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Taxing Blackstone

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I. Introduction

Certain high-profile deals capture the zeitgeist of Wall Street. KKR's 1988 takeover of RJR-Nabisco, memorialized in *Barbarians at the Gate*, embodied the 1980's takeover boom.[1] The startling first-day

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[1] See Bryan Burrough & John Helyar, Barbarians at the Gate: The Fall of RJR Nabisco (1990); Barbarians at the Gate (HBO/Columbia Pictures 1993) (the takeover occurred on Nov. 30, 1988).

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pop of the 1995 Netscape IPO marked the birth of the dot com boom.[2] Google's IPO ushered in the Web 2.0 era.[3]

The next iconic deal was the 2007 Blackstone IPO.[4] Blackstone's boosters portrayed its public offering as a logical, inevitable step in the maturing of a fundamentally sound industry, one that fuels the engine of U.S. growth and prosperity.[5] Blackstone's critics say the deal marked the hubris of an opportunistic industry addicted to cheap credit, financial engineering, and generous tax breaks.[6] Time will tell. One thing we do know is that the Blackstone IPO turned the question of the taxation of private equity fund managers from an academic pastime into a salient, heated political issue.

Just a week before Blackstone's IPO, Senators Max Baucus and Charles Grassley introduced the so-called "Blackstone Bill" or "PTP" (publicly-traded partnership) bill.[7] The bill would classify Blackstone

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[2] See Eric Niiler, Netscape's IPO Anniversary and the Internet Boom (NPR podcast 2005), available at http://www.npr.org/templates/story/story.php?storyId=4792365 (discussing Netscape IPO).

[3] Christine Hurt, What Google Can't Teach Us About IPO Auctions (and What It Can), 37 U. Toledo L. Rev. 403 (2006) (discussing Google IPO); Victor Fleischer, Brand New Deal: The Branding Effects of Corporate Deal Structures, 104 Mich. L. Rev. 1581 (2006) (discussing effect of Google IPO structure on Google's brand image).

[4] The deal was announced in March 2007. The Blackstone Group L.P., Registration Statement (Form S-1) (Mar. 22, 2007) [hereinafter Blackstone S-1], available at http://www.sec.gov/Archives/edgar/data/1393818/000104746907002068/a2176832zs-1.htm

For press coverage of the deal, see, e.g., Dennis K. Berman & Henny Sender, Big Buyout Firm Prepares to Sell Stake to Public, Wall St. J., Mar. 17, 2007, at A1; Why a Blackstone IPO?, Wall St. J., Mar. 17, 2007, at B14; Henny Sender, Blackstone Plan Could Reshape Private Equity, Wall St. J., Mar. 19, 2007, at A1; Andrew Ross Sorkin & Peter Edmonston, A Titan of Private Equity May Go Public, N.Y. Times, Mar. 17, 2007, at C1; Andrew Ross Sorkin, Jenny Anderson, Peter Edmonston, & Michael J. de la Merced, Blackstone Says It Plans to Go Public, N.Y. Times, Mar. 23, 2007, at C1.

For press coverage of the tax issues, see Ryan J. Donmoyer, Blackstone Says IPO Tax Stance May Prompt IRS Action, Bloomberg Wire Serv., Mar. 29, 2007, available at http://www.bloomberg.com/apps/news?pid=2060113&sid=AAPFVvo2Ag8E; Emily Chasan, Unusual IPO Tax Structure May Plague Blackstone, Reuters Wire Serv., Mar. 30, 2007, available at http://www.reuters.com/article/idUSN3027579520070330; Editorial, Taxing Private Equity, N.Y. Times, Apr. 2, 2007, at A22 (discussing congressional inquiry into capital gains preference for carried interest distributions); Ben White & Eoin Callan, US Congress Could Slice Buy-Out Wealth, Financial Times, Apr. 23, 2007, at 8.

[5] See, e.g., Hamilton E. James, Speech at U.S. Embassy in Rome, Italy, Nov. 27, 2006, at 23, available at http://italy.usembassy.gov/events/2006/PrivateEquity/JamesSpeech.pdf (describing private equity's fueling corporate competitiveness, economic growth, job creation, and new investment, creating "a virtuous circle for all of society").

[6] See The Trouble with Private Equity, The Economist, July 7, 2007, at 9 (reciting the critics' arguments).

[7] S. 1624, 110th Cong. (2007), available at http://thomas.loc.gov/cgi-bin/query/z?c110:S.1624: (hereinafter Senate PTP Bill). Congressional staffers began investigating the structure following the Fortress deal, even before the Blackstone deal was announced. See Henny Sender & Sarah Lueck, Tax Plan Adds to the Pressures on Buyout Firms, Wall St. J., June 16, 2007, at A1 ("The fuse to Thursday's bomb was apparently lit back in February shortly after Democrats took control of Congress. That's when Fortress launched its public

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and other publicly-traded private equity firms like Fortress, Oaktree, and Apollo as corporations for tax purposes.

There are two ways of looking at this bill. The first way is to think of the bill as a substantive change in the tax law. Specifically, the bill may be viewed as a rifleshot approach to changing the tax treatment of the profits earned from managing investment funds, known as carried interest.[8] Under current law, carried interest usually is taxed at the long-term capital gains rate of 15%.[9] While there is significant support in Congress for the idea of taxing carried interest as ordinary income (taxed at 35%) instead of long-term capital gain, the scope of the change is an open question. Under the House carried interest bill introduced by Representative Sander Levin, the change would apply to investment management and real estate partnerships.[10] Senator Charles Schumer proposed broadening the approach to cover timber, oil and gas, and any other partnerships that use a carried interest structure to achieve capital gains treatment on compensation income.[11] We could limit the change to private investment funds, as I suggested elsewhere.[12] We could apply the change to all partnerships, as Mark Gergen suggested,[13] or we could limit the change to large partnerships, as Joseph Bankman argued.[14]

Viewed in terms of scope, the Blackstone Bill is an extremely narrow approach to the carried interest issue. Because corporations pay tax on capital gains at a 35% rate,[15] the same rate as ordinary income, the Blackstone Bill has the practical effect of taxing carried interest received by these publicly-traded partnerships at the same rate as ordinary income.[16] But the change would apply only to a sliver of the industry—the handful of private equity firms that have gone public.

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offering, stirring heavy press coverage of big payouts—and drawing more scrutiny from the new leaders on Capitol Hill, who came in hungry to find new revenues to pay for new spending plans.")

[8] See Victor Fleischer, Two and Twenty: Taxing Partnership Profits in Private Equity Funds, 83 NYU L. Rev. 1 (2008).

[9] IRC § 702(b) (pass-through of character), § 1(h) (maximum capital gains rate of 15%).

[10] See H.R. 2834, 110th Cong. (2007), available at http://thomas.loc.gov/cgi-bin/query/z?c110:H.R.2834:.

[11] See Brody Mullins, Schumer Backs Broadening of Rise in Partnership Tax, Wall St. J., Aug. 15, 2007, at A4.

[12] See Fleischer, note 8, at 58.

[13] Carried Interest, Part 1: Hearing Before the S. Comm. on Finance, 110th Cong. (2007) (statement of Prof. Mark P. Gergen, U. of Texas School of Law), available at http://www.senate.gov/~finance/sitepages/hearing071107.htm.

[14] Carried Interest, Part 2: Hearing Before the S. Comm. on Finance, 110th Cong. (2007) (statement of Prof. Joseph Bankman, Stanford Law School), available at http://www.senate.gov/~finance/sitepages/hearing073107.htm.

[15] IRC § 11(b).

[16] Taxing Blackstone as a corporation also would subject those earnings to a potential second level of tax at the shareholder level.

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Add in transition relief for the firms that filed to go public before the Blackstone Bill was introduced, and the substantive reach of the law is quite limited indeed. It is precisely the bill's limited scope that makes it a politically viable compromise on the issue of taxing carried interest.

The second way to look at the bill is as a defense of two separate "rule of law" values: namely, the principle that equals ought to be treated alike, and the principle that clever avoidance of rules should not be tolerated. Viewed in this way, the bill is just a technocratic response to the regulatory gamesmanship of the Blackstone IPO structure.

The Blackstone structure capitalizes on the (mis)treatment of carried interest as capital gains and parlays it into a method of avoiding the corporate tax that most public companies must pay. Absent a legislative response, the innovative structure may tempt still more firms to go public as partnerships instead of corporations. Moreover, the structure undermines the respect for the income tax on which our voluntary system of tax compliance relies. The Blackstone Bill would respond to this new strategy by forcing publicly-traded private equity firms like Blackstone, Fortress, Oaktree, and Apollo to pay corporate taxes, just like Goldman Sachs, Merrill Lynch, Lehman Brothers, Morgan Stanley, and similarly-situated financial services firms already pay.

This Essay argues that the Blackstone Bill is justifiable only in this second sense—as a response to regulatory gamesmanship. So long as we have a corporate tax, defending the boundaries of the tax base is a prudent response. In terms of a substantive change in the tax treatment of carried interest, the narrow scope of the Blackstone Bill leaves Congress with unfinished business.

The Blackstone Bill fails to achieve the high-level policy goal of taxing the returns from managing financial assets consistently regardless of the form in which the business is conducted. Financial intermediaries may choose to conduct business through entities that are corporate entities, limited liability companies, trusts, or partnerships. The manager may be publicly traded, quasi-public (like Oaktree and Apollo, whose partnership units trade on a platform for qualified institutional buyers), or privately held. The Blackstone IPO reminds us that to avoid wasteful gamesmanship, promote efficient governance structures, and treat smaller investors equitably, in the long run we must strive to eliminate tax disparities that turn on these attributes of organizational form. As a rifleshot approach to the carried interest issue, then, the bill is neither a logical compromise nor a viable long-term solution.

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Of course, the desire for a comprehensive, efficient system for taxing financial intermediaries need not be understood as an excuse for standing idle. Taxing Blackstone and its publicly-traded brethren as corporations is defensible as a response to a deal structure that undermines existing law.

Congress did not pass the Blackstone Bill in 2007.[17] As credit markets seized up in the latter part of the year, the private equity industry saw profits diminish, and private equity firms chose to sell off pieces of themselves to foreign investors and sovereign wealth funds rather than the public.[18] As policymakers look ahead to possible tax reform proposals, however, the issue of how to tax Blackstone and its peers seems likely to reignite.[19]

This Essay is organized as follows. Part II describes the Blackstone IPO deal structure and the aspects of the deal that make it potentially offensive from a regulatory perspective. Part III analyzes the bill as a response to this gamesmanship. In Part IV, I return to the other way of looking at the bill, as a substantive change in the tax treatment of carried interest. A key lesson we might learn from the Blackstone IPO is that the deal—through its blending of private equity and the public markets—reveals how our current set of rules for taxing financial intermediaries undermines the very populist and egalitarian goals they were designed to achieve. Many of these rules are artifacts of the Great Depression and reflect an anachronistic vision of the capital markets. In the long run, broader reform will be needed. Part V concludes.

II. The Blackstone IPO

The Blackstone Group, a New York-based private equity firm, went public on June 22, 2007.[20] Blackstone manages about a dozen private investment funds, most of which focus on leveraged buyouts and real estate deals.[21] More recently, the firm has extended its range of services to include managing hedge funds, distressed debt funds, and funds of funds.[22] The firm also has expanded into investment bank-

[17] S. 1624, note 7, did not make it out of the Senate Finance Committee.

[18] See Andrew Ross Sorkin, The Mideast Money Flows, N.Y. Times, Sept. 27, 2007, at C1 (reporting Carlyle's sale of 7.5% of itself to the Abu Dhabi government).

[19] See Jessica Holzer, Once Targets of Tax Hikes, Hedge Funds Now Unscathed, TheHill.com, Dec. 20, 2007, available at http://thehill.com/the-executive/once-targets-of-tax-hikes-hedge-funds-now-unscathed-2007-12-20.html (reporting that the unforeseen partisan showdown over the "pay-go" budget rules, not just the lobbying campaign, helped the industry stave off the bill in 2007).

[20] See Yvonne Ball, Blackstone Makes Splashy Debut, Wall St. J., June 22, 2007.

[21] See Blackstone S-1, note 4, at 1-4.

[22] See id.

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ing, providing sell-side services such as fund placement services, corporate finance advisory services, and restructuring and reorganization services.[23] Blackstone was not taking a particular investment fund public. Instead, Blackstone took itself—the management company—public.[24]

Blackstone reportedly had several motivations for going public. Liquidity for the founders and top brass was likely a factor. Retention issues were another concern. Having publicly-traded shares also helps retain key employees; the ability to readily value the equity in the firm facilitates compensation negotiations.[25] Publicly-held equity also provides a stable base of permanent capital and acquisition currency for future growth. Finally, some press reports indicated that fund managers sought to monetize the value of their carried interest before changes in the tax law reduced the value of those future cash flows.[26]

The structure of the deal set a new high-water mark for tax-driven "regulatory cost engineering" in an IPO.[27] Regulatory cost engineering is the process of tweaking a deal structure to achieve better regulatory treatment without unduly altering the underlying business arrangements.[28] Here, Blackstone sold equity to the public while achieving better tax results than most other public companies receive. The deal was not an abusive tax shelter; the IPO was a real business

[23] See id.

[24] See id. at 4-6.

[25] Carried Interest, Part 2: Hearing Before the S. Comm. on Finance, 110th Cong. (2007) (statement of John B. Frank, Oaktree Capital Management), at 2, available at http://www.senate.gov/~finance/sitepages/hearing073107.htm ("We believed having tradable equity would provide a valuation mechanism and liquidity that will help us succeed in the intense competition for talented investment professionals and facilitate an orderly transition from the current owners of Oaktree to our future leaders.")

[26] See White & Callan, note 4, at 8. Of course, in theory, the tax risk should have been capitalized into the price of the offered units. Still, it is possible that investors did not fully discount the value of the units to reflect the risk of a change in the taxation of carried interest or, for that matter, a change in the tax treatment of Blackstone itself.

[27] See generally Victor Fleischer, The MasterCard IPO: Protecting the Priceless Brand, 12 Harv. Negot. L. Rev. 137 (2007) (discussing a recent example of "regulatory cost engineering"); Steven L. Schwarcz, Explaining the Value of Transactional Lawyering, 12 Stan. J. L. Bus. & Fin. 486, 491 n.35, 500-02 (2007) (discussing "reducing regulatory costs" and "regulatory cost engineering" as elements of transactional lawyering). The MasterCard deal was remarkable for its careful balancing of economic concerns and antitrust concerns; managing antitrust risk was essential to the pricing of the deal. See Fleischer, supra, at 148-50. The Blackstone deal, however, achieves a higher degree of complexity, and with even more money at stake on achieving the sought-after regulatory outcome.

[28] I use the term "regulatory cost engineering" to define the signature role of the deal lawyer, in contrast to the "transaction cost engineering" as defined by Ron Gilson's seminal article and the literature that has followed that model. See Ronald J. Gilson, Value Creation By Business Lawyers: Legal Skills and Asset Pricing, 94 Yale L.J. 239 (1984). While lawyers continue to play a role in managing transaction costs through contractual design, I suggest here and elsewhere that regulatory cost engineering better accounts for much of the value that lawyers bring to the deal.

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transaction with a real, nontax business purpose. But the end result is contrary to congressional intent. Blackstone treats taxes not as the price for civilization, but rather as "an obstacle course to be gamed and gotten around."[29]

A. *The Blackstone Deal Structure*

The Blackstone IPO used a novel structure.[30] Rather than incorporate and issue common stock, Blackstone retained its structure as a partnership under state law.[31] The founders and managing directors created a new partnership that issued "common units" to the public;[32] these limited partnership units trade on the New York Stock Exchange under the ticker symbol BX.[33]

The regulatory finesse of the deal was critical to the structure. Section 7704(a) normally requires that publicly-traded partnerships be taxed as if they were corporations. Congress enacted this section specifically to block entities that functionally resemble corporations from accessing the public equity markets without paying a corporate-level tax.[34] Through some complex deal engineering, Blackstone wedged itself into the literal language of the "passive-type income" exception in § 7704(c), even though its income is active, not passive, as those words are normally used in the Code and regulations.[35]

This structural element of the deal—first used in the private equity context by Fortress Investment Group in its February 2007 IPO—was a creative tax planning innovation.[36] The Code has always been con-

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[29] See Alan Zibel, Blackstone's Unusual Tax Strategy Comes Under Scrutiny in Washington, AP Wire Serv., July 13, 2007 (quoting Senator Max Baucus).

[30] Fortress Investment Group, a U.S. hedge fund manager, went public using a similar structure in February 2007. Matthew Lynn, Blackstone a Credit Bellwether: If Fund Goes Private Again Rest Assured the Credit Market Has Hit Bottom, St. Paul Pioneer Press, Jan. 20, 2008, at D3 (discussing Fortress' structure).

[31] See Blackstone S-1, note 4, at 16.

[32] See id.

[33] "As in bucks. Lots of bucks." Dennis Berman, Blackstone's Ticker Symbol: It's BX, Wall St. J., Mar. 23, 2007, available at http://blogs.wsj.com/deals/2007/03/23/blackstones-ticker-symbol-its-bx/.

[34] See H.R. Rep. No. 101-139 (II), at 1065-66 (1987), reprinted in 1987 U.S.C.C.A.N. 2313-378, 2313-681-83.

[35] For an example of active business language, see Reg. § 1.355-3(b)(2)(iii) (defining active conduct in terms of "substantial management and operational functions").

[36] Prior to Fortress, most publicly traded partnerships conducted real estate, timber, and oil and gas activities, although a few conducted asset management activities. I am not aware of any firms structured as PTPs that conducted active private equity management operations prior to the Fortress, Oaktree, Blackstone, and Apollo deals in 2007. See Susan Beck, The Transformers, The American Lawyer, Nov. 2007, at 94 (describing Skadden's role in designing deal structure).

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sidered an impediment to taking private equity public.[37] Private equity firms enjoy two key tax advantages over publicly traded corporations. First, because both the firms and the funds they manage are pass-through entities for tax purposes, individual partners may take advantage of the capital gains preference.[38] Private equity fund managers receive much of their compensation in the form of a profits interest in a partnership, known as carried interest. Carried interest distributions are often taxed at the long-term capital gains rate of 15%.[39] Corporations, however, cannot take advantage of the capital gains preference; corporations pay tax on such gains at a 35% rate.[40] So if Blackstone were treated as a corporation for tax purposes, it would pay substantially more tax on the compensation it earns for managing funds. Second, private equity firms pay no entity-level tax.[41] Shareholders in publicly traded entities, on the other hand, face an individual-level tax in addition to a separate entity-level tax. The deal structure allows Blackstone to go public while holding on to the tax break for carried interest.

Blackstone's current structure allows a dollar of carried interest compensation to be taxed once, when it's ultimately received by the individual partners, at a tax rate of 15%. This leaves 85 cents of after-tax income. If Blackstone were taxed as a corporation, by contrast, a dollar of carried interest would be taxed first at the corporate rate of 35%, leaving 65 cents available for distribution to shareholders. If the 65 cents were then distributed out to the shareholders as a dividend, they would pay tax on that distribution at a 15% rate.[42] This leaves just 55 cents of after-tax income.

In 2006, Blackstone earned close to $2 billion in carried interest distributions.[43] Assume that in 2007, the public partnership, which holds about 25% of Blackstone, earns $500 million in carried interest. The individual unitholders would pay capital gains taxes of about $75 million, leaving $425 million after-tax income. If Blackstone had been taxed as a corporation, the corporate entity would have paid $175 mil-

[37] See Larry E. Ribstein, The Rise of the Uncorporation (U. Ill. Law & Econ. Research Paper No. LE07-026, 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1003790.

[38] IRC § 702(b).

[39] See Fleischer, note 8, at 14-15.

[40] See IRC § 11. The 34% marginal rate begins at $75,000; the 35% marginal rate begins at $10 million. IRC § 11(b)(1)(C)-(D). For simplicity, I refer only to the 35% rate.

[41] See IRC § 701 ("A partnership as such shall not be subject to income tax imposed by this chapter.") As described below, Blackstone will pay an entity-level tax, through a blocker entity, on certain income, such as management fees, advisory fees, and other nonqualifying income under § 7704. And, of course, partners and investors in Blackstone will still pay income tax in their individual capacities.

[42] IRC § 1(h)(11).

[43] See Blackstone S-1, note 4, at 20.

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lion in tax on those carried interest distributions, leaving $325 million available to shareholders. If that amount were then distributed as a dividend, the shareholders would pay an additional $48.75 million in tax, leaving about $276 million after-tax income in the hands of shareholders. The difference—about $150 million in tax revenue—gives a sense that the dollars at stake are significant.[44] The tax treatment of the deal is, obviously, the driving force behind the structure.[45] If not for the tax rules, Blackstone would likely have just achieved its business goals by incorporating and selling common stock to the public.

The Blackstone Group, L.P., a Delaware limited partnership, is the entity that went public (the "public partnership").[46] It issued "common units" to investors, who became limited partners in the public partnership and have extremely limited voting rights.[47] The senior managing directors of Blackstone control the public partnership through Blackstone Group Management LLC, a Delaware limited liability company. This entity, which serves as the general partner of the public partnership, exists solely as a governance device and has no economic rights in the public partnership.[48] The senior managing directors and other existing owners of Blackstone instead hold economic interests, alongside the public partnership, in "Blackstone Holdings," a group of partnerships that serve as general partners in the various Blackstone investment funds.[49]

Wedged in between the public partnership and Blackstone Holdings is a blocker entity which, as I discuss below, allows Blackstone to fit into the exception to the publicly-traded partnership rules. (I am simplifying the structural elements slightly; the actual structure contains two blocker entities, an additional layer of holding company partnerships, and other entities not critical for purposes of this tax analysis.)[50] The blocker entity is capitalized with both intercompany debt and equity; interest payments on the debt allow Blackstone to strip income out of the blocker for tax purposes.

Blackstone Holdings serves as the general partner in the various investment funds that Blackstone runs.[51] Pension funds, university endowments, banks, insurance companies, and other institutional in-

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[44] I discuss the revenue implications of the bill in more detail below. See text accompanying notes 130-32.

[45] The deal structure still works if Blackstone is taxed as a corporation in the sense that the Blackstone founders and managing directors will still achieve the nontax goals of the deal, such as liquidity, acquisition currency, and access to permanent capital.

[46] See Blackstone S-1, note 4, at 16.

[47] See id. at 18, 76-78.

[48] See id.

[49] See id. at 17, 76-78.

[50] See id. at 16, 76-78.

[51] See id. at 17, 76-78.

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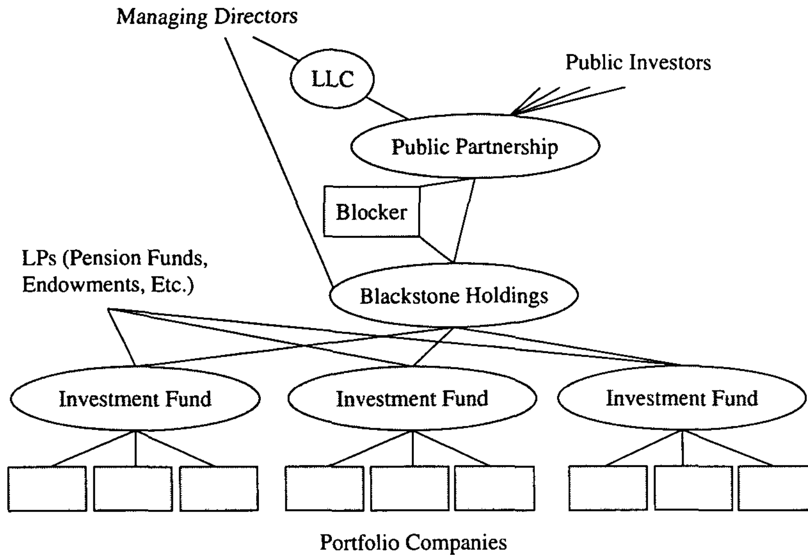

vestors are the limited partners in these funds.[52] Blackstone Holdings receives management fees, carried interest distributions, and other fees in exchange for its management of the investors' capital. Finally, at the bottom of the structure, are the portfolio companies—the actual operating businesses that Blackstone buys, restructures, operates, and sells.[53] Such companies include the real estate management company Equity Office Properties Trust, Freescale Semiconductor, The Tussauds Group, and educational publisher Houghton Mifflin.[54] Blackstone also provides a variety of alternative asset management services in additional to traditional private equity investment, from managing hedge funds, mezzanine and structured debt funds, funds of funds, and deal advisory services.[55]

B. Regulatory Cost Engineering

The economics of the Blackstone deal—raising permanent equity capital from public investors—is functionally identical to a plain vanilla initial public offering of a corporation. By adopting a tiered partnership structure with a corporate blocker entity, however, Blackstone's advisors improved the deal's regulatory treatment in several important ways.

[52] See id. at 8.
[53] See id. at 16.
[54] See id. at 162-65.
[55] For a general discussion of Blackstone's business model, see id. at 1-4, 167-74.

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1. *Governance*

Blackstone's founders and managing directors are accustomed to having a wide range of discretion in how they manage the business. Public company managers are increasingly constrained by federal law.[56] As a public entity, Blackstone will be treated as a public company for purposes of the securities laws, including Sarbanes-Oxley.[57] The partnership structure, however, allows Blackstone to avoid certain NYSE listing requirements that otherwise would apply.[58] Blackstone does not have a majority of independent directors on its board, a nominating/governance committee consisting entirely of independent directors, or a compensation committee consisting of independent directors.[59] Nor does Blackstone plan to hold annual meetings.[60] From a governance standpoint, Blackstone must accept the disclosure and accounting requirements necessary to access the public capital markets, but the partnership structure allows Blackstone to avoid many of the governance restrictions associated with the major stock exchanges.[61] The potential for conflicts of interest between public investors and other entities in the Blackstone structure is substantial; the partnership structure allows Blackstone to substantially limit the fiduciary duties that otherwise would apply under Delaware law.[62]

2. *Investment Company Act of 1940*

The second area of regulatory cost engineering concerns the Investment Company Act of 1940 ("the 1940 Act").[63] That statute establishes detailed rules for the operation of mutual funds and other investment vehicles. The 1940 Act defines "investment company" broadly to include, among other things, any issuer engaged primarily in the "business of investing, reinvesting, or trading in securities[.]"[64] Private equity funds typically avoid the requirements of the 1940 Act through two exemptions, which allow funds with fewer than 100 inves-

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[56] For an excellent general discussion of federal lawmaking and oversight of corporate governance issues, see Mark J. Roe, Delaware's Competition, 117 Harv. L. Rev. 588, 600-34 (2003).

[57] 15 U.S.C. §§ 7201-7266. Blackstone noted as a risk factor that it was not yet Sarbanes-Oxley compliant. See Blackstone S-1, note 4, at 39.

[58] See id. at 55.

[59] See id.

[60] See id.

[61] On the differing approaches to the concept of independence by the exchanges and under Delaware law, see Usha Rodrigues, The Fetishization of Independence, 33 J. Corp. L. (forthcoming 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=968 513.

[62] See Blackstone S-1, note 4, at 55-56, 219-25.

[63] 15 U.S.C. §§ 80a-1-80a-64 (2001).

[64] See id. § 80a-3(a)(1)(A).

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tors, or only qualified purchasers, to become partners.[65] The 1940 Act has prevented most individual private equity funds from going public, as compliance with the 1940 Act is not a practical option.[66]

Because Blackstone is taking the management company public rather than an individual fund, it avoids the regulatory reach of the 1940 Act. This is a startling result at first glance. If you were to ask yourself what Blackstone does, buying and selling securities in portfolio companies would seem to be a logical answer. Because the management company itself is going public, however, rather than an individual fund, it's more accurate to think of Blackstone as a service provider that helps other people—the limited partners in each fund—buy portfolio companies. This point is easier to understand by thinking of Blackstone as a diversified financial services firm similar to Citigroup or Goldman Sachs, not an investment vehicle like a Fidelity mutual fund. As Blackstone explained in its regulatory filings, its primary source of income is earned in exchange for services provided.[67]

The SEC accepted Blackstone's position that it is not an investment company. The statutory analysis is fairly straightforward. Section 3 of the 1940 Act uses two tests to determine whether an issuer is subject to the act. Section 3(a)(1)(A), the "orthodox" investment company test, looks to whether a company holds itself out as an investment company. Section 3(a)(1)(C), the "inadvertent" investment company test, looks to whether the company is engaged in the business of investing, reinvesting, owning, holding or trading in securities and owns investment securities in excess of 40% of the company's total assets.[68] In reviewing the Blackstone deal, the SEC concluded that Blackstone was neither an orthodox nor an inadvertent investment company.[69] Andrew Donohue, the director of the Division of Investment Man-

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[65] See id. § 80a-3(c)(1), (7).

[66] There are a variety of ways to take a private equity fund public without becoming an investment company for purposes of the 1940 Act. A handful of private equity firms have taken specific funds public using an arcane exception for "business development companies," or BDCs. Other firms have taken specific funds public in Europe, avoiding the jurisdictional reach of the 1940 Act.

[67]

> We believe that we are engaged primarily in the business of providing asset management and financial advisory services and not in the business of investing, reinvesting or trading in securities. *We also believe that the primary source of income from each of our businesses is properly characterized as income earned in exchange for the provision of services.* We hold ourselves out as an asset management and financial advisory firm and do not propose to engage primarily in the business of investing, reinvesting or trading in securities.

Blackstone S-1, note 4, at 60 (emphasis added).

[68] The Investment Company Act of 1940, 15 U.S.C. § 80a-3(a)(1)(c).

[69] See Testimony Concerning Initial Public Offerings of Investment Managers of Hedge and Private Equity Funds Before the S. Comm. on Fin., 110th Cong. (2007) (statement of Andrew J. Donohoe, Director, Div. of Investment Management, SEC).

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agement, explained: "Fortress and Blackstone are engaged primarily (and hold themselves out as being engaged primarily) in the business of providing asset management and financial advisory services to others. . . ."[70] They were not, he continued, "primarily in the business of investing in securities with their own assets."[71] On the "inadvertent" investment company question, the key issue is whether the general partnership interests that Blackstone holds in its various funds are investment securities for purposes of the 1940 Act. Because the profits related to general partnership interests depend on the efforts of the general partners, as opposed to the efforts of others, the SEC concluded that the general partner interests were not investment securities.[72]

The AFL-CIO and others have objected to the SEC's conclusion.[73] But Blackstone's position with respect to the 1940 Act is not abusive. It is in accordance with the goals of that legislation, which, broadly speaking, is aimed at regulating investment vehicles. Blackstone is not merely a vehicle pooling the capital from small investors. Rather, it is an operating company in a service business. As a result, the Securities Act of 1933 and the Securities Exchange Act of 1934—not the 1940 Act—are expected to provide investors with adequate disclosure and protection. Blackstone's position with respect to the 1940 Act is, however, striking when contrasted with its tax position.

3. *Tax Law*

Having established itself as an active financial services firm for purposes of the 1940 Act, Blackstone tiptoes along a narrow beam to avoid the corporate tax. Blackstone accomplishes this by qualifying as a publicly-traded partnership with "passive-type income," exempting it from the corporate tax. To qualify, Blackstone must receive at least 90% of its income from passive income, like interest, dividends, rents, royalties, and capital gains.[74]

To make this work, Blackstone transforms its income from its active business as a financial services firm—carried interest, management fees, deal advisory fees, fund placement fees, and so on—into passive income. It does so in two, possibly three, ways. First, because carried interest is treated as capital gain under current law, it is classified as

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[70] Id. at 3.

[71] Id.

[72] See id. at 4-5; see also Williamson v. Tucker, 645 F.2d 404 (5th Cir. 1981); Tamar Frankel, The Regulation of Money Managers: The Investment Company Act and the Investment Advisers Act § 5.02[D] (1978).

[73] See Beck, note 36, at 98-99.

[74] See IRC § 7704(c), (d).

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passive income for these purposes.[75] Given the longstanding tax treatment of carried interest as capital gain,[76] Blackstone is not being aggressive in its statutory interpretation. Rather, it is parlaying one fiction (that carried interest is passive income and therefore generates capital gain) to support another fiction (that Blackstone is a passive partnership and therefore not subject to the corporate tax).[77] Second, like many other private equity firms, Blackstone may periodically waive management fees in favor of increased priority allocations of carried interest, which then are treated as capital gain when received (and thus permissible under § 7704(c)).[78] Third, any remaining active income is funneled through the blocker entity in the structure, an LLC that elects to be treated as a corporation and pays an entity-level tax. The blocker entity then distributes the after-tax cash up to the public partnership in the form of a dividend, which qualifies as passive income under § 7704(c). Blackstone may pay less tax on the blocker's income than it appears at first glance; the blocker entity is capitalized in part with intercompany debt, which allows Blackstone to strip income out of the blocker, where it would be subject to the corporate tax, and into the parent partnership, where it is not.[79]

It is worth mentioning one more tax aspect of the deal that has received some attention: the Tax Receivable Agreement.[80] The founders and other selling shareholders entered into a contract with the public partnership that shifts some of the tax benefits of the deal away from the public investors back to the selling shareholders.[81] The sale of shares to the public generates a new tax asset, goodwill, that the corporate blocker entity will amortize over time.[82] This amortization generates tax deductions that will reduce the corporate tax liability of the blocker entity.[83] The Tax Receivable Agreement takes 85% of these tax benefits and shifts them back to the selling shareholders.[84] Because the amortization generates deductions at a 35% rate, while

[75] See text accompanying note 116.

[76] See Fleischer, note 8, at 14-15.

[77] See text accompanying notes 95-118.

[78] There is both tax risk and economic risk involved. See Fleischer, note 8, at 23-24; Staff of the Joint Comm. on Tax'n, 110th Cong., Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests 50 (Comm. Print 2007), available at http://www.house.gov/jct/x-41-07.pdf.

[79] See Beck, note 36, at 97 (describing the blocker loan in the Fortress deal as "aggressive").

[80] See David Cay Johnston, Tax Loopholes Sweeten a Deal for Blackstone, N.Y. Times, July 13, 2007, at A1 (describing how Blackstone partners paid tax at capital gains rates on shares sold and will be able to take deductions for goodwill at ordinary rates).

[81] See Blackstone S-1, note 4, at 207-09.

[82] See id.

[83] See id.

[84] See id.

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the sale of the Blackstone units generated capital gain at only a 15% rate, the rate differential creates an opportunity for the selling shareholders to eliminate much of their tax liability from the transaction.[85] (The selling shareholders presumably will report additional income on payments received pursuant to the tax receivable agreement, potentially at capital gains rate under the theory that the sale remains an open transaction.)

The Tax Receivable Agreement does not deprive the Treasury of revenue that it would otherwise receive. The rules for the tax treatment of goodwill create the tax asset;[86] the Tax Receivable Agreement merely allocates the benefit of this tax asset among the parties. It is, nonetheless, illustrative of Blackstone's aggressive attitude towards tax planning—in this case, taking a tax asset away from its own investors.[87] In theory, of course, the impact of the Tax Receivable Agreement ought to have been priced into the deal. If the market were fully efficient, investors would have paid a lower share price for Blackstone in the IPO to account for the future payments to the selling shareholders. Not every investor must have conducted this tax analysis; rather, if enough investors priced in the payments, then demand for Blackstone's shares would have softened and shifted the price downwards at the margin. Still, given the complexity of the issue and the opacity of Blackstone's disclosure, it is not clear to me that the payments were, in fact, fully priced into the shares.[88] As a result, the Tax Receivable Agreement is probably best characterized as primarily an "agency costs" problem—Blackstone insiders may have extracted rents from their principals, the public shareholders—rather than as a tax issue.

4. *Regulatory Arbitrage*

The genius of the structure lies in the arbitrage between the 1940 Act and the Code. The key tax advantage is the treatment of carried interest as investment capital that gives rise to long-term capital gain. The income to management companies like Blackstone is better characterized as a return on human capital, not investment capital; management companies receive this income in exchange for services provided. Blackstone's income is compensation for services rendered,

[85] See Johnston, note 80.

[86] See IRC § 197 (rules for amortization of goodwill).

[87] On the relationship between tax avoidance, agency costs, and firm value, see Mihir Desai & Dhammika Dharmapala, Corporate Tax Avoidance and Firm Value (2007), available at http://papers.ssrn.com/S013/papers.cfm?abstract_ia=689562.

[88] Cf. Testimony of John Frank, note 25 (noting that Oaktree's investors did not price tax risk into the deal before the Blackstone bill was introduced, notwithstanding earlier public statements that legislation was possible).

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and ought to be taxed as such.[89] But the tax treatment of carried interest instead creates an opportunity to exploit the gap between the economics of the transaction (compensation for services rendered) and its tax treatment (return on investment capital).[90] This opportunity then leads to another planning opportunity: Blackstone performs *active* services for 1940 Act purposes but remains *passive* for tax purposes, because § 7704 defines passive income in terms of capital gains.[91] This sort of arbitrage is hardly unheard of, as different regulatory schemes often serve different objectives. In this case, the Blackstone bill would take an incremental step towards harmonizing the Code and the securities laws.

III. The Blackstone Bill as a Response to Regulatory Gamesmanship

The week before Blackstone's IPO, Senators Baucus and Grassley introduced a bill that would treat Blackstone and other financial services firms using the PTP structure as corporations for tax purposes.[92] While Blackstone's stakeholders felt unfairly targeted by the legislation[93]—why single out Blackstone?—lawmakers and staffers saw it in exactly the opposite way. Blackstone singled itself out, they say, by creating a structure that thwarts congressional intent and avoids the corporate tax.[94] The bill, then, may be justified as a defense of "rule of law" values, such as the notion that equals should be treated alike, and the notion that clever gamesmanship should not be rewarded. Viewed in this way, the bill is a technocratic response to the regulatory gamesmanship of Blackstone's deal structure, which allows it to avoid the corporate tax that other, similarly-situated financial intermediaries pay.

A. *Two and Twenty*

Blackstone's entity-level gamesmanship is a derivative of a broader tax arbitrage opportunity–the conversion of returns from human capi-

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[89] See Fleischer, note 8, at 43-47.

[90] See id. at 24-26.

[91] See 15 USC § 80a-3(a)(1)(A), 3(a)(1)(c); IRC § 7704(c)(d).

[92] See Dennis K. Berman, Sarah Lueck & Henny Sender, Tax Boost Sought for Buyout Firms Planning IPOs, Wall St. J., June 15, 2007, at A1.

[93] See Editorial, The Blackstone Tax, Wall St. J., June 20, 2007.

[94] See Committee on Finance, Baucus-Grassley Bill Addresses Publicly Traded Partnerships (News Release), June 14, 2007, available at http://www.senate.gov/~finance/press/Bpress/2007press/prb061407e.pdf ("'Right now, some businesses are crossing the line between reasonably lowering their tax burden and pretending to be something they're not to avoid most, if not all, corporate taxes,' said Grassley.")

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tal into returns from investment capital.[95] Fund managers take much of their compensation in the form of a profits interest in a partnership; distributions of profits pursuant to that contractual arrangement with the fund often create capital gains.[96] The Code thus treats carried interest distributions—the bread and butter of fund manager compensation—as a return on low-taxed investment capital rather than as high-taxed labor income.[97]

Whether carried interest distribution should be treated as labor income is an intricate question. In another article, I suggest that a profits interest in a partnership has elements that resemble a return on human capital and elements that resemble a return on investment capital.[98] Allowing the carried interest to go untaxed at the date of grant or vesting is appropriate, but only if taxed as ordinary income on an accrual basis or when profits ultimately are realized.[99] Other commentators have suggested that the problem is not related to the partnership tax rules, but rather must be addressed by eliminating the capital gains preference.[100] Still others think, given other potential planning opportunities, that the status quo is preferable.[101] The congressional tax-writing committees are exploring the issue. Meanwhile, it remains clear that under current law, carried interest distributions generate capital gain.

The tax advantages of the Blackstone deal structure disappear if the tax treatment of carried interest changes. If carry is treated as ordinary income, then compliance with the PTP rules would require Blackstone to cleanse substantially all its income through the blocker structure, which may require paying a corporate-level tax (at least to the extent not zeroed out by deductible interest payments on debt in the blocker entity, as I discuss below). So long as carried interest is treated as investment capital, however, firms have the ability to treat active management income as passive income for purposes of the publicly-traded partnership rules.

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95 See Fleischer, note 8, at 14-15.

96 See id.

97 See id.

98 See id. at 36.

99 See id. at 51-52 for further discussion, see Morrison & Foerster memo, http://mofo.com/news/updates/files/12183.html, Kirkpatrick, Lockhart & Gates memo, http://www.klgates.com/newsstand/Detail.aspx?publication=3755;.

100 Cf. Chris Sanchirico, The Tax Advantage to Paying Private Equity Fund Managers with Profit Shares: What is it? Why Is it Bad? 75 U. Chi. L. Rev. (2008) (forthcoming).

101 See David A. Weisbach, The Taxation of Carried Interests in Private Equity, 94 Va. L. Rev. 715 (2008)

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B. *Publicly-Traded Partnership Rules*

The publicly-traded partnership rules draw the line between partnerships and corporations for tax purposes. Partnerships are generally pass-through entities. The character and timing of income is determined at the entity level, but the partnership entity itself does not pay tax.[102] Instead, income and deductions are allocated to the partners in accordance with the terms of the partnership agreement. Corporations, on the other hand, are taxed as separate entities; corporate distributions also may be taxed when received by shareholders, creating the so-called "double tax" on corporate profits.[103]

The publicly-traded partnership rules were enacted just twenty years ago.[104] In the 1970's and early 1980's, individual tax rates were often much higher than corporate tax rates, making operating in the corporate form appealing in some circumstances. When the Tax Reform Act of 1986 lowered the top individual tax rate from 50% to 28%,[105] the pass-through feature of the partnership form became more attractive. Simultaneously, the 1986 Act also raised capital gains rates from 20 to 28%[106] and repealed the so-called *General Utilities* doctrine,[107] a common law interpretation of the corporate tax rules that had permitted the distribution of appreciated property to shareholders without triggering an entity-level tax. Together, these changes made the bailout of corporate earnings more costly. Businesses had a strong incentive to avoid corporate tax classification.

To avoid the corporate tax, some businesses adopted a "master limited partnership" (MLP) structure. Like Blackstone, these partnerships had publicly-traded securities but retained the tax status of partnerships. Congress became concerned about the possible "disincorporation of America" and erosion of the corporate tax base as more and more businesses adopted the MLP structure.

In response Congress enacted the PTP rules, codified as § 7704, to stem the threat that MLPs posed to the integrity of the corporate tax base.[108] Section 7704(a) provides that partnerships with publicly-traded securities are taxed as corporations, regardless of how they are organized under state law, carving out an exception for partnerships

[102] IRC §§ 701, 702(a).

[103] IRC §§ 11(a), 61(a)(7).

[104] H.R. Rep. No. 101-139(II), note 34, at 1071, reprinted in 1987 U.S.C.C.A.N. 2313-378, 2313-687.

[105] Tax Reform Act of 1986, Pub. L. No. 99-514, § 101(a), 100 Stat. 2085, 2096-2099.

[106] Id. at § 302(a), 100 Stat. at 2218.

[107] See Gen. Utils. & Operating Co. v. Helvering, 296 U.S. 200 (1935); IRC § 311(b) (taxing a corporation on the distribution of appreciated property).

[108] See 1987 House Report, note 34, at 1063-79, as reprinted in 1987 U.S.C.C.A.N. 2313-678-2313-694.

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with "passive-type income." The exception distinguishes passive investment activities, for which pass-through treatment is appropriate, from the operation of an active trade or business, for which it is not.

Drawing the line between corporations and partnerships has always been a challenge. For many years, entity classification depended on a four-factor test of limited liability, continuity of life, centralized management, and free transferability.[109] Under the old four-factor test, it is obvious that Blackstone would be treated as a corporation. In 1996, however, Treasury issued regulations (the "check-the-box" regulations) that allow unincorporated entities to elect whether to be taxed as a corporation or a partnership, regardless of how they would come out under the old four-factor test.[110] Section 7704, then, serves as the substantive backstop to the elective check-the-box regulations, ensuring that publicly-traded active businesses cannot elect out of corporate taxation by organizing as partnerships or LLCs under state law.

Searching for a coherent normative justification for taxing publicly traded entities as corporations is not a satisfying endeavor. The starting point is the "corporate resemblance" test derived from an old 1935 Supreme Court case, *Morrissey v. Commissioner*.[111] In colloquial terms, if it walks like a duck and quacks like a duck, it should be taxed like a duck.[112] When Congress enacted the PTP rules in 1987, it concluded that PTPs that conduct an active business look enough like corporations to be treated as such for tax purposes. Broadly speaking, the rules tend to operate under a benefit theory: In exchange for accessing public equity markets, one must pay a corporate-level tax on profits. Because the normative case for having a corporate tax at all is rather weak, the line drawing in this area tends to be pragmatic, not principled.

Defining the corporate tax base is even more complicated for financial intermediaries.[113] Middle class investors often invest through mutual funds, which provide investment advice, diversification, and facilitate asset allocation. Wealthy individuals and institutions, on the other hand, can hire private investment advisors to provide these services. Imposing an entity-level tax on mutual funds would systematically advantage larger investors who can invest directly in portfolio companies without the help of a pooling vehicle in the form of a pub-

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[109] See Gregg D. Polsky, Can the Treasury Overrule the Supreme Court?, 84 Boston U. L. Rev. 185, 187 (2004) (discussing the definition of the term "association").

[110] See id. at 186 (referring to Reg. §§ 301.7701-1 to -3).

[111] See id. at 187 (referring to Morrissey v. Commissioner, 296 U.S. 344, 357-58 (1935)).

[112] Victor E. Fleischer, Note, "If it Looks Like a Duck": Corporate Resemblance and Check-the-Box Elective Tax Classification, 96 Colum. L. Rev. 518, 522 (1996).

[113] See generally Robert C. Clark, The Federal Income Taxation of Financial Intermediaries, 84 Yale L.J. 1603 (1975).

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licly traded intermediary. In 1936, following the *Morrissey* case, Congress designed the rules that govern the taxation of mutual funds and other registered investment companies.[114] Broadly speaking, investment companies that reach out to large numbers of investors can avoid paying an entity-level tax, but only if they comply with the Investment Company Act of 1940.[115]

Blackstone relies on the "passive income" exception to avoid the corporate tax. The exception defines passive income to include interest, dividends, and gain from the sale or disposition of a capital asset held to produce passive income.[116] Much of Blackstone's income comes from carried interest distributions. These distributions, in turn, are generated by the sale of portfolio companies held by the underlying Blackstone funds. Do these carried interest distributions qualify as passive income? Section 7704(d)(1) lists the different types of qualifying income, including under § 7704(d)(1)(B), dividends. Portfolio companies generate dividends. Section 7704(d)(1)(F) counts as passive income "gain from the sale or disposition of a capital asset . . . held for the production of income described in any of the foregoing subparagraphs of this paragraph." Under the plain language of § 7704(d)(1)(F), then, carried interest distributions, as allocations of fund-level capital gain, appear to fit the definition of passive income.

Blackstone's active business income normally would disqualify the fund from the passive income exception. Fund managers derive income not just from carried interest, but also from management fees, advisory fees, break-up fees, and other streams of income that would be difficult to characterize as passive. Regulation § 1.7704-3(a)(2) explains that qualifying income does not include income derived in the ordinary course of a trade or business. Much of Blackstone's income does not fit the statutory language, making it a challenge to meet the 90% requirement of § 7704(c), notwithstanding the statute's treatment of carried interest as passive income. This is where the corporate blocker entity comes in.

By running the fee income through the blocker entity and paying a corporate-level tax on that income, the fee income is "cleansed" and is passed through to the public partnership as a dividend, which fits within the plain language of the statute. On the one hand, this seems too good to be true; the blocker turns active income into passive income. On the other hand, Blackstone could pay a corporate-level tax on some of that income; the chief advantage of running fee income

[114] See Mark J. Roe, Political Elements in the Creation of a Mutual Fund Industry, 139 U. Pa. L. Rev. 1469, 1483 (1991).

[115] 15 U.S.C. §§ 80a-1 et seq.

[116] See IRC § 7704(d).

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through the blocker is that it allows the income that does not go through the blocker—carried interest income—to flow through without paying the corporate tax.[117]

A sticking point with regulators has been the use of debt in the blocker entity.[118] By capitalizing the blocker entity with debt issued by the parent partnership (or a subsidiary of the parent), some of the active business income in the blocker may be stripped out. Indeed, if the blocker is loaded up with sufficient debt, the entity-level tax may be extinguished altogether.

C. *Responding to Blackstone's Gamesmanship*

Regulatory cost engineering is potentially offensive from a policy standpoint if it thwarts congressional intent. To determine the best policy response, then, a more careful analysis of the legislative history is appropriate.

1. *Legislative Purpose*

a. *Legislative History*

The House Report explains that the purpose of the "passive-type income" exception is to distinguish "those partnerships that are engaged in activities commonly considered as essentially no more than investments" from "those activities more typically conducted in corporate form that are in the nature of active business activities."[119] On the one hand, Blackstone's activities largely resemble those of other private equity firms, which are not typically conducted in corporate form. On the other hand, Blackstone's activities also resemble the asset management activities of investment banks, which in recent years have tended to be organized as corporations. The legislative history on this point, then, is not terribly helpful.

More illuminating is a statement in the House Report that pass-through treatment is appropriate if the partners could "independently acquire such investments."[120] Public investors cannot independently acquire a general partnership investment in a Blackstone fund or a

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[117] Conceivably, one could look through the controlled blocker entity—a sort of a domestic subpart F—to determine the underlying character of the income. Looking through the blocker entity, however, undermines the validity of the check-the-box election; it is not self-evident why we would prohibit a blocker entity here but permit the election elsewhere. I am indebted to Adam Rosenzweig for this insight. I should note that Rosenzweig was not endorsing the idea of a domestic subpart F, but only offering it as a useful point of analysis.

[118] See Beck, note 36, at 97.

[119] 1987 House Report, note 34, at 1068, as reprinted in 1987 U.S.C.C.A.N. 2313-683.

[120] Id.

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share in Blackstone's deal advisory or restructuring business. This indicates that Blackstone is not merely acting as a conduit, but rather is conducting active business activities.[121] More explicitly, the House report then explains that interest is not passive if it is derived in the conduct of a financial or insurance business, such as banking.[122] The rationale for dropping different financial intermediaries into different compartments is rather slippery.[123] But the basic idea is that while the corporate tax should apply to operating businesses, it should not apply to investment vehicles that merely facilitate direct investment into underlying securities.

From a policy perspective, then, the question is the same as under the 1940 Act—whether Blackstone is an operating service business, or whether it is merely an investor in its own funds. While the legislative history does not address the classification of private equity firms—at the time, no one would have predicted private equity firms going public—Blackstone's activities mark it as an active service business. The receipt of management fees and other fees that do not depend on the profitability of the underlying portfolio companies is pretty clearly active income. The receipt of carry is something closer to investment income, although it too is derived from the performance of services.

b. *The Mechanics of the Senate Bill*

The Blackstone Bill[124] appears to operate on this theory of protecting the original purpose of the PTP rules. It isolates firms that it views as properly in the "active" category and tweaks the statute to ensure that these firms cannot rely on the passive income exception. Specifically, the legislation would add new § 7704(c)(4), which would state that the passive income exception does not apply to any partnership that derives income from services provided as an investment adviser (as defined in the 1940 Act, without regard to whether one is required

[121] The House report goes on to explain that in the context of interest and rental income, amounts contingent on profits are not intended to be included as passive income. See id. at 1068, as reprinted in 1987 U.S.C.C.A.N. 2313-683 to 2313-684. Interest that is contingent on profits "involves a greater degree of risk, and also a greater potential for economic gain," than fixed or market-indexed interest rates, "and thus is properly regarded as from an underlying business activity." Id. at 1068, as reprinted in 1987 U.S.C.C.A.N. 2313-684. Carried interest distributions are obviously contingent on profits—the profits of the underlying fund. On the other hand, the fund itself is an intermediary, one step removed from the underlying business activity of the portfolio companies. Still, at the end of the day it is awfully difficult to characterize carry as passive income as that term is usually used in tax law.

[122] See id.

[123] See Clark, note 113, at 1609-22.

[124] See Senate PTP Bill, note 7 and accompanying text.

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to register as an adviser).[125] This language, by incorporating by reference the 1940 Act, reaches only financial asset management activities; the PTP bill does not seek to reopen the broader debate over integration of corporate- and shareholder-level taxes. But for the controversy swirling around the taxation of private equity firms generally, the PTP bill might have been understood as in the nature of a technical correction.

But does the active/passive distinction hold water? Blackstone's strongest argument is to push for a principled distinction between firms that are subject to the corporate tax and firms that are not. It can argue that the exceptions swallow the rule. Oil and gas and other natural resources firms often qualify as PTPs despite conducting some active business activities.[126] The policy rationale is unclear. The House Report explains, rather unhelpfully, that "[i]n the case of natural resources activities, special considerations apply."[127] The Report continues: "Thus, passive-type income from such activities is considerably broader, and includes income and gains from exploration, development, mining or production, refining, transportation . . . or marketing of, any mineral or natural resource, including geothermal energy and timber."[128] Many active oil and gas, timber, and other energy companies can operate as PTPs under the passive income exception, and some do. Similarly, many real estate firms operate without paying a corporate level tax, either through the PTP rules (which allow certain rental activities to qualify as passive income)[129] or the REIT rules. Congress created a special rule for REITs, § 856(i)(1), which allows them to "cleanse" small amounts of "bad" income through a taxable REIT subsidiary, much like the blocker entity in the flow-through structure. Insurance companies, cooperatives, and other industry groups have their own methods of managing corporate tax liability. Why not Blackstone?

There is no normatively satisfying answer to this question. In the end, taking the corporate tax scheme as a given, whether to allow the Blackstone structure amounts to a political question of whether financial asset management activities should be subject to corporate taxation. Absent full-scale corporate integration, in order to minimize deadweight loss, Congress should lump together firms that conduct similar activities. I find it persuasive, on balance, that Blackstone is

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[125] Id.

[126] See Joseph A. Snoe, Entity Classification Under the Internal Revenue Code: A Proposal to Replace the Resemblance Model, 15 J. Corp. L. 647, 719-20 (1990) (pointing out that Congress intentionally classified income from natural resources as passive income).

[127] House Report, note 34, at 1069, as reprinted in 1987 U.S.C.C.A.N. 2313-684.

[128] Id.

[129] See IRC § 7704(c), (d).

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better grouped together with publicly-traded commercial banks, investment banks, and insurance companies, who pay the corporate tax, rather than real estate, oil and gas, and other publicly-traded firms who do not.

To be sure, Congress could rationally come out the other way. If we view Blackstone not as a diversified financial services firm, but rather as just another private equity firm, then the case is strong that Blackstone should be taxed like its privately-held private equity rivals like Carlyle, KKR, and Bain Capital. Moreover, just as Congress has affirmatively carved out certain activities—real estate, oil and gas, timber—to reduce the cost of capital for those industries and stake them a competitive advantage over other industries, it could make that same choice for private equity.

In sum, evidence from the legislative history is mixed. Blackstone is an active operating company, not a passive investment vehicle, and this fact would drop it into the corporate tax bucket. But it's not crazy for Blackstone to argue that given the arbitrary lines of the PTP rules, carving out one more escape hatch from corporate taxation is not the end of the world.

2. *Revenue Concerns*

The adoption of "pay-go" budget rules and the need for AMT reform has led some to wonder if the Blackstone Bill can be justified as a revenue raiser. The bill is difficult to justify on these grounds.

The bill will raise the taxes of Blackstone, Oaktree, Fortress, and Apollo, among others. Blackstone estimated its own taxes would rise by $525 million annually; given the market capitalization of Oaktree, Fortress, and Apollo, an estimate of $2 billion in annual revenue collected from the public partnerships provides a rough starting point.

But it is hard to know where to go from there. To get a true estimate of the overall revenue effects of the bill, one must consider the effect of the bill on the future behavior of private equity firms considering going public. The bill creates an incentive, at the margins, to remain privately held. Firms that otherwise would go public using the Blackstone structure and pay corporate tax on a substantial portion of their income may not do so. By remaining private, this reduces capital gains revenue that Treasury otherwise might have received from sale of the partnership units.[130] On the other hand, if § 7704 is not

[130] The Blackstone founders and managing directors sold about 22% of the firm to the public in the IPO, generating capital gains. See Elizabeth Hester & Jason Kelly, Blackstone IPO Raises $4.13 Billion at $31 a share (June 21, 2007), available at http://www.bloomberg.com/apps/news?pid=20601087irefer=home&sid=AGUNA116rIYo ("Blackstone's owners will keep 78.3 percent of the company.") In a letter to Senator John Kerry,

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amended, then some firms that would have gone public as corporations might go public using the Blackstone structure instead, thereby reducing the corporate-level taxes that the Treasury otherwise would have received.

How many private equity firms would choose to go public as PTPs but would not go public as corporations? Blackstone has argued that "[i]t is very hard to see how any business partnership would volunteer to pay this penalty" or "how anyone could possibly be confident enough about enhanced growth prospects in this uncertain world" to be willing to pay the tax costs associated with going public as a corporation.[131] But it may be useful to recall that many investment banks have gone public as corporations. Goldman Sachs, for example, had been a private partnership for generations before it went public as a corporation in 1999 for many of the same reasons that Blackstone went public (liquidity, acquisition currency, retention issues, permanent capital).[132]

Blackstone's hyperbole aside, it is difficult to predict the behavior of other private equity firms considering going public. KKR and others have proceeded with plans to go public following the introduction of the Blackstone Bill; it seems likely that, as with investment banks, private investment fund managers will seek the permanent capital and liquidity that public equity provides. On the other hand, it is certain that the Blackstone Bill will increase the cost of doing so and affect the decision at the margin.

3. *Rule of Law Concerns*

The stronger justification for the bill is as a mechanical correction of an oversight—the unintended result of Congress, in 1987, defining passive income in terms of capital gains rather than by reference to the underlying business activities that generate those gains. Viewed in this way, the bill defends "rule of law" values.

Blackstone argues that this substantial revenue would be lost if the Blackstone bill were enacted. See Blackstone Letter to Senator John Kerry (Aug. 23, 2007), at 1, available at http://taxprof.typepad.com/taxprof_blog/files/blackstone_letter_august_2007.pdf. But the issue strikes me as more complicated than that. The sale represents the monetization of the future stream of earnings in the firm, earnings that would have been taxed in the future at a 15% rate. The IPO accelerates a tax at capital gains rates on those future cash flows, but it also creates goodwill, which will be amortized by the public partnership's blocker entities at a 35% rate. Because of the rate differential, it is not self-evident to me that the sale of shares generates net revenue for the Treasury.

131 See Blackstone Letter, note 130, at 2.

132 See Anita Raghavan, Goldman, Wall Street's Holdout, to Go Public, The Wall St. J., June 15, 1998, at C1.

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Consider first the horizontal equity principle that equals should be treated alike. Congress laid out a set of rules that taxes publicly-traded entities as corporations. Blackstone is publicly-traded. The passive income exception gives Blackstone a possible counter-argument: that it is more like the investment conduits, real estate partnerships, and oil and gas firms that avoid the rules than the banking, insurance, and many other businesses subject to the rules. Given the legislative history, this argument is difficult but not impossible for Blackstone to make.

The more powerful "rule of law" argument relates to the gamesmanship of the deal. Rather than lobby for a legislative change, Blackstone thumbed its nose at Congress, cleverly structuring its way around the corporate tax. It relied on self-help, using the combination of a blocker entity and the treatment of carried interest as capital gain to punch a loophole in the publicly-traded partnership rules. While certainly not a crime, there is something to be said for responding swiftly to new structures that erode the corporate tax base.

The bill, in other words, has some independent merit as a matter of protecting the integrity of the tax system, however theoretically flawed that system may be. In 1987, when Congress enacted § 7704(c), it could not have reasonably been expected to predict the Blackstone structure. Blackstone identified a flaw in the statute and exploited it. If Congress fails to act, it encourages other firms to follow Blackstone's lead. Conversely, a swift and effective response may deter firms from engaging in similar tax avoidance activities. This, of course, was the rationale for the PTP rules in the first place.[133]

Consider the recent experience of income trusts in Canada. In the last ten years or so, Canadian firms increasingly adopted a flow-through "income trust" structure that allowed them to qualify as mutual funds for Canadian tax purposes, stripping out corporate profits and greatly reducing entity-level taxes in a fashion similar to the Blackstone structure.[134] Many companies restructured themselves as income trusts. Tax collections dropped significantly; the Canadian government estimated that in 2005, Canadian federal tax revenues were $120 million lower than if income trusts had been structured as corporations.[135] Canada eventually responded by amending its tax

[133] I do not mean to overstate this point. Firms already have strong economic incentives to avoid taxes, and the decline in the corporate tax base reflects the challenge of collecting revenue from a corporate income tax. But a swift response may prevent much needless planning activity.

[134] See Can. Dep't of Fin., Tax and Other Issues Related to Publicly Listed Flow-Through Entities (Income Trusts and Limited Partnerships), Sept. 8, 2005, available at http://www.fin.gc.ca/activty/pubs/toirplf_1e.html.

[135] See id. at Section 5 (Tax Revenue Impact).

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laws in 2006;[136] many Canadian tax lawyers are busy restructuring firms out of the income trust structure back into other entities. While such back-and-forth regulatory engineering is profitable for the tax and corporate lawyers involved, it does not represent useful economic activity from a social welfare perspective.

It's unclear whether the Blackstone structure, like the Canadian income trust structure, might create a domino effect beyond investment fund managers. Blackstone's business closely resembles the merchant banking and, to some extent, the investment banking activities of Goldman Sachs, Morgan Stanley, Merrill Lynch, and other Wall Street firms. If Congress fails to act, it puts these banks at a competitive disadvantage, which may encourage them to spin-off their merchant banking and other asset management activities into separate entities.[137]

The potential for erosion of the corporate tax base may encourage Congress to err on the side of acting quickly. Whatever the merits of the "broken window" hypothesis in understanding street crime, Congress and the taxing authorities often worry that seeing the wealthiest firms and individuals avoid tax takes a toll on the morale of average taxpayers. In the 1970's and early 1980's, individual tax shelters snowballed until shut down by the passive loss and at-risk rules.[138] In recent years, corporate tax shelters proliferated, only to be shut down in large part through fortuitous changes in accounting and corporate governance standards.[139] When Treasury or the Service learns of a new deal structure that seems abusive, it often quickly issues guidance to put other taxpayers on notice that further interpretive guidance may shut down the structure.[140] The Blackstone deal, while hardly abusive in the same sense as a typical loss-generating tax shelter, nonetheless feeds into the perception that "these guys" play by a dif-

[136] See Can. Dep't of Fin., Canada's New Government Announces Tax Fairness Plan, Oct. 31, 2006, available at http://www.fin.gc.ca/news06/06-061e.html.

[137] Because the corporate tax rules make it difficult to extract unrealized gains from the corporate form without paying tax, however, the risk of existing firms restructuring as PTPs may be limited. On the other hand, all sorts of corporations recognize capital gains in the course of business operations; many corporations hold land or plants, property and equipment, or hold other investment assets that give rise to long-term capital gain. Because corporate capital gains are taxed at a 35% rate, many new firms considering going public–not just private equity firms–have reason to consider whether the Blackstone structure might work for them.

[138] See IRC §§ 465, 469.

[139] See Susan Cleary Morse, The How and Why of the New Public Corporation Tax Shelter Compliance Norm, 75 Fordham L. Rev. 961, 963 (2006) (arguing that enforcement efforts wholly unrelated to tax had positive impact on compliance).

[140] See IRS, Listed Abusive Tax Shelters and Transactions, available at http://www.irs.gov/businesses/corporations/article/0,,id=120633,00.html.

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ferent set of rules.[141] Congress may not want to stand idle while other firms make plans to go public using the same structure.

In sum, while none of the normative arguments in favor of enforcing the PTP rules is overwhelming, the bill can be understood as a response to unwanted gamesmanship, and as a protective measure meant to defend rule of law values.

IV. The Blackstone Bill as a Compromise on Taxing Carried Interest

Return now to the other way of looking at the Blackstone Bill—as a rifleshot approach to the carried interest issue. If one steps back to consider the broader social policy implications of the bill, it becomes clear that more comprehensive tax reform eventually will be required.

A. *As a Political Compromise on Carried Interest*

Many partnerships are potentially affected by a change in the tax treatment of carried interest. Rational arguments can be made to limit the scope to private equity firms, which have taken the tax subsidy for carried interest to unprecedented levels. The Blackstone Bill, however, would reach only publicly-traded private equity firms–notably Fortress, Oaktree, Blackstone, and Apollo. Moreover, some of those firms would receive transition relief under the bill.[142]

The narrow scope of the bill is warranted only if we view it as a response to regulatory gamesmanship. Because the scope of the bill is so narrow, it fails to address the broader problems that the current tax treatment of carried interest raises, both at the individual and firm levels. The current tax treatment of carried interest raises both efficiency concerns and distributive justice concerns; the Blackstone Bill solves neither.

The status quo treatment of carried interest is troubling from an efficiency standpoint because it treats the performance of services for a private equity firm more favorably than other jobs. This distorts the labor market, drawing talent away from other sectors of the economy.[143] The status quo also induces wasteful tax planning activities, such as the conversion of management fees into priority allocations of carried interest, which may distort the economic relationship between the general partner and investors in the fund.[144] The Blackstone Bill

[141] See Johnston, note 80, at A1 (quoting Lee Sheppard ("These guys have figured out how to turn paying taxes into an annuity.")).

[142] See Senate PTP Bill, note 7, at § 1(b)(2).

[143] See Fleischer, note 8, at 18-20; Bankman, note 14, at 2-3.

[144] See Victor Fleischer, The Missing Preferred Return, 31 J. Corp. L. 77, 116 (2005).

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does little to address these concerns because it fails to reach most private equity firms that take advantage of the tax treatment of carried interest. Moreover, by reinforcing the public/private distinction, the bill deters firms from going public on the margins, creating an additional efficiency loss.

Nor does the Blackstone Bill address the distributive justice concerns raised by the status quo treatment of carried interest. The tax treatment of carried interest allows some of the wealthiest workers in the country the opportunity to pay tax at a low rate; this is at odds with a progressive income tax system.[145] Again, by addressing only a handful of firms, the Blackstone Bill is unlikely to increase the tax rates of most private equity professionals. Blackstone's managing directors, for example, are not directly affected by the bill; because they continue to hold interests in Blackstone Holdings, not the public partnership, they can continue to benefit from the low tax rate on carried interest even as the public partnership pays at the higher corporate rate. Finally, it's worth noting that the incidence of the tax—who bears the real economic burden—is unclear, as it is with the corporate tax generally.

Targeting a small handful of firms also creates the impression that Blackstone is being unfairly singled out for adverse tax treatment. The bill has been referred to as the "birthday party" bill; a rumor even circulated around Washington that founder Stephen Schwarzman's lavish birthday party led to the introduction of the bill.[146] In fact, tax-writing committees were interested in this issue long before news of Schwarzman's activities surfaced.[147] But by focusing narrowly on the earnings of a few firms, the Blackstone Bill leaves the unsatisfying impression that Blackstone is being punished simply for having too much money. The broader the scope of a carried interest bill, the less likely it is that this impression, which I think is mistaken, will stick.

B. *Egalitarianism*

Equally troubling is the bill's effect of reinforcing the disparate treatment of public and private firms with respect to the profits earned from asset management activities. Setting aside rule of law concerns, the bill may actually decrease social welfare, at least in the

[145] See Fleischer, note 8, at 1-3.

[146] See Andrew Ross Sorkin, In Defense of Schwarzman, N.Y. Times, July 29, 2007, at BU.6.

[147] Id. ("But Mr. Grassley wasn't reacting to Mr. Schwarzman's 60th birthday party, convenient as it may be to think that. An early proposal to increase the tax rate, spurred after a college professor brought the matter to the attention of Congress, had already made its way through Washington's sausage factory well before Rod Stewart serenaded guests at Mr. Schwarzman's party.").

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absence of a broader carried interest fix. Counter-intuitively, the Blackstone model for taking private equity firms public might move us marginally closer to achieving two historical goals of regulating financial intermediaries: (1) providing egalitarian access to asset management advice and (2) reducing the concentration of wealth.

First consider the egalitarian goal of the Revenue Act of 1936, which first liberalized the tax rules for mutual funds (vis-à-vis corporations).[148] Congress created pass-through taxation rules for mutual funds in order to give middle-class investors access to the professional asset management services already available to the wealthy.[149] The idea was that if Daddy Warbucks can hire a personal investment adviser without that adviser paying an entity-level tax,[150] thousands of middle-class investors should be able to accomplish the same thing by pooling together their capital in a mutual fund—and also without paying an entity-level tax.

The egalitarian goal is a worthy one. But in its devilish details, the rules for taxing mutual funds reflect an antiquated understanding of investment advice that unwittingly thwarts the purpose of the rules. The tax rules preclude mutual funds from becoming active in the corporate governance of underlying portfolio companies.[151] As a result, these funds do little to help the average investor. Most mutual fund managers cannot create value by picking stocks; modern markets are too efficient. It is not that capital markets are perfectly efficient; rather, mutual fund managers lack the institutional capacity to capitalize on the market inefficiencies that remain. Private equity fund managers, on the other hand, can and do create real value by taking control positions in companies and improving operational efficiency. Because the tax law requires mutual funds to be diversified and prevents them from taking substantial equity positions in portfolio companies, mutual funds typically cannot create positive, risk-adjusted returns (known as "alpha").

The net result contributes to a dual-caste system of investing. Middle-class individuals put money into mutual funds; wealthy individuals and institutions invest a portion of their portfolios in alpha-generating alternative investment vehicles like private equity funds, hedge funds,

148 Revenue Act of 1936, § 48(e)(2)(A)-(B), Pub. L. No. 74-740, 49 Stat. 1648, 1669.

149 See Roe, note 114, at 1483 (stating 1936 Act had fairness-based justification, "giving the middle-class collective access to professional investment management by returning to the view that picking a fragmented portfolio was not really a business after all").

150 To be sure, the personal investment adviser will pay income tax on whatever Daddy Warbucks pays her; so too do the individual partners in Blackstone.

151 See IRC §§ 851, 852.

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and venture capital funds.[152] The Blackstone deal actually provides more meaningful egalitarian access to the capital markets by allowing public investors to participate, albeit indirectly, in alternative asset classes without forcing a financial intermediary to pay an entity-level tax.

The Blackstone Bill, by contrast, reinforces the two-tier system, which only allows wealthy individuals to employ alpha-generating intermediaries without incurring a second level of tax. In the long run, a thorough reform of subchapter M is necessary to rationalize the taxation of financial intermediaries.

C. *Populism*

Now consider the populist goal of preventing the concentration of wealth. The current rules for taxing financial intermediaries are rooted in Depression-era distrust of the concentrated power and wealth of financial institutions.[153] The rules prevent mutual funds from accumulating substantial equity positions in operating companies. But by imposing strict rules on the operation of mutual funds, the tax law encourages institutional money to flow instead into private investment funds, which operate relatively free from regulation. These funds avoid not just the 1940 Act, but also the securities laws that apply to publicly-traded companies. By shifting the flow of capital away from mutual funds and into private investment funds, the tax law has unwittingly encouraged the accumulation of power and wealth in privately-held hands, free from the scrutiny of regulators and the public. Wall Street bankers exert substantial control over Main Street companies, just as Depression-era legislators feared. Allowing private equity fund managers to go public, which requires a heightened level of disclosure under the securities laws, increases public accountability. The Blackstone deal, by introducing a new level of disclosure, increases transparency and may even spread out wealth. To be sure, the disclosure of Blackstone and other publicly-traded private equity fund managers is largely limited to structure, operations, and financial results at the public partnership level; we learn little about the various Blackstone funds, and even less about the portfolio companies that Blackstone owns. From a populist point of view, this disclosure is a

[152] It is also worth noting that many government employees often participate in private equity indirectly through defined benefit pension plans.

[153] Mark J. Roe, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance 102-03 (1994); see Reuven S. Avi-Yonah & Dganit Sivan, A Historical Perspective on Corporate Form and Corporate Real Entity: Implications for Corporate Social Responsibility, in The Firm as an Entity: Implications for Economics, Accounting, and the Law 153 (Yuri Biondi, Arnaldo Canziani & Thierry Kirat eds., 2007).

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marginal improvement, but still a long way from the level of disclosure associated with publicly-held operating companies.

A broader carried interest bill would begin to address these egalitarian and populist goals by decreasing the tax advantage to remaining privately held. But assuming for the moment that a broader carried interest bill is not politically feasible under the current administration, the Blackstone Bill leaves in place a troubling set of rules governing the taxation of financial intermediaries. The rules fail to achieve meaningful egalitarian access to the capital markets for individual investors. Nor do they prevent the concentration of power and wealth. Instead, private financial intermediaries are more powerful, and less transparent, than at any time since the Great Depression.

V. Conclusion

Ultimately, what we want is a tax system that taxes the returns from managing financial assets consistently regardless of the form in which the business is conducted. Accomplishing that goal may require us to reconsider the integration of corporate and shareholder-level taxes. But the corporate tax is resilient. Short of full-scale integration, however, there are other legislative fixes that might improve things. One possibility is to reform the tax rules that restrict mutual fund activities, which could increase investment returns for middle class investors.

The disparity of the tax treatment of private and public firms creates efficiency losses. The Blackstone Bill does not and cannot fix this. Some firms that would like to go public for business reasons will choose to remain private. One way to reduce the incentive to stay private is to make it cheaper to go public, as the Blackstone structure does.

But the other way to reduce the incentive to stay private is to make it more expensive to stay private. Specifically, Congress could change the tax treatment of carried interest—a tax benefit that under current law can only be enjoyed by privately-held firms. If carried interest were taxed at ordinary income rates, it would be easier for firms on the margin to go public.

Meanwhile, the Blackstone Bill is best understood, and may be justified, as a defense of the rule of law. Treating Blackstone like other public firms that conduct similar activities treats equals alike, and it signals that aggressive regulatory engineering will not be tolerated.

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