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CARRIED INTEREST AND BEYOND: THE NATURE OF PRIVATE EQUITY INVESTMENT AND ITS INTERNATIONAL TAX IMPLICATIONS

Young Ran (Christine) Kim *

Private equity funds (PEFs) eliminate entity-level taxation by using pass-through entities. They further minimize their investors' tax liability by taking the position that profits distributed to both general partners (GPs) and limited partners (LPs) are passive portfolio investment income and taxed preferentially. The taxation of carried interest at low capital gains rates is likely the most infamous loophole. This article challenges such tax position and instead argues that the nature of PEF investment is active. PEFs seek to influence their portfolio companies to increase their value so that they actively manage the companies by acquiring at least 10% of their stock, which does not conceptually accord with portfolio investments. The proposed theory that PEFs are active is further supported by recent proposals on carried interest as well as cases and rulings holding that PEFs are involved in a "trade or business."

This article also considers international tax implications of the new theory: it switches the primary tax jurisdiction to levy tax on PEFs' cross-border income. This change may be justified for GPs who erode the tax base of a source country, but less justified for LPs because of their genuinely passive involvement, notwithstanding that LPs' tax-exempt or nonresident status enables GPs' abusive activities. Finally, determining the true nature of PEF investment and reforming PEF tax accordingly would increase worldwide revenue without significantly reducing the revenue of traditional residence countries, because the traditional residence countries, such as the United States, are also major source countries in the PEF industry.

* Associate Professor of Law, University of Utah, S.J. Quinney College of Law. I would like to thank Allison Christians, Jeff Colon, Mitchell Kane, Susan Morse, Steven Rosenthal, Daniel Shaviro, Lina Sugin, Alan Viard, and participants in the National Business Law Scholars Conference (Salt Lake City, 2017), the Annual Meeting of the Law and Society Association (New Orleans, 2016), and the NYU School of Law JSD Forum for their helpful comments on an earlier draft of this article. Jennifer Graber (J.D.'17, NYU Law) provided excellent research assistance.

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I. INTRODUCTION

Private equity funds (PEFs) essentially eliminate entity-level taxation, which would have occurred had it used a C corporation to pool and invest the capital, by taking the form of pass-through entities, particularly a limited partnership.¹ In addition to enjoying partnership tax, PEFs further take the traditional position that profits distributed from the partnership vehicle to both general partners (GPs) and limited partners (LPs) are passive investment incomes, such as capital gains.² Since the flexibility of partnership tax allows for the difference in allocation of partnership profits and the underlying ownership of the partnership interest,³ the PEF market has an established practice of allocating 20% of profits, as carried interest, to GPs as a reward for their service to the fund on top of the return to their capital interest.⁴

Carried interest has been called the most famous tax loophole of PEFs,⁵ allowing private equity firms to pay tax on their income at lower capital gains rates. Recent proposals for carried interest suggest recasting the carried interest portion of a GP's profit from capital gains to ordinary income, specifically as compensation for services of the GP.⁶ These proposals have been circulating for many years,⁷ and they have gained bipartisan support. In fact, reforming the tax treatment of carried interest was one of the few issues that both then-candidates Hillary Clinton and Donald Trump agreed upon during the 2016 presidential election.⁸ However, although the Trump

¹ DONALD J. MARPLES, CONG. RESEARCH SERV., RS2269, TAXATION OF HEDGE FUND AND PRIVATE EQUITY MANAGERS 2 (2014).

² *Id.* at 5.

³ See I.R.C. § 704(b) (providing that a partner's distributive share of income and distribution may be different from the partner's interest in the partnership if the partnership agreement provides as such); RICHARD M. LIPTON ET AL., PARTNERSHIP TAXATION 121 (3d ed. 2012) (explaining that I.R.C. § 704(b) allows flexibility for determining partners' allocable share of partnership income and distributions).

⁴ Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 3 (2008).

⁵ Victor Fleischer, *The Top 10 Private Equity Loopholes*, N.Y. TIMES, Apr. 15, 2013, https://dealbook.nytimes.com/2013/04/15/the-top-10-private-equity-loopholes/?_r=0.

⁶ See *infra* text accompanying notes 185–200.

⁷ Congress started discussing the issue in 2007. See Steven M. Rosenthal, *Taxing Private Equity Funds as Corporate "Developers,"* 138 TAX NOTES 361, 361 (2013).

⁸ Melissa Mittelman, *With Close Trump Ties, Private Equity Eyes Tax, Financial Reform*, BLOOMBERG NEWS, Jan. 19, 2017, <https://www.bloomberg.com/news/articles/2017->

administration first sought to close the carried interest loophole in the recent tax reform,⁹ the Tax Cuts and Jobs Act of 2017 did not effectively close the loophole.¹⁰

Carried interest is not the only tax technique that a taxpayer may use to minimize tax burden. A recent article addressing private equity's "tax game" of using 2% management fees and expense deductions illustrates other ways to reduce tax liability and suggests how to correct the issue.¹¹

More fundamentally, the discussion on carried interest and management fees raises questions about the nature of investments in private equity.¹² Traditionally, investors in PEFs are treated as passive investors, as opposed to active investors who manage and control the business to generate business profits. Thus, fund investors (both GPs and LPs) have been treated as portfolio investors, who are not involved in the business operation but simply receive passive income from their investment. International finance and tax policy literature agrees with this view and classifies cross-border investments by PEFs as foreign portfolio investments.¹³

However, this article argues that such a view is at odds with the true nature of PEF investment: PEFs seek to influence their portfolio companies in order to increase their value, so that the PEFs actively manage and operate the portfolio companies by acquiring at least 10% of the stock of the portfolio companies.¹⁴ Given that the foreign portfolio investment refers to the

01-19/with-close-trump-ties-private-equity-eyes-tax-financial-reform.

⁹ Rebecca Shabad, *Trump Says His Administration Is Targeting Carried Interest Loophole in Tax Reform*, CBS NEWS, May 1, 2017, <http://www.cbsnews.com/news/trump-says-his-administration-is-targeting-carried-interest-loophole-in-tax-reform/>.

¹⁰ The Tax Cuts and Jobs Act of 2017 applies a three-year holding period in order for investment managers to enjoy long-term capital gains rates on carried interest. Pub. L. No. 115-97, § 13309, 131 Stat. 2054, 2130 (codified as amended at I.R.C. § 1061(a)(2)). However, in many cases the effect is not likely material because private equity funds often hold investments longer than three years before realizing gains. Jason Factor & Meyer Fedida, *Tax Cuts & Jobs Act: Considerations for Funds*, CLEARLY GOTTLIEB ALERT MEMORANDUM (Jan. 2, 2018), <https://www.clearlygottlieb.com/~media/organize-archive/cgsh/files/2017/publications/tax-cuts-and-jobs-act-2017/updates-1-2-18/tcja-summary-private-equity-jan-2.pdf>. For further discussion, see *infra* Part IV.A.

¹¹ See Gregg D. Polsky, *A Compendium of Private Equity Tax Games* (U.N.C. Legal Stud., Res. Paper No. 2524593, Nov. 14, 2014), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2524593.

¹² See, e.g., Rosenthal, *supra* note 7.

¹³ See, e.g., PETER CORNELIUS, INTERNATIONAL INVESTMENTS IN PRIVATE EQUITY: ASSET ALLOCATION, MARKETS, AND INDUSTRY STRUCTURE 155 (2011); *infra* text accompanying note 146.

¹⁴ See, e.g., JACK S. LEVIN & DONALD E. ROCAP, STRUCTURING VENTURE CAPITAL, PRIVATE EQUITY AND ENTREPRENEURIAL TRANSACTIONS 1–3, 1–6 (2013) (providing that PEFs' active involvement in managing portfolio companies distinguish PEFs from other types of investing).

investment owning less than 10% of the foreign entity to indicate its passive nature,¹⁵ the nature of PEF investment does not conceptually accord with that of portfolio investment. Carried interest proposals signal a challenge to the traditional position for GPs in tax law by admitting their active involvement in the investment. Moreover, the recent *Sun Capital* case decided in the First Circuit¹⁶ and an Internal Revenue Service (Service) ruling,¹⁷ which held that private equity is involved in a “trade or business,” the term of art describing active business in tax law, further complicates the traditional view of private equity investments as passive investments.

The concerns that PEFs are abused to minimize the tax liability of private equity firms and investors¹⁸ need more attention in the context of recent developments. Business income that used to be earned from C corporations has been shifted to pass-through entities over the last two decades, and the United States has likely lost substantial tax revenue due to such changes in the origin of business income.¹⁹ Business activity from pass-through entities was low in 1980, when pass-through entities produced only 20.7% of all business income, and had more than doubled to 54.2% by 2011.²⁰

However, discourse on private equity tax is still limited to domestic matters. There is scant research analyzing international tax aspects of PEFs’ cross-border investment, despite the dramatic increase in international capital flows. Indeed, PEFs invest all over the world. American private equity houses were in charge of 32% of international buyout investments between 2003 and 2007.²¹ During the same period, 34% of the investments from the European private equity market were deployed in nondomestic countries.²² Recent proposals on carried interest and the challenge to the traditional tax position of PEFs as passive investors have significant implications for international tax as well, one of which could be changes the primary tax jurisdictions among relevant countries.

¹⁵ The Internal Revenue Code (Code) assumes that the dividing line between foreign direct investment and foreign portfolio investment is 10% of the investee entity. *See infra* Part III.B.

¹⁶ *Sun Capital Partners III LP v. New England Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129 (1st Cir. 2013). For more discussion on the *Sun Capital* case, see *infra* Part IV.B.2.

¹⁷ I.R.S. Chief Couns. Mem. 201501013 22 (Jan. 2, 2015), <http://www.irs.gov/pub/irs-wd/201501013.pdf>. For more discussion, see *infra* Part V.C.1.

¹⁸ *See, e.g.*, MARPLES, *supra* note 1, at 5 (indicating that current tax treatment harms horizontal equity between fund managers and other taxpayers); Fleischer, *supra* note 5.

¹⁹ Michael Cooper et al., *Business in the United States: Who Owns It and How Much Tax Do They Pay* 2 (Nat’l Bureau of Econ. Research, Working Paper No. W21651, 2015), <https://ideas.repec.org/h/nbr/nberch/13689.html>.

²⁰ *Id.*

²¹ ELI TALMOR & FLORIN VASVARI, INTERNATIONAL PRIVATE EQUITY 8 (2011).

²² *Id.*

Since the 1920s, countries have reached a consensus in international tax to allocate the primary tax jurisdiction of active business income to source countries where the income is produced and allocate the passive or portfolio income to residence countries.²³ According to this consensus, a GP's income, such as carried interest, and an LP's income are both subject to the residence country's primary tax jurisdiction.²⁴ However, the policy alternatives recognizing the active nature of PEF investment would treat the income of GPs and LPs as active income, subject to the source country's primary tax jurisdiction, thus strengthening source-based taxation.²⁵ This article asserts that a change that strengthens the source-based taxation in international tax may be justified for a GP's income, because a GP actively erodes the tax base of source country by converting the character of income (carried interest) as well as eroding the tax base of portfolio companies (via management fee waiver and expense allocation).²⁶ On the other hand, an LP's income would be subject to source-based taxation for being active, because a GP's active performance is attributable to the fund under the laws of partnership and partnership tax.²⁷ Furthermore, an LP's tax-exempt or nonresident status is essential to enable a GP's abusive activities. Nonetheless, strengthening source-based taxation on an LP's income may be less justified considering its genuinely passive involvement in PEF investments. Thus, this article urges policymakers to consider both the public goods that LPs may provide and the alternative perspective challenging the tax consequences of LPs when deciding the proper partnership tax rule for LPs in PEF investment.

It might be tempting to think that since recent discourse on policy alternatives suggests changing a portion of partners' income from passive to active, there would be a revenue loss for residence countries with primary tax jurisdiction for passive income and a revenue gain for source countries with primary tax jurisdiction for active business income. Given that the United States is a major residence country like other developed countries,²⁸ this

²³ Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1306 (1996); Michael J. Graetz & Itai Grinberg, *Taxing International Portfolio Income*, 56 TAX L. REV. 537, 556–75 (2003); Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U. S. International Taxation*, 46 DUKE L.J. 1021, 1023, 1066–89 (1997). For more discussion on the allocation of international tax jurisdictions, see *infra* text accompanying notes 161–63.

²⁴ Avi-Yonah, *supra* note 23; Graetz & Grinberg, *supra* note 23; Graetz & O'Hear, *supra* note 23.

²⁵ See *infra* Part V.

²⁶ See *infra* Part V.A.1.

²⁷ See *infra* text accompanying notes 233–40.

²⁸ Michael J. Graetz, *David R. Tillinghast Lecture Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 264 (2001) (noting that the United States could be simply viewed as a capital exporting country ("residence country" in international tax terminology) in the 20th century but not if it is both a

could raise the concern that tax reform of private equity could reduce U.S. tax revenue if it expands to the international context. This article demonstrates, however, that tax reform of private equity would not significantly reduce the revenue of traditional residence countries, and yet it would significantly increase the revenue of source countries, thus increasing total worldwide revenue. Finally, since the United States is the biggest source country as well as the major residence country in the PEF industry,²⁹ determining the true nature of PEF investments and reforming PEF tax accordingly would not harm the United States's revenue domestically or internationally.

In sum, this article analyzes international tax implications of recent tax reforms and rulings on private equity. Part II describes the growth and globalization of PEFs. Part III argues that PEFs cannot be treated as pure passive investments due to the hybrid nature of their investment activity, which has the form of a passive investment, but is substantively active investment. However, the extent to which PEF investments should be treated as active is a difficult consideration. In order to understand the nature of PEF investments, tax scholars should compare other types of cross-border investments, thereby setting a new benchmark for taxing PEF investments. Part IV discusses the details of the alternatives to PEF taxation. In addition to the recent proposals on carried interest and management fees, a more ambitious position worth considering is to treat a PEF as a "trade or business." Part V analyzes the international tax implications of the various proposals. Part VI demonstrates how the revenue of each country would be affected by the representative alternatives. Part VII concludes.

II. THE GROWTH AND GLOBALIZATION OF PEFs

A. Background of Private Equity

Private equity has grown significantly over the last two decades.³⁰ Private equity is "responsible for up to a quarter of global M&A activity and as much as half of the leveraged loan issues in the capital markets,"³¹ and

large capital importer ("source country" in international tax terminology) and capital exporter).

²⁹ See *infra* Part II.C.

³⁰ A partner at Texas Pacific Group, which ranked 5th in 2014 in The Private Equity International 300's top 50 list, PRIVATE EQUITY INTERNATIONAL, *The PEI 300 2014* (2014) [hereinafter *PEI 300 2014*], described the newsworthy feature of private equity deals as follows: "You can't pick up the paper or turn on the TV and not hear about [private equity] . . ." Andrew Ross Sorkin, *Of Private Equity, Politics and Income Taxes*, N.Y. TIMES, Mar. 11, 2007, <http://www.nytimes.com/2007/03/11/business/yourmoney/11deal.html>.

³¹ TALMOR & VASVARI, *supra* note 21, at 3.

many commentators now call it a “new industry.”³² However, because of the private nature of the market, “it is extremely challenging for the outsider to understand and form a view on the workings of the industry.”³³

The name “private equity” refers to investments in securities which are not usually listed in the public markets.³⁴ In fact, a *raison d’être* of the private equity industry is that it allows companies to access capital that is not available on the public market for various reasons.³⁵ On the flip side, investors in PEFs have a propensity to pursue relatively “high risk and high illiquidity” investments in a market that is currently lightly-regulated.³⁶

Generally, PEFs are divided into two categories: buyout funds and venture capital funds. Both buyout funds and venture capital funds share similar investment structures, using special purpose funds (or limited partnerships) which are established for a particular investment opportunity with a finite life.³⁷ Investment strategies for buyout funds and venture capital funds, on the other hand, are quite different. Buyout funds’ targets are mostly “established and matured companies.”³⁸ They raise funds through both debt and equity financing, and they are larger in size than venture capital funds. Venture capital funds focus on “startups, young and high-growth companies”³⁹ and do not use debt capital financing. But for both funds, the general partners or managers of the funds take an active role in the operation of portfolio companies, often taking seats on the board of portfolio companies to execute and monitor their business strategies.⁴⁰ Usually, when successful, a PEF exits a portfolio company after three to seven years.⁴¹

The origin of private equity dates back to the 1930s and 1940s, when wealthy families started investing in venture capital firms.⁴² In the 1980s,

³² *Id.*; see also Robert Cressy, Federico Munari & Alessandro Malipiero, *Playing to Their Strengths? Evidence that Specialization in the Private Equity Industry Confers Competitive Advantage*, 13 J. CORP. FIN. 647, 648 (2007).

³³ TALMOR & VASVARI, *supra* note 21, at 21.

³⁴ *Id.* at 4.

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.* at 21.

³⁸ *Id.* at 4.

³⁹ *Id.*

⁴⁰ *Id.*; see also LEVIN & ROCAP, *supra* note 14, at 1–3 (explaining that such active involvement significantly distinguishes PEFs from other types of investment, such as portfolio investments by a mutual fund or other money manager).

⁴¹ LEVIN & ROCAP, *supra* note 14, at 1–3

⁴² Wealthy families, such as the Rockefellers, Vanderbilts, and Bessemers, started investing in venture capital firms, such as J.H. Whitney & Company and American Research & Development Corporation. Since small business investment companies (SBICs) were licensed in 1958, venture capital became very popular in the 1960s, resulting in the development of limited liability partnerships (LLPs). The big boost for venture capital took

today's big private equity firms⁴³ started acquiring companies with leverage financing. By the late 1980s, private equity had emerged as a major asset class but became notorious for its leveraged buyouts of famous companies.⁴⁴ Private equity has subsequently experienced three major waves of expansions,⁴⁵ followed by the global financial crisis in 2008.

The aftermath of the global financial crisis affected the private equity industry as well. Because private equity is private in nature, it has been exempted from many regulatory oversight procedures, such as reporting and registration with financial regulators.⁴⁶ However, two recent statutes — the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010⁴⁷ in the United States and the Directive on Alternative Investment Fund Managers⁴⁸ in Europe — now place additional requirements and restrictions on private equity, and more transparency is expected in the industry.⁴⁹

B. Economics, Governance, Operation, and Basic Tax Issues

The basic structure of a PEF is illustrated in Figure 1 below. PEFs are typically organized as one or more limited partnerships,⁵⁰ established for the

place in the 1970s because of the reduction of capital gains tax and the enactment of the Employee Retirement Income Security Act (ERISA) by permitting pension funds to invest in PEFs. TALMOR & VASVARI, *supra* note 21, at 5.

⁴³ The first of today's big private equity firms, Warburg Pincus, came up in the late 1960s. *Id.* Another large private equity firm today, Thomas Lee Partners, was founded in 1974 and Kohlberg Kravis Roberts (KKR) was founded in 1978. Warburg Pincus is ranked at fourth and KKR at second in PEI 300 2014. *PEI 300 2014*, *supra* note 30.

⁴⁴ When KKR bought the Safeway Stores in 1986, it borrowed 97% of \$4.8bn that the deal cost. TALMOR & VASVARI, *supra* note 21, at 6. For more history written by journalists about how the private equity started, see DAVID CAREY & JOHN E. MORRIS, *KING OF CAPITAL: THE REMARKABLE RISE, FALL, AND RISE AGAIN OF STEVE SCHWARZMAN AND BLACKSTONE* (2012); JOSH KOSMAN, *THE BUYOUT OF AMERICA: HOW PRIVATE EQUITY WILL CAUSE THE NEXT GREAT CREDIT CRISIS* (2010).

⁴⁵ The first expansion of private equity was in the 1980s with many high-yield junk bonds. The second expansion was in the 1990s with the dotcom technology bubble. And the third expansion was in the mid-2000s with the buyout boom and credit bubble. All three expansions collapsed when the relevant bubble burst. TALMOR & VASVARI, *supra* note 21, at 6.

⁴⁶ *Id.* at 13.

⁴⁷ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929-Z, 124 Stat. 1376, 1871 (2010) (codified as amended at 15 U.S.C. § 780).

⁴⁸ Council Directive 2011/61, 2011 O.J. (L 174) 1.

⁴⁹ TALMOR & VASVARI, *supra* note 21, at 13–14.

⁵⁰ LEVIN & ROCAP, *supra* note 14, at 1–13 (explaining that the choice of a partnership or LLC is to avoid entity-level taxation). The U.S.-based PEFs are commonly registered in Delaware as LPs, but some are registered in Cayman Islands or Bermuda. TALMOR & VASVARI, *supra* note 21, at 27. The U.K. based PEFs are commonly registered in Jersey or Guernsey.

specific purpose of raising investment.⁵¹ In the early days of PEF investment, LPs were usually individuals. Now, LPs are largely institutional investors, such as pension funds, university endowments, financial institutions (mostly insurance companies), sovereign wealth funds, and high net-worth individuals.⁵² Retail investors cannot access private equity investments unless they invest in listed private equity funds,⁵³ so the number of limited partners per private equity investment is typically smaller compared to that of mutual funds. LPs are mostly tax-exempt organizations and thus provide important tax planning opportunities for PEFs.⁵⁴ Investors become LPs by making a “commitment” of a certain sizable amount of capital to the partnership, which is “a legally binding promise to deliver [their] pro rata share of the aggregate fund commitments as and when they are asked for” by GPs.⁵⁵

The private equity firms become GPs themselves or affiliates of GPs, responsible for all investment-related matters in PEFs.⁵⁶ GPs typically make a small capital contribution, usually 1% to 5% of the fund’s capital,⁵⁷ and promise management services in exchange for a “profit” (carried interest) in the partnership and “fees” (management fees).⁵⁸ There is an industry standard practice, called “two and twenty:” 2% of the committed capital as an annual management fee and 20% of the fund’s future profit (or carried interest).⁵⁹ GPs can receive such carried interest after investors have received a priority

⁵¹ Rosenthal, *supra* note 7, at 361; *see also* TALMOR & VASVARI, *supra* note 21, at 21.

⁵² TALMOR & VASVARI, *supra* note 21, at 21–22; Fleischer, *supra* note 4, at 17–18.

⁵³ TALMOR & VASVARI, *supra* note 21, at 21; Brian Cheffins & John Armour, *The Eclipse of Private Equity*, 33 DEL. J. CORP. L. 1, 5–6 (2008); David Cho, *Firms Go Private in Search of Deeper Pockets*, WASH. POST, Jan. 31, 2007, <http://www.washingtonpost.com/wp-dyn/content/article/2007/01/30/AR2007013002038.html>.

⁵⁴ Fleischer, *supra* note 4, at 13–14, 17–18.

⁵⁵ TALMOR & VASVARI, *supra* note 21, at 21–22.

⁵⁶ *Id.* at 22.

⁵⁷ Fleischer, *supra* note 4, at 8; Lily Batchelder, *What Is Carried Interest and How Should It Be Taxed?*, TAX POL’Y CTR.: BRIEFING BOOK (2012), <http://www.taxpolicycenter.org/briefing-book/key-elements/business/carried-interest.cfm>.

⁵⁸ Rosenthal, *supra* note 7, at 361–62.

⁵⁹ Fleischer, *supra* note 4, at 3. Such carried interest combined with the clawback provision gives a powerful financial incentive to GPs. *See infra* note 60 and accompanying text.

rate of return (or a hurdle rate),⁶⁰ subject to a retrospective “clawback.”⁶¹

PEFs acquire target companies or portfolio companies with capital received from LPs and GPs, and with debt-financing when they plan a leveraged buyout.⁶² Seeking control of the portfolio company and an active role in managing and operating the company, PEFs acquire “a very substantial equity stake”⁶³ and/or appoint their employees to serve on the boards of the company.⁶⁴ They then improve “the operations, governance, capital structure, and strategic position” of the portfolio company.⁶⁵ From the beginning of their investments, PEFs have exit plans, either to resell the company or make an initial public offering.⁶⁶ Income and sale proceeds arising from the exit are distributed to investors, rather than reinvested.⁶⁷ The fund in most cases dissolves within eight to twelve years (the average being ten years, which reflects the expected lifetime of a given PEF).⁶⁸

⁶⁰ Until a fund’s return reaches a hurdle rate of return (e.g., 8%), the GP is not entitled to receive any profits from the fund, and all profits are allocated to LPs. However, once the fund’s return reaches the hurdle rate, profits are allocated disproportionately between the GP and LPs until the GP receives 20% of carried interest had they received the profits of the fund from the first dollar. Once the GP’s carried interest is satisfied, the remaining profits going forward are allocated between the GP and LPs according to their capital interests in the fund. Fleischer, *supra* note 4, at 22.

⁶¹ The clawback provision requires the individual partners of the PEF to return distributions to the extent of any subsequent losses in other investments of the fund, so that the GP never obtains profits more than its designated portion (e.g., 20%) of profits. It makes the GP share in the downside of the investment so that the GP’s retention of a carried interest functions as “both a risk-sharing mechanism and as an incentive” *Carried Interest (Part II): Hearing Before the S. Comm. on Fin.*, 110th Cong. 3 (2007)[hereinafter Rosenblum] (statement of Bruce Rosenblum, Chairman of the Bd. of the Private Equity Counsel) <http://www.finance.senate.gov/imo/media/doc/073107testbr.pdf>; Andrew W. Needham, *A Guide to Tax Planning for Private Equity Funds and Portfolio Investments*, May 20, 2002 TAX NOTES 1256, 1228 (2002).

⁶² LEVIN & ROCAP, *supra* note 14, at 1–8, 1–10.

⁶³ See Rosenblum, *supra* note 61, at 3 (testifying that “[a PEF] usually maintains a very substantial equity stake in the company and continues to take an active role in improving the company’s performance”).

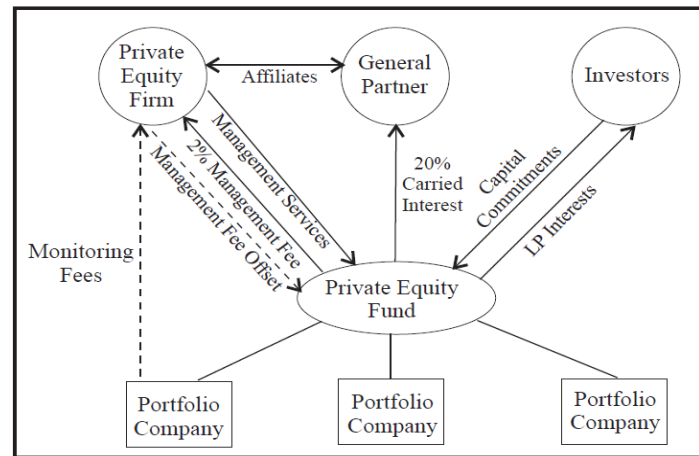
⁶⁴ LEVIN & ROCAP, *supra* note 14, at 1–3, 1–6. It is a common practice, as seen in the *Sun Capital* and *Loan Star Fund* cases, to appoint the GP’s employee to the board of the portfolio company.

⁶⁵ Rosenblum, *supra* note 61; Rosenthal, *supra* note 7, at 362 n.7.

⁶⁶ LEVIN & ROCAP, *supra* note 14, at 1–4; Rosenthal, *supra* note 7, at 362.

⁶⁷ LEVIN & ROCAP, *supra* note 14, at 1–12, 1–13.

⁶⁸ HARRY CENDROWSKI ET AL., *PRIVATE EQUITY: HISTORY, GOVERNANCE, AND OPERATIONS* 7 (2d ed. 2012); Rosenthal, *supra* note 7, at 36.

FIGURE 1. STRUCTURE OF A BASIC PRIVATE EQUITY INVESTMENT⁶⁹

The fundamental tax objective of PEF investments is to avoid entity-level taxes by using a partnership or pass-through entity.⁷⁰ This way, PEFs are treated as passive investors, not engaging in active business,⁷¹ and the income generated by selling the securities of portfolio companies are treated as long-term capital gains.⁷² This income then flows through to partners, and the character determined at the entity level is preserved to partners because the partnership is a pass-through entity.⁷³

Tax scholars acknowledge that there is a significant issue with how to tax carried interest of GPs.⁷⁴ While the management fee is treated as ordinary income, there are disagreements over the character of carried interest.⁷⁵ Although current U.S. tax law treats the carried interest as capital gains,

⁶⁹ Gregg D. Polsky, *The Untold Story of Sun Capital: Disguised Dividends*, 143 TAX NOTES 556, 558 (2014).

⁷⁰ Needham, *supra* note 61, at 1219.

⁷¹ Brief of the Private Equity Growth Capital Council as Amicus Curiae in Support of Appellees' Petition for Panel Rehearing or Rehearing en banc, *Sun Capital Partners III LP v. New England Teamsters & Trucking Industry Pension Fund*, 724 F.3d 129 (1st Cir. 2013) (No. 12-2312) [hereinafter Amicus Brief in *Sun Capital* case].

⁷² I.R.C. §§ 1221, 1222.

⁷³ I.R.C. § 702(b); Fleischer, *supra* note 4, at 15.

⁷⁴ For articles addressing the issue, see, e.g., Batchelder, *supra* note 57; 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. 1071 (2008).

⁷⁵ For articles suggesting treating carried interest as ordinary income, see, e.g., Fleischer, *supra* note 4, at 10–11; Karen C. Burke, *The Sound and Fury of Carried Interest Reform*, 1 COLUM. J. TAX L. 1, 6 (2010). For articles endorsing current law, see, e.g., David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 VA. L. REV. 715 (2008). For articles suggesting a modified approach, see, e.g., Noel B. Cunningham & Mitchell L. Engler, *The Carried Interest Controversy: Let's Not Get Carried Away*, 61 TAX L. REV. 121 (2008).

recognizing it as “a payout of a distributable share of partnership income,”⁷⁶ a number of proposals suggest reforming how carried interest is taxed by treating it instead as ordinary income.⁷⁷ In addition, a recent reform proposal suggests that certain GP management fees and expense allocations should be treated as disguised dividends, effectively taxing this income as compensation.⁷⁸ Part IV discusses these reforms in detail.⁷⁹

C. The Globalization of PEFs and Their Regional Distribution

Notwithstanding the growing role of private equity in the international financial intermediation, it has been observed that the private equity industry has grown regionally, if not locally, “more or less in isolation, with differences in national legal and regulatory regimes, differential access to information and behavioral biases discouraging cross-border transactions.”⁸⁰ Since the 1990s, however, a globalization process began, led by U.S. GPs.⁸¹

This subpart examines the representative jurisdictions of GPs and LPs (which correspond to residence country or home country), and destination market (which corresponds to source country or host country). This Subpart will show that (1) developed countries, such as the United States and the United Kingdom, are dominant source countries in PEF investment; (2) more than 90% of the GPs are located either in the United States or the United Kingdom; and (3), developed countries are also major regions for LPs.

First, the United States is the largest destination market receiving private equity investment, absorbing 40.7% of private equity investment worldwide, followed by the United Kingdom and non-U.K. Europe.⁸² The Asia-Pacific region is the fourth largest destination market.⁸³ Table 1 shows the ranks of both GPs’ jurisdictions and their destination markets. The share of the developing countries in the PEFs’ destination markets is not substantial compared to that of developed countries.

Second, the United States is also ranked first in terms of GP jurisdiction, followed by the United Kingdom.⁸⁴ The U.S. GPs account for 53% of

⁷⁶ Fleischer, *supra* note 4, at 14–15.

⁷⁷ *Id.* at 47–59. For more discussion on the carried interest, see *infra* text accompanying notes 181–200.

⁷⁸ For more discussion on management fees, see *infra* text accompanying notes 201–06.

⁷⁹ See *infra* Part IV.

⁸⁰ CORNELIUS, *supra* note 13, at 139 (citing William L. Megginson, *Toward a Global Model of Venture Capital?*, 16.1 J. APPLIED CORP. FIN. 89 (2004)).

⁸¹ CORNELIUS, *supra* note 13, at 144.

⁸² *Id.* at 153–54.

⁸³ *Id.*

⁸⁴ *Id.*

investment value worldwide, and the U.K. GPs account for 40%.⁸⁵ Although the U.S. GPs tend to invest in the domestic market rather than invest offshore, they have been increasing offshore investment significantly.⁸⁶ The U.S. GPs' outward orientation was initially focused on the European market, and then expanded into other regions, such as Asia, Latin America, and the Middle East.⁸⁷ The European market, being a mature market, has both attractive and unattractive features for U.S. GPs. It is a very competitive market, but it also has a substantial number of undervalued companies whose potential will bloom out "through superior governance, operational improvements, and financial leverage."⁸⁸ Just before the global financial crisis started in late 2007, more than one-third of all European deals in terms of overall value involved U.S. buyout firms.⁸⁹ More recently, U.S. firms have expanded into other regimes. The Asia-Pacific region is the world's third largest private equity market, although its deal size is relatively small compared to that of mature markets.⁹⁰

European GPs have made considerable efforts to penetrate the U.S. market as well as emerging markets, especially in the Asia-Pacific and Central and Eastern Europe (CEE) markets.⁹¹ However, on a net basis, Europe has been an importer of private equity capital, while the United States has been an exporter.⁹² The Asia-Pacific region is also a significant net importer of private equity capital.⁹³

Nonetheless, among European GPs, the United Kingdom should be treated differently based on the empirical evidence. As shown in Table 1, 40% of the acquisitions made by all buyout PEFs in a study is made with U.K.-based funds.⁹⁴ 53% is managed by U.S.-based funds.⁹⁵ Conversely, the United Kingdom absorbed only 22% of the overall amount of capital deployed.⁹⁶ Thus, the United States and the United Kingdom are two key

⁸⁵ *Id.*

⁸⁶ *Id.* at 152 (comparing, for example, U.S.-based funds raised in late 1990s and early 2000s and observing a significant increase in their investments in Europe).

⁸⁷ CORNELIUS, *supra* note 13, at 157.

⁸⁸ *Id.* at 144.

⁸⁹ The most active investor in Europe is KKR, ranked second in PEI 300 2014. *Id.* at 144; PEI 300 2014, *supra* note 30.

⁹⁰ CORNELIUS, *supra* note 13, at 145–46.

⁹¹ *Id.*

⁹² *Id.* at 149.

⁹³ *Id.* at 154.

⁹⁴ *Id.* at 153–54.

⁹⁵ *Id.*

⁹⁶ *Id.* Cornelius seems to imply that the United Kingdom is a net exporter of capital by comparing 22% of global private equity capital invested in the United Kingdom. portfolio company with 40% of private equity capital deployed worldwide being managed by U.K.-

jurisdictions of GPs, accounting for 93% of the private equity capital deployed worldwide.

TABLE 1. INVESTMENT VALUE BY ORIGIN OF GP AND DESTINATION MARKET⁹⁷

Investor Country	Recipient Country											
	United States		United Kingdom		Non-U.K. Europe		Asia-Pacific		Latin America		Total	
	€ billion	%	€ billion	%	€ billion	%	€ billion	%	€ billion	%	€ billion	%
United States	37,398	72.7	4,098	8.0	5,865	11.4	2,520	4.9	1,542	3.0	51,424	100 (53)*
United Kingdom	2,194	5.7	17,266	44.6	19,101	49.3	168	0.4	-	-	38,731	100 (40)
Non-U.K. Europe	26	0.4	2	0.0	5,882	99.5	-	-	-	-	5,909	100 (6)
Asia-Pacific	83	5.6	-	-	-	-	1,385	92.7	27	1.8	1,495	100 (1)
Total	39,704	40.7	21,365	21.9	30,848	31.6	4,074	4.2	1,568	1.6	97,559	100 (100)

Looking at the relationship between destination countries and GPs' countries, of the capital exported by U.S. buyout funds, the largest (11.4%) was invested in non-U.K. Europe, followed by the U.K. (8.0%) and Asia (4.9%).⁹⁸ By contrast, the Latin American market did not play a significant role for U.S.-based funds (3%).⁹⁹ The U.K.-based funds invested heavily in non-U.K. European markets (49.3%) out of the capital deployed.¹⁰⁰ For both U.S.-based and U.K.-based funds, the Middle East and North Africa (MENA) market did not show a meaningful number in the study.

However, the data in Table 1 will need to be updated to fill in missing

based funds. However, it is not clear whether the United Kingdom could be characterized as a net exporter of capital with this data, because 40% investment made by U.K.-based funds presumably relates to capital raised from all over the world. Nonetheless, it can be argued that the United Kingdom is "the most international market." *See id.* at 154.

⁹⁷ *Id.* at 153, Table 7.4. (data compiled from source table). In the table created by Cornelius, I added the percentage ratio (*) of the total invest amount of each investor country to the total invest amount of all countries in the parenthesis at the right first column. Cornelius relied on AlpInvest Partners' proprietary database for this table, in which the sample includes 102 buyout funds raised between 1995 and 2004. The AlpInvest Partners is a Dutch-based PEF, ranked at forty-ninth in PEI 300 2014. *See PEI 300 2014, supra* note 30.

⁹⁸ CORNELIUS, *supra* note 13, at 153–54.

⁹⁹ *Id.* at 154.

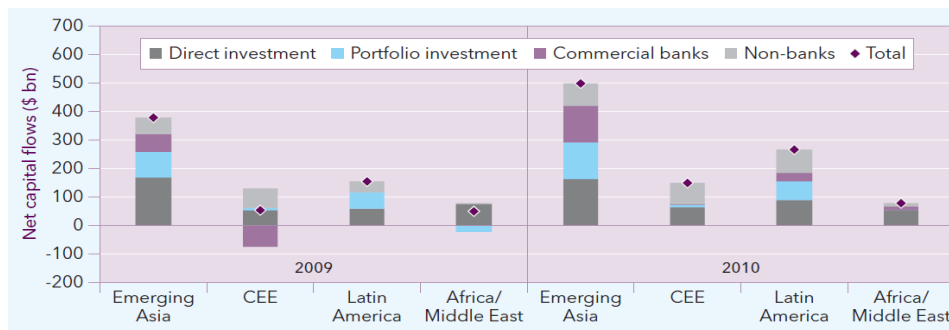
¹⁰⁰ *Id.* at 153–54.

data from the recent decade. As shown in Table 2 and Figure 2, the Latin American market exceeds the net capital flows toward the non-U.K. European or CEE markets since 2009. Among emerging markets, Asia-Pacific and Latin American markets are the most important capital importing regions.

TABLE 2. PEFS WITH REGIONAL FOCUS RAISED BY YEAR¹⁰¹

USD (BILLION)	2007	2008	2009
EMERGING ASIA	28.7	39.7	15.9
CEE AND CIS	14.6	5.6	1.6
LATIN AMERICA/CARIBBEAN	4.4	4.5	2.2
MENA	5.3	6.9	1.1
SUB-SAHARAN AFRICA	2.0	2.2	1.0
MULTI-REGION	4.1	7.7	0.8
EMERGING MARKET (NO. OF FUNDS WITH CLOSURES)	59.2 (204)	66.5 (210)	22.6 (196)

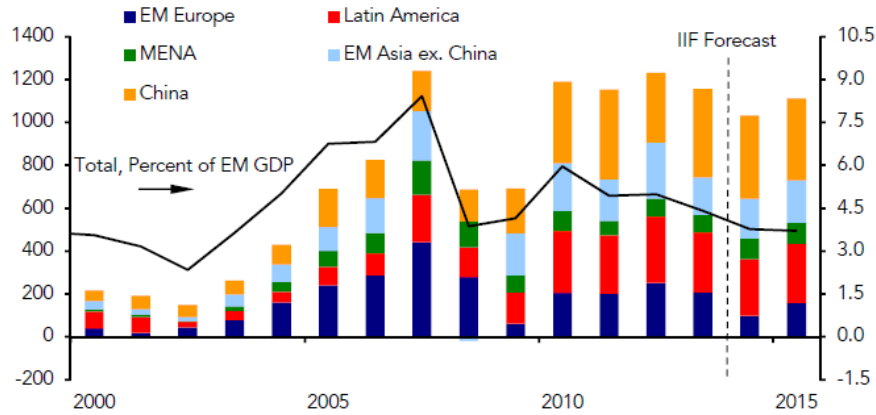
FIGURE 2. NET CAPITAL FLOWS TO EMERGING ECONOMIES, BY REGION AND INVESTMENT TYPE¹⁰²



¹⁰¹ TALMOR & VASVARI, *supra* note 21, at 60, Exhibit 4.1. (data compiled from source table). Talmor and Vasvari relied on many reports issued by Emerging Markets Private Equity Association for this table. *Id.*

¹⁰² Peter Cornelius, *Financial Deepening, Private Equity and Capital Flows to Emerging Markets*, 1 REV. PRIVATE EQUITY, 9, Fig. 11 (2011), http://alpinvest.com/assets/pdfs/The_Review_of_Private_Equity_-_Volume_1_Issue_2.pdf. Cornelius relied on a report issued by the Institute of International Finance in 2011 to create this chart. *Id.* Although this data includes overall capital flows, including FDI and FPI, it can be a reference to show the time when the size of Latin American economy exceeds that of CEE.

FIGURE 3. EMERGING MARKET PRIVATE CAPITAL INFLOWS, NET (\$ BILLION)¹⁰³

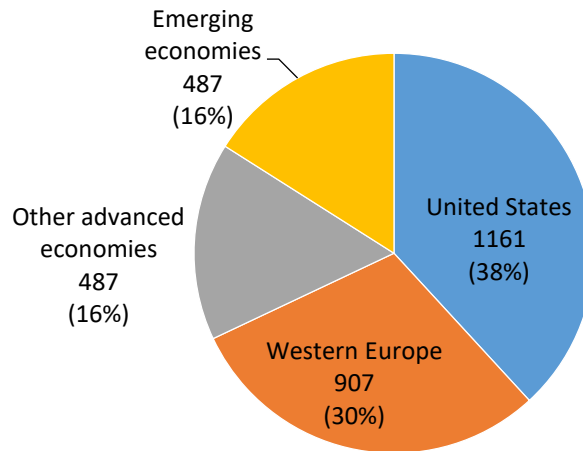


Third, LPs' jurisdictions are less known to the public. Although it is hard to find data on LPs' regional distributions in global PEF investment, Preqin's global database of data of LPs' origin in the emerging market investment could work as a sample of the LPs' jurisdictions for the broader investment region.¹⁰⁴ As shown in Figure 4, the United States (38%) and Western Europe (30%) are the top two regions of 3542 LPs listed in the database in 2011.¹⁰⁵

¹⁰³ INSTITUTE OF INTERNATIONAL FINANCE, CAPITAL FLOWS TO EMERGING MARKETS 1, Chart 1 (2014), <http://iif.com/emr/capflows201405.php>.

¹⁰⁴ Talmor and Vasvari introduce Preqin database as follows: "Preqin, an independent data provider, offers one of the most comprehensive and detailed sources of private equity performance data covering both buyout and venture funds. Their statistics are based on data from a number of different sources, including from GPs themselves. This dataset covers over 5,000 private equity funds of all types and a geographic focus that represents about 70% of all private equity capital committed worldwide" as of 2009. See TALMOR & VASVARI, *supra* note 21, at 8–9. For more information, visit www.preqin.com.

¹⁰⁵ Cornelius, *supra* note 102, at 10.

FIGURE 4. EMERGING MARKET LPS, BY GEOGRAPHY¹⁰⁶

III. THE NATURE OF PEF INVESTMENT IN THE CROSS-BORDER CONTEXT

A. *Insufficient Study for PEFs*

The international finance and tax policy literature has divided cross-border transactions into two major categories: foreign direct investment (FDI)¹⁰⁷ and foreign portfolio investment (FPI).¹⁰⁸ With regards to certain challenges under the traditional international tax regime that we encounter

¹⁰⁶ *Id.* at 10, Fig. 13. (data compiled from source table). Cornelius accessed the Preqin database on July 15, 2011, and asserted that only a small portion of LPs in the PEF investing in the emerging markets are headquartered in emerging markets, and a large portion of them are foreign. However, I use the same statistics to show that the United States and Western Europe are the top two regions for the origin of the LPs in the emerging markets.

¹⁰⁷ FDI is defined as ownership of foreign investors of a controlling form, typically at least 10% of voting stock in the local investing entity. There is plenty of traditional international tax scholarship accumulated with regard to FDI, so that the examples of multinational enterprises are easily caught by international tax policy radar screen, attracting constant attention from public and academia. For more on FDI in general, *see, e.g.*, Pol Antràs, Mihir A. Desai & C. Fritz Foley, *Multinational Firms, FDI Flows, and Imperfect Capital Markets*, 124 Q.J. ECON. 1171, 1171–219 (2009); Lars P. Feld & Jost H. Heckemeyer, *FDI and Taxation: A Meta-Study*, 25 J. ECON. SURV. 233, 233–272 (2011); Roger H. Gordon & James R. Hines Jr., *International Taxation* (Nat'l Bureau of Econ. Research, Working Paper No. 8854, 2002), http://www.nber.org/papers/w8854.pdf?new_window=1.

¹⁰⁸ For more on FPI, *see, e.g.*, DORON HERMAN, *TAXING PORTFOLIO INCOME IN GLOBAL FINANCIAL MARKETS* (2002); Avi-Yonah, *supra* note 23; Graetz & Grinberg, *supra* note 23; Yaron Z. Reich, *Taxing Foreign Investors' Portfolio Investments: Developments & Discontinuities*, 98 TAX NOTE INT'L 1975, 1976–1986 (1998) (focusing on inbound FPI).

when dealing with cross-border investments,¹⁰⁹ both FDI and FPI have been the subject of extensive analysis. FDI is the most basic form of cross-border investment; corporations or individuals who directly invest in a foreign company with substantial ownership to influence the foreign company's business decision are engaged in FDI. The multinational enterprises (MNEs), such as Google and Apple, which have their own affiliates all over the world, are major players in FDI.¹¹⁰ Since MNEs' tax strategies constantly garner media coverage, plenty of resources in international tax are focused on this issue either to attack or to defend the MNEs' strategy.¹¹¹

In addition, in the last decade, the public finance and tax law literature have started studying FPI as distinguished from FDI.¹¹² Using the term FPI as the opposite concept of FDI, income arising from FPI or portfolio income usually refers to the passive investment income, such as dividends, interest, or capital gains.

By contrast, there has been relatively little study of foreign indirect investments (FII),¹¹³ particularly the use of fund vehicles, notwithstanding the fact that they are of increasing economic importance. Recognizing a lack

¹⁰⁹ A commentator described the current international tax regime as a "flawed miracle." See Avi-Yonah, *supra* note 23, at 1303–04 (arguing that it is a miracle because "a coherent international tax regime exists" notwithstanding the fact that it is very hard to reach a consensus among sovereign states, but still flawed especially in two areas: one is FPI and the other is MNEs).

¹¹⁰ OECD, BENCHMARK DEFINITION OF FOREIGN DIRECT INVESTMENT 14 (4th ed. 2008).

¹¹¹ See generally Chris William Sanchirico, *As American as Apple Inc.: International Tax and Ownership Nationality* 1–3 n.1–6 (U. Pa. L. Sch. Pub. L. Res. Paper No. 14-5, U. Pa. Inst. L. & Econ. Res. Paper No. 14-3, 2014), <http://papers.ssrn.com/abstract=2394227>. In regard to Apple's tax strategy, see, e.g., OFFSHORE PROFIT SHIFTING AND THE U.S. TAX CODE—PART 2 (APPLE INC.) BEFORE THE PERM. SUBCOMM. ON INVESTIGATIONS OF THE SEN. COMM. ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS, 113TH CONG., 152–91 (2013), <http://www.gpo.gov/fdsys/pkg/CHRG-113shrg81657/html/CHRG-113shrg81657.htm>; Charles Duhigg & David Kocieniewski, *How Apple Sidesteps Billions in Taxes*, N.Y. TIMES, Apr. 28, 2012, <http://www.nytimes.com/2012/04/29/business/apples-tax-strategy-aims-at-low-tax-states-and-nations.html>. In regard to Google's tax strategy, see, e.g., Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699, 707–14 (2011), Jesse Drucker, *Google 2.4% Rate Shows How \$60 Billion Lost to Tax Loopholes*, BLOOMBERG NEWS, Oct. 21, 2010, <http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html>; Jesse Drucker, *"Dutch Sandwich" Saves Google Billions in Taxes*, BLOOMBERG BUSINESSWEEK, Oct. 22, 2010, http://www.nbcnews.com/id/39784907/ns/business-us_business/t/dutch-sandwich-saves-google-billions-taxes/.

¹¹² See *supra* text accompanying note 1078.

¹¹³ In this article, "indirect investment" refers to an investment to pool capital for investment from multiple investors and to invest in the underlying assets through vehicles, such as funds, trusts, or other entities. It is commonly called a "fund investment" or "collective investment" in a rough sense, although these terms are not always used identically or consistently. See also *infra* Part III.C for more details.

of international tax rules dealing with indirect investment in international tax, the Organization for Economic Co-operation and Development (OECD)¹¹⁴ and the International Fiscal Association (IFA)¹¹⁵ have released several reports dealing with the application of tax treaties to FII mechanisms. However, the OECD and IFA reports limit the scope of their suggestions to mutual funds or collective investment vehicles (CIVs),¹¹⁶ and explicitly exclude “the issue of treaty entitlement with respect to investment through private equity funds, hedge funds or trusts or other entities” from their scope.¹¹⁷ Existing studies in the international tax field on fund investments also deal mostly with investment by mutual funds or CIVs only, to the exclusion of PEFs and similar vehicles.¹¹⁸ As a result, PEFs have been understudied, despite their significance, and the resulting gap in the literature has made tax authorities and taxpayers suffer from the lack of proper rules and policy for taxing cross-border investment by PEFs.

Traditionally, the PEF industry has argued that PEFs are passive investors subject to the same rule as FPI.¹¹⁹ This part of the article argues

¹¹⁴ For OECD’s discussion, see OECD, TAXATION OF CROSS-BORDER PORTFOLIO INVESTMENT - MUTUAL FUNDS AND POSSIBLE TAX DISTORTIONS (1999); OECD, FIRST MEETING OF THE INFORMAL CONSULTATIVE GROUP ON THE TAXATION OF COLLECTIVE INVESTMENT VEHICLES, LONDON, 9–10–11 (2007); OECD, REPORT OF THE INFORMAL CONSULTATIVE GROUP ON THE TAXATION OF COLLECTIVE INVESTMENT VEHICLES AND PROCEDURES FOR TAX RELIEF FOR CROSS-BORDER INVESTORS ON THE GRANTING OF TREATY BENEFITS WITH RESPECT TO THE INCOME OF COLLECTIVE INVESTMENT VEHICLES (2009); OECD, R(24). THE GRANTING OF TREATY BENEFITS WITH RESPECT TO THE INCOME OF COLLECTIVE INVESTMENT VEHICLES, in MODEL TAX CONVENTION ON INCOME AND ON CAPITAL 2010 1–34 (2012) [hereinafter CIV REPORT].

¹¹⁵ For IFA’s discussion, see INT’L FISCAL ASSOC., Volume LXXIIB THE TAXATION OF INVESTMENT FUNDS : 51ST CONGRESS OF THE INTERNATIONAL FISCAL ASSOCIATION, NEW DELHI 1997 (1997).

¹¹⁶ Mutual funds are the equivalent concept of CIVs as the term is used in OECD literature, or of regulated investment companies (RIC) under the Code. See I.R.C. § 851(f)(1). These funds differ from private equity funds to the extent that the former are more open to the public, and are regulated by the government, while the latter are private, and are often not regulated by the government.

¹¹⁷ CIV REPORT, *supra* note 114, at R(24)–4.

¹¹⁸ See, e.g., TOMI VIITALA, TAXATION OF INVESTMENT FUNDS IN THE EUROPEAN UNION 13 (2005). Viitala defines the term “investment fund” in his study to refer to CIVs within the scope of UCITS Directive of 1985: COUNCIL DIRECTIVE 85/611/EEC OF 20 DECEMBER 1985 ON THE COORDINATION OF LAWS, REGULATIONS AND ADMINISTRATIVE PROVISIONS RELATING TO UNDERTAKINGS FOR COLLECTIVE INVESTMENT IN TRANSFERABLE SECURITIES. The UCITS Directive covers “only publicly-offered open-end investment funds which invest in transferable securities and money market instruments.” *Id.* at 2, n. 5.

¹¹⁹ See, e.g., Amicus Brief in *Sun Capital* case, *Sun Capital*, 724 F.3d 129 (1st Cir. 2013) (No. 12-2312). Many PEFs have historically relied on certain tax authorities, including the following two United States Supreme Court cases, to support the position that they are not engaged in a “trade or business” for federal income tax purposes: The first case is *Higgins v.*

that PEF investment should not be treated as purely passive because of the hybrid nature of its investment activity. However, to what extent private equity is active is a difficult question. Conceptualizing the nature of PEF investment by comparing other types of cross-border investment would help set a new benchmark for taxing PEF investment that should be aimed for in international tax.

B. Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI): Active and Passive Distinction in International Tax

Before outlining the distinct features of PEFs in more detail, it will be useful to clarify some key terms used to characterize patterns of investment in the modern global economy.

In a very general sense, the phrase “foreign direct investment” can be defined as “an investment made by a company or entity based in one country in a company or entity based in another country.”¹²⁰ However, for public finance and tax law, FDI means more than just acquiring an ownership interest in a foreign company. The term “direct investment” usually refers to a long-term relationship between direct investors and investees in which the investors exercise a significant degree of influence and control over the investee,¹²¹ and in which the investors typically acquire at least 10% of the investee entity.¹²² The Internal Revenue Code (Code) also assumes that the foreign investment is classified as direct (and thus treated as an FDI) when the investing entity owns at least 10% of the investee’s voting stock.¹²³

Two terms should be distinguished from FDI. First, the term “foreign indirect investment” refers to an investment mechanism that pools capital from multiple investors in order to invest in underlying assets through intermediary vehicles, such as CIVs or PEFs.¹²⁴ It may acquire less than a

Commissioner, 312 U.S. 212 (1941) and the second case is *Whipple v. Commissioner*, 373 U.S. 193 (1963).

¹²⁰ Investopedia, FOREIGN DIRECT INVESTMENT (FDI) DEFINITION, <http://www.investopedia.com/terms/f/fdi.asp>.

¹²¹ OECD, FOREIGN DIRECT INVESTMENT OECD FACTBOOK 2013: ECONOMIC, ENVIRONMENTAL AND SOCIAL STATISTICS (2013), <http://www.oecd-ilibrary.org/sites/factbook-2013-en/04/02/01/index.html?itemId=/content/chapter/factbook-2013-34-en>.

¹²² Gordon & Hines Jr., *supra* note 107, at 42; Graetz & Grinberg, *supra* note 23, at 539 (acknowledging that the dividing line between direct and portfolio investment may be controversial, because some countries use a lower threshold — 5% or even 1% — in classifying investment as direct. However, it argues that some dividing line exists and 10% is the commonly used throughout the OECD).

¹²³ See, e.g., Act of Aug. 16, 1954, Pub. L. No. 83–591, ch. 736, 68A Stat. 286 (codified as amended at I.R.C. § 902 (1954)), *repealed by* Tax Cuts and Jobs Act of 2017, Pub. L. No. 115–97, § 14301(a), 131 Stat. 2054, 2221.

¹²⁴ A layperson might intuitively think that when the individual or corporation owns less

10% ownership in the investee entity, but not necessarily so.

Second, the public finance and tax literature use the phrase “foreign portfolio investment” as the complementary concept to FDI.¹²⁵ Like FDI investors, FPI investors invest in the securities of the investee company (such as stocks and bonds), but they generally are not particularly interested in the management of the investee company, and they typically do not own more than 10% of the voting stock.¹²⁶ FPI is often accomplished using a vehicle such as a fund, but, again, no particular form is inherent to the definition of FPI.

Further complication comes with the distinction between “active business income” and “passive income” in international taxation. The present consensus among international community allocates taxpayers’ active business income to the source jurisdiction, and passive or portfolio income to the residence jurisdiction.¹²⁷ Many international tax scholars articulate the boundary between active and passive income as follows: active business income is derived from the economic activities of FDI, involving direct control over the local entity, while passive income (or portfolio income) is derived from activities which are not related to the exercise of direct control by the taxpayer.¹²⁸ Active business income also corresponds to the income “effectively connected” with a U.S. “trade or business” under the Code,¹²⁹ and to the income attributable to a “permanent establishment” under tax treaties.¹³⁰

In essence, the concept of FDI is inherently linked with the acquisition and exercise of direct control over a target or investee entity, and it involves the receipt of active business income for tax purposes. By contrast, the notion

than 10% of the voting stock in foreign entity, such an investment would be classified as FII. However, it is not the definition of FII. *See infra* Part III.C.

¹²⁵ Graetz & Grinberg, *supra* note 23, at 539 (stating that “[i]nvestment is classified as portfolio when the individual or corporation owns less than 10% of the foreign entity”).

¹²⁶ Investopedia, Foreign Portfolio Investment – FPI, <https://www.investopedia.com/terms/f/foreign-portfolio-investment-fpi.asp>. For the ownership threshold of portfolio investment, *see, e.g.*, Graetz & Grinberg, *supra* note 23, at 539.

¹²⁷ Avi-Yonah, *supra* note 23, at 1306.

¹²⁸ *Id.* at 1309–10 (recognizing that direct investors may earn passive income, such as a direct dividend, from FDI, in which case such dividend is treated differently from the passive portfolio dividend. Nonetheless, even such direct dividend is taxed primarily in the residence country of the direct investors. Thus, he reserves the term portfolio income for passive income which is not connected to the direct control). *See also* Graetz & Grinberg, *supra* note 23, at 539–42 (often using passive investment and portfolio investment as synonym).

¹²⁹ I.R.C. §§ 871(b), 882; *see also* Avi-Yonah, *supra* note 23, at 1318 (noting that the terms “trade or business” and “effective connected” are not defined in the Code, but it has been established that such terms refer to the active business operation by rulings and court precedents).

¹³⁰ Avi-Yonah, *supra* note 23, at 1307.

of FPI connotes a more passive investment model, without direct control over the target entity, and it elicits passive or portfolio income for tax purposes. However, the term FPI has also traditionally been used to cover cross-border fund investment that I defined as FII, because FPI often uses intermediary vehicles.¹³¹ Nonetheless, using an intermediary is not conceptually necessary for FPI. Hence, this article will distinguish FII from FPI, and will use the term FPI to refer to a category of pure portfolio investment without using an intermediary, after showing how the term FPI has been analytically blurred with analysis of CIV and PEF in the next Subpart.

C. Foreign Indirect Investment (FII): PEF and Collective Investment Vehicle (CIV)

As noted above, FII can be defined as an investment mechanism that pools capital from multiple investors through intermediary vehicles. FII may be further divided into two subcategories. The first category is variously described as mutual funds, regulated investment companies (RICs), or CIVs, regardless of what term is used,¹³² which are “subject to investor-protection regulation in the country in which they are established.”¹³³ The second category includes a wide range of alternative investment vehicles in the international finance market with different investment objectives and organizational structures, such as PEFs or hedge funds.¹³⁴ Since hedge funds are often included in the broad definition of PEFs, the second subcategory will usually refer to PEFs in this article.¹³⁵

¹³¹ Investopedia, Foreign Investment Routes: The FDI and FPI, <https://www.investopedia.com/articles/investing/012914/foreign-investment-routes-fdi-and-fpi.asp>.

¹³² See *supra* text accompanying note 116.

¹³³ CIV REPORT, *supra* note 114, at 3.

¹³⁴ For a comparison between hedge funds and mutual funds, see, e.g., Alan L. Kennard, *The Hedge Fund Versus the Mutual Fund*, 57 TAX L. 133 (2003).

¹³⁵ I include hedge funds in the broad concept of PEFs in light of the wide spectrum of forms within the category of hedge funds. First, traditional hedge funds sought positive returns whether the market rose or fell by holding both long and short positions in their investments. The hedge funds sought profit by adjusting the ratio of long and short position according to prevailing and predicted market conditions. This “hedging” behavior prompted the name of the funds. Gain or loss of the hedge funds depended on inefficiencies in the market, not on whether the market is good or bad. The investment strategy heavily focusing on arbitrage is quite anomalous, and not a good business model to start thinking about the general tax reform. (For the tax issues and analysis of hedge funds, see Andrew W. Needham & Christina Brause, *Hedge Funds*, 736-2nd TAX MGMT. BNA U.S. INCOME PORTF., I.A. (2014).) However, today’s hedge funds are not market neutral any more, and instead employ investment strategy similar to that of private equity funds. In this regard, some literatures include hedge funds in the broad definition of private equity funds. See CENDROWSKI ET AL., *supra* note 68, at 4; Sanchirico, *supra* note 111, at 48.

The notion that FII is somehow more related to passive FPI than to FDI is in general only true for the first subcategory of FIIs (i.e., the CIVs). On the contrary, the investment objectives of PEFs, the second subcategory of FII, are not limited to passive investment but “cover the full spectrum of the market.”¹³⁶ Nonetheless, existing studies of PEFs seem to focus on portfolio investment in general and do not distinguish PEFs in particular,¹³⁷ resulting in an unfortunate analytical blurring of the two terms.

As a matter of fact, PEFs typically seek to acquire control over — or at least significant positions in — a target company, acquiring at least 10% of the stock, because the PEF managers seek to influence the target company and change the capital structure optimally in order to increase its value, especially in the case of buyout funds.¹³⁸ Hence, in terms of ownership ratio, PEFs typically involve a higher degree of control over portfolio companies than CIVs’ holdings in portfolio equities.¹³⁹ In this respect, PEFs share a common feature with FDI.

The extent to which PEF investment income should be treated as active income is somewhat controversial. Traditionally, the private equity industry has argued that PEFs are passive investors and partnership profits allocated to both GPs and LPs are passive income, because “making and deriving income from investments (in the form of income and capital gains), and paying professional managers to manage those investments does not constitute a ‘trade or business’ for purposes of the [Code].”¹⁴⁰ However, recent proposals on carried interest envision that at least GP’s carried interest among partnership profits should be treated as ordinary income.¹⁴¹ Furthermore, the recent ruling in the *Sun Capital* case by the U.S. Court of Appeals for the First Circuit, holding that the Sun Capital fund was engaged

¹³⁶ Andrew W. Needham, *Private Equity Funds*, 735-2nd TAX MGMT. BNA U.S. INCOME PORTF., II.A.1. (2014).

¹³⁷ See, e.g., CORNELIUS, *supra* note 13, at 155. By addressing the home bias issue in the fund investment both by mutual funds and by private equity, Cornelius criticizes the existing Survey of International Monetary Fund and U.S. Treasury, contending that both surveys are limited to FPI and does not include data of FDI. He further argues that this is an important shortcoming for his study on the private equity because PEFs are typically holding more than 10% of the foreign company. Cornelius also criticizes the data capturing FDI in Philip R. Lane & Gian Maria Milesi-Ferretti, *The External Wealth of Nations Mark II: Revised and Extended Estimates of Foreign Assets and Liabilities, 1970–2004*, 73 J. INT’L. ECON. 223 (2007) and Philip R. Lane & Gian Maria Milesi-Ferretti, *The Drivers of Financial Globalization*, 98 AM. ECON. REV. 327 (2008), arguing that such data does not provide information on private equity either because it does not identify individual classes of foreign investors, such as private equity. *Id.*

¹³⁸ TALMOR & VASVARI, *supra* note 21, at 4.

¹³⁹ *Id.*

¹⁴⁰ VIITALA, *supra* note 118, at 6.

¹⁴¹ See, e.g., Fleischer, *supra* note 4, at 57.

in a trade or business,¹⁴² broadens the tax agenda of activeness of PEF from the GP's carried interest to the overall income of both GPs and LPs arising from the investment activity of PEFs.¹⁴³ This issue will be further discussed in Part IV.

Nevertheless, the traditional position — that not only CIVs but also PEFs are merely passive investors in portfolio companies and are not engaged in a “trade or business” — may explain the confusion that results from treating both CIVs and PEFs as a genre of portfolio investment (or FPI in cross-border transactions), notwithstanding the higher degree of control shown by many PEFs.

However, since using an intermediary is not conceptually necessary for FPI, this article will distinguish FII from FPI. A similar distinction will be drawn between PEFs and CIVs: a PEF involves direct control while a CIV does not.

D. Conceptualizing the Hybrid Nature of PEF Investment

The foregoing suggests that it is possible to distinguish FDI, FPI, PEFs, and CIVs along two conceptual axes: direct control vs. noncontrol, and traditional direct investment without intermediaries vs. indirect investment with intermediaries. A 2x2 matrix in Table 3 below shows how FDI, FPI, PEFs and CIVs are placed in each of the four squares.

¹⁴² Sun Capital Partners III LP v. New England Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129 (1st Cir. 2013). See *infra* Part IV.B.2 for more discussion on the *Sun Capital* case.

¹⁴³ Although the *Sun Capital* case involved the definition of the term trade or business for ERISA purposes only, “it is not a big leap to argue that the fund was engaged in a trade or business for tax purposes.” See Victor Fleischer, *Sun Capital Court Ruling Threatens Structure of Private Equity*, N.Y. TIMES, Aug. 1, 2013, <http://dealbook.nytimes.com/2013/08/01/sun-capital-court-ruling-threatens-private-equity-structure/>. Many practitioners are criticizing the *Sun Capital* case with the concern that it might change the tax treatment of PEFs adversely affecting the private equity industry. See Davis Polk, *First Circuit Sun Capital Decision Increases ERISA Exposure for Private Equity Funds* (Aug. 6, 2013), http://www.davispolk.com/sites/default/files/08.06.13.Sun_Capital.pdf; see also Deloitte, *FIRST CIRCUIT HOLDS PRIVATE EQUITY FUND POTENTIALLY LIABLE FOR PORTFOLIO COMPANY PENSION OBLIGATIONS DUE TO TRADE OR BUSINESS ACTIVITY* (2013); Christian M. McBurney, *Private equity funds need not fear tax consequences of Sun Capital, but should they be concerned about where the IRS might take it?* (Nov. 18, 2013), http://www.nixonpeabody.com/files/166177_Private_Equity_Alert_18NOV2013.pdf; PwC, *TAX ALERT: SUN CAPITAL PARTNERS COURT CASE RULING* PwC, <http://www.pwc.com/us/en/alternative-investment/publications/sun-capital-partners-pension-fund-ruling.jhtml>. However, there are comments from public sector for supporting the *Sun Capital* case. See Steven M. Rosenthal, *Private Equity Is a Business: Sun Capital and Beyond*, 140 TAX NOTES 1459 (2013); Rosenthal, *supra* note 7.

TABLE 3. CLASSIFICATION OF CROSS-BORDER INVESTMENTS

	DIRECT CONTROL	NONCONTROL
DIRECT INVESTMENT (WITHOUT INTERMEDIARY)	FDI	FPI
INDIRECT INVESTMENT (WITH INTERMEDIARY)	PEF	CIV

Such a classification certainly simplifies the features of each type of investment, because they often overlap with each other to some extent. To be specific, although this article distinguishes FII from FPI, FPI has been generally used to cover FII, including through both PEFs and CIVs. In addition, PEFs have features of both FDI and CIVs.¹⁴⁴ The ownership ratio of a PEF in the portfolio company is mostly more than 10%, as with FDI.¹⁴⁵ Nor is it clear whether a PEF's investment should be treated as active or passive. On the other hand, PEFs, like CIVs, have typically treated themselves as passive investors for tax purposes and not as if they were engaged in a "trade or business," relying in part on two U.S. Supreme Court cases.¹⁴⁶ In addition, the investment structure used by a PEF resembles that used by a CIV, although PEFs tend to have more flexible and complicated investment structures than FDI or CIVs, often involving multiple layers of pass-through entity and corporate-type special purpose vehicles spread across multiple jurisdictions.¹⁴⁷

However, this overlapping does not justify treating PEFs in the same way as other types of investment. PEFs are distinguished from FDI by their use of an intermediary vehicle. In addition, a PEF's investment spectrum is typically different from that of a CIV, or FPI. Moreover, PEFs, which are essentially privately held partnerships, are less transparent to the public than

¹⁴⁴ Kimberly Evans, *Foreign Portfolio and Direct Investment: Complementarity, Differences, and Integration*, OECD GLOB. FORUM INT'L INV. (2002), <http://www.oecd.org/daf/inv/investmentfordevelopment/2764407.pdf>. Although Evans did not distinguish PEF as an independent category from FPI and FDI, she illustrated PEF as an overlapping area where the FDI and FPI merge, by arguing as follows: "There is no identifiable dividing line between portfolio and direct investment, but only an area of overlap where the two merge. For instance, a portfolio investor may be active in the equities market, but equity holdings are also one of the main means of direct investment."

¹⁴⁵ A recent research study comparing private equity and conglomerates, which represent direct investment, also concluded that although private equity firms differ significantly from conglomerates, those two share a lot in common. See Cheffins & Armour, *supra* note 53, at 8, 39.

¹⁴⁶ *Whipple v. Commissioner*, 373 U.S. 193 (1963); *Higgins v. Commissioner*, 312 U.S. 212 (1941); see also Rosenthal, *supra* note 143, at 1462.

¹⁴⁷ See *infra* Figure 6. Structure of the *Loan Star Fund* case. For a basic domestic PEF structure, see *supra* Figure 1. Structure of a Basic Private Equity Investment.

FDI, FPI, and/or CIVs,¹⁴⁸ and the information is less available even to the domestic regulatory agencies because reporting requirements have been limited.¹⁴⁹ However, if the administrative authorities tried to obtain information on the individual investors behind the vehicle, it would be easier to do so for PEFs than in CIVs, because PEFs tend to have only a handful of high profile investors,¹⁵⁰ which rarely change during the lifetime of a fund,¹⁵¹ while CIVs generally have many more, including private retail investors.

Therefore, the tax implications of FDI, FPI, CIVs, and PEFs should be as different as their economics and business strategies are, and, in particular, the international tax rules and policy for each type of investment should reflect differences between these mechanisms. In the last decade, public finance and tax law literature have started to distinguish FPI and CIVs from FDI for the purpose of policy analysis.¹⁵² However, little independent analysis of PEFs has been conducted,¹⁵³ which is astonishing given the

¹⁴⁸ Cheffins & Armour, *supra* note 53, at 5 (arguing that the rise of private equity has been controversial in many ways, citing some critics point about counterproductive lack of transparency of the private equity as private partnerships). For media criticizing the private feature of the big deals done by private equity, see Cheffins & Armour, *supra* note 53, at 5 n.21 (citing Eli Noam, *Private Equity Is a Problem for Public Media*, FIN. TIMES, Feb. 19, 2007, <http://www.ft.com/intl/cms/s/2/50ca3cb0-c01e-11db-995a-000b5df10621.html#axzz32yhzc5K2>; Eli Noam, *Invading the privacy of private equity*, FIN. TIMES, Feb. 24, 2007, <http://www.ft.com/intl/cms/s/0/2866ab32-c3ac-11db-9047-000b5df10621.html#axzz32yhzc5K2>).

The lack of transparency in the private equity industry is not limited to international tax issues. See TALMOR & VASVARI, *supra* note 21, at 21 (arguing that because of the private nature of the market, “it is extremely challenging for the outsider to understand and form a view on the workings of the industry”).

¹⁴⁹ Sanchirico, *supra* note 111, at 48. However, the Dodd-Frank Act now imposes disclosure requirement on the managers of hedge funds, private equity funds, or venture capital funds. See The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 404, 124 Stat. 1376 (2010); see also TALMOR & VASVARI, *supra* note 21, at 17.

¹⁵⁰ One can easily imagine thousands of investors in a mutual fund. However, private equity firms have made a practice of only seeking investment capital from high profile investors, such as pension funds, charitable endowments, and high net-wealth individuals. Such practice inhibits access to the private equity from the ordinary private investors. See Cheffins & Armour, *supra* note 53, at 5–6.

¹⁵¹ Interest in PEFs is “an intrinsically illiquid asset class” so that partners in PEFs rarely change during the lifetime of PEFs. Although the recent development of the secondary market for trading interests in PEFs to provide liquidity will give greater complexity, it is still true that the change in partners is relatively less common in PEFs than in CIVs. See TALMOR & VASVARI, *supra* note 21, at 187.

¹⁵² For FPI, see *supra* note 108. For FDI, see *supra* note 107. For CIVs, see *supra* notes 1163, 116.

¹⁵³ Graetz, *supra* note 28, at 327 n.254. Extensive studies have been conducted with respect to PEFs under the U.S. domestic tax law since 2000, especially concentrating on taxing carried interest as either ordinary income or capital gains. See, e.g., Michael S. Knoll, *The*

growth of private equity over the last 20 years.¹⁵⁴

E. A New Benchmark for PEF Investment

Given the hybrid nature of PEF investment, the norms of existing international tax policy with respect to FDI and/or FPI cannot simply be applied to PEFs. The literature on international tax policy with respect to FDI is dominated by global welfare benchmark models to advance worldwide economic efficiency, or neutrality, such as Capital Export Neutrality (CEN), Capital Import Neutrality (CIN), National Neutrality (NN), Capital Ownership Neutrality (CON), and National Ownership Neutrality (NON).¹⁵⁵

The literature on FPI also discusses whether the above global welfare theory could apply to FDI. For example, Michael Graetz and Itai Grinberg argue that neither CEN nor CIN is relevant to the taxation of FPI, whereas they recommend NN for FPI to enhance American national well-being over the global welfare.¹⁵⁶ None have discussed recognizing PEFs' hybrid nature of FDI and FPI.

More fundamental criticism on the global welfare theory is that the international tax neutralities that are standard criteria to evaluate normative superiority of international tax policy in the global welfare theory are "not appropriate tools for designing tax policy."¹⁵⁷ Each neutrality represents one margin of distortion among many, and it is theoretically impossible to satisfy the various neutralities at the same time.¹⁵⁸ However, the debate concerning U.S. international tax policy too often relies on the "single-bullet approach" among "alphabet soup."¹⁵⁹ Furthermore, the various neutralities are not

Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of Taxing Profit Interests as Ordinary Income, 50 WM. & MARY L. REV. 115 (2008); Adam Lawton, *Taxing Private Equity Carried Interest Using an Incentive Stock Option Analogy*, 121 HARV. L. REV. 846 (2008); Fleischer, *supra* note 4; Weisbach, *supra* note 75. However, few studies are found in relation to the international tax. Cf. Kimberly S. Blanchard, *Cross-border Tax Problems of Investment Funds*, 60 TAX LAW. 583 (2007) (including analysis on the private equity investment in addition to the mutual funds' investment).

¹⁵⁴ TALMOR & VASVARI, *supra* note 21, at 3 (calling private equity a "new industry" and providing that "private equity is responsible for up to a quarter of the global M&A activity and as much as half of the leveraged loan issues in the capital markets").

¹⁵⁵ See generally Mihir A. Desai & James R. Hines Jr., *Evaluating International Tax Reform*, 56 NAT'L TAX J. 487 (2003); Graetz, *supra* note 28, at 270–77; Daniel Shaviro, *The David R. Tillinghast Lecture - The Rising Tax-Electivity of U.S. Corporate Residence*, 64 TAX L. REV. 377, 386–87 (2010).

¹⁵⁶ Graetz & Grinberg, *supra* note 23, at 556–75.

¹⁵⁷ David A. Weisbach, *The Use of Neutralities in International Tax Policy*, 68 NATL. TAX J. 635 (2015).

¹⁵⁸ *Id.* at 640.

¹⁵⁹ DANIEL N. SHAVIRO, *FIXING U.S. INTERNATIONAL TAXATION* 14 (2014); Shaviro,

directly related to the normative reasons for taxing relevant income.¹⁶⁰

Thus, leaving aside the global welfare theory that does not lead to a meaningful benchmark to PEF, this article draws attention to a fundamental consensus in international taxation with regard to the active and passive distinction, which provides more convincing standard for taxing income earned from cross-border transactions. When allocating international tax jurisdiction, active business income goes to the source country (where the income is produced), and passive or portfolio income goes to the residence country (where the income is consumed).¹⁶¹ Such consensus has been reached since the development of the modern international tax regime led by the League of Nations in 1920s,¹⁶² and the League's 1928 model treaties which codified this norm became the basis for more than 2000 bilateral treaties throughout the world in addition to the model income tax treaties of the OECD, the United Nations, and the United States.¹⁶³

Tax scholars have been considering whether such consensus is justified. Commentators who argue for a pure residence-based taxation for FPI seem to agree with this consensus.¹⁶⁴ However, there are commentators who disagree with the consensus and argue for shifting the source-based tax system on active corporate income to the pure residence-based tax system (based on the residence of individual shareholders).¹⁶⁵ By applying the global welfare theory to evaluate the policy of allocating of tax jurisdiction, some proponents of CEN also argue that residence-based taxation is normatively superior to source-based taxation.¹⁶⁶ While the argument for the pure residence-based tax system would be reasonable for the very limited case of a passive individual investor,¹⁶⁷ it has problems when it comes to FDI or an active investment by MNEs. First, it is difficult to determine the residence of the business entity that is easily manipulated, or to impute the income to its investors because of their complex investment structure.¹⁶⁸ Second, the pure

supra note 155, at 386.

¹⁶⁰ Weisbach, *supra* note 157, at 648.

¹⁶¹ Avi-Yonah, *supra* note 23, at 1306.

¹⁶² *Id.* at 1305–06; Graetz & O'Hear, *supra* note 23, at 1066–89.

¹⁶³ Graetz & O'Hear, *supra* note 23, at 1023.

¹⁶⁴ Avi-Yonah, *supra* note 23, at 1331–33; Graetz & Grinberg, *supra* note 23, at 568–74.

Although Graetz and Grinberg argue that national neutrality policy might be proper for FPI, they still borrow that policy to support the residence country's primary taxing right over the FPI.

¹⁶⁵ See, e.g., Robert A. Green, *Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18 (1993).

¹⁶⁶ See Graetz & O'Hear, *supra* note 23, at 1102.

¹⁶⁷ Avi-Yonah, *supra* note 23, at 1311–13.

¹⁶⁸ *Id.* at 1313; Shaviro, *supra* note 155. Although Avi-Yonah and Shaviro discuss the electivity of residence by multinational corporations, the same is true for PEFs. PEFs use

residence-based tax system will increase revenue for developed countries and reduce revenue for developing countries, since the long-standing tax position of the former is the country of residence whereas that of the latter is the country of source.¹⁶⁹ However, the source country will never forgo its taxing right on business income produced on its soil.¹⁷⁰ Therefore, the current consensus on the distinction between active and passive and allocation of tax jurisdiction accordingly serves as a reasonable and practical norm in international tax.

The above discussion on the normative superiority of allocating tax jurisdiction between source and residence countries suggests a useful benchmark for taxing PEFs. The traditional position that PEF is a subcategory of FPI and subject to residence-based taxation is not justified, because it does not accurately reflect the investment nature of PEF, and thus does not accord with the fundamental consensus in the international tax regime. It also harms the tax neutrality between direct and indirect investment in the PEF investment context by improperly allocating tax jurisdiction. Given that PEF overlaps with FDI in terms of activeness in business and that portfolio companies are often located in developing countries, it would be difficult for source countries to yield the entire tax jurisdiction over the income arising from PEFs.¹⁷¹ Thus, the new baseline should be that PEF's income arising from the features of FDI or active business activity should be subject to the source country's tax jurisdiction, and income arising from the features of FPI or passive investment should be subject to the residence country's tax jurisdiction.

Therefore, rather than adding another margin for worldwide efficiency in the already complicated "alphabet soup,"¹⁷² this article proposes an incremental reform of PEFs by applying the current consensus in international tax more precisely according to PEF's true nature. The new benchmark would contribute to recovering tax neutrality between direct and indirect investment by properly allocating tax jurisdiction. It would also be a useful tool to evaluate various tax policy alternatives to reforming the

holding companies, which are corporations, so that the discussion can be applied as it is. In addition, the issue of residence of partnership in international tax is even more complicated than that of corporations. For further discussion, see OECD, *R(15). The Application of the OECD Model Tax Convention to Partnerships*, in MODEL TAX CONVENTION ON INCOME AND ON CAPITAL 2010, at 1–98 (2012), <http://www.oecd-ilibrary.org/content/chapter/9789264175181-108-en>.

¹⁶⁹ Avi-Yonah, *supra* note 23, at 1313–14.

¹⁷⁰ Graetz & O'Hear, *supra* note 23, at 1103.

¹⁷¹ See Avi-Yonah, *supra* note 23, at 1313 (acknowledging that pure residence-based taxation allows more revenue to developed countries and less revenue to developing countries).

¹⁷² SHAVIRO, *supra* note 159, at 14.

taxation of PEF and its partners. Keeping the new benchmark in mind, the next part will review recent proposals on carried interest and management fees, and relevant cases contributing to the discussion. Their international tax implications will be discussed in Part V.

IV. CARRIED INTEREST AND BEYOND: ALTERNATIVES TO THE TAXATION OF PEFS

Since the sensational article *Two and Twenty: Taxing Partnership Profits in Private Equity Funds* by Victor Fleischer, which publicized the carried interest issue, was first circulated among tax policy groups in 2007,¹⁷³ scholars and policy makers have discussed tax loopholes in PEF investment and suggested reforms. However, not every proposed reform is based on the understanding that PEFs are carrying out active investment or discusses its international implications.

The most popular suggested tax reform for PEFs concerns the tax treatment of GPs' carried interest.¹⁷⁴ The agenda has been expanded to GPs' management fees since media coverage describing how little private equity firms and their managers pay tax incited discussions during Mitt Romney's presidential campaign in 2011.¹⁷⁵ However, those reform proposals are limited to GPs' income. Are LPs not guilty of playing the tax games that GPs are playing? They might be, if LPs are taxable. However, most LPs are tax-exempt, which is the key factor that makes the private equity tax game possible.¹⁷⁶ Meanwhile, recent cases in the United States and other countries open the door for reframing the hybrid nature of PEF investment more broadly.¹⁷⁷ This Part discusses the proposals and cases as alternatives to the taxation of PEF, and envisions the extent to which PEF income should be treated as active and passive.

A. *Proposals on Carried Interest and Management Fees*

A GP's income consists of three parts. First is the return of its capital contribution (as capital interest), typically 1% to 5% of the fund's entire capital.¹⁷⁸ Given that a PEF is established as a limited partnership, and that it invests in the securities of portfolio companies and then sells them when it exits, the fund's income would be treated as long-term capital gains.¹⁷⁹ Such

¹⁷³ Fleischer, *supra* note 4, at 59.

¹⁷⁴ Burke, *supra* note 75, at 1–2.

¹⁷⁵ Polsky, *supra* note 11, at 10.

¹⁷⁶ Fleischer, *supra* note 4, at 13.

¹⁷⁷ *See infra* Parts IV.B.2., V.C.2.

¹⁷⁸ *Supra* note 57.

¹⁷⁹ I.R.C. §§ 1221, 1222. From time to time, the funds also earn other types of passive

income flows through to partners, including the GP, and the character determined at the entity level is transferred to partners as the partnership is a pass-through entity.¹⁸⁰

Second is carried interest. Carried interest is in substance a “contingent fee for services,” but it is structured as a special allocation of the partnership’s profit to the GP.¹⁸¹ Section 707 of the Code provides that a transaction between a partner and a partnership by which the partner receives interest in profits in return for her services to the partnership would be treated as a bona fide partnership transaction, as long as (i) the partner receives it in her capacity as a partner and (ii) the payment is not guaranteed (i.e., entrepreneurial risk exists).¹⁸² Since the GP can receive carried interest once the partnership profits reach the hurdle rate of return, current tax law respects the carried interest as “a payout of a distributable share of partnership income” under section 707.¹⁸³ Therefore, carried interest is taxed as capital gains at a top rate of 20% under current law, which is preferential to ordinary income with a top rate of 37%.¹⁸⁴

A number of proposals have suggested reforming the tax treatment of carried interest.¹⁸⁵ Congressman Sander Levin of Michigan introduced a bill to treat carried interest as ordinary income in 2007, but he ultimately dropped it.¹⁸⁶ Former President Obama also included a proposal for taxing carried interest as ordinary income during his presidential campaign in 2008,¹⁸⁷ and again included the proposed change in his budget proposal for fiscal years 2010 through 2014.¹⁸⁸ However, neither of the Obama Administration’s

income, such as dividends and interest, from portfolio companies. For simplicity, this article discusses capital gains only as the funds’ income.

¹⁸⁰ I.R.C. § 702(b); Fleischer, *supra* note 4, at 15.

¹⁸¹ Polsky, *supra* note 11, at 1.

¹⁸² I.R.C. § 707(a)(2)(A).

¹⁸³ Fleischer, *supra* note 4, at 14–15.

¹⁸⁴ Batchelder, *supra* note 57.

¹⁸⁵ Fleischer, *supra* note 4, at 47–59.

¹⁸⁶ H.R. 2834, 110th Cong. (2007).

¹⁸⁷ See LEONARD E. BURMAN ET AL., AN UPDATED ANALYSIS OF THE 2008 PRESIDENTIAL CANDIDATES’ TAX PLANS 1, 12, 23 (2008), <http://www.urban.org/url.cfm?ID=411741>.

¹⁸⁸ Hazel Bradford, Obama 2014 Budget Calls for Carried Interest Rate Elimination, Retirement Savings Cap, PENSIONS & INVESTMENTS (Apr. 10, 2013), <http://www.pionline.com/article/20130410/ONLINE/130419982/obama-2014-budget-calls-for-carried-interest-rate-elimination-retirement-savings-cap>; Department of the Treasury, General Explanations of the Administration’s Fiscal Year 2013 Revenue Proposals 134-35 (2013), <https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf>; Department of the Treasury, General Explanations of the Administration’s Fiscal Year 2012 Revenue Proposals 61-62 (2012), <https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2012.pdf>; Department of the Treasury, General Explanations of the Administration’s Fiscal

attempts succeeded.¹⁸⁹

The tide turned in 2015. The proposal to tax carried interest as ordinary income had bipartisan support. Former President Obama again included the proposal in his 2015 budget,¹⁹⁰ and Congressman Dave Camp, Republican chairman of the House Ways and Means Committee, also proposed reforming the tax treatment of carried interest.¹⁹¹ Tax plans by then-presidential candidates Hillary Clinton and Donald Trump all endorsed such a change during the 2016 election,¹⁹² and President Trump continued his plan to cut the carried interest tax break.¹⁹³ Economists estimated that the reform will increase billions of tax revenue over ten years, but the estimates varied from more than \$3 billion over the next ten years¹⁹⁴ to \$17.4 billion over a decade¹⁹⁵ and \$180 billion over ten years.¹⁹⁶

Nevertheless, the final tax reform bill, also known as the Tax Cuts and Jobs Act of 2017, did not successfully close the loophole.¹⁹⁷ It introduces a

Year 2011 Revenue Proposals 91-92 (2011), <https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2011.pdf>; Department of the Treasury, General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals 23-24 (2010), <https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2010.pdf>.

¹⁸⁹ See Louis Jacobson & Molly Moorhead, *Tax Carried Interest as Ordinary Income*, POLITIFACT, <http://www.politifact.com/truth-o-meter/promises/obameter/promise/42/tax-carried-interest-as-ordinary-income/>.

¹⁹⁰ Eileen Appelbaum & Rosemary Batt, *Time to Close Private Equity's "Carried Interest" Loophole*, THE HILL: CONGRESS BLOG (Apr. 2, 2014), <http://cepr.net/publications/op-eds-columns/time-to-close-private-equitys-carried-interest-loophole>.

¹⁹¹ Richard Rubin, *Camp Hits Carried Interest in Tax Plan Focused on Finance*, BLOOMBERG BUSINESS. Feb. 25, 2014, <http://www.bloomberg.com/news/articles/2014-02-26/camp-hits-carried-interest-in-tax-plan-focused-on-finance>.

¹⁹² Sean Neary, *The Candidates Take on Taxes and Carried Interest*, THE HILL, Sept. 11, 2015, <http://thehill.com/blogs/congress-blog/presidential-campaign/253323-the-candidates-take-on-taxes-and-carried-interest>.

¹⁹³ Sahil Kapur, *Here's How Trump Could Try to Kill Carried-Interest Tax Break*, BLOOMBERG NEWS, Jan. 17, 2017, <https://www.bloomberg.com/politics/articles/2017-01-17/here-s-how-trump-could-try-to-kill-carried-interest-tax-break>; Shabad, *supra* note 9.

¹⁹⁴ Appelbaum & Batt, *supra* note 190.

¹⁹⁵ CONG. BUDGET OFF., *OPTIONS FOR REDUCING THE DEFICIT: 2014 TO 2023* 128 (2013).

¹⁹⁶ Victor Fleischer, *How a Carried Interest Tax Could Raise \$180 Billion*, N.Y. TIMES, June 5, 2015, <https://www.nytimes.com/2015/06/06/business/dealbook/how-a-carried-interest-tax-could-raise-180-billion.html>.

¹⁹⁷ Although then-candidate Trump's challenge to the carried interest loophole was similar to the previous reform proposals that recharacterize carried interest as ordinary income, the House Ways and Means Chairman Kevin Brady (R-Texas) introduced first a two-year holding period and then a three-year holding period in the House Tax Bill, which is backed by the former White House political strategist Steve Bannon. John Voskuhl & Melissa Mittelman, *Carried Interest Tax Break May Be Changed, House Tax Chief Says*, BLOOMBERG BNA: DAILY TAX REALTIME, Nov. 6, 2017, <https://www.bloomberg.com/news/articles/2017-11->

new three-year holding period in order for investment managers to enjoy the low capital gains tax rate.¹⁹⁸ However, given the fact that the average lifetime of a PEF is about ten years, and in many cases PEFs hold investments longer than three years,¹⁹⁹ many practitioners and commentators expect that the reform bill may not effectively close the loophole.²⁰⁰

Third is the management fee, which is the compensation for the managers' service to the fund. Current tax law taxes management fees as compensation for services (i.e., ordinary income).²⁰¹ Gregg Polsky's recent study addressed the tax planning technique using management fees, expense deduction, and monitoring fee offset. Many private equity firms, which become a GP or a GP's affiliates, waive the 2% management fee during the formation of the fund in exchange for receiving additional partnership profits interest without bearing any entrepreneurial risk, resulting in the conversion of ordinary income tax treatment of management fees to capital gains.²⁰² Allocating all expenses of funds to management fees and pushing down the fund's obligation to pay management fees to portfolio companies by fee offset arrangements could also reduce GPs' income from management fee payment.²⁰³ In turn, GPs are compensated by receiving more partnership

06/carried-interest-tax-break-may-be-changed-house-tax-chief-says; Kevin Cirilli, *Bannon Backs Limit to Carried Interest in House Tax Bill*, BLOOMBERG BNA: DAILY TAX REALTIME, Nov. 9, 2017, <https://www.bloomberg.com/news/articles/2017-11-09/bannon-backs-limit-to-carried-interest-break-in-house-tax-bill>. In the Senate, Senator Susan Collins (R-ME) evaluated the carried interest provision in the House Tax Bill as modest and again proposed to close the carried interest loophole in a more rigorous way, stating that President Trump agreed with her in doing so in order to cover increased amount of child and adult-dependent credit. Erik Wasson & Terrence Dopp, *Sen. Collins: End Carried Interest Break to Cover Child Credit*, BLOOMBERG BNA: DAILY TAX REALTIME, Nov. 30, 2017. However, the Senate Tax Bill and the Final Tax Bill signed by President Trump only introduced the new three-year holding period with respect to carried interest' eligibility for the long-term capital gains tax rate.

¹⁹⁸ Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 13309, 131 Stat 2054, 2130 (codified as amended at I.R.C. § 1061).

¹⁹⁹ See *supra* note 68 and accompanying text.

²⁰⁰ See, e.g., Tae Kim, *Gary Cohn: We 'Tried 25 Times' To Cut Hedge Fund Loophole in Tax Reform Bill, But Failed*, CNBC, Dec. 20, 2017, <https://www.cnbc.com/2017/12/20/cohn-tried-25-times-to-cut-hedge-fund-loophole-but-failed.html>; Factor & Fedida, *supra* note 10; Brian Schwartz, *Private Equity Firms Lobbied Tax Reform Bill as Carried Interest Survives*, FOX BUSINESS, Jan. 31, 2018, <http://www.foxbusiness.com/politics/2018/01/31/private-equity-firms-lobbied-tax-reform-bill-as-carried-interest-survives.html> (reporting that at least six private equity groups, including The Carlyle Group, lobbied to maintain the carried interest tax break).

²⁰¹ Gregg D. Polsky, *Private Equity Management Fee Conversions*, 122 TAX NOTES 743, 746 (2008).

²⁰² Polsky, *supra* note 11, at 5–10.

²⁰³ GPs or their affiliated management firms provide management and consulting services to

profits, which are taxed at a preferential rate.²⁰⁴

Governments began to recognize the need to challenge PEFs' fees and expenses. On July 22, 2015, the U.S. Treasury Department and the IRS released a proposed regulation under section 707 of the Code, providing that if a management fee waiver arrangement lacks "significant entrepreneurial risk," the carried interest received in return for waiving this fee would be treated as a disguised payment for services, and taxed as ordinary income.²⁰⁵ Furthermore, the treasurer of California recently called for legislation to make PEFs disclose their fees to investors for full transparency.²⁰⁶

However, since the conversion of management fees from ordinary income into capital gains is available only when carried interest is taxed as capital gains, the reforms taxing carried interest as ordinary income could prevent exploiting the management fee waiver more fundamentally. Therefore, this article includes the reform proposal on management fees as part of a broader alternative of taxing carried interest as ordinary income.

B. Beyond the Carried Interest: PEF as a Trade or Business

The reforms discussed in Subpart A only deal with GPs' activity and income. However, a more ambitious position which has impact on both GPs' and LPs' activity and income has emerged: treating the entire activity of PEF as a "trade or business" (ToB).

Treating PEFs as ToB is in line with recognizing the hybrid nature of PEF investment based on the terms of international finance and tax discussed in Part III, which notes that despite the passivity in form of using funds as with portfolio investment, PEFs in substance acquire more than 10% ownership in the portfolio company and then actively manage and monitor the operation of the portfolio company. "Trade or business" is a more technical term of art used in tax law. It is used many times throughout the Code, but neither the Code nor the Treasury Regulations thereunder have

portfolio companies directly, and the management firms charge "monitoring fees" for these services to portfolio companies directly. GPs further receive "management fees" from the fund for the same service. Hence, in order to avoid double-compensation of GPs for the same service, most PEFs provide management fee offset arrangements which reduce GPs' management fee to the extent that their affiliated management firms receive a fee from the portfolio company for management services. Mark E. Berkowitz & Jessica Duran, *Private Equity Funds and the Unrelated Business Income Tax*, 149 Tax Notes 669, 673 (2015). This results in not only reducing GPs' income from management fee payment but also reducing portfolio companies' profits. For more discussion, see *infra* Part V.A.1.

²⁰⁴ Polsky, *supra* note 11, at 10–17.

²⁰⁵ Disguised Payments for Services, 80 Fed. Reg. 43,652 (proposed July 22, 2015).

²⁰⁶ See, e.g., Gretchen Morgenson, *Challenging Private Equity Fees Tucked in Footnotes*, N.Y. TIMES, Oct. 17, 2015, <http://www.nytimes.com/2015/10/18/business/challenging-private-equity-fees-tucked-in-footnotes.html>.

defined the term.²⁰⁷ However, it is commonly used to describe a taxpayer's activities to produce income or profits from actively engaging in business, as distinguished from a passive endeavor such as holding income-producing property.²⁰⁸ The most recent Supreme Court case discussing the ToB is the *Groetzinger* case, where the court held that "to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and . . . the taxpayer's primary purpose for engaging in the activity must be for income or profits."²⁰⁹

One of the leading proponents of this position is Steven Rosenthal. Rosenthal argues that PEFs are engaged in a ToB for tax purposes, because PEFs' activities of buying, developing, and finally reselling portfolio companies are for profits, and these activities are continuous, regular, and substantial.²¹⁰ Rosenthal further asserts that any gains and losses of PEFs conducting ToB should be treated as ordinary, not as capital, because assets held by PEFs are excluded from the definition of capital assets.²¹¹

1. Capital Gains vs. Ordinary Income

Can a PEF's asset be excluded from capital assets? The Code excludes from capital assets (1) inventory and (2) property held by the taxpayer for sale to customers in the ordinary course of his trade or business.²¹² Rosenthal's point is on the latter — a PEF's assets are for sale to customers in the ordinary course of ToB.²¹³ If a PEF is to be treated as ToB, the main question is whether the PEF's assets are for sale "to customers."

Many commentators think that the second category of exception to capital assets is analogous to the first category (i.e., inventory held by merchants or stock dealers), so that investors' holding assets neither constitutes ToB nor sale to customers.²¹⁴ Thus, investors treat their stock as

²⁰⁷ Rosenthal, *supra* note 143, at 1463; F. Ladson Boyle, *What Is a Trade or Business?*, 39 TAX LAW. 737 (1986).

²⁰⁸ CHARLES H. GUSTAFSON ET AL., TAXATION OF INTERNATIONAL TRANSACTIONS: MATERIALS, TEXT, AND PROBLEMS 142 (4th ed. 2011).

²⁰⁹ *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987).

²¹⁰ Rosenthal, *supra* note 143, at 1465.

²¹¹ Rosenthal, *supra* note 7, at 364.

²¹² I.R.C. § 1221(a)(1).

²¹³ Rosenthal, *supra* note 7, at 363.

²¹⁴ There are three classes of taxpayers holding stocks: dealers, traders, and investors. Dealers are holding stock as inventory to realize profits not for the appreciation of the stock price, but for the mark-up in excess of the stock price. Traders are engaging in a large number of stock transactions, realizing profits from the appreciation of the stock price. Both dealers and traders are engaged in ToB, but only dealers have customers. Therefore, dealers treat the stock as inventory, while traders treat the stock as capital assets. Investors are similar to traders, making profits from the appreciation of the stock price when they sell it. However,

capital assets.

On the other hand, Rosenthal argues that the second exception is added to deny arbitrary deduction by Wall Street bankers, and that the term “to customers” is meant to describe the middleman’s business, not to identify a vendee.²¹⁵ Furthermore, capital assets “must be narrowly applied and its exclusions interpreted broadly,” because the preferential rate of capital gains is an exception to the usual tax rate.²¹⁶ He concludes that because PEFs make their money from the everyday operation of a business, its income should be treated as ordinary.²¹⁷

However, it is not clear to what extent Rosenthal would treat a PEF’s income as ordinary. In his first article discussing this issue, he seems to target only the income of private equity firms (i.e., GPs).²¹⁸ He refrains from applying his theory to tax-exempt LPs and foreign LPs.²¹⁹ However, in his subsequent article on the *Sun Capital* case,²²⁰ which held that a PEF is engaged in ToB under the Employee Retirement Income Security Act (ERISA), he seems to expand his position, arguing that a PEF’s ToB influences an LP’s income portion as well.²²¹

Whether a PEF’s assets can be excluded from capital assets is still controversial. Although Rosenthal argues that a PEF can satisfy the requirement of “to customers,” it is not likely accepted by leading tax authorities yet. Nonetheless, excluding a PEF’s assets from capital assets and treating the entire PEF’s income as ordinary is certainly a policy alternative to consider in the spectrum of various alternatives. It could be supported further if one would emphasize the active investment nature of PEF and argue for a fundamental reform of PEF taxation.

Rosenthal’s argument that PEFs engage in ToB has drawn attention in

investors purchase stocks without regard to the fluctuation of the daily market price, and their managerial attention to the stock is never considered as ToB, no matter how extensive such activities might be. Thus, investors treat the stock as capital assets. *See* *United States v. Wood*, 943 F.2d 1048 (9th Cir. 1991); *Higgins v. Commissioner*, 312 U.S. 212 (1941); *see also* MICHAEL J. GRAETZ & DEBORAH H. SCHENK, *FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES* 564 (6th ed. 2009).

²¹⁵ Rosenthal, *supra* note 7, at 363–364. In the case of dealers discussing the requirement of “to customers,” the Service is likely to support this argument, providing that “a middleman’s vendees are customers per se whenever the middleman is seeking to earn a profit by reselling to such vendees.” I.R.S., *supra* note 17.

²¹⁶ Rosenthal, *supra* note 7, at 367; GRAETZ & SCHENK, *supra* note 214, at 558; *Corn Prods. Ref. Co. v. Commissioner*, 350 U.S. 46, 52 (1955).

²¹⁷ Rosenthal, *supra* note 7, at 366.

²¹⁸ *Id.*

²¹⁹ *Id.* at 366 n.50.

²²⁰ *Sun Capital Partners III LP v. New England Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129 (1st Cir. 2013).

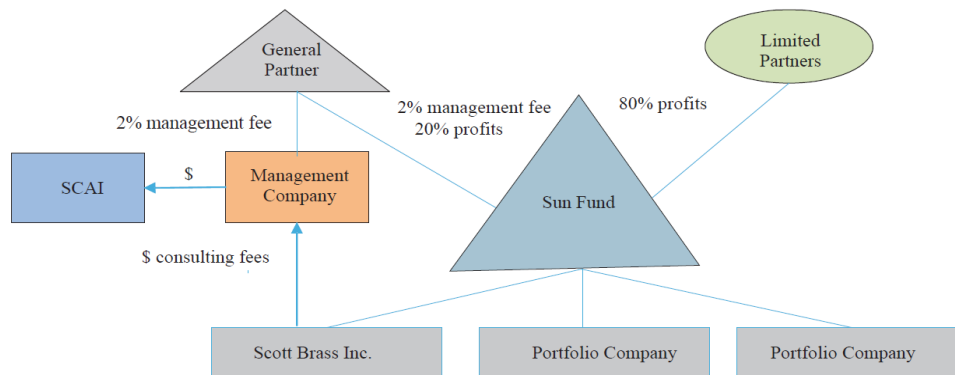
²²¹ Rosenthal, *supra* note 143, at 1469.

the tax policy group, influencing the conclusion of the *Sun Capital* case by the First Circuit.²²² Besides the capital assets discussion, PEFs as ToB itself has an impact on the tax consequences of LPs. Before discussing how to tax LPs of PEFs further, let us examine the *Sun Capital* case.

2. The Sun Capital Case

In 2006, Sun Capital Advisors Inc. (SCAI), a private equity house, decided to invest in Scott Brass Inc. (SBI), and acquired the SBI through three Sun Capital Funds.²²³ The Sun GP could receive the well-known “two and twenty.” The Sun GP also owned a Management Company (Sun Management Co.) that entered into a Service Agreement with SBI to provide management services to SBI in exchange for consulting fees. When the Sun Management Co. collected consulting fee from the SBI, the 2% management fees payable by the Sun Funds to its GP were offset by these consulting payments made by SBI (the “fee offset”).

FIGURE 5. STRUCTURE OF THE *SUN CAPITAL* FUND CASE²²⁴



The management services were actually provided by the employees of SCAI pursuant to an agreement between the Sun Management Co. and SCAI. Two to three directors of SBI who were appointed after the Sun Funds acquisition were SCAI employees. Other SCAI personnel helped SBI’s operation, such as by sending weekly reports to SCAI regarding “[SBI]’s revenue streams, key financial data, market activity, sales opportunities,

²²² See *Sun Capital*, 724 F.3d at 146 (quoting Rosenthal, *supra* note 7); Rosenthal, *supra* note 143, at 1462.

²²³ *Sun Capital*, 724 F.3d at 149–50 (the Sun Capital Fund IV and two parallel funds of the Sun Capital Fund III divided SBI ownership 70% and 30%, respectively).

²²⁴ Rosenthal, *supra* note 143, at 1460.

meeting notes, and action items.”²²⁵ These SCAI personnel were copied in SBI’s email regarding “liquidity, possible mergers, dividend payouts, and revenue growth.”²²⁶

In 2008, however, SBI went into bankruptcy and stopped making contributions to its pension plan, the New England Teamsters & Trucking Industry Pension Fund (Teamsters Plan). As a result, SBI became liable for its proportionate share of the Teamster Plan’s unfunded vested liability.²²⁷ The Teamsters Plan asserted that the Sun Capital Funds were jointly and severally liable for the SBI’s obligations to the Teamsters Plan under the theory that the Sun Capital Funds were engaged in a ToB and they were in an ERISA common controlled group with SBI. ERISA did not define ToB or common control but directed the Federal Pension Benefit Guaranty Corporation (PBGC) to prescribe regulations consistent with Treasury Regulations under Code section 414(c). The PGBC promulgated a regulation that defined common control as generally 80% or greater common ownership by vote or value,²²⁸ but neither PBGC nor the Treasury Department has promulgated regulations addressing what constitutes a ToB under ERISA or the Code. Thus, the main issue was whether the Sun Capital Funds were engaged in a ToB.

In 2012, the U.S. District Court for the District of Massachusetts ruled that the Sun Capital Funds were not engaged in a ToB and granted summary judgment in their favor. In 2013, however, the U.S. Court of Appeals for the First Circuit reversed the District Court’s decision, unanimously holding that the Sun Capital Funds were engaged in a ToB, and thus were jointly and severally liable for the unfunded pension obligations of its portfolio company (SBI), based on the theory of “investment plus analysis” by which an otherwise passive investment, when coupled with certain activities, could cause an investor to be a ToB.²²⁹

²²⁵ *Id.* at 1461.

²²⁶ *Id.*

²²⁷ Title IV of the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. § 1301(b)(1) (2012). The liability is \$4.5 million, greater than the total Sun Funds cash investment.

²²⁸ Congress did not define common control or trade or business under ERISA section 1301(b)(1), but authorized the Federal Pension Benefit Guaranty Corporation (PBGC), a wholly owned U.S. government corporation, to prescribe regulations consistent and coextensive with regulations prescribed by the Secretary of Treasury under the Code section 414(c), which is the tax rules for employee benefit plans maintained by partnerships and proprietorships that are under common control. However, neither the PBGC nor Treasury has promulgated regulations addressing what constitutes a “trade or business” for purposes of the relevant provision of the MPPAA or I.R.C. § 414(c). *See* Rosenthal, *supra* note 143, at 1461–62.

²²⁹ *Id.* at 1462; *see also* Sun Capital Partners III LP v. New England Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129, 141 (1st Cir. 2013).

The First Circuit addressed several factors that might satisfy the “plus” in the investment plus analysis, including the active involvement of the Sun GP in the management and operation of the portfolio company and the fee offset arrangement.²³⁰ As a matter of fact, the Sun GP actively managed and operated SBI. The SCAI personnel monitored even the smallest details of SBI, such as signing all checks for SBI and holding frequent meetings with senior officers of SBI regarding operation, competition, new products and personnel.²³¹

It is worth noting a couple of implications of the *Sun Capital* case for ToB. First, although the First Circuit’s decision was made for ERISA purposes only, the definition of “trade or business” under ERISA refers to the definition of section 414(c) of the Code, so that it would not be surprising if tax authorities initiated an action to expand the holding to tax cases.²³² Since the term “trade or business” for tax purposes refers to active business operations, such an expansion would challenge PEFs’ fundamental tax position that they are passive investors.

Second, the court’s ruling on ToB is not limited to the GP’s activity, but applies to the fund itself. Partnership is a pass-through entity, so that the partnership does not pay tax and its income flows through to the partners.²³³ However, when it comes to determining and computing the items of income, gain, loss, deductions, and credits of the partnership, tax law generally treats the partnership as an entity to calculate such tax attributes and then has them pass through to the partners to pay tax.²³⁴ In addition, under the law of partnership, partners are agents of the partnership for carrying on the ordinary course of the partnership business.²³⁵ The general partner is of course an agent of a limited partnership.²³⁶ Thus, the act of any partner is attributable to the partnership as long as the partner’s act is apparently undertaken within the scope of the partnership’s ordinary course of business.²³⁷ Applying this partnership rule to determine ToB, the act of a GP (or agent) on behalf of the partnership (or principal) is attributable to the partnership in determining

²³⁰ *Sun Capital*, 274 F.3d at 141–42.

²³¹ Rosenthal, *supra* note 143, at 1462; *see also Sun Capital*, 724 F.3d at 142–43.

²³² Fleischer, *supra* note 143 (expecting that notwithstanding the absence of clear definition, the concept of “trade or business” under ERISA and the Code are related, so that it would “not be a big leap to argue that the fund was engaged in a trade or business for tax purposes”).

²³³ I.R.C. § 701.

²³⁴ I.R.C. § 702(a).

²³⁵ ANGELA SCHNEEMAN, LAW OF CORPORATIONS AND OTHER BUSINESS ORGANIZATION 63 (6th ed. 2013).

²³⁶ UNIF. LIMITED PARTNERSHIP ACT, § 402(a) (2008).

²³⁷ SCHNEEMAN, *supra* note 235.

whether the partnership is engaged in a ToB.²³⁸ Accordingly, relying on Delaware law,²³⁹ the First Circuit found that the Sun Funds acted through the Sun GP as their agent, and attributed the Sun GP's ToB activities to the Sun Funds.²⁴⁰ Therefore, the fund itself was treated as engaging in the (active) ToB (through the activity of the GP,) rather than passively investing in the portfolio company.

As a result, if all of the fund's profits are treated as arising from the fund's ToB, it would also have an impact on the tax consequences of LPs. More broadly, the active and professional investment activities conducted by fund managers have implications not only on the taxation of their carried interests but also on the overall income of both GPs and LPs. Such active business activities of PEFs also have an impact on the international tax consequences of the PEF investments, including those of foreign LPs, which will be discussed in Part V. The next subpart discusses the domestic tax consequences of tax-exempt LPs.

3. Tax-Exempt LPs and the UBTI Rule

Under current law, tax-exempt organizations are exempted from taxation,²⁴¹ but their unrelated business taxable income (UBTI) is not exempted from taxation.²⁴² More specifically, tax-exempt LPs, such as pension funds, have relied on the rule that dividends, interest, royalties, and gains or losses from the sale of stock, securities and most other types of assets are excluded from the UBTI, so that such income is not subject to tax.²⁴³

However, if the fund is treated as engaging in ToB, the income of tax-exempt LPs could be treated differently. Capital gains are generally exempted from tax, but gains from the sale of property primarily held for sale to customers in the ordinary course of the ToB are considered as UBTI, subject to tax.²⁴⁴ If a partnership's ToB generates UBTI to an exempt organization that is a partner of a partnership, the exempt organization (or the partner) includes its share of the UBTI of the partnership whether or not such UBTI is distributed.²⁴⁵

Traditionally, the PEF's assets are treated as being held neither for sale to customers nor in the course of the ToB.²⁴⁶ However, if PEF investment is

²³⁸ *Commissioner v. Boeing*, 106 F.2d 305, 309 (9th Cir. 1939).

²³⁹ DEL. CODE ANN. tit. 6, § 15-301 (1999).

²⁴⁰ Rosenthal, *supra* note 143, at 1463; *see also Sun Capital*, 724 F.3d at 147.

²⁴¹ I.R.C. § 501(a).

²⁴² I.R.C. § 511(a).

²⁴³ I.R.C. § 512(b)(5).

²⁴⁴ I.R.C. § 512(b)(5)(B).

²⁴⁵ I.R.C. § 512(c)(1).

²⁴⁶ For detailed discussion, *see supra* Part IV.B.1; Rosenthal, *supra* note 7, at 363–65

determined to be ToB, the issue arises of whether the requirement of “to customers” is satisfied, which is identical to the discussion relating to capital assets in Subpart B.1. Although the issue is controversial, it is fair to make an ambitious argument to exclude PEF assets from capital assets if one underscores the active business nature of PEFs.

More importantly, fundamental policy concerns with regards to tax-exempt organizations and the UBTI rule should be considered. In fact, tax-exempt entities are generally viewed positively as providing public goods,²⁴⁷ so that they are entitled to be exempt from tax on their investment income as long as it is not UBTI. Because of the benefits that tax-exempt organizations contribute to society, Congress exempts them from tax despite the fact that this exemption could cause unfair competition between taxable entities and exempt organizations.²⁴⁸ However, Congress added the UBTI rule in 1950 because it decided that income unrelated to the business of the exempt organizations would be presumed not to further their exempt purpose.²⁴⁹ In light of that, at least from a policy perspective, whether the tax-exempt LP’s income from PEF investment should be exempted or taxable as UBTI should be discussed regardless of the technical “to customer” requirement being satisfied.

It is hard to blame taxpayers for wanting to optimize their tax consequences as long as it is legitimate under the current law. It could be argued that tax-exempt organizations’ investment strategy to avoid UBTI is not abusive because it falls within an exception of the tax law.²⁵⁰ However, it is unclear whether the tax-exempt entity’s yet undisclosed strategy of participating in PEF investments is within the limit of the tax law. First, it is doubtful whether their investments through PEFs are entirely passive. If the private equity investment is to be treated as active investment as discussed above, the tax-exempt entity’s income should be treated as taxable UBTI. Second, when their tax-exempt status avails other taxpayers of tax games and exploiting the loophole, it should be subject to criticism and reform. Polsky has shown that the carried interest loophole exists largely because of the tax-indifference of the LPs,²⁵¹ which will be demonstrated in detail in Part VI. In addition, other strategies using various fees and expenses have been less scrutinized by investors because the investors are less sensitive to the tax strategies designed by managers, as long as the managers make sure to make

(criticizing the traditional position to treat the PEFs’ assets as such).

²⁴⁷ Daniel Shaviro, *Assessing the Contract Failure Explanation for Nonprofit Organizations and Their Tax-Exempt Status*, 41 N.Y.L. SCH. L. REV. 1001, 1007 (1996).

²⁴⁸ Rosenthal, *supra* note 143, at 1469.

²⁴⁹ *Id.*

²⁵⁰ Samuel D. Brunson, *Repatriating Tax-exempt Investments: Tax Havens, Blocker Corporations, and Unrelated Debt-financed Income*, 106 NW. UNIV. L. REV. 225, 242 (2012).

²⁵¹ Polsky, *supra* note 11, at 3–5.

their income non-UBTI.

Apart from the tax consideration, many tax-exempt LPs have started inquiring whether their investment in PEF is desirable or consistent with their interests and values.²⁵² For example, pension funds pursue long-term stability of their investment strategy, so their investment in PEFs that seek to maximize short-term gains would not be desirable.²⁵³ Furthermore, the complex relationship between GPs and LPs put the LPs “in an asymmetric or unequal relationship with [GPs].”²⁵⁴ Thus, some LP organizations, such as California Public Employees’ Retirement System, the Wisconsin Investment Board, and the New York City pension fund, decided to disinvest in PEFs.²⁵⁵ While some LPs still prefer to invest in PEFs, a recent survey by Collier Capital of 140 LPs suggests that 37% of pension plans and 43% of foundations and endowments wanted to decrease their investment in or disinvest from PEFs.²⁵⁶

This attitude of LPs implies that tax-exempt LPs’ investment in PEFs would be at odds with their interests and values. If their investments in PEFs are undesirable, then there is no longer a legitimate reason to exempt their PEF investment income from tax from a policy perspective, given that PEF is to be treated as ToB. Therefore, it is worth considering the policy argument that tax law should classify the tax-exempt LPs’ investment income from PEFs as taxable UBTI.

If such LPs’ income is treated as UBTI, then how would it be taxed? The key question is whether the LPs’ income is capital gains or ordinary income. The UBTI rule only determines whether the income is taxable, so that the character of income is still subject to the usual partnership tax rule. Under current law, because character of partnership gains allocated to partner is determined at partnership level, the partnership profits from the acquisition and the subsequent sale of the securities in portfolio companies would be treated as capital gains for both GPs and LPs.²⁵⁷ However, a more aggressive policy alternative discussed in Subpart B.1. treats the PEF as a ToB and thus treats GPs’ and LPs’ income as ordinary.

C. Summary

This part specified three policy alternatives to tax PEFs. The proposal to tax a GP’s carried interest as ordinary income has gained bipartisan support.

²⁵² EILEEN APPELBAUM & ROSEMARY BATT, PRIVATE EQUITY AT WORK: WHEN WALL STREET MANAGES MAIN STREET 241 (2014).

²⁵³ *Id.*

²⁵⁴ *Id.* at 240.

²⁵⁵ *Id.* at 259–60.

²⁵⁶ *Id.* at 259.

²⁵⁷ I.R.C. § 702(b); Treas. Reg. § 1.702-1(b) (2017).

The second proposal also relates to a GP's income in connection with management fees and expenses. The government has proposed a regulation to treat certain carried interest received in return for a fee waiver arrangement disguised as payment for services. However, this article suggests that rather than pursuing management fee reform separately from carried interest reform, it would be better to enact carried interest reform that may encompass the management fee issue as well. If the carried interest proposal were enacted as law, the carried interest payment from the partnership to a GP would be treated as an ordinary deduction to the partnership and ordinary income to the GP.

The third alternative is the most ambitious: to treat the entire activity of a PEF as a ToB. Inasmuch as this article demonstrates that the nature of PEF investment is active in terms of acquiring at least 10% control of portfolio companies, this policy alternative is a reasonable deduction under the law of partnership, attributing a GP's action to the fund. However, it further affects an LP's income, now being earned from an active ToB, which would probably make income of tax-exempt LPs as UBTI that is subject to tax. Because the LP's tax-exempt status is the key to making the private equity tax game effective, this would be a sensible policy argument. However, considering the policy goal to exempt income of such tax-exempt organizations for their positive function to provide public goods, policy makers should clarify whether Congress still intends to exempt tax or apply the UBTI rule for those LPs' investment in PEFs.

V. INTERNATIONAL TAX IMPLICATIONS OF THE ALTERNATIVES

The policy alternatives discussed in Part IV support the hybrid nature of PEF investment. While PEF investment has the form of portfolio investment, its substance is more or less active. The difference between the alternatives is the extent to which the PEF investment is active. Proposals on carried interest limit the extent to which the GP's income is active, while treating a PEF as a ToB ambitiously frames the entire income of the PEF as active.

The issue of recognizing the active business feature of PEFs in the international tax environment has not received much attention from international tax experts. The extent of the activeness of PEF investment has an impact on allocating tax jurisdictions between source and residence countries in the cross-border context. In general, active business income is allocated to the source jurisdiction, while passive or portfolio income is allocated to the residence jurisdiction by the present consensus in international tax.²⁵⁸ The alternatives recognizing the active nature of the PEF

²⁵⁸ See *supra* notes 161–63 and accompanying text.

investment would push the extant line for source-based taxation.²⁵⁹

This might raise a question on why we should impose another layer of source-based taxation for PEF investment in international tax. I argue that the way to justify strengthening source-based taxation on a GP's income would be different from that on an LP's income, because a GP actively harms source-based taxation while an LP connives at the GP's action at best. Thus, to what extent we may strengthen source-based taxation for the PEF's income must be examined.

Furthermore, considering that developed countries, which are traditionally conceived as countries of residence, have led the development of international tax norms,²⁶⁰ the developed countries might not be interested in recognizing the active nature of PEF investment, which would presumably result in the loss of their revenue. However, it would be hasty to presume that the revenue effect of alternatives would be as such. Developed countries, such as the United States and those in the European Union, are not necessarily the residence countries in PEF investment, as demonstrated in Part II.

The discourse of the nature of PEF investment has already begun, not only in developing countries or host countries where portfolio companies are located, but also in developed countries, such as the United States, although the discourse is still limited to domestic tax issues. It is worth studying this issue further in the international context since the *Sun Capital* case recognized the active business feature of PEF in domestic tax environment.²⁶¹ In this part, I present an in-depth analysis of the important issues in international tax that the alternative perspective toward PEF investment would implicate. Part VI includes a more detailed analysis on revenue effects.

²⁵⁹ My argument is different from that of the group of scholars who try to reformulate the consensus in international tax; that is, the series of scholarship discussing the superiority of either source or residence as criteria of tax jurisdiction. Some argue in favor of pure residence-based tax; some emphasize the appeal of source-based tax by criticizing the criteria of residence as inappropriate. *See supra* notes 164–66. However, my approach is distinguished from those scholars because I do not directly attack either of the criterions. Instead, I reveal the hidden nature of the facts in PEF investment and urge for the application of the extant rule more accurately. At the end of the day, my approach would lead to strengthening source-based taxation by pushing the line for the benefit of source countries. However, my approach is more focused on interpreting the fact rather than evaluating the rule.

²⁶⁰ Yariv Brauner, *An International Tax Regime in Crystallization*, 56 TAX L. REV. 259, 307 (2003) (providing that developed countries and the OECD have led the international tax norms through bilateral tax treaty practice).

²⁶¹ *Sun Capital Partners III LP v. New England Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129 (1st Cir. 2013).

A. *How to Justify Strengthening Source-based Taxation?*

Policy alternatives that recognize the hybrid nature of PEF investments could lead to strengthening source-based taxation as opposed to the status quo, because the investors' income would be treated as active income that would be taxed primarily by the country of source, rather than as passive income that would have been taxed primarily by the country of residence.

The traditional view that treats the income of PEF investors as passive would be rooted in the view that, in addition to the tax consequences of PEFs or its investors, takes the corporate tax to be paid by portfolio companies located in the host country into account.²⁶² Proponents of this view might argue that because portfolio companies have paid corporate tax on their profits derived from the active business performed in the host country, profits extracted from the investment in portfolio companies — such as capital gains when investors sell the stock, and dividends — are passive and thus taxed as passive income. These proponents might ask why we should impose another layer of source-based taxation on the profits earned by investors solely because the fund (or the pass-through vehicle) is arguably treated as active, while we already impose source-based taxation on the profits created by portfolio companies.

Such criticism relates to the question of how to justify source-based taxation on the fund's income paid by portfolio companies, and to what extent. This subpart examines such justification for GPs' income and LPs' income in turn, assuming that GPs and LPs are foreigners of the host country.

1. GP: Manipulating the Fund's Income and Eroding the Tax Base of Portfolio Companies

Portfolio companies pay two types of returns to PEFs: one is the return of labor (i.e., management service) performed by the PEF's personnel, and the other is the return of capital injected by PEFs. A GP receives both types of return. From the nontax perspective, a large extent of such income relates to the return of labor. Due to tax loopholes, however, carried interest converts the return of labor, or ordinary income, into the return of capital, or capital gains.²⁶³ Such conversion of the return's character could manipulate the source of income in international tax and thus harm source-based taxation in the host country.²⁶⁴

²⁶² I am indebted to Professors Linda Sugin and Jeff Colon for this insight.

²⁶³ See *supra* text accompanying notes 181–200.

²⁶⁴ More precisely, it is not conclusive whether such manipulation harms the source-based taxation, because although the primary tax jurisdiction of capital gains is the residence country, the primary tax jurisdiction of labor income is not always the source country. More details are discussed *infra* in Subpart B. In brief, the country where the services are performed

Furthermore, by waiving the management fee, allocating expenses of funds to management fees, and pushing down the funds' obligation to pay management fees to portfolio companies (i.e., fee offset), PEFs strip such return to the management function out of the portfolio companies' profits.²⁶⁵ The reduced corporate tax base of the portfolio companies as such would have been subject to source-based taxation. This is an example of earnings-stripping in international tax, which is another major strategy to erode source-based taxation. The United States has taken earnings-stripping seriously and tried to restrict it by, for example, adding section 163(j) to the Code as part of the Revenue Reconciliation Act of 1989.²⁶⁶

In other words, we are observing both tax-base stripping and the conversion of character simultaneously. On both accounts, GPs are culpable for eroding source-based taxation in international tax. Therefore, it justifies expanding source-based taxation on GPs' income by treating the PEF investment as active.

2. LP: Status Enabling the PEF's Tax Game

On the LP's side, the accusation is quite different. An LP's income is purely the return of capital, which is passive investment income unless the laws of partnership and partnership tax apply. In international tax, passive income of foreign investors, such as capital gains of foreign LPs, are not generally taxed by the host country, but it will eventually be taxed (or exempted from tax) according to the law of the country where the foreign

has primary tax jurisdiction for the compensation of service. In order not to trigger source country's primary tax jurisdiction on labor income, fund managers try to provide management services offshore. However, it is often inevitable to provide the service in the host country if the fund managers are actively engaged in the operation of portfolio companies, as shown in the *Sun Capital* case. For those cases, converting the character of GP's income result in the change of primary tax jurisdiction of such income and harm source-based taxation of the host country.

²⁶⁵ Management fee waiver, expense allocation, and fee offset are GPs' strategy to reduce their compensation paid by the fund and instead to increase their compensation paid by portfolio companies. The fund has earned economic benefit because it has saved expenses due to the portfolio companies' payment to GPs and their affiliated management firms, while the portfolio companies have suffered economic loss due to such payment. See Berkowitz & Duran, *supra* note 203, at 673–74 (showing that *Sun Capital* case has noted a direct economic benefit of the fund due to the fee offset arrangement). This reduced profits of portfolio companies would have constituted corporate tax base that is payable to the source country where portfolio companies are located.

²⁶⁶ GUSTAFSON ET AL., *supra* note 208, at 288. For a recent discussion on the earnings-stripping relating to corporate inversions, see J. Clifton Fleming, Robert J. Peroni & Stephen E. Shay, *Getting Serious About Cross-Border Earnings Stripping: Establishing an Analytical Framework*, 93 N.C. L. REV. 673 (2015).

investors reside.²⁶⁷ Such nonresident status of foreign LPs is equivalent to a domestic LP's tax-exempt status in terms that both statuses enable the private equity tax game conducted by GPs. However, the policy alternatives that recognize the hybrid nature of PEF investment would change the primary tax jurisdiction of foreign LP's income from the country of residence to the country of source, because if the fund is treated as engaging in active business in the host country, both GPs and LPs are treated as engaging in such active business, resulting in the foreign LP's income being subject to the source-based taxation.²⁶⁸

Although the entire PEF and its investors (including foreign LPs) would be treated as engaging in active ToB under the law of partnership and partnership tax,²⁶⁹ LPs are not themselves actively involved in any such activities. They do not provide management service to portfolio companies, nor do they convert the character of their income or strip the earnings of the portfolio companies. The only reason LPs are responsible for the private equity tax game is because of their nonresident status availing other taxpayers of tax games and exploiting the loopholes.

In short, foreign LPs are responsible for the private equity tax game not because of their actions but because of their status. Specifically, an LP's status relates more strongly to a GP's converting the character of income, and relatively less to the GP's earnings-stripping. Despite the fact that LPs play the tax game, the justification for strengthening source-based taxation of LPs would be less convincing considering the LP's inherent passive nature. Furthermore, if such foreign LPs would eventually be taxable in the residence country, it would be more or less unreasonable to change the primary tax jurisdiction of LP's income just because of the GP's action.²⁷⁰

However, such criticism should first overcome the law of partnership and partnership tax law that attributes a GP's activity to the entire fund.²⁷¹ As long as the fund is treated as engaging in active business, income attributable to foreign LPs is also active, with the result of expanding source-based taxation. From a policy perspective, it is fair to argue that international tax law should allow residence-based taxation on an LP's portion of income even if the nature of a PEF's investment is active. However, given that PEF

²⁶⁷ Needham, *supra* note 61, at 1219–30.

²⁶⁸ *See infra* Subpart C.

²⁶⁹ *See supra* text accompanying notes 233–40.

²⁷⁰ It would be the same even if the LPs are tax-exempt in their home country, because it is the policy decision made by the residence country, which has nothing to do with the source country.

²⁷¹ *See* Unif. Ltd. P'ship Act § 402 (Unif. Law Comm'n 2013); *Johnston v. Commissioner*, 24 T.C. 920 (1955) (individual partner in Canadian partnership that invested in partnership engaged in U.S. business treated as engaged in trade or business); *Rosenthal*, *supra* note 7, at 365 n.43.

investment is treated as active ToB, it would be difficult for LPs to keep the passive nature of their income under current law as long as they take advantage of investing in a pass-through vehicle.

B. Foreign GPs: Where Are the Services Performed?

Subparts B and C examine specific international tax issues discussed in Subpart A in greater detail. Let us assume a cross-border investment by a PEF. In a case of inbound investment, the PEF acquires stocks or securities of U.S. corporations,²⁷² and the partners, including the fund manager who is a GP, are based in a foreign country. In a case of outbound investment, the PEF acquires stocks or securities of foreign corporations, and the partners, including the GP fund manager, are based in the United States. The fund manager provides management services to the portfolio companies and receives a 2% management fee and 20% carried interest from the fund. Under current law, carried interest is treated as capital gains of the fund manager, while the management fee is considered ordinary income (more specifically compensation for services). For discussion purposes, whether the PEF constitutes a ToB is ignored for now.

In a case of inbound investment, if the foreign GP's income is not effectively connected with a U.S. ToB, most of her U.S. source income is subject to a 30% flat tax on the gross amount, while her foreign source income is not subject to U.S. taxation. Most types of ordinary income other than business profits, such as "interest . . . dividends, rents, wages, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income" are subject to such 30% tax,²⁷³ and collectively referred to as "FDAP income."²⁷⁴ The Code's source determination rules regarding compensation for services hold that the income is sourced where the services are performed.²⁷⁵ Hence, if the foreign GP performs management services offshore, such income is not subject to U.S. taxation, while if she performs services in the United States, such income is subject to U.S. taxation.²⁷⁶

On the other hand, gains from the sale of U.S. personal property, including stock of U.S. corporations (i.e., capital gains), are not treated as

²⁷² Here, which country the fund has been established does not matter in most cases, because the fund is a pass-through entity and does not pay tax.

²⁷³ I.R.C. §§ 871(a) (nonresident aliens), 881(a) (foreign corporations).

²⁷⁴ GUSTAFSON ET AL., *supra* note 208, at 228.

²⁷⁵ I.R.C. §§ 861(a)(3), 862(a)(3).

²⁷⁶ If services are performed partly within and partly without the United States, compensation will be apportioned between U.S. and foreign sources. Treas. Reg. § 1.861-4(b)(1)(i) (2005).

FDAP income.²⁷⁷ Furthermore, such capital gains realized by a foreign person who was not present in the United States for 183 days or more in the tax year are not taxed even when they derive from the stock of U.S. corporations, because it is likely treated as foreign source.²⁷⁸

The analysis of the outbound investment is similar. Most countries' tax treaties and laws allocate tax jurisdiction of compensation for services to the source country, and that of capital gains to the residence country.²⁷⁹ The source of compensation is the jurisdiction where the services are performed, while that of capital gains arising from the stock sale is where the taxpayer resides.

Therefore, if the proposals on carried interest to tax compensation as ordinary income were enacted as law, the question of where the services are performed would necessarily follow.

Traditionally, fund managers try to perform services in their home country and avoid performing services in the host country by not staying 183 days or more in the host country in a given year.²⁸⁰ This is intended to avoid the source rule of compensation for their management fee portion, as well as to avoid becoming a tax resident of the host country for their carried interest portion. However, it is often inevitable to provide their services in the host country if the fund managers are actively engaged in the operation of the portfolio companies, in which case both the GP's management fee and carried interest would be subject to the host country's taxation.

C. Foreign LPs

1. Effectively Connected Income with a Trade or Business

Let us assume that foreign LPs invest in a PEF, which acquires stocks or securities of U.S. corporations.²⁸¹ When the PEF sells the stocks or securities of portfolio companies, capital gains realized by foreign investors are treated as passive investment income under current law, so that they are generally not taxed even when they derive from the sale of the U.S. corporations' stock.²⁸² In the language of international tax, capital gains realized by the PEF and then attributed to foreign LPs are not effectively connected with a

²⁷⁷ Treas. Reg. § 1.1441-2(b)(2)(i) (2017).

²⁷⁸ GUSTAFSON ET AL., *supra* note 208, at 261 n.1.

²⁷⁹ See, e.g., U.S. Model Income Tax Convention, Feb. 17, 2016, art. 14, 15; *supra* text accompanying notes 275, 278.

²⁸⁰ See, e.g., U.S. Model Income Tax Convention, Feb. 17, 2016, art. 14, 15.

²⁸¹ Here, which country the fund has been established does not matter in most cases, because the fund is a pass-through entity and does not pay tax.

²⁸² Needham, *supra* note 61, at 1230.

U.S. ToB, and thus they are not generally taxed.²⁸³ That income will eventually be taxed according to the tax law of the country where the foreign LPs reside.

However, if such capital gains are effectively connected income (ECI) — that is, connected with the conduct of a ToB within the United States — they are subject to U.S. taxation at the usual tax rates.²⁸⁴ The term ECI in international tax generally refers to the income arising from active business activities, or ToB.²⁸⁵ In other words, active business income, or ECI with the U.S. ToB, is subject to the U.S. taxation, whereas passive investment income is subject to the taxation of the residence country. This U.S. international tax rule accords with the active/passive distinction in international tax norms.²⁸⁶

If the fund is treated as engaging in a ToB within the United States, the current tax position of foreign LPs that their capital gains are not ECI would be endangered. When a GP's active management of the portfolio companies on behalf of the partnership is attributable to the partnership, the partnership is treated as engaging in ToB.²⁸⁷ Furthermore, once the partnership is determined to conduct a ToB in the United States, each partner — whether LP or GP — is deemed to be engaged in the U.S. ToB.²⁸⁸ Therefore, if a PEF is treated as a ToB, foreign LPs would also be treated as conducting a U.S. ToB, with the result that their income would be ECI and no longer exempted from U.S. taxation.

However, there is a safe harbor even if an investor is considered to have a U.S. ToB. When an “investor” holding stocks and securities is determined to have a ToB, such investor usually wants to be treated as a “trader” of stocks and securities, which is a slightly more active type of stock holder than an investor.²⁸⁹ The Code provides foreign taxpayers with a safe harbor for

²⁸³ GUSTAFSON ET AL., *supra* note 208, at 261. However, if the foreign person was present in the United States for 183 days or more during the taxable year, the capital gains are subject to 30% tax. I.R.C. § 871(a)(2).

²⁸⁴ I.R.C. § 871(b)(1). Here, the net income, not the gross amount, is subject to tax. To explain more technically, gains from the sale of U.S. personal property, including stock of U.S. corporations (i.e., capital gains) are not treated as FDAP income. Treas. Reg. § 1.1441-2(b)(2)(i) (2017). Furthermore, non-ECI capital gains realized by foreign person who was not present in the United States for 183 days or more are not taxed even when they derive from U.S. sources, because it is likely treated as foreign source. (Sometimes, source is determined by the taxpayers' residence.) However, if capital gains are ECI with U.S. ToB, it is likely to be treated as U.S. source, subject to U.S. tax at usual tax rates.

²⁸⁵ I.R.C. §§ 871(b)(1), 882(a)(1).

²⁸⁶ See *supra* text accompanying notes 127–30.

²⁸⁷ See *supra* text accompanying notes 233–40.

²⁸⁸ I.R.C. § 875(a).

²⁸⁹ For three classes of stock holders, see *supra* note 214. Traders' activities are more active than those of investors in terms that they have a ToB, but stocks and securities held by both investors and traders are considered as capital assets. Both earn income from the

trading stocks or securities (“trading safe harbor”) under which the foreign person will not be considered to be engaged in the U.S. ToB.²⁹⁰

Traditionally, the foreign investors in PEF have asserted that they qualify for the trading safe harbor, so that regardless of whether the fund is treated as having a U.S. ToB, their investment income from PEF would not be ECI and would be exempted from U.S. taxation. However, whether the trading safe harbor would protect the investment activities of PEFs is no longer certain because of a recent IRS opinion. In January 2015, the IRS released a Chief Counsel Advice (CCA) memorandum, which concluded that an offshore PEF was engaged in a ToB in the United States as a consequence of the fund’s lending and underwriting activities, which were conducted on behalf of the offshore fund by a fund manager based in the United States.²⁹¹ The CCA memorandum rejected the application of the trading safe harbor because it found that the nature of the fund’s business was (active) lending and underwriting activities, and that “those activities were neither investment activities nor trading in stocks or securities.”²⁹²

The CCA memorandum provides some insight into the overarching argument of this article. First, the U.S. tax authorities would be more comfortable and ready to recognize in tax cases that the entire PEF would be engaging in a U.S. ToB if the GP were involved in active business. Second, the type of ToB conducted by the GP and the PEF would be determined by the nature of such activity, rather than simply classified as trading stocks or securities.

This case suggests that by recognizing PEF as a ToB, the United States could raise its revenue as a source country in the case of inbound investment. In contrast, the revenue could decrease in outbound investment cases, where the United States would be a residence country. However, the United States is the largest destination market of private equity investment, absorbing more than 40% of private equity investment worldwide.²⁹³ That is, unlike the traditional notion that the United States is a country of residence, it is more likely a country of source in PEF investments. Thus, the policy alternative of treating PEF as a ToB could raise U.S. revenue in the aggregate. These

appreciation of the stock price. Dealers are the most active class of stock holders. They earn income not from the appreciated stock, but from the fees or mark-ups in excess of the stock price.

²⁹⁰ I.R.C. § 864(b)(2)(A)(ii).

²⁹¹ I.R.S., *supra* note 17.

²⁹² *Id.* at 23. The CCA memorandum added that even if the fund’s lending and underwriting activities constitutes trading activities, the fund would not have qualified for the Trading Safe Harbor, because (i) the fund manager acting as an agent of the fund had discretionary authority, and (ii) its underwriting activities made the fund a dealer in stocks and securities rather than a trader. *Id.* at 15–23.

²⁹³ See *supra* text accompanying Table 1.

revenue effects will be discussed further in Part VI.

2. Effect of Tax Treaty – Permanent Establishment

What if there is a tax treaty between the source country where a PEF has a ToB and the residence country where LPs reside? Section 894(a)(1) of the Code states that the Code applies “to any taxpayer with due regard to any treaty obligation of the United States which applies to such taxpayer.”²⁹⁴ Since most U.S. persons’ cross-border investment and business activities are engaged in foreign countries with which the United States has entered into bilateral tax treaties, treaty analysis is almost always necessary to complete the U.S. international tax analysis.²⁹⁵

If a foreign taxpayer derives ECI from a U.S. ToB, the net income is subject to U.S. taxation at the usual rate. However, tax treaties provide that such business income is not subject to the U.S. taxation unless the foreign taxpayer carries on the U.S. ToB through a “permanent establishment” (PE) to which the income is attributable.²⁹⁶ A PE is defined as a fixed place of business through which the business of a foreign enterprise is carried on.²⁹⁷ Income attributable to a PE is subject to tax in the source country. Thus, generally speaking, income attributable to a PE under tax treaties is equivalent to ECI for a U.S. ToB under the Code, which describes active business income in international tax. With respect to the income not effectively connected with a U.S. ToB, the foreign taxpayer is not considered to have a PE in the United States.²⁹⁸

Thus, if a PEF is treated as engaging in U.S. ToB, such income may be considered ECI and attributed to the PE in the United States under tax

²⁹⁴ I.R.C. § 894(a)(1).

²⁹⁵ GUSTAFSON ET AL., *supra* note 208, at 181.

²⁹⁶ *See, e.g.*, U.S. Model Income Tax Convention, Feb. 17, 2016, art. 5 (Permanent Establishment), 7 (Business Profits).

²⁹⁷ Article 5 of the U.S. Model Income Tax Treaty provides that a PE can be found when there is a fixed place of business through which the business is carried on. *See id.* at art. 5(1). This includes a place of management, a branch, an office, a factory, a workshop, etc., while it excludes such fixed place of business from PE if its overall activities are only preparatory or auxiliary. *See id.* at art. 5(2), (4).

Furthermore, if an agent in the United States is acting on behalf of a foreign enterprise and has and habitually exercises in the United States an authority to conclude contracts that binds on the enterprise, that foreign enterprise is deemed to have a PE. In this case, the agent herself constitutes a PE of such foreign enterprise even if the agent does not act through a fixed place of business. *See id.* at art. 5(5). However, if the agent is a broker, general commission agent, or any other agent of independent state, the agent is not treated as a deemed PE. *See id.* at art. 5(6).

²⁹⁸ I.R.C. § 894(b).

treaties. Then the income flows through to non-U.S. investors,²⁹⁹ making them subject to U.S. tax and resulting in less favorable tax consequences for foreign LPs.³⁰⁰ However, under the traditional tax position, neither the fund nor foreign LPs are considered to earn active business income, which impedes further analysis of PE in the cross-border investment by PEFs.

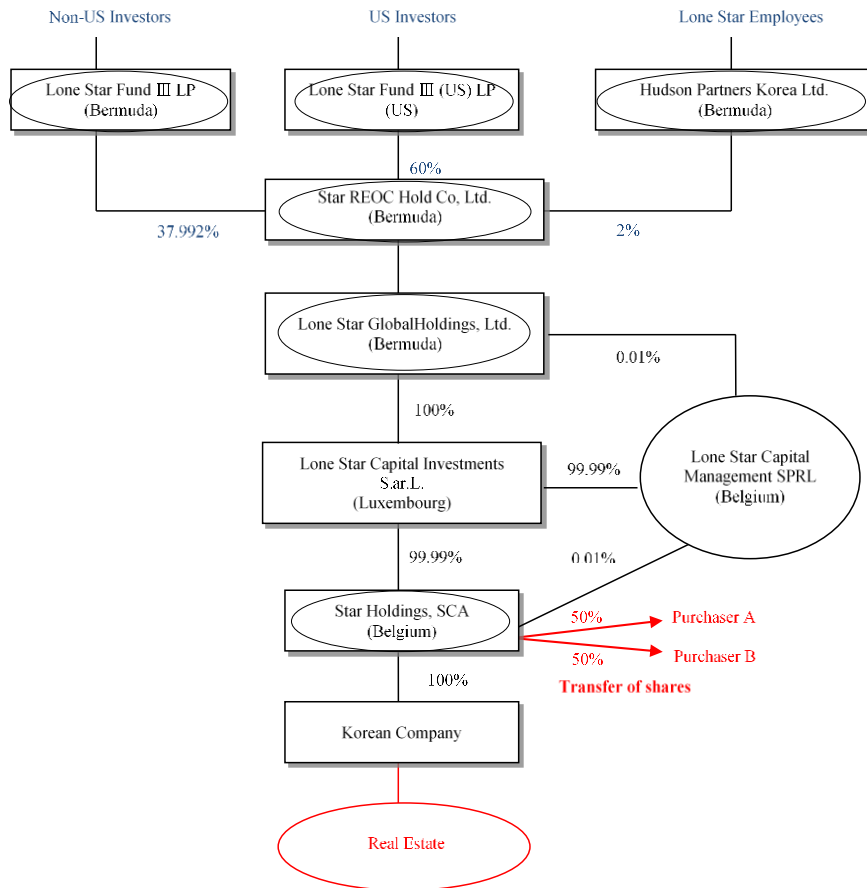
Nonetheless, the question of whether a PEF conducting cross-border investment could have a PE in the source country has been repeatedly discussed in tax cases relating to PEF in foreign countries, such as the *Loan Star Fund* case³⁰¹ and the *Standard Chartered Bank* case (involving Newbridge Capital Group L.L.C.)³⁰² in South Korea.

²⁹⁹ If a partnership operates a business through a PE, the tax consequences of such partnership are generally attributable to partners as if each partner had the PE. Rev. Rul. 90-80, 1990-2 C.B. 170.

³⁰⁰ I.R.C. §§ 871(b), 882; see Rosenthal, *supra* note 143, at 1469; see also McBurney, *supra* note 143.

³⁰¹ Supreme Court [S. Ct.], 2010Du5950, Jan. 27, 2012 (S. Kor.).

³⁰² Seoul Administrative Court [Seoul Admin. Ct.], 2008Guhap17110, Dec. 30, 2009, *aff'd*, Seoul High Court [Seoul High Ct.] 2010Nu3826 (2010), *rev'd*, S. Ct., 2010Du20966 (2013) (S. Kor.). The permanent establishment issue was discussed at the Seoul Administrative Court level.

FIGURE 6. STRUCTURE OF THE *LONE STAR* FUND CASE³⁰³

VI. REVENUE EFFECTS OF THE ALTERNATIVES

This Part discusses possible revenue effects when two different alternatives to the taxation of PEF apply instead of the status quo, where all PEF profits are treated as passive investment income (scenario 1).³⁰⁴ Recasting carried interest from capital gains into ordinary income as compensation is the first representative alternative (scenario 2), and treating the PEF's entire profits — regardless of the GP's share or LPS' share — as ordinary income arising from ToB is the second representative alternative (scenario 3).

Starting from the domestic revenue effects of the two alternatives, this part expands the analysis to the international tax environment to examine

³⁰³ Supreme Court [S. Ct.], 2010Du5950, Jan. 27, 2012 (S. Kor.).

³⁰⁴ This Part ignores management fees to simplify the analysis.

how the revenue of each country would be affected by each alternative. Since multiple fiscs are involved in international tax, it is important to recognize which fisc is losing in the international PEF investment. This helps to explain the motivation and reaction of relevant countries to the reform alternatives.

The Tax Cuts and Jobs Act of 2017 is not likely to change the analysis in this Part. As to the domestic analysis, the Tax Cuts and Jobs Act of 2017 introduces the three-year holding period for carried interest, which may not effectively close the current loophole.³⁰⁵ It further reduces the effective tax rates for partnership income by allowing partners to deduct an amount equal to 20% of certain qualified business income (QBI) from a ToB conducted by a partnership.³⁰⁶ This new deduction only applies to income from a ToB, which does not include income earned as an employee or payment for services rendered, and phases out if taxable income is above a specific amount.³⁰⁷ Since GPs' income is either paid as an employee or likely to be above the specific amount, and LPs are mostly tax-exempt, the new QBI deduction appears to be irrelevant.³⁰⁸

As to the international analysis, the United States was — until recently — one of the few OECD countries that used a worldwide system of international taxation where a U.S. resident corporation was subject to U.S. taxation on all its active income earned abroad or domestically.³⁰⁹ The Tax Cuts and Jobs Act of 2017 changed the worldwide system to a territorial system. Under this international tax system, dividends received by a U.S. corporation from foreign subsidiaries in which the U.S. corporation has at least a 10% interest are generally exempted from tax.³¹⁰ However, this so-

³⁰⁵ See *supra* Part IV.A.

³⁰⁶ Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, §11011, 131 Stat. 2054, 2063–71 (2017) (codified as amended at I.R.C. §199A).

³⁰⁷ I.R.C. § 199A(c), (d). For 2018, the QBI deduction starts phasing out if taxable income is above \$157,500 for a single taxpayer and \$315,500 for a married couple filing jointly, and phases out in full if taxable income is above \$207,500 for a single taxpayer and \$415,500 for a married couple filing jointly. I.R.C. § 199A(d)(3).

³⁰⁸ However, since the eligibility of the new pass-through tax rate is susceptible to tax games, there might be a creative way for LPs and GPs to further exploit the new QBI deduction, which is beyond the scope of this article. See, e.g., David Kamin et al., *The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the New Legislation* (Dec. 7, 2017), <https://ssrn.com/abstract=3084187>.

³⁰⁹ In 2015, all but seven OECD countries (Chile, Ireland, Israel, Mexico, Poland, South Korea, and the United States) have adopted a territorial system for taxing corporations' foreign active earnings. Rosanne Altshuler et al., *Lessons the United States Can Learn from Other Countries' Territorial Systems for Taxing Income of Multinational Corporations*, TAX POL'Y CTR., URB. INST. & BROOKINGS INST. 10 (Jan. 21, 2015), <http://www.taxpolicycenter.org/UploadedPDF/2000077-lessons-the-us-can-learn-from-other-countries.pdf>.

³¹⁰ Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, §14101, 139 Stat. 2054, 2189–92

called participation exemption rule does not apply to dividends received by noncorporate taxpayers, such as PEFs and their individual partners.³¹¹ Therefore, it is not likely to matter substantially whether a home country has a worldwide tax system or territorial tax system when analyzing the international revenue effects of the above three scenarios.³¹²

A. Domestic Effects: GP's Carried Interest and Tax-Exempt LPs

Current reform proposals on carried interest mostly focus on the GP's activity and the character of its income — capital gains vs. ordinary income as compensation. However, it is important to note that, unless LPs are tax-exempt, converting the character of carried interest only relates to the distribution of tax on a given PEF income among LPs and GPs, and does not affect the overall revenue.³¹³ In other words, since most LPs are tax-exempt, the conversion of ordinary income as compensation into capital gains as carried interest results in the loss of revenue. Below is an example demonstrating such revenue effects, which is developed from the example that Polsky demonstrated in his recent paper.³¹⁴

Assume that a private equity fund realizes \$100 in capital gains (CG) and pays \$20 in carried interest to the GP in Scenario 1, where all PEF income is treated as passive investment income. Assume further that CG are taxed at a 20% rate and ordinary income (OI) is taxed at a 40% rate³¹⁵ in Country A, where all LPs, GP, managers, and the portfolio company (PC) are located. Capital loss (CL) can only offset CG, and ordinary deduction (OD) can offset OI, so CL can save tax at a 20% rate and OD can save tax at a 40% rate. The GP obtains \$20 CG (20% of \$100), subject to \$4 of tax (20% x \$20), and the

(2017) (codified as amended at I.R.C. § 245A).

³¹¹ Factor & Fedida, *supra* note 10, at 5–6.

³¹² First, the fund is a partnership or pass-through vehicle, so it is not subject to the corporate tax system where the distinction between worldwide and territorial matters. Second, a substantial portion of investors are tax-exempt entities in their home countries. Third, managers who pay tax to home countries are subject to individual income tax, which does not differ in either territorial or worldwide tax system.

³¹³ Polsky, *supra* note 11, at 4.

³¹⁴ *Id.* at 4–5. The numbers of income and losses are the same as the example used in Polsky's paper. However, the revenue analysis with specific tax rate is done by the author. Although Polsky argues that by converting the incentive fee to carried interest managers win, the investors do not lose because of their tax indifference, and only the fisc loses on an overall, net basis, he does not clearly show the revenue effects caused by such conversion, which inspires the author to conduct that analysis.

³¹⁵ The example assumes a 40% tax rate based on the top marginal tax rate of 39.6% under previous tax law. The Tax Cuts and Jobs Act reduced the top marginal tax rate to 37%, effective January 1, 2018. To keep the examples simple, this article continues to assume a 40% tax rate for ordinary income and deduction.

LP obtains the remaining \$80 CG. If LPs are taxable, they are subject to \$16 of tax (20% x \$80), and the total revenue would be \$20. However, since LPs are tax-exempt, LP is not obliged to pay \$16 of tax, and the total revenue would be only \$4.

In scenario 2, assume the same, but here the fund pays \$20 as compensation for services to the GP. The GP obtains \$20 OI, subject to \$8 of tax (40% x \$20). However, the LPs earn \$100 CG (100% of \$100 profits). If LPs are taxable, then they would be subject to \$20 of tax on that income (20% x \$100), but they should pay \$20 compensation to GP, resulting in \$20 of OD. Assuming that LPs have plenty of OI from other sources to use the entire \$20 OD, this OD saves the LPs \$8 of tax (40% x \$20). The total revenue would be the same \$20 as in scenario 1. However, since LPs are tax-exempt, tax consequences of the LPs should be ignored, resulting in \$8 of total revenue.

TABLE 4. REVENUE ANALYSIS (DOMESTIC)

	GP's income	GP's tax consequences (①)	LPs' income	LPs' tax consequences (②)		Total tax revenue (=① + ②)
Scenario 1: Carried Interest as CG	\$20 CG	\$4 tax	\$80 CG	LPs are tax-exempt	-	\$4 (③)
				If LPs are taxable	\$16 tax	\$20 (④)
Scenario 2: Carried Interest as Compensation (OI)	\$20 OI	\$8 tax	\$100 CG & (\$20 OD)	LPs are tax-exempt	-	\$8 (⑤)
				If LPs are taxable	\$20 tax & \$8 tax saving	\$20 (⑥)
Scenario 3: All profits are from active business income	\$20 OI	\$8 tax	\$100 OI & (\$20 OD)	LPs are taxable	\$32 tax	\$40 (⑦)

Comparing scenarios 1 and 2 shows that if the LPs are taxable, then changing the character of compensation to carried interest would cause different tax consequences for the GP than the LPs. This change benefits the GP and harms the LPs, but the total revenue would be the same (compare ④ and ⑥). However, if the LP is tax-exempt, tax benefit and detriment do not precisely offset each other because of the tax-indifference of the LPs. The character swap benefits the GP by reducing tax from \$8 to \$4, while the LPs

are neutral in tax liability due to its tax-indifferent status. Only the revenue reduces by the amount that the GP obtains in tax benefits (compare ③ and ⑤).

This example shows that the carried interest loophole is substantially attributed to the tax-exempt LPs.³¹⁶ However, the solution of the current reform proposals is likely to recast carried interest into ordinary income and increase the GP's tax amount, say from \$4 to \$8 in the above example. Yet, it does not consider whether the role of the LPs and their tax-exempt status in the private equity tax game is justified.

Then, what if PEF is a ToB and all profits are treated as ordinary income (scenario 3)? The GP obtains \$20 OI, subject to \$8 of tax (40% x \$20). LPs earn \$100 OI (100% of \$100 profits) and \$20 OD, resulting from the \$20 compensation to GP. LPs would no longer be tax-exempt because all PEF profits are OI. Therefore, LPs are subject to \$32 of tax (40% x \$80).

In addition to the common recovery of the \$20 revenue due to the recapture of the LP's income as UBTI, the fisc additionally wins by \$12 and \$16, respectively, compared to scenarios 1 and 2 (compare ③ and ⑦, and ⑤ and ⑦). The revenue effect in scenario 3 relative to scenarios 1 and 2 is much more significant than the difference between scenarios 1 and 2. In sum, total revenue is worse off as income arising from PEF investment is treated more as passive income, and it is even further worse off compared to the hypothetical total revenue where LPs are taxable.

B. International Effects

As to the example in Subpart A, it is fair to say that the overall revenue effects rely on the tax policy of Country A, so that the fisc is responsible for the loss caused by its own tax policy. It is capable of fixing the system at will. On the other hand, in the cross-border investments by PEFs, there are multiple fiscs involved, which means that the fisc that allows the carried interest loophole and the exemption status of the investors is different from the fisc that loses the revenue due to the PEF tax policy.

To compare the above three scenarios in the international domain, assume now that all LPs are tax-exempt entities located in Country A, while the PC is located in Country B. The GP and the fund managers are also residents of Country A, but they conduct the investment activities, including their service at the board of the PC, in Country B. There is a tax treaty between Countries A and B, whereby capital gains are taxed by the residence country or home country only, and compensation for service or employment is taxed by the country where the service or employment is exercised. Both countries tax CG at a 20% rate and OI at a 40% rate. Assuming that LPs have

³¹⁶ Polsky, *supra* note 11, at 5.

plenty of OI from other sources to use the entire \$20 OD, the OD saves the LPs \$8 of tax (40% x \$20).

TABLE 5. REVENUE ANALYSIS (INTERNATIONAL)

		Income subject to Country A's Taxation (Residence Country)	Revenue of Country A (①)	Income subject to Country B's Taxation (Source Country)	Revenue of Country B (②)	Total worldwide revenue (=①+②)
Scenario 1: Carried Interest as CG (All profits are passive income)	LPs are tax-exempt	GP: \$20 carried interest (CG) → \$4 tax LPs: \$80 CG → no tax	\$4 (③)	No income, no tax	0 (④)	\$4 (⑤)
	If LPs are taxable	GP: \$20 CG → \$4 tax LPs: \$80 CG → \$16 tax	\$20 (⑥)	No income, no tax	0 (⑦)	\$20 (⑧)
Scenario 2: Carried interest as Compensation (OI)	LPs are tax-exempt	LPs: \$100 CG & \$20 OD → no tax	0 (⑨)	GP: \$20 OI → \$8 tax	\$8 (⑩)	\$8 (⑪)
	If LPs are taxable	LPs: \$100 CG & \$20 OD → \$12 tax	\$12 (⑫)	GP: \$20 OI → \$8 tax	\$8 (⑬)	\$20 (⑭)
Scenario 3: All profits are from active business income	LPs are taxable	No income, no tax	0 (⑮)	GP: \$20 OI → \$8 tax LP: \$80 OI → \$32 tax	\$40 (⑯)	\$40 (⑰)

In the first scenario, where all profits are treated as capital gains derived from passive investment, Country B does not collect any revenue from this investment. Country A would collect \$20 tax from this investment if the LPs were taxable (\$16 tax from the income of LPs and \$4 tax from carried interest), but it can only collect \$4 from carried interest.

In the second scenario, where carried interest is treated as ordinary income for services, Country B can collect \$8 tax from carried interest. However, Country A does not collect any tax from the income of the tax-exempt LP, while it could collect \$12 tax if the LPs were taxable and had plenty of OI from other sources to use the entire \$20 OD.

In the third scenario, where all profits of the PEF are active business income, Country A does not collect any tax, while Country B exercises primary tax jurisdiction on all income from this active business and collects \$40 in tax revenue.

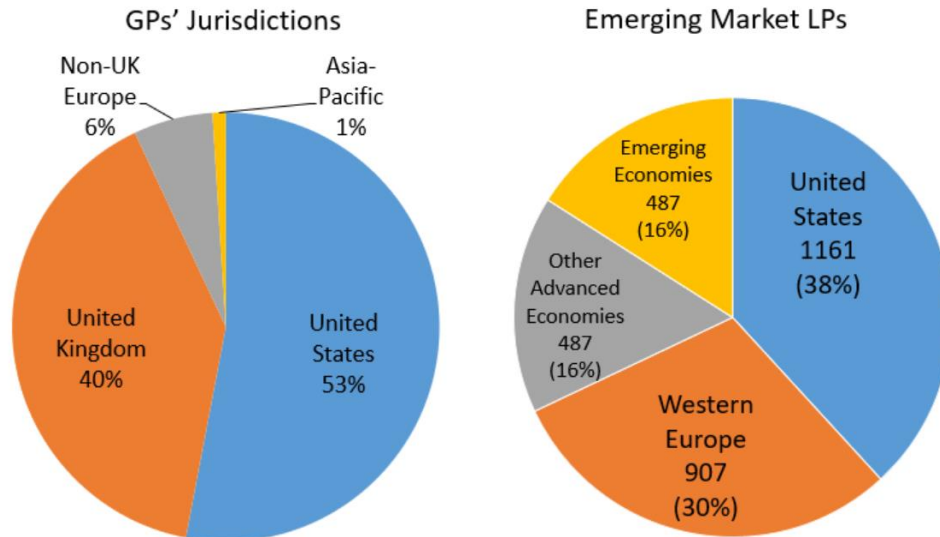
Country A (the home country) is losing more revenue as more income arising from private equity investment is treated as active or ordinary income (compare ③, ⑨, and ⑮), while Country B (the host country) is losing more revenue as more income arising from private equity investment is treated as passive investment income (compare ⑯, ⑩, and ④). However, both countries' tax benefits and detriments do not offset each other because of the tax-indifference of the LPs. For example, while Country B would gain \$8 more revenue by moving from scenario 1 to 2, Country A would lose only \$4 of revenue (compare ⑩ and ③).

In addition, total worldwide revenue is also worse off as income arising from private equity investment is treated more as passive income (compare ⑰, ⑪, and ⑤). It is even further worse off when compared to the hypothetical worldwide revenue where LPs are taxable (compare ⑧ and ⑤, and ⑭ and ⑪).

As such, the issue of fiscs losing in the private equity tax game becomes more complicated in the international domain. If it were a single jurisdiction case in Subpart A, the relevant government may control whether it would fix the policy or endure the revenue loss for the sake of other policy goals, such as promoting exempt organizations or attracting more foreign investment. However, in the international domain, the government pursuing such other policy goals is different from the government suffering from the resulting revenue loss. Furthermore, because of the tax-indifferent investors, a home country is less susceptible to the private equity tax games, while a host country is more susceptible to them. This phenomenon is not limited to the issues of the character of carried interest or the active/passive nature of private equity investment. The monitoring fee offset, interest deductions, and debt push-downs to PCs also harm the revenue of host countries, whereas the home countries are less susceptible as long as the LPs are tax-indifferent.

Whether the alternatives to the PEF taxation would negatively affect the U.S. tax revenue is not certain. Some would prefer the status quo in scenario 1 if they consider the United States as the traditional country of residence as shown in Figure 6.

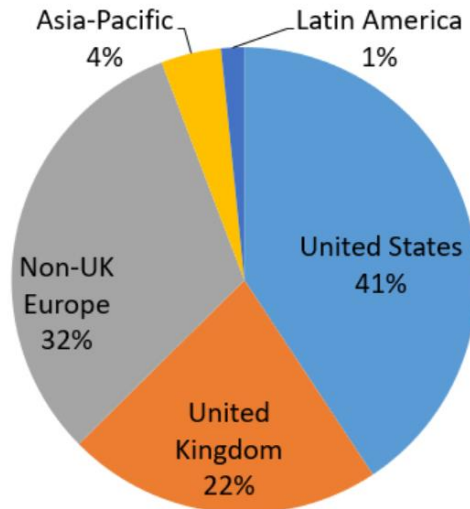
FIGURE 6. GPs' JURISDICTIONS AND EMERGING MARKET LPS' JURISDICTIONS³¹⁷



However, it would be hasty to presume the revenue loss of the United States, because it is necessary to take into account bilateral cashflows in order to determine the precise revenue effect. In fact, developed countries are major source countries as well as major residence countries in the PEF industry. Figure 7 shows the rank of source countries where international PEF investments are deployed. Advanced economies, such as the United States and the United Kingdom, are dominant source countries in PEF investment.³¹⁸ Hence, the precise revenue effect of any given country is theoretically indeterminate, to the extent that a country, like the United States, is simultaneously acting as a residence and source country.

³¹⁷ This chart was created using Table 1 and Figures 3 and 4.

³¹⁸ The United States is the largest destination market, absorbing 41% of private investment worldwide, followed by the United Kingdom and non-U.K. Europe. See text accompanying *supra* note 82, Table 1.

FIGURE 7. DESTINATION MARKET (SOURCE COUNTRIES)³¹⁹

This Subpart has conducted a numerical exercise on a marginal revenue effect among relevant countries. This article further urges experts to conduct empirical studies on the macroeconomic revenue effects of the PEF tax reform by incorporating data on bilateral cash flows. The result is theoretically ambiguous. However, because traditional residence countries with advanced economies are source countries at the same time, it is expected that determining the true nature of PEF investments and reforming PEF tax accordingly would increase worldwide revenue without significantly reducing the revenue of traditional residence countries.

More fundamentally, scenarios 2 or 3 are normatively superior in light of international tax theory. These alternatives allocate tax jurisdiction more accurately than the status quo because they envisage the nature of PEF investment more squarely in the cross-border context. However, the policy choice between scenarios 2 and 3 would not be simple, due to the conflicting policy goals for LPs. In that regard, the tax effect analysis in this subpart provides a guideline for the government to perform revenue cost analysis of those alternatives.

³¹⁹ This chart was created using data from Table 1.

VII. CONCLUSION

PEF investment has been treated as a passive portfolio investment despite the fact that it acquires at least 10% equity of portfolio companies, which is seemingly active. The true nature of PEF investment is in fact hybrid: a PEF seeks to acquire control over portfolio companies, just like active direct investment does, while it uses a pass-through vehicle subject to partnership tax, thereby taking the form of passive investment.

The goal of partnership tax is to achieve tax neutrality between direct and indirect investment by not imposing entity-level taxation. Current tax law on PEFs does not perfectly accomplish this tax neutrality because a PEF converts the active business income into passive investment income. However, the flaws could be cured by modifying the partnership tax rule applicable to PEFs, both domestically and internationally, to reflect the nature of the PEF more precisely. Finding the true nature of PEF investment and reforming PEF tax accordingly would not reduce the revenue of traditional residence countries, but it would significantly increase the revenue of source countries. Thus, the overall worldwide revenue would be expected to increase.

Given that a pass-through tax regime is the normatively proper system for taxing PEFs, the discussion of reform in this article envisions two simplified model environments: a single jurisdiction for domestic tax analysis and bilateral jurisdictions for international tax analysis. International tax norms and treaties that allocate tax jurisdiction according to active and passive distinction are also bilateral solutions. In reality, however, most cross-border investment by PEFs involves at least three countries, not two — (1) a residence country (or home country) where investors are located, (2) a source country (or host country) where portfolio companies are located, and (3) an intermediary jurisdiction where investment vehicles (and particularly holding companies) are located. Since the alternatives in this article are still confined to the bilateral model, further research of the problem in the context of the multinational environment is needed to propose a more comprehensive and effective reform.