *Id.* at 4122.

42. Treasury and the Joint Committee on Internal Revenue Taxation had already spent two years working on the reorganization. *Id.* at 4600.

43. This is a perennial problem. Cf. Stephanie Condon, *Will Congress Read Bills Before Voting?*, CBS NEWS (June 24, 2009, 5:33 PM), <http://www.cbsnews.com/news/will-congress-read-bills-before-voting/> [<https://perma.cc/XQQ9-3A49>] (discussing attempts to get legislators to pledge to read important bills before voting on them).

ages and tobacco were heavily edited in the 1954 Act.⁴⁴ Regarding tobacco products, for example, Ways and Means had considered very detailed statutory language that was eventually removed in favor of authorizing changes by regulation.⁴⁵ Currently, Section 707 grants the Treasury regulatory control over partnership exchanges of services for payment.⁴⁶ Although regulations for Section 721 were not specified in the I.R.C. text, the Treasury was quick to publish them to clarify an ambiguous Code provision.

B. TREASURY REGULATION § 1.721-1

As passed in 1954, Section 721 read in full: “No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.”⁴⁷ This language is now Section 721(a).⁴⁸

Regulation 1.721 was proposed in 1955.⁴⁹ The original version was shorter than the one adopted in 1956, and subsection (b) was quite different. The first sentence originally read: “Section 721 does not apply to the extent that an interest in partnership capital is obtained by a partner as compensation for services (or in satisfaction of obligations) and not in exchange for his contribution of property to the partnership.”⁵⁰ Essentially, this was filling a gap in the 1954 Act. As described above, services exchanged for a partnership interest was a taxable event at common law.⁵¹ But, while other common law rules were codified, this was not. Therefore, the Treasury stepped in to clarify that the common law still stood. The final version of the regulation would, however, attempt to clarify this clarification, causing decades of dispute.

In 1956, Treasury Regulation 1.721-1 was enacted.⁵² The most important part of the regulation for this discussion is subsection (b)(1), which includes a parenthetical clause distinguishing capital interests from profit interests. What was once a simple clarification now became a more detailed and grammatically confusing explanation:

44. H.R. REP. NO. 83-1337, at 4121.

45. *Id.*; see also S. REP. NO. 83-1622, at 129–33 (1954), as reprinted in 1954 U.S.C.C.A.N. 4621, 4762 (concurring with Ways and Means concerning excise tax simplicity and giving Treasury room to adapt by regulation).

46. See I.R.C. § 707(a)(2) (West through Pub. L. No. 114-244). This delegation was not in the 1954 version. See Internal Revenue Code of 1954, Pub. L. No. 591-736, § 707(a), 68A Stat. 1, 243 (1954). It was added in 1984. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 73, 98 Stat. 494, 591 (1984).

47. Internal Revenue Code of 1954, Pub. L. No. 591-736, § 721, 68A Stat. 1, 245 (1954).

48. I.R.C. § 721(a) (West through Pub. L. No. 114-244).

49. See Prop. Treas. Reg. § 1.721, 20 Fed. Reg. 5866 (Aug. 12, 1955).

50. *Id.*

51. See H.R. REP. NO. 83-1337, at 68 (1954), as reprinted in 1954 U.S.C.C.A.N. 4017, 4094; *Lehman v. Comm’r*, 19 T.C. 659, 661–62 (1953).

52. T.D. 6175, 1956-1 C.B. 211 (1956). The language for Reg. § 1.721-1(a)–(b) remains relatively untouched to this day. See Treas. Reg. § 1.721-1 (as amended in 1996).

To the extent that any of the partners gives up any part of his right to be repaid his contributions (*as distinguished from a share in partnership profits*) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply.⁵³

There is no evidence of what comments were received on the draft regulation or what internal forces caused the change.⁵⁴ Arthur B. Willis suggested that 1.721-1(b)(1) was written in response to the 1955 case *Farris v. Commissioner*.⁵⁵ There, the taxpayer was a service partner who received a quarter of the partnership's net proceeds upon termination and liquidation of the partnership.⁵⁶ The court found this sum to be capital gains, not ordinary income, based upon the partnership agreement, the partnership's financial book, and the partner's conduct.⁵⁷ Under Regulation 1.721-1(b)(1), the receipt of the capital interest for services would have been ordinary income.

The second parenthetical allows for profit interests to escape taxation in a way capital interests cannot. Let us take a step back to explain why. I.R.C. Section 61 includes compensation for services in gross income.⁵⁸ Such compensation may be cash or property.⁵⁹ If property is transferred "in connection with the performance of services," then Section 83 applies and the property's fair market value (minus its basis) becomes gross income for the recipient.⁶⁰ Section 721 avoids recognition of gains or losses when a partner contributes property to a partnership in exchange for a partnership interest.⁶¹ Unfortunately for the partners, services do not constitute property.⁶² Therefore, Section 721 non-recognition would not apply. Yet, Regulation 1.721-1(b)(1) identifies "a share in partnership profits" as distinct from "an interest in such partnership capital," the latter being taxable under Section 61.⁶³ Therefore, by a negative inference, while receipt of the capital interest is taxable, the receipt of profit interest is not.

The distinction between capital and profits interests was not unique to Regulation 1.721-1. Section 707, also introduced in the 1954 Act, made the distinction several times. For example, Section 707(b)(1), discussing

53. Treas. Reg. § 1.721-1(b)(1) (emphasis added).

54. Arthur Willis called the regulation "cryptic." ARTHUR B. WILLIS, HANDBOOK OF PARTNERSHIP TAXATION 56 (1957). Two decades later, the Tax Court lamented the regulation's "opaque draftsmanship." *Diamond v. Comm'r*, 56 T.C. 530, 546 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974).

55. See Willis, *supra* note 54, at 56 n.9; *Farris v. Comm'r*, 222 F.2d 320, 323 (10th Cir. 1955).

56. See *Farris*, 222 F.2d at 321-22.

57. *Id.* at 322.

58. See I.R.C. § 61(a)(1) (West through Pub. L. No. 114-254).

59. See *Comm'r. v. Lo Bue*, 351 U.S. 243, 247 (1956) ("It makes no difference that the compensation is paid in stock rather than in money.").

60. I.R.C. § 83(a) (West through Pub. L. No. 114-254).

61. § 721(a).

62. See *Mojonnier & Sons, Inc. v. Comm'r*, 12 T.C. 837, 849 (1949) (receipt of stock in exchange for services created recognizable gain because the stock was not exchanged for property under Section 112(b)(5) of the Revenue Act of 1928).

63. Treas. Reg. § 1.721-1(b)(1) (as amended in 1996).

the disallowance of losses in certain situations, applied to exchanges between “a partnership and a partner owning, directly or indirectly, more than 50 percent of the *capital interest, or the profits interest*, in such partnership.”⁶⁴ Subsection (b)(3) further describes determination of capital and profits interests via Section 267(c).⁶⁵

The same differentiation was reiterated not long after Regulation 1.721-1 was adopted. In 1965, the Tax Court affirmatively cited the regulation for the proposition that “the mere receipt of a partnership interest in future profits does not create any tax liability.”⁶⁶ Regulations like 1.721-1 have garnered reliance for many decades. Long before *Chevron* deference, although there was disagreement about how much credence to give IRS publications, the Supreme Court often supported its interpretations with IRS guidance.⁶⁷ Even the Ways and Means Committee felt it could adequately rely on the regulation’s results. In 1957, the Subcommittee on Internal Revenue Taxation reported to Ways and Means that Regulation 1.721-1(b)(1) provided proper results.⁶⁸ Furthermore, the subcommittee found capital and profits interests readily distinguishable by liquidation value.⁶⁹ The IRS did not formalize this distinction until 1993, as discussed below.

Treasury Regulations for Section 721 were an attempt to fill a gap left by Congress. Unfortunately, in explaining the corrective, the Treasury created more questions than answers. The real mistake was not amending the regulations or publishing further guidance on the difference between profits and capital interests. As the next section will make clear, the light touch with profits interests pushed these queries into the twenty-first century.

64. Internal Revenue Code of 1954, Pub. L. No. 591-736, § 707(b)(1)(A), 68A Stat. 1, 245 (1954) (emphasis added).

65. § 707(b)(3). The House and Senate Reports do not explain the inclusion of the term “profits interest.” See H.R. REP. NO. 83-1337, at 67–68 (1954), as reprinted in 1954 U.S.C.C.A.N. 4017, 4093–94; S. REP. NO. 83-1622, at 92 (1954), as reprinted in 1954 U.S.C.C.A.N. 4621, 4724–45.

66. *Hale v. Comm’r*, 24 T.C.M. (CCH) 1497, 1497 n.3 (T.C. 1965). However, as the Seventh Circuit noted nine years later, the *Hale* decision includes “no explanation of how this conclusion was derived from the regulations.” *Diamond v. Comm’r*, 492 F.2d 286, 289 (7th Cir. 1974).

67. See Kenneth Culp Davis, *Administrative Rules—Interpretive, Legislative, and Retroactive*, 57 YALE L. J. 919, 923 (1948) (pointing out inconsistencies in Supreme Court rhetoric—both cautioning against reliance on IRS rulings and relying upon them); see also, e.g., *Helvering v. Wilshire Oil Co.*, 308 U.S. 90, 98 (1939) (relying upon a General Counsel Memorandum).

68. ADVISORY GROUP ON SUBCHAPTER K OF THE INTERNAL REVENUE CODE OF 1954, 85TH CONG., 1ST SESS., REVISED REP. ON PARTNERS AND PARTNERSHIPS 21 (1957). While the Report agreed with the regulation, it also suggested adding a new Section 724 to provide a statutory foundation for the regulation. See *id.* at 21–23.

69. *Id.* at 21 (“An interest in the capital of a partnership can be distinguished from a profits interest in that the former conveys a right to receive a specific share of the partnership property in a distribution of property upon liquidation . . . and is not dependent upon profits from partnership operation.”).

C. REVENUE PROCEDURE 93-27 AND LATER PROPOSALS

In the early 1990s, the discussion of carried interest shifted from theory to practical considerations.⁷⁰ Revenue Procedure 93-27 was the IRS's response to various common law interpretations spanning the almost four decades since Regulation 1.721-1. Revenue Procedure 93-27 defines capital interests as those with liquidation value when the interest is received.⁷¹ Profits interests, on the other hand, are all other partnership interests.⁷² While very brief, the procedure mentions several cases interpreting partnership profit interests. Some, like *Campbell v. Commissioner*, suggested that profits interests are not taxable.⁷³ Others, like *Diamond v. Commissioner*, found the profits interest in question had an ascertainable value and rejected the contention that receipt of a partnership profit interest was not taxable as ordinary income.⁷⁴

In exchange for arranging a million dollar real estate acquisition, Sol Diamond was offered an interest in a business venture.⁷⁵ The IRS argued that Diamond's partnership interest had a fair market value of \$40,000 that, when received for his services, was ordinary income under I.R.C. § 61.⁷⁶ The Tax Court went so far as to say the Commissioner "disavow[ed]" applying Section 721 to Diamond's partnership interest, as it would "call for a distortion of statutory language."⁷⁷ Specifically, the Tax Court ruled that Regulation 1.721-1 did not *explicitly* state that receipt of a partnership interest for services already performed would receive Section 721 non-recognition.⁷⁸

Three years later, the Seventh Circuit found the IRS to have agreed with the Tax Court's interpretation of Section 721 by silent acquiescence.⁷⁹ While affirming the Tax Court, the Seventh Circuit limited the previous decision's scope to interests "immediately having a determinable market value."⁸⁰ The court thought that profits interests typically only have "speculative value."⁸¹ The atypical nature of the *Diamond* case was reiterated by the Ninth Circuit the same year, finding *Diamond* to be a "rather unique situation" of an interest being immediately sold and thus

70. Howard E. Abrams, *Taxation of Carried Interests: The Reform that Did Not Happen*, 40 LOY. U. CHI. L.J. 197, 207 (2009) ("So the fight shifted from the theoretical to the practical.").

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

72. *Id.*

73. See *Campbell v. Comm'r*, 943 F.2d 815, 822-23 (8th Cir. 1991).

74. See *Diamond v. Comm'r*, 56 T.C. 530, 545-46 (1971) *aff'd*, 492 F.2d 286 (7th Cir. 1974).

75. *Diamond*, 56 T.C. at 543-44.

76. *Id.* at 544.

77. *Id.* at 546.

78. *Id.* ("[I]n the absence of a clearer statement to that effect, we will not approve any such interpretation of them as is requested by petitioners.")

79. See *Diamond*, 492 F.2d at 290 ("[T]he Commissioner has not by regulation or otherwise acted affirmatively to reject it, and in a sense might be said to have agreed by silence."). Furthermore, the Seventh Circuit found it "clearly desirable" that the IRS promulgate "appropriate regulations, to achieve a degree of certainty." *Id.* at 291.

80. *Id.* at 289.

81. *Id.* at 290.

having an established market value.⁸²

Afterwards, the “*Diamond* problem” was “under active consideration” by the IRS.⁸³ Possibly in response, the IRS wrote a proposed Revenue Ruling. However, a General Counsel Memorandum explained that the ruling would be tabled “pending further discussion” of “alternative positions” on profits interests.⁸⁴ According to another IRS memorandum, some inside the Service had suggested simply ignoring *Diamond*.⁸⁵ Finding such a plan unacceptable, the IRS took to distinguishing *Diamond* on its facts, concluding that the interest in that case was primarily a capital interest.⁸⁶ The proposed ruling made it explicit: “The Internal Revenue Service will not follow the decision in *Sol Diamond* to the extent that it holds that the receipt by a partner of an interest in future partnership profits as compensation for services results in taxable income.”⁸⁷ Not taxing profits interests received as compensation was due to Regulation 1.721-1(b), which was “apparently designed to reach such a result.”⁸⁸ Additionally, this Memorandum adopted the liquidation valuation method of distinguishing between a capital and profits interest (the same method defined in Revenue Procedure 93-27 and accepted by Ways and Means in 1957).⁸⁹

Did the IRS flip on its interpretation of profits interests? No, because the Service’s agreement with *Diamond* was constrained by the case’s facts. An IRS Action on Decision from 1975 noted that an initial memorandum by the Committee on Partnerships suggested adopting the Tax Court’s *Diamond* opinion.⁹⁰ Recognizing that the partnership in *Diamond* was formed after services were rendered to the business, the IRS reiterated that *Diamond*’s services were not performed as a partner because the partnership did not yet exist.⁹¹ Furthermore, the IRS found “no authority for taxing one who agrees to accept a profits interest in a partnership in a *bona fide* exchange for his promise to render future services as a partner.”⁹² Section 721 was understood to force this conclusion.⁹³ Essentially, the IRS understood *Diamond* to apply in a very narrow fac-

82. United States v. Pacheco, 912 F.2d 297, 302 (9th Cir. 1990).

83. I.R.S. Gen. Couns. Mem. 37,058 (Mar. 28, 1977).

84. I.R.S. Gen. Couns. Mem. 36,346 (July 23, 1975).

85. See *id.* (“Previously it has been proposed that the Service not follow *Diamond* when a profits interest is received as compensation for services rendered in a capacity as partner.”).

86. *Id.*

87. *Id.*

88. *Id.* Use of the word “apparently” hints at the Service’s incredulity to the situation.

89. *Id.* (“For purposes of section 1.721-1(b)(1) a partner’s right to be repaid his contributions consists of the value of any property that would be distributable to him on liquidation of his interest.”).

90. I.R.S. Act. On Dec. 18281, 1975 WL 183780, at *1 (Sept. 29, 1975).

91. *Id.* at *2.

92. *Id.* at *3; see I.R.C. § 707(a), (c) (West through Pub. L. No. 114-244).

93. Interestingly, the Action on Decision only once mentions Regulation 1.721-1 in passing. Its analysis was not clearly grounded on the regulation’s text, instead focusing on Section 707. See *id.*

tual situation, where the profits interest has a market value and is received in exchange for services rendered as a non-partner.

After *Diamond*, the debate over profits interests quickly lulled until 1991 when *Campbell* was decided.⁹⁴ In 1990, the Tax Court held that an exchange of services for partnership interests was a taxable event.⁹⁵ Although *Campbell* received a mix of profits and capital interests in various ventures, the Tax Court ruled that Section 721 “makes no distinction between the receipt of a capital interest and a profits interest.”⁹⁶ On appeal to the Eighth Circuit, the IRS put its internal determinations into practice, conceding not only that *Campbell*’s profits interests were not ordinary income, but also that *Campbell*’s services were performed as an employee and not as a partner.⁹⁷ The circuit court rejected the latter based upon insufficient facts.⁹⁸ Yet, the court accepted the former, agreeing with *Campbell* that his profits interests “had only speculative, if any, value.”⁹⁹

This judicial back-and-forth is why Revenue Procedure 93-27 makes clear: “[I]f a person receives a profits interest [in exchange for services] in a partner capacity or in anticipation of being a partner, the Internal Revenue Service will not treat the receipt of such an interest as a taxable event for the partner or the partnership.”¹⁰⁰

While high profile court cases have ceded, a slew of proposals have come and gone since 1993. Eight years later, the Service clarified Procedure 93-27 and widened its application. Revenue Procedure 2001-43 held that the capital or profits interest determination is to be made when a partnership interest is granted, “even if, at that time, the interest is substantially non-vested.”¹⁰¹ In 2005, the IRS proposed a procedure that would have required an affirmative election by both partner and partnership when determining the value of a partnership interest.¹⁰² This proposal has since languished.

Proposals have also come and gone for regulation amendments. In 1971—the year the Tax Court decided *Diamond*—the IRS proposed reg-

94. This was due to the Service’s “hands off” approach. See Egerton & Levine, *supra* note 31, at 454–55.

95. *Campbell v. Comm’r*, 59 T.C.M. (CCH) 236 (1990), *aff’d in part, rev’d in part*, 943 F.2d 815 (8th Cir. 1991).

96. *Id.*

97. *Campbell v. Comm’r*, 943 F.2d 815, 818 (8th Cir. 1991); see also *supra* notes 83–89 and accompanying text (discussing IRS memoranda).

98. *Campbell*, 943 F.2d at 818.

99. *Id.* at 823.

100. Rev. Proc. 93-27, 1993-2 C.B. 343. Although the liquidation method has been enshrined in tax law since the 1993 Revenue Procedure, it has its critics. See, e.g., Laura E. Cunningham, *Taxing Partnership Interests Exchanged for Services*, 47 TAX. L. REV. 247, 248 (1991) (arguing that capital and profit interests are economically indistinguishable, thus the liquidation method should be replaced with a rule that taxes all partnership interests based upon whether the service done in exchange for the interest is complete when the interest is transferred).

101. Rev. Proc. 2001-43, 2001-2 C.B. 191.

102. See I.R.S. Notice 2005-43, 2005-1 C.B. 1221.

ulations amending 1.721-1(b)(1).¹⁰³ The amendment would have added a subsection that explicitly applied Section 83 to transfers of “such interest in partnership capital.”¹⁰⁴ Notice of proposed regulations in 2003 included a request for comment on the 1971 proposal and Section 83’s applicability to capital interests and service partners.¹⁰⁵ Then, in a 2005 regulation proposal, the IRS withdrew the 1971 proposal.¹⁰⁶

As for profits interests specifically, in 2005, the IRS proposed treating capital and profits interests the same way under Section 83, writing, “the Treasury Department and the IRS do not believe that there is a substantial basis for distinguishing among partnership interests for purposes of section 83.”¹⁰⁷ The Treasury also suggested that the same tax rules should apply to both interests in *all* contexts, and that taxpayers were exploiting current differences.¹⁰⁸ But like the various interpretations of Section 721, coordinating with Section 83 has taken many decades to propose, as Section 83 was added to the I.R.C. in 1969.¹⁰⁹

Taken together, the 2005 Proposed Treasury Regulation and Revenue Procedure seemed to be a sweeping shift in policy toward profits interests. However, a Treasury official downplayed the change in a 2007 hearing before the Senate Committee on Finance. According to Eric Solomon (then Secretary for Tax Policy), the 2005 regulation and procedure proposals were not reversals of opinion, but adjustments in administration.¹¹⁰ They would have “continue[d] in most instances the approach adopted in 1993.”¹¹¹ The purpose of the proposals was to preserve symmetry between partner and partnership—under a Section 83 election, there would be no income for the partner and no deduction for the partnership.¹¹²

103. Prop. Treas. Reg. § 1.721-1, 36 Fed. Reg. 10787, 10799 (June 3, 1971).

104. *Id.*

105. See Prop. Treas. Reg. § 1.721-1, 68 Fed. Reg. 2930-01, 2930 (Jan. 22, 2003).

106. See Prop. Treas. Reg. § 1.83-3, 70 Fed. Reg. 29675-01, 29675 (May 24, 2005) (withdrawing June 3, 1971 proposal).

107. *Id.* at 29676. The 2005 version of Section 1.721-1 would have provided: “[S]ection 721 does not apply to the transfer of a partnership interest in connection with the performance of services . . . [because that] constitutes a transfer of property to which section 83 and the regulations thereunder apply.” *Id.* at 29683. Doing so would arguably create more questions than answers. Section 83 is itself complicated, and how the 2005 proposals would interact with Section 83 is a topic much larger than the scope of this paper. See generally Douglas A. Kahn, *The Proper Tax Treatment of the Transfer of a Compensatory Partnership Interest*, 62 TAX. LAW. 1, 2 (2008) (providing excellent explanation and analysis of various issues surrounding partnership interests and Section 83).

108. See Prop. Treas. Reg. § 1.83-3, 70 Fed. Reg. 29675-01, 29676 (May 24, 2005) (“[C]ommentators have suggested that taxpayers may exploit any differences in the tax treatment of partnership profits interests and partnership capital interests. The Treasury Department and the IRS agree with these comments.”).

109. See Tax Reform Act of 1969, Pub. L. No. 91-172, § 321, 83 Stat. 487, 588 (1969).

110. See *Carried Interest: Hearings Before the S. Comm. on Fin.*, 110th Cong. 460–69 (2007) [hereinafter 2007 Hearings] (statement of Hon. Eric Solomon, Treasury Secretary for Tax Policy); see also *infra* Part IV.B for a more detailed discussion of Solomon’s testimony.

111. 2007 Hearings, *supra* note 110, at 464.

112. *Id.*

At the end of the day, it took the IRS almost twenty years to publicly announce its conclusions about profits interests. Internally, the Service had discussed going against *Diamond* since at least 1975.¹¹³ And after 1993, it took another twelve years to explain how Sections 721 and 83 work together. What took so long? As will be discussed below,¹¹⁴ there are clear rationales for why the Treasury and IRS can and should produce tax rules. Possibly the small number of adjudicated controversies meant profits interests were not a pressing concern. Even so, the economic and political environment has now changed. Perhaps the Service was acting in an abundance of caution; we value stability in the Code (giving notice and enhancing predictability), and all agency changes burden the legal system with learning how to function under new rules.¹¹⁵ On the other hand, common law tax rules are malleable not only over time, but also by jurisdiction.

In conclusion, the development of various tax law provisions affecting partnership interests and carried interest have shown the need for clear rulemaking. A dearth of unifying explanations from the Treasury and the IRS has compounded confusion. The history of carried interest is replete with the institutional jockeying between branches of government. But what has it all led to?

III. CARRIED INTEREST IN ACTION

Having discussed the vacillations in understanding between judges, congressmen, and the Treasury, it is worthwhile to apply the current carried interest rules to investment funds. As it stands, the law allows for a general partner receiving a profits interest in a fund to characterize the gains from the fund as capital gains.

Private equity, hedge funds, and venture capital funds are all variations on a common theme. All three are private pools of capital given to a manager for investment. Private funds are normally set up as limited partnerships.¹¹⁶ Limited partnerships contain two groups of actors: (1) the general partner (GP), who forms the fund and manages the invested capital; and (2) the limited partners (LP), who are passive investors with limited liability exposure.¹¹⁷ This simple structure can be expanded into a complex business organization for large funds. Take the Carlyle Group—as one of the largest private equity firms in the world, it manages \$169

113. See *supra* notes 83–89 and accompanying text.

114. See *infra* Part V.

115. See Walter D. Schwidetzky, *The Partnership Allocation Rules of Section 704(B): To Be or Not To Be*, 17 VA. TAX REV. 707, 709 (1998) (“There is also much to be said for stability in the law. It gives practitioners time to learn a given area and can provide for greater predictability. . . . The improvement must be substantial to justify the burdens it places on the legal system by way of learning time.”).

116. THOMAS D. SIMPSON, FINANCIAL MARKETS, BANKING, AND MONETARY POLICY 320 (2014).

117. *Id.* at 321.

billion held in 125 funds and 177 fund of funds vehicles.¹¹⁸

Compensation for fund management normally comes in two forms. Fund management receives an annual management fee for the service of running the fund and investing the capital.¹¹⁹ Most firms charge 2% of assets under management, an amount that covers salaries and other expenses.¹²⁰ This is ordinary income for the fund managers.¹²¹ The central source of fund revenue, however, is the performance fee that funds exact when a fund closes and profits are distributed. Under most limited partnership agreements, any profits will first go to the LPs. If the rate of return exceeds a certain percentage (the hurdle rate), then the GP can receive their performance fee, normally 20% of profits.¹²² From this setup we get the term “two and twenty.”

Payouts of profits interests escape ordinary income taxation in two ways. First, when a partnership pays a partner in its capacity as a partner (as opposed to its capacity as an employee) and the amount is not guaranteed (i.e., tied to the income of the partnership), the payment is a distribution of partnership interest, not salary.¹²³ Second, because partnerships are pass-through entities, the character of income is determined at the partnership level and goes unchanged when distributed to the partners.¹²⁴ The sale of a security or an interest in a portfolio company becomes a capital gain for the partnership and, therefore, a capital gain for the partner as well.¹²⁵ Because of this, the real point of contention has been whether the profits interest is, from the start, a taxable event.

118. See Carlyle Group L.P., Current Report 2 (Form 8-K) (Oct. 26, 2016), <http://ir.carlyle.com/secfiling.cfm?filingID=1527166-16-34&CIK=1527166> [<https://perma.cc/D2WV-89KU>].

119. SIMPSON, *supra* note 116, at 321.

120. *Id.* This small percentage fee is possible because most private funds are lean operations. It does not require a large staff to make investment decisions. However, this also means that later profits are spread out among a small group, in part leading to certain fund managers having very large incomes.

121. See I.R.C. § 61(a)(1) (West through Pub. L. No. 114-254) (gross income covers “compensation for services,” including “fees”). There are ways to reduce taxable fee income and shift more income into carried interest. Fund managers may simply reduce their fees for an increased profit interest. A more complicated method is “cashless capital contribution” whereby management fees are converted (pretax) into investment capital. See Fleischer, *supra* note 10, at 23–24 (discussing methods of converting management fees into profits interest).

122. See, e.g., Carlyle Group L.P., Annual Report 17 (Form 10-K) 17 (Feb. 24, 2016), <http://ir.carlyle.com/secfiling.cfm?filingID=1527166-16-18&CIK=1527166> [<https://perma.cc/36UT-87ZC>] (“The receipt of carried interest . . . is dictated by the terms of the partnership agreements that govern such funds, which generally allow for carried interest distributions . . . after satisfaction of obligations relating to the return of capital from all realized investments, any realized losses, allocable fees and expenses and the applicable annual preferred return.”).

123. I.R.C. § 707(c) (West through Pub. L. No. 114-244). If payment is guaranteed and not determined by partnership income, then the payout becomes salary and therefore ordinary income under Section 61(a).

124. See § 702(b) (“The character of any item of income, gain, loss, deduction, or credit included in a partner’s distributive share . . . shall be determined as if such item were realized directly from the source from which realized by the partnership.”).

125. When capital assets are sold, they incur capital gains for the taxpayer. See §§ 1221–1222. Currently, net capital gains are taxed at a maximum rate of 28%. See § 1(h).

IV. THE FAILURE OF SECTION 710

The tax structure described above has “proven resilient, however, against criticism from many quarters and ideological perspectives, and has managed for the most part to creak along”¹²⁶ Myriad academic proposals have failed to become law.¹²⁷ But in 2007 without Treasury guidance, Congress decided to address carried interest with the intent of closing a perceived loophole. Senator Max Baucus made it clear in his opening statement before the Senate Committee on Finance: “Today we examine whether some people who are earning great wealth are also avoiding their full and proper share of the burden of taxation.”¹²⁸

A. OUTLINE OF THE PROVISION

Section 710 has been proposed in Congress in varying forms at least twenty-two times since 2007. Several versions passed the House, but the Senate Committee on Finance scrubbed Section 710 from the bills every time.¹²⁹ Professor Philip Postlewaite suggests that carried interest only caught the eye of Congress in recent years because of the sheer amount of income being recognized as capital gains for investment managers.¹³⁰ This is probably true, although it misses the context of the 2008 recession. The early 2000s were a time ripe for investment and big profits.¹³¹ Once the floor fell out from under the economy, however, Wall Street excess fell into the crosshairs. Thus, Professor Fleischer’s *Two and Twenty* had a large part in jumpstarting the discussion.¹³²

The most recent version of Section 710 would create a new type of interest: an “investment services partnership interest.”¹³³ This is defined

126. JOSEPH ISENBERGH, *INTERNATIONAL TAXATION* xv (3d ed. 2010) (discussing the imperishable nature of international tax, a quality that is equally applicable to partnership taxation).

127. See *supra* note 12 (listing several articles discussing carried interest reform).

128. 2007 Hearings, *supra* note 110, at 1.

129. See H.R. 4213, 111th Cong. (2nd Sess. 2010); H.R. 6275, 110th Cong. (2nd Sess. 2008); H.R. 3996, 110th Cong. (1st Sess. 2007); H.R. 3970, 110th Cong. (1st Sess. 2007).

130. Philip F. Postlewaite, *Fifteen and Thirty-Five—Class Warfare in Subchapter K of the Internal Revenue Code: The Taxation of Human Capital Upon the Receipt of a Proprietary Interest in a Business Enterprise*, 28 VA. TAX REV. 817, 867 n.133 (2009). Postlewaite also wonders why, given the longstanding existence of profits interests as compensation, private equity firms did not start utilizing them earlier. *Id.*

131. See DONALD J. MARPLES, CONG. RES. SERV., RS22689, *TAXATION OF HEDGE FUND AND PRIVATE EQUITY MANAGERS 2* (2014).

132. See Lisa Lerer, *Professor’s proposal angers Wall Street*, POLITICO (Oct. 20, 2007, 6:45 AM), <http://www.politico.com/story/2007/10/professors-proposal-angers-wall-street-006594> [<https://perma.cc/3D48-5VFW>] (discussing the fervent political response to Fleischer’s article); *supra* note 123 and accompanying text.

133. Jobs! Jobs! Act of 2015, H.R. 3555, 114th Cong. § 412(a) (2015). All references to Section 710 in this paper are to the most recently proposed version, which was included in the 2015 Act. Section 710 is in Section 412 of the 2015 Act. For ease of reference, all further citations will be to the parts and subparts of Section 710 directly, not Section 412. For example, “investment services partnership interest” is defined in Section 710(c). See § 710(a). The first version of Section 710, introduced by Representative Sander Levin in 2007, is much shorter, but accomplishes the same goal. See H.R. 2834, 110th Cong. § 710 (2007).

as an interest in an investment partnership that conducts business advising, managing, or arranging financing for investments in specified assets.¹³⁴ If a partner in an investment partnership performs the services described in the previous sentence, the partner holds an interest in the partnership, and the value of the interest is “substantially related” to the income from such services, then the partner’s income or gain is treated as ordinary income.¹³⁵ Section 710 includes an ordinary income exception for “qualified capital interest,” which is a partnership interest attributable to money or property contributed in exchange for a partnership interest (i.e., anything but the exchange of services for interest).¹³⁶ The analysis of Section 710 has been ongoing since its introduction, and many commentators have included more thorough analyses of the provision than is necessary here.¹³⁷

B. CONGRESSIONAL HEARINGS

Between three Finance Committee hearings and one Ways and Means hearing in 2007—all of which created over 800 pages of material—economists, law professors, and investment professionals abounded. Yet, the only witness from the Treasury or the IRS was Eric Solomon, then Treasury Secretary for Tax Policy. He testified before the Finance Committee during its first hearing on July 11, 2007.¹³⁸

Solomon’s testimony revolved around the idea that carried interest presented a question about longstanding rules that promote entrepreneurship.¹³⁹ Emphasizing the important role partnerships play in the U.S. economy, Solomon argued that risk was crucial: “It is important to emphasize that a partner receives a benefit from owning a profits interest only if the partnership is successful.”¹⁴⁰ Moreover, Solomon argued that current tax rules provided taxpayers with certainty and made partnership interest transactions more administrable for the IRS.¹⁴¹ He warned the

134. Jobs! Jobs! Jobs! Act of 2015, H.R. 3555, 114th Cong. § 710(c)(1)–(2) (2015). Specified assets include securities, investment real estate, partnership interests, commodities, cash, and options contracts. § 710(c)(4).

135. § 710(e)(1)–(2). Section 710 would also alter Section 702(b), making distributive shares of investment services partnership interests ordinary income when equal to the net capital gain with respect to the partnership interest. See § 710(a)(1)(A).

136. § 710(d)(7).

137. See, e.g., Abrams, *supra* note 70, at 211–14; Letter from Stanley L. Blend, Chair, ABA Section of Taxation, to Senate Committee on Finance and House of Representatives Committee on Ways & Means (Nov. 13, 2007), <http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2007/071113commentshr2834.authcheckdam.pdf> [<https://perma.cc/6CUS-WLEZ>]; Daniel Feldman, *Carried Interest: “That is Pure Poppycock!”*, 12 RUTGERS J. L. & PUB. POL’Y 513, 526–29 (2015); Brunson, *supra* note 12, at 92–94.

138. See 2007 Hearings, *supra* note 110, at 6–8, 460–89 (statement of Hon. Eric Solomon, Treasury Secretary for Tax Policy).

139. *Id.* at 8 (“Partnerships of every size and in every industry have established and operated their businesses in reliance on the existing tax rules. While it is important to review our tax laws and policies, we must be cautious about making significant changes to partnership tax rules that have worked successfully to promote and support entrepreneurship for many decades.”).

140. *Id.* at 7.

141. *Id.* at 8.

Finance Committee to be “cautious about making significant changes to partnership tax rules that have worked successfully . . . for many decades.”¹⁴² In Solomon’s written testimony, he rejected three alternatives to the current structure: taxing profit interests as ordinary income upon receipt, taxing carried interest as ordinary income at distribution, and taxing partners annually via the “cost of capital” method.¹⁴³

Interestingly, Solomon also provided some insight into the IRS’s slow reaction to cases construing Section 721 and Regulation 1.721-1. In the context of *Diamond* and *Campbell*, Solomon stated that “[r]ather than continue to expend resources in asserting that the receipt of a profits interest is taxable and challenging the valuation of profits interests, the Treasury Department and IRS in 1993 adopted [Revenue Procedure 93-27].”¹⁴⁴ By making profits interests generally untaxed (based on the difficulty of their valuation), the IRS found the most efficient way to administer taxation of a profits interest—avoid it. While nothing was said about the Treasury developing its stance on carried interest, Solomon did mention that a group of IRS and Treasury officials had convened earlier that year (2007) to consider various issues surrounding hedge funds.¹⁴⁵

Clearly, the Treasury saw no need for congressional tinkering with Subchapter K. The 2005 proposals, discussed previously, had the same goals as Congress’s 2007 reform efforts—update the tax code to better coordinate provisions that ensured equitable administration. For whatever reason, the Treasury did not think the issue was ripe enough in 2007. Nevertheless, Congress pushed forward, giving Section 710 full committee consideration.

C. COMMITTEE REPORTS

As stated above, the only bills carrying Section 710 to pass either chamber of Congress were the Tax Increase Prevention Act of 2007 (2007 Bill)¹⁴⁶ and the Alternative Minimum Tax Relief Act of 2008 (2008 Bill).¹⁴⁷ Both bills contained the same version of Section 710, both were reported out of the House Ways and Means Committee, and the sections of the reports devoted to Section 710 are virtually identical. For ease of citation and discussion, this subsection will focus on the 2008 report.¹⁴⁸

Ways and Means took on the 2008 Bill because it had “become aware” that private investment funds were paying capital gains rates on carried interest.¹⁴⁹ In response, Ways and Means focused not on the undergirding

142. *Id.*

143. *See id.* at 466–68.

144. 2007 Hearings, *supra* note 110, at 464 (statement of Hon. Eric Solomon, Treasury Secretary for Tax Policy).

145. *Id.* at 477. This matches the Securities and Exchange Commission’s contemporaneous scrutiny of hedge funds. *See infra* Part V.B.

146. H.R. 3996, 110th Cong. (1st Sess. 2007) (originally introduced as the Temporary Tax Relief Act of 2007).

147. H.R. 6275, 111th Cong. (2nd Sess. 2008).

148. *See generally* H.R. Rep. No. 110-728 (2008).

149. *Id.* at 16.

structure of partnership taxation but rather on the fact that managing partners in investment funds provide services. For the sake of “neutrality of the tax law” and “fairness,” the Committee wrote that income derived from the performance of services must be taxed as ordinary income.¹⁵⁰ Equity loomed large in the 2008 report.¹⁵¹

The majority of Ways and Means found that the valuation discussion in *Diamond, Campbell*, and Revenue Procedure 93-27 had proved useless in combatting the error that the Committee hoped to solve. The 2008 report acknowledged that the IRS’s position on carried interest in 2008 was that of Revenue Procedure 93-27.¹⁵² Evident frustration with this approach led to the creation of Section 710. And, noticing the gap in substantive regulations, the 2008 Report commanded the Treasury to write new regulations upon passage of the bill.¹⁵³

Bucking the Treasury’s slower, almost generational view of carried interest, Ways and Means reported bills with a clunky and complicated reform proposal. But Section 710 failed, and it has continued to be proposed and subsequently forgotten each congressional session. Carried interest transformed from a technical tax question into a harbinger of economic inequality and recession-era instability.¹⁵⁴

D. CRITIQUES OF SECTION 710

Plenty of articles debating the pros and cons of *how* Section 710 would apply have already been written. Nevertheless, to cement the idea that Section 710 is a misguided congressional Band-Aid, a short overview of current commentary should suffice.

Some commentators simply believe Section 710 would complicate an already complicated Subchapter K. Professor Heather M. Field thinks Section 710 would “make the tax code more complex, increase transaction costs, and further distort taxpayer incentives as to the structure of compensation for service partners.”¹⁵⁵ The American Bar Association Section of Taxation (the Tax Section) also believes that Section 710 is

150. *Id.* at 17.

151. *See id.* (“The tax rules should not permit investment managers to structure their compensation so it is subject to preferential capital gains rates of 15 percent, and to pay no employment tax on these amounts, while wage-earners who have no such restructuring opportunities are subject to tax on ordinary income up to a top rate of 35 percent, plus employment tax.”).

152. *Id.*

153. *Id.* at 25.

154. The Congressional Record is replete with Members discussing carried interest in familiar, comparative terms. In 2015, Senator Tammy Baldwin referred to carried interest as a loophole and compared tax rates between “Wall Street billionaires” and “truckdrivers [sic], teachers, and nurses.” 114 CONG. REC. S2641 (daily ed. May 5, 2015) (statement of Sen. Tammy Baldwin). Senator Sheldon Whitehouse compared private equity fund managers with firefighters and brick masons. 113 CONG. REC. S3828 (daily ed. May 23, 2013) (statement of Sen. Sheldon Whitehouse).

155. Heather M. Field, *The Real Problem with Carried Interests*, 65 HASTINGS L.J. 405, 409 (2014); *see also* Postlewaite, *supra* note 130, at 880 (“From a policy standpoint, an old tax is a good tax because all have come to accept it and have adjusted their activities accordingly.”).

burdensome and unwieldy.¹⁵⁶ Such critiques of Section 710 are not new for the Tax Section, which first began its campaign against variations of the bill in 2007.¹⁵⁷ It should also be noted that while the Tax Section dislikes Section 710, it has commented approvingly on the Treasury's 2005 Regulation Proposal.¹⁵⁸

Professor Howard E. Abrams has discussed what he considered the "most important conceptual failure" of Section 710.¹⁵⁹ The 2007 version of Section 710¹⁶⁰ excluded from characterization (as ordinary income) a "reasonable allocation" to a partner based upon the partner's invested capital.¹⁶¹ As Abrams explained, this provision would not account for a service partner's share of contributed capital increases because capital is distributed to other partners.¹⁶² Such is the case in many investment funds where capital is initially distributed to the investors (LPs) before being distributed to the managers (GPs).¹⁶³

There is also a fear that Section 710 would negatively affect other types of businesses. The Tax Section worried the bill went far afield, affecting C corporations, non-grantor trusts, and tiered partnerships.¹⁶⁴ Jason Sacks, in a student note, found two primary shortcomings of Section 710.¹⁶⁵ First, Sacks was concerned with 710's overbroad application to C corporations in that it could disallow certain deductions.¹⁶⁶ More importantly, however, Section 710 would stop carried interest losses in one fund from offsetting carried interest gains in another fund.¹⁶⁷ Sacks feared a conglomeration of investment funds, reduced investor selection, and market inefficiency.¹⁶⁸ Congressman Pete Sessions has voiced similar

156. See Letter from Charles H. Egerton, Chair, ABA Section of Taxation, to Senate Committee on Finance and House of Representatives Committee on Ways & Means (Nov. 5, 2010), <http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2010/110510comments.authcheckdam.pdf> [<https://perma.cc/F34P-72BS>] ("[W]e believe Proposed Section 710 would add significant and burdensome complexities to the Code.").

157. See generally Blend, *supra* note 137.

158. Letter from Dennis B. Drapkin, Chair, ABA Section of Taxation, to Commissioner of I.R.S., 2006 WL 4774960, at *7 (Dec. 29, 2005) ("We concur with the Service and Treasury determination that profits-only partnership interests should be treated as property and that section 83 should apply to both capital and profits-only partnership interests.").

159. See Abrams, *supra* note 70, at 223–227.

160. Abrams based his analysis on the version of Section 710 contained within the Tax Reduction and Reform Act of 2007. See Abrams, *supra* note 70, at 211–12, 212 n.82 (discussing H.R. 3970, 110th Cong. (1st Sess. 2007)).

161. Abrams, *supra* note 70, at 224.

162. *Id.* at 225 ("But by ignoring such distributions, proposed Section 710 blinds itself to the changing economic relationship of the parties.").

163. See *supra* Part III (explaining standard fund structure).

164. Egerton, *supra* note 156, at 2–3, 3 n.6.

165. See Jason A. Sacks, Note, *Effective Taxation of Carried Interest: A Comprehensive Pass-Through Approach*, 89 WASH. U. L. REV. 449, 462–64 (2011).

166. *Id.* at 462.

167. *Id.*

168. *Id.* at 462–63 ("The net result of this development will be reduced investor selection, both in terms of fund strategies and actual numbers of funds. Reduced consumer (and by extension, investor) selection is often broadly regarded as an undesirable outcome.").

concerns.¹⁶⁹

As this Part strived to show, the proposal of Section 710 was a shift of the carried interest question from agency to congressional control. Political pressures forced Congress's hand, but it turned out to be a donk bet.¹⁷⁰ Since then, the Treasury's stolidity has returned. If reform is indeed proper, when will the time be right? As the following Part will make clear, the Treasury and the IRS, not Congress, should make that decision.

V. WHY THE TREASURY AND NOT CONGRESS

A. EXECUTIVE POWER TO ACT ON CARRIED INTEREST: DOCTRINAL AND STRUCTURAL RATIONALES

While presidents (or more generally, the executive branch of government) often use their executive power to achieve policy objectives,¹⁷¹ one clear caveat is tax. As Professor Daniel Hemel points out, while past presidents have used their powers to make changes in environmental, health, and labor law (to name a few), tax policy has been cabined to congressional action.¹⁷²

President Obama repeatedly asked Congress to reform carried interest. In 2007, then-presidential candidate Obama made a similar pledge: "We need to close the loophole that allows managers at some large hedge funds and private equity funds to unfairly cut their tax bills more than in half by treating regular service income as capital gains."¹⁷³ And in late 2015, President Obama told the Business Roundtable that "[k]eeping this tax loophole . . . is not in any demonstrable way improving our economy."¹⁷⁴ The President's tax proposals have not been limited to public

169. See 111 CONG. REC. H4090 (daily ed. May 28, 2010) (statement of Rep. Pete Sessions) (discussing how a proposed jobs bill would have thrown "billions of dollars at a bunch of short-term solutions while creating permanent, new taxes on business," including carried interest hikes affecting real estate, energy, and investment firms).

170. In poker, a "donk bet" is a bad bet made by an inexperienced player (sometimes called a "donkey"). See *Standard Lines: Donk bet*, POKERSTRATEGY, <https://www.pokerstrategy.com/strategy/fixed-limit/58/1/> [<https://perma.cc/4B99-JECD>]; see also *infra* Part V.B for a discussion of political pressures behind Congress's interjection.

171. See, e.g., Exec. Order No. 13,658, 79 Fed. Reg. 9851, 9851 (Feb. 12, 2014) (raising minimum wage for federal contractors); Exec. Order No. 13,672, 79 Fed. Reg. 42791, 42791 (July 21, 2014) (prohibiting gender identity discrimination of federal employees); Exec. Order No. 13,435, 72 Fed. Reg. 34591, 34591 (June 22, 2007) (limiting federal funding for stem cell research).

172. Daniel J. Hemel, *The President's Power to Tax*, 102 CORNELL L. REV. (forthcoming 2016) (manuscript at 5) (on file with author) ("[T]he past three Presidents have repeatedly asked Congress to close 'loopholes' in the tax laws—even when existing statutes gave them ample (or at least arguable) authority to enact a desired change, and even when legislative gridlock made it exceedingly unlikely that Congress would act.").

173. Kevin Drawbaugh, *Hillary Clinton slams private equity tax rate*, REUTERS (July 13, 2007, 8:12 PM), <http://www.reuters.com/article/us-privateequity-clinton-idUSN1339356720070714> [<https://perma.cc/2CH4-LM9A>].

174. Toluse Olorunnipa & Angela Greiling Keane, *Obama Renews Carried Interest Tax Fight With Republican Help*, BLOOMBERG (Sept. 16, 2015, 11:11 AM), <http://www.bloomberg.com/politics/articles/2015-09-16/obama-dusts-off-carried-interest-tax-fight-with-republican-help> [<https://perma.cc/7FCQ-3DEB>]. While the term "loophole" is frequently used, it is worth noting: "A provision [] regarded as a loophole for one group is often justified as a

comments, however. Each year, the President compiles a book of suggested tax reforms, known as the “Greenbook.”¹⁷⁵ All of President Obama’s Greenbooks contained calls for carried interest reform.¹⁷⁶

1. Doctrine

IRS inaction is not for lack of authority. Although the Origination Clause of the Constitution requires bills raising revenue to begin in the House of Representatives,¹⁷⁷ the Supreme Court has explained that the Clause “implies nothing about the scope of Congress’ power to delegate discretionary authority under its taxing power once a tax bill has been properly enacted.”¹⁷⁸ Congress can either “impose appropriate [tax] obligations”¹⁷⁹ or broadly delegate power to the executive for prescribing tax rules and regulations.¹⁸⁰ Therefore, Hemel argues that, theoretically, the President’s power over executive agencies should apply with equal force to Treasury and the IRS.¹⁸¹

Options abound for an agency wishing to implement policy. In order of descending authority and force, agencies can utilize: (1) substantive rulemaking; (2) agency adjudication; (3) initiation of litigation in court; (4) informal guidance; (5) advice-giving; and (6) information-gathering and promulgation.¹⁸² The Treasury can, and often does, make substantive rules. The statutory authorization for Treasury Regulations is I.R.C. § 7805(a), authorizing the Treasury Secretary to prescribe rules and regulations for enforcing Title 26 (containing the Internal Revenue Code).¹⁸³

major improvement in equity or as essential to promote economic growth by another.” Joseph A. Pechman, *Comprehensive Income Taxation: A Comment*, 81 HARV. L. REV. 63, 66 (1967).

175. See *Administration’s Fiscal Year Revenue Proposals*, U.S. DEP’T OF TREASURY, https://www.treasury.gov/resource-center/tax-policy/Pages/general_explanation.aspx [<https://perma.cc/J7HF-94CE>].

176. Hemel, *supra* note 172 (manuscript at 6). For instance, the most recent Greenbook argues that carried interest “should be taxed as ordinary income and subject to self-employment tax because such income is derived from the performance of services.” *General Explanation of the Administration’s Fiscal Year 2017 Revenue Proposals*, U.S. DEP’T OF TREASURY 162 (Feb. 2016), <https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf> [<https://perma.cc/BJ36-MDCM>]. Characterizing carried interest as capital gains “creates an unfair and inefficient tax preference . . . with some of the highest-income Americans benefiting from the preferential treatment.” *Id.*

177. U.S. CONST. art. I, § 7, cl. 2.

178. *Skinner v. Mid-America Pipeline Co.*, 490 U.S. 212, 221 (1989).

179. *Oceanic Steam Navigation Co. v. Stranahan*, 214 U.S. 320, 339 (1909).

180. *Skinner*, 490 U.S. at 222 (quoting *Bob Jones Univ. v. United States*, 461 U.S. 574, 596–97 (1983) (“Since Congress cannot be expected to anticipate every conceivable problem that can arise or to carry out day-to-day oversight,” the IRS is tasked with “construing” the Tax Code.)).

181. See Hemel, *supra* note 172 (manuscript at 11–13); see also Hemel, *supra* note 172 (manuscript at 9–13) (describing the President’s various tools for using agencies to enact policy objectives). Treasury is an executive department, and the IRS is a bureau within the Treasury Department. *Bureaus*, U.S. DEP’T OF TREASURY, <https://www.treasury.gov/about/organizational-structure/bureaus/Pages/default.aspx> [<https://perma.cc/L4SD-XZ22>].

182. Eskridge, *supra* note 4, at 64–68.

183. See I.R.C. § 7805(a) (West through Pub. L. No. 114-254) (“[T]he Secretary shall prescribe all needful rules and regulations for the enforcement of [Title 26], including all

The clearest delegation of authority in the context of carried interest is in Section 707 of the I.R.C. Section 707(a)(2) grants the Treasury Secretary the power to write regulations treating the exchange of services for “related direct or indirect allocation and distribution” as an exchange between a partnership and a partner acting outside his or her capacity as a partner.¹⁸⁴ Acting as a non-partner enables ordinary income characterization under Section 61(a).¹⁸⁵ Suggestions for the use of Section 707 authority come from both popular and academic sources.¹⁸⁶

The fact that presidents have not wielded such power falls into what Professor Kristin Hickman calls “tax exceptionalism,” whereby tax law is ignored by legal developments in other areas.¹⁸⁷ According to Hickman, a lack of deference to the Treasury on tax interpretation and rulemaking has led to courts intervening and hampering the Treasury’s ability to resolve issues.¹⁸⁸ Moreover, this has created inequity through circuit splits and the pressure of *stare decisis*.¹⁸⁹ Granted, the United States Tax Court is special in this regard because it was created to house judges with tax expertise.¹⁹⁰ However, Tax Court decisions are still reviewable by United States Courts of Appeal and the United States Supreme Court.¹⁹¹ The *Diamond* and *Campbell* decisions exemplify this concern—different circuit courts coming to different conclusions twenty years apart about one piece of the tax code.¹⁹² Notably, a Revenue Procedure resolved this split.¹⁹³

In 2011, many of Hickman’s concerns were resolved by *Mayo Foundation v. United States*, which for the first time granted *Chevron* defer-

rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.”).

184. § 707(a)(2)(A)(ii).

185. § 707(c).

186. See David Lebedoff, *Why Doesn’t Obama End the Hedge Fund Tax Break?*, SLATE (June 2, 2014, 4:00 PM), http://www.slate.com/articles/business/moneybox/2014/06/taxation_of_carried_interest_the_loophole_for_hedge_fund_managers_could.html [https://perma.cc/6728-92SG] (“Go for it, Mr. President. With one call you could bring enormous new revenues into the Treasury each year, and, not incidentally, cut the price of Picassos in half, to say nothing of the effect on \$80 million condos.”); Hemel, *supra* note 172 (manuscript at 17–20). Although Hemel’s article remains “agnostic” on carried interest reform, he clearly agrees Section 707 could be affirmatively used. *Id.*

187. See Kristin E. Hickman, *The Need for Mead: Rejecting Tax Exceptionalism in Judicial Deference*, 90 MINN. L. REV. 1537, 1541 (2006). Hickman defines the problem of exceptionalism partly this way: “The view that tax is different or special creates, among other problems, a cloistering effect that too often leads practitioners, scholars, and courts considering tax issues to misconstrue or disregard otherwise interesting and relevant developments in non-tax areas, even when the questions involved are not particularly unique to tax.” *Id.* (citing Paul L. Caron, *Tax Myopia, or Mamas Don’t Let Your Babies Grow Up to Be Tax Lawyers*, 13 VA. TAX REV. 517, 518–19 (1994)).

188. *Id.* at 1539–40.

189. *Id.*

190. See I.R.C. § 7442 (West through Pub. L. No. 114-254).

191. § 7482(a)(1) (granting appellate review of Tax Court decisions).

192. See *Diamond v. Comm’r*, 492 F.2d 286, 291 (7th Cir. 1974); *Campbell v. Comm’r*, 943 F.2d 815, 823 (8th Cir. 1990); *supra* Part II.C (describing both cases and their impact on Revenue Procedure 93-27).

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

ence¹⁹⁴ to Treasury rulemaking.¹⁹⁵ This decision resolved a longstanding dispute over deference levels in *Chevron* and *National Muffler*, a case where the Supreme Court created a multifactor test for determining judicial deference for Treasury regulations.¹⁹⁶ Overtime, the Supreme Court waffled back and forth between the two deference standards.¹⁹⁷ Importantly, since *Chevron* applies to Treasury and IRS interpretations of the Tax Code, one can look back to what then-Professor Elena Kagan described as the roots of *Chevron*: “[A] conception of agencies as instruments of the President, entitled to make policy choices, within the gaps left by Congress, by virtue of his relationship to the public.”¹⁹⁸

Three conclusions can be made. First, for the time being, this means deferring to Regulation 1.721-1 and Revenue Procedure 93-27.¹⁹⁹ Second, it also means that the Treasury and IRS interpretations of the Regulation will receive deference.²⁰⁰ And third, even if that interpretation was changed (for example, by enactment of the 2005 proposals), then the adjusted interpretation would probably also receive deference.²⁰¹

2. Structure

Practical limitations should be acknowledged. The IRS does not expend much of its resources on tax code enforcement. Because violations of the tax code are implicated through myriad violations of other statutes (within the enforcement jurisdiction of other federal agencies), the IRS has focused its efforts on issues unenforced by others.²⁰² Plus, the IRS is

194. It is beyond the scope of this article to fully explain *Chevron* deference. Essentially, courts ask if a statute is ambiguous; if ambiguous, then a reasonable agency interpretation should hold, and if unambiguous then Congress's voice holds. See generally Cass R. Sunstein, *Law and Administration After Chevron*, 90 COLUM. L. REV. 2071 (1990) (excellent overview of *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984) and its implications).

195. See *Mayo Found. for Med. Educ. & Research v. United States*, 562 U.S. 44, 55 (2011) (“The principles underlying our decision in *Chevron* apply with full force in the tax context.”).

196. See *Nat'l Muffler Dealers Ass'n, Inc. v. United States*, 440 U.S. 472, 477 (1979) (Factors include harmonization with the plain language of the statute, contemporaneous construction, length of time regulation has been in effect, consistency in interpretation, and degree of Congressional scrutiny in later statutory reenactments.).

197. *Mayo Found.*, 562 U.S. at 54 (listing cases).

198. Elena Kagan, *Presidential Administration*, 114 HARV. L. REV. 2245, 2373 (2001).

199. Cf. *Helvering v. Winmill*, 305 U.S. 79, 83 (1938) (“Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law.”).

200. Cf. *Auer v. Robbins*, 519 U.S. 452, 462 (1997) (“There is simply no reason to suspect that the interpretation does not reflect the agency's fair and considered judgment on the matter in question.”).

201. Cf. *Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 981 (2005) (“Agency inconsistency is not a basis for declining to analyze the agency's interpretation under the *Chevron* framework.”); see *infra* Part V.B (discussing Supreme Court precedent for allowing agencies to change policy and still receive deference).

202. Note, *Business Expenses, Disallowance, and Public Policy: Some Problems of Sanctioning with the Internal Revenue Code*, 72 YALE L. J. 108, 129 (1962) (“The result of the criteria used by the IRS has been the enforcement of proscriptions which are often unenforced in the jurisdiction of their enactment.”).

swamped with tax returns. During the 2015 fiscal year, the IRS examined over 1.2 million tax returns out of almost 147 million filed (a coverage rate of approximately 0.84%).²⁰³ In comparing the IRS with the Federal Election Commission, Professor Lloyd Mayer argued that IRS activity suffers from two restraints: a focus on minimizing the tax gap and a built-in yearlong gap between taxpayer actions and their tax filings.²⁰⁴

The Treasury's views on the tax code are also not infallible. For instance, the Taxpayer Relief Act of 1997 included an eleven-month moratorium on Treasury regulations adjusting the definition of "limited partner" under I.R.C. § 1402(a)(13).²⁰⁵ Two aspects of this are worth considering. First, President Clinton had the final word on the bill and could have vetoed the moratorium. Since line item vetoes are no longer an option,²⁰⁶ a president would have to veto the entire bill to remove the regulatory override (or at the very least threaten a veto to spur change while the bill is still in committee). When bills are vetoed, Congress can attempt to muster a two-thirds majority and override the veto.²⁰⁷ Professor Hemel argues that situations like these demonstrate presidents are "unwilling to use their veto power in order to defend the Treasury Department's revenue-raising efforts."²⁰⁸

Second, these congressional limitations on Treasury authority are very small parts of very large bills. Save for the most important of policy changes, it is probably not worth vetoing an entire revenue bill to strike one sentence among thousands of others. Many modern bills are omnibus constructions that affect a wide range of laws.²⁰⁹ Moreover, if a tax policy is so important that it is worth being vetoed, it is probably not hidden within the folds of a larger bill. Congress does not, as Justice Scalia put it, "hide elephants in mouseholes."²¹⁰

203. *Fiscal Year 2015 Enforcement and Service Results*, I.R.S., <https://www.irs.gov/pub/newsroom/fy2015enforcementandserviceresults2015.pdf> [<https://perma.cc/2SAN-VXZH>].

204. See Lloyd H. Mayer, *The Much Maligned 527 and Institutional Choice*, 87 B.U. L. REV. 625, 672–73 (2007).

205. See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 935, 111 Stat. 788, 882 (1997).

206. See *Clinton v. City of New York*, 524 U.S. 417, 421 (1998) (holding the Line Item Veto Act of 1996 unconstitutional because it allowed the President to enact federal law without constitutional safeguards).

207. Eskridge, *supra* note 4, at 33–34 (explaining options and procedures for presidential vetoes).

208. Hemel, *supra* note 172 (manuscript at 40). Professor Hemel also notes that congressional overrides of presidential vetoes of tax-related legislation are "rarer than lightning strikes"—the last one was in 1948 under President Harry Truman. *Id.*

209. See Eskridge, *supra* note 4, at 689 ("In the last generation, Congress has done an increasing amount of its work through gigantic and complex omnibus proposals . . ."). Cf. Abbe R. Gluck & Lisa Schultz Bressman, *Statutory Interpretation From the Inside—An Empirical Study of Congressional Drafting, Delegation, and the Canons: Part I*, 65 STAN. L. REV. 901, 979 (2013) ("[I]n the omnibus context, there is less legislative history, and what does exist is often confused, typically because omnibus bills involve the throwing together of different bills from various committees.") (internal quotation marks omitted).

210. *Whitman v. Am. Trucking Ass'ns, Inc.*, 531 U.S. 457, 468 (2001).

With all this said, there are other reasons why a President may not wield agency power. Professor Hemel offers three: (1) regulations are more easily overturned than statutes; (2) statutes stand up better to judicial scrutiny; and (3) fear of political charges that the president is wielding imperial power.²¹¹ Together, these reasons make sense. Individually, however, each one has flaws. For example, courts do not often overturn agency regulations. A 2008 study by Professor William Eskridge, Jr. and Lauren Baer found that under varying levels of judicial deference (spanning from *Skidmore v. Swift & Co.* to *United States v. Curtiss-Wright Exp. Corp.*), courts uphold agency interpretations of statutes at least three-quarters of the time.²¹² As for claims of heavy-handed presidential power,²¹³ while this is clearly a reality of partisan politics, it has never completely halted presidents from using executive powers. President Obama, for instance, implemented executive changes to the United States' immigration policies starting in late 2014.²¹⁴ But when wielding executive power through agencies, one must acknowledge: "[O]ne can never tell which Party will be in control of the White House, and hence in theoretical control of the federal agencies."²¹⁵

As a final note on structure, the fact that Congress consistently failed to enact carried interest reform during President Obama's tenure may lend some credence to the idea that Congress has, in the aggregate, accepted the current tax regime. Congressional inaction is often given little significance when determining congressional intent.²¹⁶ At the same time, one cannot ignore how the judicial and legislative branches react to one another. As Guido Calabresi famously explained, when a court interprets a statute, it invites the legislature to respond if it disagrees.²¹⁷

211. See Hemel, *supra* note 172 (manuscript at 47). Professor Hemel's article continues on to analyze such claims through game theory and other lenses. See generally *id.* (manuscript at 47–62).

212. See William N. Eskridge, Jr. & Lauren E. Baer, *The Continuum of Deference: Supreme Court Treatment of Agency Statutory Interpretations from Chevron to Hamdan*, 96 GEO. L.J. 1083, 1100 tbl.1 (2008). Under *Skidmore v. Swift & Co.*, agency interpretations are deferred to in proportion to their "power to persuade." See 323 U.S. 134, 140 (1944). Under *United States v. Curtiss-Wright Exp. Corp.*, agency interpretations involving foreign affairs or national security receive super-strong deference. See 299 U.S. 304, 329 (1936).

213. See, e.g., Charles C.W. Cooke, *Obama's Imperial Transformation Is Now Complete*, NATIONAL REVIEW (Nov. 20, 2014, 2:13 PM), <http://www.nationalreview.com/article/393111/obamas-imperial-transformation-now-complete-charles-c-w-cooke> [<https://perma.cc/2UJY-LHKN>] ("Today, the transformation of Barack Obama from wide-eyed idealist to bitter *imperator* will finally be completed.").

214. *Executive Actions on Immigration*, U.S. CITIZENSHIP AND IMMIGRATION SERVS., <https://www.uscis.gov/immigrationaction> [<https://perma.cc/74PW-BAQA>] (listing and explaining various Obama Administration immigration initiatives).

215. JASPER L. CUMMINGS, JR., *THE SUPREME COURT, FEDERAL TAXATION, AND THE CONSTITUTION* 587 (2013).

216. See *Red Lion Broad. Co. v. FCC*, 395 U.S. 367, 381 n.11 (1969) ("[U]nsuccessful attempts at legislation are not the best of guides to legislative intent.").

217. See GUIDO CALABRESI, *A COMMON LAW FOR THE AGE OF STATUTES* 31–32 (1982) ("When a court says to a legislature: 'You (or your predecessor) meant X,' it almost invites the legislature to answer: 'We did not.'").

The Supreme Court has given credence to legislative silence in certain situations. Justice Brennan once found that since Congress had not enacted statutory amendments to reject the Court's construction of Title VII, "we therefore may assume that our interpretation was correct."²¹⁸ A more recent example comes from Justice O'Connor in her opinion in *FDA v. Brown & Williamson Tobacco Corp.*²¹⁹ Congress had considered and rejected several bills that would have given the Food and Drug Administration (FDA) jurisdiction to regulate tobacco.²²⁰ Therefore, concluded the Court, Congress was evidently aware of the FDA's longstanding position that it had no jurisdiction over tobacco.²²¹ The fact that no bills were passed granting jurisdiction meant Congress had "effectively ratified" the FDA's position.²²² In a 2014 case, the Court recognized two failed bills as evidence of a "congressional choice."²²³

Lower courts have done likewise. For instance, in *Ulane v. Eastern Airlines, Inc.*, the Seventh Circuit found meaning in several failed attempts to amend Title VII to include protections for sexual orientation discrimination.²²⁴ Repeated failure to amend a statute showed the court that Congress accepted the common law rule at the time.²²⁵

One case is particularly analogous to Section 710's failures. In *Bob Jones University v. United States*, the majority looked to Congress's non-action in response to the IRS's interpretation of nonprofit tax exemption under Section 501(c)(3).²²⁶ As evidence of congressional approval, the Court cited "[e]xhaustive hearings" and the introduction of thirteen bills within twelve years to change the Code sections at issue.²²⁷ Such a bounty of opportunities for reform led the Court to remark, "[W]e do not have an ordinary claim of legislative acquiescence."²²⁸ The conclusion from this evidence was that Congress had been "abundantly" and "acutely" aware of the IRS's position on nonprofit tax exemptions.²²⁹ Therefore, Congress had indeed acquiesced to the IRS's interpretation.

218. *Johnson v. Transp. Agency*, 480 U.S. 616, 629 n.7 (1987) ("The fact that inaction may not always provide crystalline revelation, however, should not obscure the fact that it may be probative to varying degrees."). Justice Scalia vehemently disagreed with Brennan on this point, writing in dissent, "I think we should admit that vindication by congressional inaction is a canard." *Id.* at 672 (Scalia, J., dissenting).

219. *See FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 125–26 (2000).

220. *Id.* at 146–56 (explaining, at length, the legislative history of various tobacco proposals and statutes).

221. *Id.* at 156 (citing *Bob Jones Univ. v. United States*, 461 U.S. 574, 600–01 (1983)).

222. *Id.*

223. *Michigan v. Bay Mills Indian Cmty.*, 134 S.Ct. 2024, 2038–39 (2014).

224. 742 F.2d 1081, 1085–86 (7th Cir. 1984), *cert. denied*, 471 U.S. 1017 (1985).

225. *Id.* at 1086. (Repeated "rejection strongly indicates that the phrase in the Civil Rights Act prohibiting discrimination on the basis of sex should be given a narrow, traditional interpretation.").

226. *See Bob Jones University v. United States*, 461 U.S. 574, 600–01 (1983).

227. *Id.* at 600.

228. *Id.*

229. *Id.* at 600–01 ("It is hardly conceivable that Congress—and in this setting, any Member of Congress—was not abundantly aware of what was going on.").

Recent attempts to reform carried interest have gone beyond those in *Bob Jones University*. As detailed above, there were exhaustive hearings and reports on the subject.²³⁰ Not only that, the Treasury and the IRS have had a published position on profits interests since 1993.²³¹ If the evidence of acquiescence in *Bob Jones University* was “overwhelming,”²³² then certainly the evidence at hand addressing carried interest is, too. Section 710 has been proposed and considered in various forms for over nine years. Beyond that, the fact that it only received serious consideration in 2007 and 2008 seems to indicate that after those rejections, momentum for reform vanished. No member of Congress today is unaware of carried interest. Yet there remains a dearth of plausible reform bills. And the Treasury has allowed regulatory proposals to rot on the vine, too.²³³ Maybe the implicit decision has been made—reform simply is not worth it.

It should be clear that, regardless of the political consequences, there are structural and doctrinal reasons why the Treasury and the IRS could act to resolve lingering concerns about how profits interests in partnerships should be taxed. If rulemaking were finalized, they would not be immune from judicial review, but would most likely receive deference. The Treasury and the IRS are not alone in deciding when and how to act. We, in the United States, live within the “administrative state” of myriad agencies making rules for every conceivable situation.²³⁴ It will be instructive, then, to see how another agency has fared reforming its policy toward investment funds.

B. LESSONS LEARNED FROM THE SECURITIES AND EXCHANGE COMMISSION

The IRS’s attitude toward carried interest can be contrasted with the Securities and Exchange Commission (SEC or Commission), another federal agency. The SEC differs from the Treasury in several ways. While a Cabinet Secretary heads the Treasury, five bipartisan commissioners serving staggered five-year terms run the SEC.²³⁵ The SEC also has clear discretionary authority to instigate investigations, bring suit in a district

230. See *supra* Part IV.B–C (discussing committee hearings and reports on proposed bills containing Section 710).

231. See Rev. Proc. 93-27, 1993-2 C.B. 343. Congress was “acutely aware” of the IRS’s position on racial discrimination based upon decade-old IRS rulings. See *Bob Jones Univ.*, 461 U.S. at 599.

232. *Solid Waste Agency v. U.S. Army Corps of Eng’rs*, 531 U.S. 159, 169 n.5 (2001) (discussing *Bob Jones Univ.*, 461 U.S. at 595, 600–601).

233. See *supra* Part II.C (discussing Treasury Regulation and Revenue Procedure proposals that have never been finalized).

234. See Kagan, *supra* note 198, at 2253 (“But as the administrative state grew and then the New Deal emerged, Congress routinely resorted to broad delegations, giving substantial, unfettered discretion to agency officials.”).

235. 15 U.S.C. § 78d(a) (2012) (setting bipartisan makeup and five-year terms for commissioners).

court, or pursue its own administrative adjudication.²³⁶ Because of this, the SEC is active and has very visible enforcement efforts.²³⁷ At the same time, some have argued that the SEC is procedurally open to undue industry influence.²³⁸

Maybe this has affected the SEC's level of activity towards investment funds. As Andrew J. Donohue, then-Director of the Division of Investment Management, admitted in a 2010 speech: "The US securities laws have not kept pace with the growth and market significance of hedge funds and other private funds and, as a result, the Commission has very limited oversight authority over these vehicles."²³⁹ In a 2003 staff report about hedge fund regulation, the Commission lamented its "wait and see" posture.²⁴⁰

That being said, the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)²⁴¹ retracted an important preferential part of securities regulations concerning investment funds. Under the Investment Advisers Act of 1940 (Advisers Act), regulated "investment advisers"²⁴² cannot use mail or interstate commerce in connection with their business unless registered with the SEC.²⁴³ Before Dodd-Frank, an important exception to this rule was Section 203(b)(3) of the Advisers Act. It exempted investment advisers who (1) had fourteen or fewer clients and (2) did not hold themselves out to the public as investment advisers.²⁴⁴ Under the statute, each corporation, partnership, LLC, or other organization to which the investment adviser provides advice counts as

236. See § 78u(a)(1) (discretion to investigate); § 77t(b) (discretion to bring district court action); 5 U.S.C. § 500 et seq. (2012) (rules for SEC administrative procedures).

237. See Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation by Enforcement: A Look Ahead at the Next Decade*, 7 YALE J. ON REG. 149, 155 (1990) ("Unlike many of its sister agencies, the SEC consistently has maintained a vigorous, highly-visible, and largely successful enforcement profile.").

238. Professor Jill Fisch observed: "The SEC's rulemaking structure enables these interest groups to engage in a high level of participation. . . . [and] control the administrative record by submitting extensive comments and studies to which the SEC is then obligated to respond." Jill E. Fisch, *The Long Road Back: Business Roundtable and the Future of SEC Rulemaking*, 36 SEATTLE U. L. REV. 695, 722 (2013).

239. Andrew J. Donohue, Speech by SEC Staff: Regulating Hedge Funds and Other Private Investment Pools, U.S. SEC. & EXCH. COMM'N (Feb. 19, 2010), <https://www.sec.gov/news/speech/2010/spch021910ajd.htm> [<https://perma.cc/CQ5C-7C7S>].

240. See U.S. SEC. & EXCH. COMM'N, STAFF REPORT TO THE U.S. SEC. & EXCH. COMM'N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS x–xi (Sept. 29, 2003), <https://www.sec.gov/news/studies/hedgcfunds0903.pdf> [<https://perma.cc/3QUG-KWCA>].

241. See generally Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1376–2223 (2010).

242. 15 U.S.C. § 80b-2(b)(11) (2012). "Investment adviser" is defined as: "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities." *Id.* This definition does not include a multitude of people and organizations, including newspaper publishers, family offices, and lawyers whose actions are incidental to their professional practice. See *id.*

243. § 80b-3(a).

244. See 15 U.S.C. § 80b-3(b)(3) (2012).

one client.²⁴⁵

Recall that most funds are structured as limited partnerships, where the general partner manages the investments that are pooled in the limited partnership. If the general partnership is the investment adviser, then each limited partnership underneath is counted as a single client, regardless of the number of investors.²⁴⁶ With fourteen “clients” available, funds can branch out into very large organizations without needing to register with the SEC. Dodd-Frank removed this safe harbor.²⁴⁷

This was not the first time the Section 203(b)(3) exemption had been reformed though. In 2004, the SEC promulgated the so-called Hedge Fund Rule, which, among other things, required advisers to “look through” their underlying funds and count individual investors as clients.²⁴⁸ This made the fourteen-or-fewer client rule almost impossible to reach for any sizeable hedge fund. Reform was short-lived, however. The Hedge Fund Rule was struck down in 2006 by the D.C. Circuit because the rule was “arbitrary” and bore “no rational relationship to achieving” the goal of the Advisers Act.²⁴⁹ Furthermore, the SEC had only recently decided on the narrower definition of client, having relied on the fund-level definition for many years.²⁵⁰

Does this example run afoul of the previous proposal for proactive agency reform? Why did the SEC fail and Congress succeed in shrinking the fund registration exemption? The distinction can be made on the basis of the SEC’s inability to properly justify its policy change (something the Treasury surely could avoid).

When finalizing the Hedge Fund Rule, the SEC explained why it was compelled to act. Changes in the marketplace meant parts of the Advisers Act were “inadequate.”²⁵¹ The Commission argued at length that Congress had a very narrow intent for the safe harbor when it was adopted in 1940 and that the Advisers Act authorized the SEC with broad, adaptive rulemaking authority.²⁵² The time was ripe for a change

245. 17 C.F.R. § 275.203(b)(3)-1(a)(2)(i) (2017).

246. This is thanks to *Goldstein v. SEC*, 451 F.3d 873, 879–80 (D.C. Cir. 2006), which defined “client” in the Investment Advisers Act to include funds or capital pools, not individual investors.

247. See generally Seth Chertok, *A Detailed Analysis of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 6 VA L. & BUS. REV. 1, 6–9 (2011) (explaining the removal of the Section 203(b)(3) exemption and its impact on investment funds).

248. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, Exchange Act Release No. 2333, 84 S.E.C. Docket 1032, 2004 WL 2785492, at *13 (Dec. 2, 2004).

249. *Goldstein*, 451 F.3d at 883–84.

250. *Id.* at 880 (“This had been the Commission’s view until it issued the new rule.”).

251. Registration Under the Advisers Act of Certain Hedge Fund Advisers, Exchange Act Release No. 2333, 84 S.E.C. Docket 1032, 2004 WL 2785492, at *6 (“Our obligations . . . require us to respond to important market developments, and the authority provided us by those laws permits us to adopt rules and interpret the statutes in order to preserve fair and honest markets.”).

252. See *id.* at *15–18. The Commission cited *Chevron* in support of its ability to interpret a statute with ambiguous application to modern hedge fund structure. *Id.* at *18 n.173.

in SEC policy.²⁵³

The Supreme Court summarily rejected the contention that inconsistent agency interpretations alone interrupt deference.²⁵⁴ The Court upheld a Federal Communication Commission (FCC) interpretation of the Communications Act of 1934 as it applied to Internet service providers.²⁵⁵ Although the FCC's view of the statute had changed overtime, the Court sensibly ruled that policy changes supported by adequate explanation did not invalidate *Chevron* deference.²⁵⁶ Inconsistent agency interpretations can backfire, however, if Congress acts on an agency's position and, thereafter, the agency tries to reverse course.²⁵⁷

Inconsistency can also backfire when a justification is not tailored to the desired result. The D.C. Circuit put the SEC to task for missing the mark with the Hedge Fund Rule by painting with too broad a brush. Although the SEC sought to change the definition of client for purposes of applying Section 203(b)(3) of the Advisers Act, the Commission's justification of industry-wide change was not narrow enough to exclude all fund investors from the safe harbor.²⁵⁸ The D.C. Circuit would have been more accepting of a rule justified on changes to the adviser-client relationship.²⁵⁹

The Treasury's 2005 Regulation Proposal is not as narrow as the SEC's. The new rule for profits interests was based on common law and agency interpretations of I.R.C. § 83.²⁶⁰ Moreover, the overarching goal was not regulation of a specific industry, but rather coordinating two disjunctive tax principles.²⁶¹ The IRS hoped to merely "simplify" Section 83's appli-

253. *Id.* at *6 (“[O]ur current regulatory program for hedge fund advisers is inadequate.”).

254. *Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 981 (2005) (“Agency inconsistency is not a basis for declining to analyze the agency's interpretation under the *Chevron* framework.”). At the same time, consistency is an important factor in weighing the persuasiveness of an agency's opinion. *See, e.g., United States v. Mead Corp.*, 533 U.S. 218, 228 (2001) (listing “consistency” as one of several factors to consider when determining the deference to grant an agency in administering a statute).

255. *Brand X*, 545 U.S. at 967–68 (answering the age-old question: is the Internet an information or telecommunication service?).

256. *Id.* at 981. And unexplained inconsistency can (but does not necessarily have to) mean an agency rule is arbitrary and thus able to be set aside. *Id.*; *see also Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 41 (1983) (“The agency's action in promulgating such standards therefore may be set aside if found to be arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.”) (internal quotation marks omitted).

257. *See FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 155–57 (2000) (finding the FDA's longstanding position that it lacked jurisdiction over tobacco products significant for disallowing a recent assertion of jurisdiction by the agency).

258. *Goldstein v. SEC*, 451 F.3d 873, 883 (D.C. Cir. 2006) (“[T]he Commission has not justified treating *all* investors in hedge funds as clients for the purpose of the rule.”).

259. *Id.* (“[T]he Commission does not justify this exception by reference to any change in the nature of investment adviser-client relationships since the safe harbor was adopted. Absent such a justification, its choice appears completely arbitrary.”).

260. *See Prop. Treas. Reg. § 1.83-3(l)*, 70 Fed. Reg. 29675, 29676 (May 24, 2005) (stating the new regulation was “[c]onsistent with the principles of section 83”).

261. *Id.* (“Certain changes to the regulations under both subchapter K and section 83 are needed to coordinate the principles of subchapter K with the principles of section 83.”).

cation to partnership interests.²⁶² Thus, the nullification of Revenue Procedures 93-27 and 2001-43 were necessary by virtue of harmonizing the tax code.²⁶³ Importantly, neither of the 2005 proposals mention the investment industry. While the SEC was too clear that the ultimate goal of the Hedge Fund Rule was to empower greater regulation of hedge funds, the Treasury and the IRS have, thus far, been more opaque about what types of businesses would be affected by these rules. This could go a long way toward justifying its new stance on partnership interests.

It is also worth mentioning that a registration exemption is very different from an increased tax burden. A shift in how partnership profits interests are taxed would be a much more consequential change in agency policy. The Investment Advisers Act already requires funds to keep records that the SEC may request.²⁶⁴ Registration with the SEC, while accompanied by some compliance costs, is certainly cheaper for funds than a loss of capital gains treatment for income.²⁶⁵ Moreover, the registration affects funds at an entity level, whereas carried interest affects individual fund managers due to partnerships being pass-through entities. This would, theoretically, put more pressure on the Treasury and the IRS to properly justify the change in policy from Revenue Procedure 93-27 to the 2005 proposals.

In summary, the SEC's failed Hedge Fund Rule stands as a clear lesson for agencies attempting to change course on interpretive policy. While the SEC was too narrow in scope and, therefore, failed to justify a new agenda, the Treasury and the IRS could easily avoid such problems if they finalize their proposed rules.

C. POSTSCRIPT: CAPITAL GAINS AT LARGE

There is, finally, a much broader lens through which to see carried interest reform. As Victor Fleischer has acknowledged, “[N]o matter what happens with the carried interest tax legislation, the chess match between tax collectors and fund managers will continue.”²⁶⁶ It is certainly worth considering the idea that, if reform is needed, the real culprit may be capital gains. Are the Treasury and the IRS's proposals too narrow?

For instance, Professor David Weisbach suggests that the “distributional problem” of wealthy fund managers is a product of capital gains

262. I.R.S Notice 2005-43, 2005-1 C.B. 1221.

263. *Id.*

264. 15 U.S.C. § 80b-4(a) (2012).

265. When adopting the Hedge Fund Rule, the SEC discussed compliance costs, finding them to be of no great obstacle to most hedge funds. Registration Under the Advisers Act of Certain Hedge Fund Advisers, Exchange Act Release No. 2333, 84 S.E.C. Docket 1032, 2004 WL 2785492, at *31–32. With a hint of irony, the SEC noted that it could not speak directly to compliance costs because it did not have access to internal financial data for most hedge funds, a conundrum to be solved by the aforementioned annual reporting. *Id.* at *32.

266. Victor Fleischer, *Why Hedge Funds Don't Worry About Carried Interest Tax Rules*, NEW YORK TIMES (May 14, 2014, 3:35 PM), <http://dealbook.nytimes.com/2014/05/14/why-hedge-funds-dont-worry-about-carried-interest-tax-rules/> [<https://perma.cc/MKM7-AH4L>].

treatment, not “technical” tax rules.²⁶⁷ Technical changes, warns Weisbach, leave capital gains treatment untouched and would not affect the economy-wide distribution of income.²⁶⁸ Apart from concerns for equity, however, the way in which income is taxed, whether capital gains or ordinary income, “is either principled or it is not.”²⁶⁹ Professor Matthew Melone argues that whether the income is \$10 or \$10 billion should be irrelevant—the underlying principle for its characterization, however, is relevant.²⁷⁰ Professor Philip Postlewaite goes further, calling long-term capital gains treatment the “true culprit” of the carried interest debate.²⁷¹ If the objection is really about capital gains rates, then legislation like Section 710 is far from responsive to that problem.

The policy merits of capital gains treatment have been debated for decades.²⁷² And if one wants to reform capital gains, then the current carried interest fight may debilitate that effort. As Senator Chuck Grassley warned during the 2007 Finance Committee hearings on carried interest: “We cannot allow the carried interest tail to wag the capital gains dog.”²⁷³

VI. CONCLUSION

In conclusion, a previously underexplored part of the carried interest debate—the long legislative and administrative history of profits interests—bolsters the argument that if carried interest reform should happen, it should happen by the hand of the Treasury. Ever since the introduction of Subchapter K to the Tax Code in 1954, elucidating partnership tax has been the job of the Treasury and the IRS. The story of partnership profits interests—known today as carried interest—shows how federal agencies have been too lax in their rulemaking. What has been published has only raised more questions. Maybe times need to change in order to spur the agencies to action. Yet, when they did act in the early 2000s, and especially when the recession began in 2008, the regulatory vacuum was filled by Congress.

Congress’s proposed Section 710 was an ill-fated response to a salient recession-era problem. For many reasons, repeated proposals have failed. Now, as the question of carried interest reform still looms large, the question of responsibility for reform also lingers. There are, however, good doctrinal and structural arguments for why the Treasury and IRS can act

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

268. *Id.* at 763–64.

269. Melone, *supra* note 12, at 490.

270. *Id.*

271. Philip F. Postlewaite, *The Taxation of Compensatory Profits Interests: The Blind Men and the Elephant*, 29 NW. J. INT’L L. & BUS. 763, 776–77 (2009). Granted, he does this in passing, saying that the questions about the merits of capital gains “is a matter for another debate.” *Id.* at 777.

272. See generally Walter J. Blum, *A Handy Summary of the Capital Gains Arguments*, 35 TAXES 247, 247 (1957).

273. 2007 Hearings, *supra* note 110, at 3 (statement of Sen. Chuck Grassley).

if they desire, including statutory authorization, expertise, and judicial deference.

Hopefully the long, historical view of carried interest has shed new light on carried interest. This is not a new issue. As with many things, much can be gleaned from the mistakes of the past. Legislative history is an important tool for statutory interpretation, and so too does it aid in policy decisions.