Did Blackstone's Initial Public Offering Really Work?: A Case Study in Rules and Standards in Tax Law

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Abstract

Typically publicly-traded entities must be treated like corporations for tax purposes. Blackstone Group LP is publicly traded; yet, it is not treated like a corporation for tax purposes. Why not? Blackstone Group LP engaged in complex tax structuring in order to qualify for an exception from the typical corporate tax treatment and, in the process, saved substantial amounts in tax liability.

In response to Blackstone Group LP's structuring, members of Congress have discussed reforms that would alter the results claimed by Blackstone Group LP. This article takes a different approach. It asks whether the results claimed by Blackstone Group LP are appropriate under current law. In the process, this article also provides an example of how standards in tax law should be interpreted.

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I. Introduction

In 2007, Blackstone Group LP began trading on the New York Stock Exchange (NYSE).[1] Blackstone Group LP is an entity that earns a portion of what a firm named Blackstone receives from sponsoring various private equity funds, real estate funds and hedge funds. When Blackstone sponsors a fund, outside investors such as pension plans, educational endowments, financial institutions, and wealthy individuals agree to invest money in the fund. Blackstone selects projects and securities in which the fund will invest, and, in exchange for its efforts, Blackstone receives a management fee plus a percentage of the profits earned by the fund (referred to as "carried interest"). Blackstone Group LP is entitled to a percentage of the payments Blackstone receives by way of management fees and carried interest from the various funds that it sponsors. Thus, anyone who buys an interest on the NYSE in Blackstone Group LP is entitled to share in what Blackstone receives as a fund sponsor.

Blackstone Group LP is publicly traded; yet, unlike many publicly-traded companies, it avoids being treated as a corporation for tax purposes. Consequently, Blackstone Group LP is not required to pay corporate level tax on all of its income and saves massive amounts in tax. Blackstone Group LP benefits from this atypical tax treatment as a result of complex tax structuring that relies on many facets of tax law.

This complex tax structuring allows Blackstone Group LP to qualify for an exception from corporate tax treatment. In particular, although entities that are publicly-traded typically must be treated as corporations for tax purposes, a publicly-traded partnership is eligible for partnership tax treatment in a given year if at least 90% of the partnership's gross income consists of certain types of "qualifying income" in that year and all previous years during which the partnership was publicly traded.[2] "Qualifying income" includes dividend income,

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[1] The Blackstone Group L.P., Registration Statement (Form S-1) (Mar. 22, 2007) available at http://www.sec.gov/Archives/edgar/data/1393818/000104746907002068/a2176832zs-1.htm [hereinafter Blackstone S-1]. For further discussion of the tax structuring used by Blackstone Group LP, *see*, *e.g.*, Victor Fleischer, *Taxing Blackstone*, 61 TAX L. REV. 89 (2008).

[2] IRC Section 7704(a) (providing general rule that publicly-traded entities must be treated like corporations); 7704(c) (providing exception).

interest income, capital gain income, and other types of investment income.[3]

Without complex structuring, Blackstone Group LP likely would fail this 90% gross income test. The income it earns consists of management fees and carried interest received by Blackstone from the funds that it sponsors. Management fees are not qualifying income. Carried interest may be, in part, qualifying income but, in part, non-qualifying income depending on the types of activities in which Blackstone's funds engage, as discussed in more detail below. Thus, without complex structuring, Blackstone Group LP would earn some qualifying income (a portion of its carried interest) and some non-qualifying income (management fees and a portion of its carried interest). If, in a given year, less than 90% of Blackstone Group LP's total gross income was qualifying income, Blackstone Group LP would be treated as a corporation in that year and in all future years.[4]

Absent complex structuring, failing the 90% gross income test would be quite likely, judging from Blackstone Group LP's actual historical earnings. For example, according to its most recent annual report, in 2011, Blackstone Group LP earned $1.8 billion in management fees and $1.2 billion in carried interest.[5] As a result, even assuming all carried interest was qualifying income, Blackstone Group LP would have failed the 90% gross income test because only 40% (or $1.2 billion divided by (1.2 billion + 1.8 billion)) of its gross income would have been qualifying income. If Blackstone Group LP were treated as a corporation, it would be required to pay corporate-level tax on all of its income (qualifying income and non-qualifying income).

To avoid this result, Blackstone Group LP does not receive management fees and carried interest directly from Blackstone's funds. Instead, Blackstone Group LP uses the structure shown in Figure 1 to ensure that it meets the 90% gross income test in all years.[6]

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[3] IRC Section 7704(d)

[4] IRC Section 7704(c). This is true assuming that Blackstone Group LP would not be entitled to relief for inadvertent failure to comply with the 90% gross income test. See IRC Section 7704(e) (describing such relief).

[5] See page 80 of 10-K.

[6] This is a somewhat simplified version of the actual structure which can be seen in Blackstone S-1 at page 11. Yet, it retains all details that are relevant to an analysis of the tax consequences. For a detailed discussion of how this structure is derived from the facts in Blackstone's registration statement, see attached Appendix.

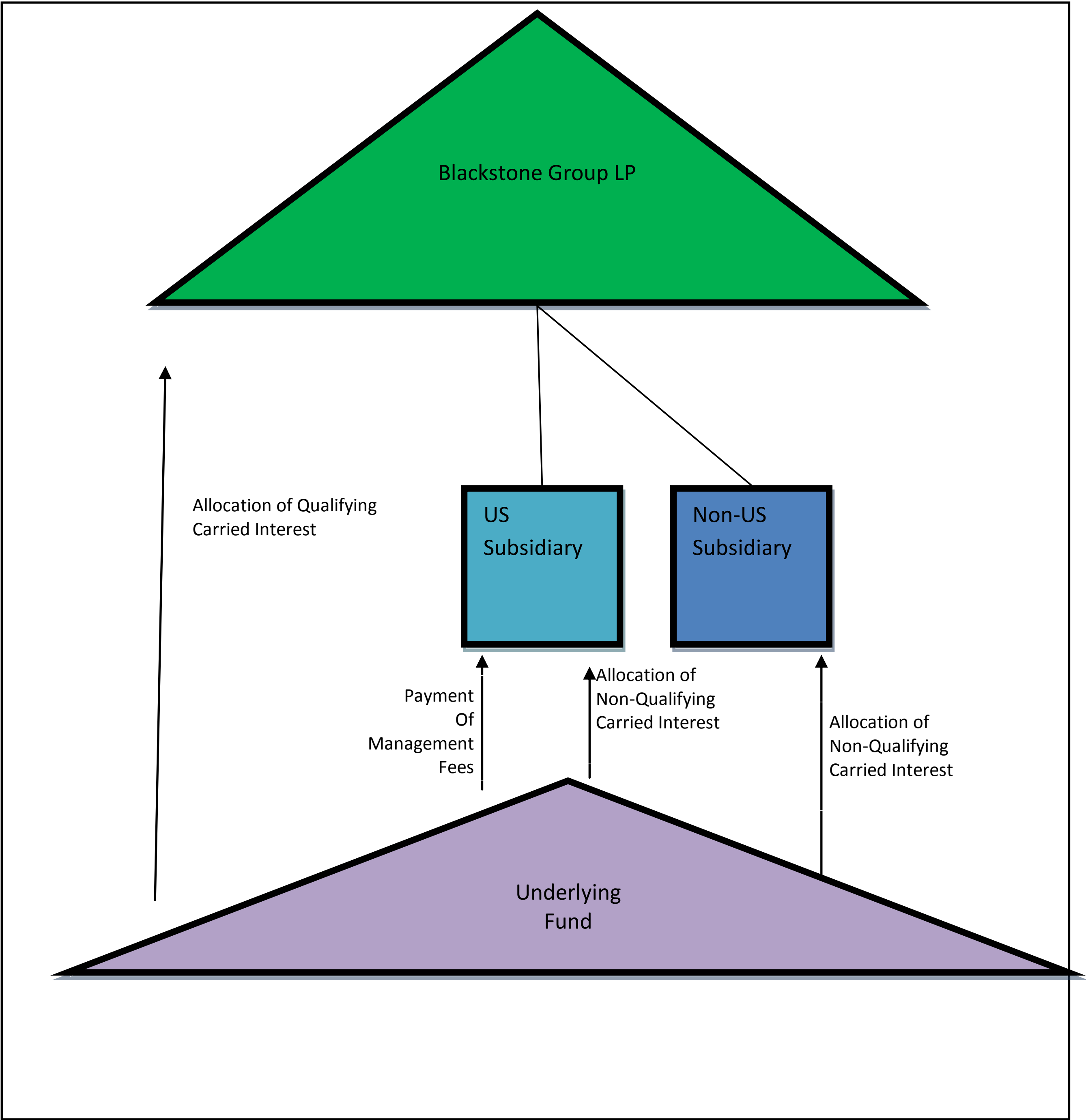

Figure 1 Blackstone Structure Simplified

In this structure, Underlying Fund is an entity treated as a partnership for tax purposes. Underlying Fund allocates qualifying carried interest income directly to Blackstone Group LP.[7] Because this income is allocated directly to Blackstone Group LP, it retains its original character, and, thus, all income Blackstone Group LP receives directly from Underlying Fund is qualifying income.[8]

Underlying Fund pays management fees and allocates non-qualifying carried interest income to either US Subsidiary (an entity formed in the US) or Non-US Subsidiary (an entity formed in Canada).[9] Both of these entities are treated as corporations for US tax purposes.[10] Because they are corporations, when these entities distribute cash to Blackstone Group LP, Blackstone Group LP recognizes dividend income or capital gain income.[11] Dividend income and capital gain income are types of qualifying income.[12] Thus, non-qualifying income allocated or paid to US Subsidiary and Non-US Subsidiary is converted into qualifying income before it reaches Blackstone Group LP.[13] As a result, Blackstone Group LP earns 100% qualifying income because its income consists of qualifying income received directly from Underlying Fund, dividend income received from US Subsidiary or Non-US Subsidiary, and capital gain income received from US Subsidiary or Non-US Subsidiary.[14] Consequently, regardless of the mix of carried interest and management fees received in any particular year, Blackstone Group LP will always qualify for the exception from corporate tax treatment because at least 90% of its income (in particular 100% of its income) will be qualifying income.[15] Finally, US Subsidiary will pay corporate level

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[7] See Blackstone S-1 pages 202-204 and attached appendix.
[8] *See infra* Part II.e.i.
[9] Blackstone S-1 pages 202-204 and attached appendix.
[10] Blackstone S-1 at pages 202-204 ("US Subsidiary" in the simplified structure is the counterpart to "Blackstone Holdings I GP Inc." and "Blackstone Holdings II GP Inc." in the actual structure, and "Non-US Subsidiary" in the simplified structure is the counterpart to "Blackstone Holdings V GP LP" in the actual structure).
[11] *See* IRC Section 301.
[12] IRC Section 7704(d).
[13] *Id.*
[14] *See supra* notes 8 and 13 and accompanying text.
[15] *See also* Blackstone S-1 at page 202 ("We intend to manage our affairs so that we will meet the [90% Gross] Income Exception in each taxable year. We believe we will be treated as a partnership and not as a corporation for U.S. federal income tax purposes. Simpson Thacher & Bartlett LLP will provide an opinion to us based on factual statements and representations made by us, including statements and representations as to the manner in which we intend to manage our affairs and the composition of our income, that we will be treated as a partnership and not as an association or publicly traded partnership (within the meaning of Section 7704 of the Code) subject to tax as a corporation for U.S. federal income tax purposes.")

tax on income it earns, so corporate-level tax is not completely avoided.[16] However, although US Subsidiary pays corporate level tax on the non-qualifying income it earns, no corporate-level tax is paid on the qualifying income allocated directly to Blackstone Group LP, and no corporate-level tax is paid on the non-qualifying income allocated to Non-US Subsidiary, as discussed in more detail below.[17] By contrast, if Blackstone Group LP did not employ this structure and were treated like a corporation for tax purposes, it would be subject to corporate level tax on all income (qualifying income and non-qualifying income).[18]

Blackstone Group LP is not the only entity that has benefited from this structure. Other private equity groups (including Fortress, KKR, and Carlyle) engaged in initial public offerings before or after Blackstone and used a similar approach. These publicly traded entities save enormous amounts of tax by using this structure. For instance, by one estimate, the structure saves Blackstone Group LP and its owners $150 million in taxes annually.[19] Likewise, KKR and its owners save an estimated $277 million in taxes annually by using this structure.[20] Furthermore, this structure has not been used exclusively by private equity groups. A recent article in the Wall Street Journal featured a publicly-traded firm that specializes in running cemeteries and benefits from a similar structure.[21] These transactions have been praised by some who admire the ingenuity of the transactions[22] and reviled by others who criticize the manipulative nature of the involved tax planning.[23]

[16] However, the structure may also be designed to reduce the amount of taxable income recognized by US Subsidiary. *See infra* Part II.c.
[17] *See infra* Part II.d.
[18] *See supra* note 5 and accompanying text.
[19] Fleischer, *supra* note 1 at 96 – 97.
[20] John D. McKinnon, “More Firms Enjoy Tax Free Status,” Wall Street Journal, January 10, 2012.
[21] *Id.* Presumably firms in this industry earn some non-qualifying income (income from providing funeral services) and some qualifying income (such as income from sale of real estate). By allocating non-qualifying income through a corporate subsidiary, these firms could maintain partnership tax treatment and avoid paying corporate level tax on qualifying income.
[22] *See*, *e.g.*, Susan Beck, *The Transformers*, THE AMERICAN LAWYER (Nov. 1, 2007) (“It was ingenious and audacious, and officials at the Internal Revenue Service were upset…. Most major companies cleverly structure transactions to reduce taxes, but Fortress's efforts-crafted by Skadden, Arps, Slate, Meagher & Flom-were Olympian. Through a dazzlingly complex structure, it managed to avoid nearly all corporate tax….”).
[23] *See*, *e.g.*, Jenny Anderson & Andrew Ross Sorkin, “Go Public, and Face Higher Taxes,” NEW YORK TIMES, June 15, 2007 (quoting Senator Charles Grassley as saying, “It's unfair to allow a publicly traded company to act like a corporation but not pay corporate tax, contrary to the intent of the tax code. We don't have a workable tax code if we don't have structural integrity.”)

In response to Blackstone's structuring, members of Congress proposed reforms that would alter the results claimed by Blackstone.[24] Although the proposed reforms were not enacted, private equity has received renewed attention, in part because of the high profile of Mitt Romney's private equity firm, Bain Capital, in the recent presidential campaign.[25] Thus, it is possible that these reforms will be revisited.[26] This article takes an approach that differs from previous reform proposals. In particular, this article asks whether the results claimed by Blackstone are appropriate under current law.

In the process, this article provides an example of how to interpret standards in tax law. As others have observed, lawmakers design rules, in tax law and elsewhere, to accommodate the most typical fact patterns.[27] Yet, as others have argued, lawmakers cannot rely exclusively on tax rules based on the most typical fact patterns because taxpayers will adjust their transactions to take the rules into account.[28] As will be discussed below, the Blackstone structure depends on partnership tax allocation rules that are premised on the assumption that partners in a partnership are unrelated and thus have opposing economic interests, which may be true in a typical partnership.[29] In the Blackstone structure, however, the partners of Underlying Fund (Blackstone Group LP, US Subsidiary, and Non-US Subsidiary) are related, and Underlying Fund's allocations take advantage of rules that were based on the assumption of unrelated partners.[30] Moreover, as demonstrated by the numerous other entities that have adopted the Blackstone structure, many taxpayers have adjusted their transactions to take the allocation rules into account, and partnerships with related partners have consequently become more common.[31]

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[24] *See infra* Part III.

[25] *See*, *e.g.*, Mark Maremont, *U.S. News – Election 2012: Tax Rule Opens Rich Vein for Debate – Romney's Favorable Treatment for Some Bain Income Draws Attention to Murky Reaches of IRS Code*, WALL STREET JOURNAL, A6 (Jan. 28, 2012).

[26] *See*, *also*, Fleischer, supra note 1 at 93 ("As policymakers look ahead to possible tax reform proposals, however, the issue of how to tax Blackstone and its peers seems likely to reignite.")

[27] *See infra* note 128.

[28] *See infra* note 129.

[29] *See infra* notes 99, 110 - 112 and accompanying text. However, the current regulations do provide special rules that apply in some cases when the partners are individuals who are members of the same family. *See* IRC Section 704(e).

[30] *See infra* Part IV.b.

[31] *See supra* notes 19 - 23 and accompanying text (discussing other entities that have used the Blackstone structure). For discussion of this phenomenon generally, see Kyle D. Logue, Tax Law Uncertainty and the Role of Tax Insurance, 25 Va. Tax Rev. 339, 366 (2005) ("[W]hat was a potentially small loophole with relevance to only a few transactions, and thus not worth worrying about, becomes a large loophole as enterprising tax advisors funnel

Standards can fill the gap left by tax rules that envision only the typical case.[32] Moreover, because standards fill the gap left by rules designed for the typical case, courts and the IRS should readily apply standards to atypical cases (or cases that the rules did not contemplate).[33] Thus, in the case of Blackstone, standards should be applied to supplement rules that were based on the assumption of unrelated partners given that the partners in the Blackstone structure are related.[34]

This article proceeds as follows. Part II explains the structure used by Blackstone in more detail. Part III describes Congressional responses to the Blackstone structure. Part IV argues that the Blackstone structure does not work even under current law. Part V suggests reasons why the IRS might, nevertheless, not challenge the tax consequences claimed by Blackstone Group LP. Part VI concludes the article.

II. Background: What does the Blackstone structure attempt to accomplish?

As discussed above, Blackstone Group LP uses a structure intended to allow it to qualify for an exception from corporate tax treatment for publicly-traded entities that earn predominately qualifying income. A complete understanding of the structure requires some knowledge of multiple areas of tax law. This section will discuss each necessary building block, in turn, and then conclude by illustrating how all of the building blocks come together in the structure used by Blackstone Group LP.

a. Publicly-Traded Partnership Rules

Although many business entities can electively decide whether they will be treated as partnerships or corporations for tax purposes, certain entities must be treated as corporations for tax purposes.[35] For example, entities that are publicly-traded typically must be treated as corporations for tax purposes.[36] An entity that is listed on an established securities exchange like the New York Stock Exchange is

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money and clients through such gaps."); David A. Weisbach, *Formalism in the Tax Law*, 66 U. CHI. L. REV. 860, 867-69 (1999) [hereinafter, Weisbach, *Formalism*].

[32] *See infra* note 130.

[33] *See infra* note 131.

[34] *See infra* Part IV.c.

[35] Treas. Reg. Section 301.7701-3(a) (providing ability to elect tax classification to many entities); Treas. Reg. Sections 301.7701-2(b)(1), 301.7701-2(b)(3) – (8) (describing entities that must be treated as corporations).

[36] IRC Section 7704.

publicly traded.[37] Thus, Blackstone Group LP is publicly traded and would fall within the general rule mandating corporate tax treatment but for the fact that it is structured to qualify for an exception from this general rule.[38]

Regarding the exception (the "90% Gross Income Exception"), publicly-traded entities nevertheless may be eligible for partnership tax treatment if at least 90% of their income consists of certain types of "qualifying income."[39] "Qualifying income" includes dividend income, interest income, capital gain income, and other types of investment income.[40]

b. Distributions by a Corporation

When a corporation distributes cash to its shareholders, the shareholders may recognize dividend income or capital gain income.[41] In particular, to the extent that the distribution does not exceed the corporation's available earnings and profits, shareholders will recognize dividend income.[42] If the distribution does exceed earnings and profits, shareholders could potentially recognize gain from sale of stock in the corporation, which will be capital gain income in most cases.[43] Thus, the income recognized by Blackstone Group LP as a result of receiving distributions from US Subsidiary and Non-US Subsidiary will be dividend income or capital gain income.[44]

c. Tax Treatment of a US Corporation

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[37] *See* IRC Section 7704(b)(1). A partnership will also be publicly-traded if interests in the partnership are traded on a "secondary market (or the substantial equivalent thereof)". *See* IRC Section 7704(b)(2).

[38] *See infra* Part II.f. (summarizing how the structuring accomplishes this objective).

[39] IRC Section 7704(c).

[40] IRC Section 7704(d).

[41] This assumes the shareholders are receiving distributions because they are shareholders and not because of some other relationship they have with the corporation (for example, not because they are also employees and they are receiving payment for services rendered to the corporation). *See* IRC Section 301 (providing that the treatment described applies only to distributions made by a corporation to a shareholder "with respect to its stock").

[42] I.R.C. Sections 301(c)(1), 316.

[43] I.R.C. Section 301(c)(3)(A).

[44] *See also* Blackstone S-1 pages 202-204 and attached appendix. The tax treatment of a shareholder of a non-US corporation could differ from what is described in the text if the non-US corporation earned passive income. In this case, special "anti-deferral" rules could apply. However, because only active income is allocated to Non-US Subsidiary, the anti-deferral rules should not apply to the Blackstone Group LP structure.

A U.S. entity treated like a corporation for tax purposes is subject to tax, generally at a rate of 35%, on all of its taxable income.[45] Thus, if Blackstone Group LP were treated like a corporation it would owe 35% tax on all of its taxable income.

Furthermore, in the structure used by Blackstone Group LP, US Subsidiary is subject to 35% tax on all of its taxable income.[46] Its taxable income consists of management fees and allocations of non-qualifying income received from Underlying Fund less allowable expenses. In order to increase the deductible expenses incurred by US Subsidiary, Blackstone Group LP might loan funds to US Subsidiary and charge US Subsidiary interest.[47] As a result, US Subsidiary could deduct this interest expense, reducing its taxable income.[48] Moreover, the interest income received by Blackstone Group LP from US Subsidiary would be qualifying income and, consequently, would not jeopardize its ability to comply with the 90% Gross Income Exception.[49]

d. <u>Tax Treatment of a Non-US Corporation</u>

A non-US corporation is subject to US tax only on US source income and income effectively connected with a US trade or business.[50] Furthermore, a corporation is considered a non-US corporation simply by virtue of the fact that it is formed outside of the US.[51] Non-US

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[45] I.R.C. Section 11.

[46] *Id. See also* Blackstone S-1 pages 202-204 ("US Subsidiary" in the simplified structure is the counterpart to "Blackstone Holdings I GP Inc." and "Blackstone Holdings II GP Inc." in the actual structure), and attached appendix.

[47] From Blackstone's documents, it is not entirely clear whether they used debt to reduce US Subsidiary's taxes in this manner. However, Fortress, a similar company that engaged in a similarly structured initial public offering, did use debt in this manner. *See*, *e.g*., Beck, supra note 22 ("The blocker [the counterpart to US Subsidiary in the Fortress structure] would borrow a large amount of money from another Fortress subsidiary, according to two people familiar with the deal. The blocker's interest payments on this debt, which are deductible, would wipe out much of its taxable income… It's not clear if Blackstone's blocker corporations are heavily debt-laden to wipe out taxable income.") *See*, *also*, Blackstone S-1 at 61 ("The wholly-owned subsidiaries of The Blackstone Group L.P. will concurrently with the Reorganization and may from time to time thereafter enter into intracompany lending arrangements with one another." This statement may or may not be referring to using debt to reduce corporate-level tax paid by US Subsidiary).

[48] *See* IRC Section 163 (providing for interest deduction). The ability to deduct interest would be subject to certain limitations. For example, if US Subsidiary were too thinly capitalized, some of the debt could be recast as equity for tax purposes. Likewise, if Blackstone Group LP charged an interest rate that was higher than a market rate, the debt could be recast as equity for tax purposes.

[49] I.R.C. Section 7704(d)(1)(A).

[50] I.R.C. Sections 881, 882.

[51] I.R.C. Sections 7701(a)(4), 7701(a)(5).

Subsidiary was formed in Alberta, Canada and elected to be treated as a corporation for US tax purposes.[52] Thus, Non-US Subsidiary is a non-U.S. corporation. Presumably, Underlying Fund allocates to Non-US Subsidiary only income that is not U.S. source and is not effectively connected with a U.S. trade or business.[53] As a result, Non-US Subsidiary owes no U.S. tax liability. Moreover, Non-US Subsidiary likely owes no Canadian tax liability because it is formed as an Alberta limited partnership that is likely a flow-through entity for Canadian tax purposes, despite its elective treatment as a corporation for US tax purposes.

e. Partnership Allocations

i. Overview of Partnership Tax System

Entities treated as partnerships for tax purposes are not subject to tax at an entity level.[54] Instead, partnerships allocate to their partners all items of tax gain, loss, income and deduction recognized by the partnership, and each partner takes into account amounts allocated to that partner when determining his, her or its taxable income.[55] Moreover, the character of income allocated to a partner is the same as the character of the income earned by the partnership.[56]

For example, assume two individuals, A and B, form a partnership. Assume the partnership, in one year, recognizes $70 of ordinary income and $30 of capital gain. The partnership will not be subject to entity-level tax on the income that it earns. Instead, the partnership will allocate some of the income to A and some of the income to B. If the partnership allocates $70 of ordinary income to A and $30 of capital gain to B, A will include $70 of ordinary income in his or her individual taxable income, and B will include $30 of capital gain in his or her individual taxable income.

Carried interest is a right to receive profits earned by a partnership and, thus, is an interest in a partnership. Consequently, the person or entity that holds the right to carried interest will be allocated a share of income earned by the partnership.[57] Moreover, because the character of income allocated to a partner depends on the character of income

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[52] Blackstone S-1 at page 204 ("Blackstone Holdings V GP L.P. [the counterpart to Non-US Subsidiary in the actual structure] is taxable as a foreign corporation for U.S. federal income tax purposes.")
[53] See Blackstone S-1 at page 204 ("Blackstone Holdings V GP L.P. [the counterpart to Non-US Subsidiary in the actual structure] is expected to be operated so as not to produce [effectively connected income].")
[54] IRC Section 701.
[55] *Id.*
[56] I.R.C. Section 702(b).
[57] I.R.C. Sections 701, 702.

earned by the partnership, the character of carried interest depends on the type of underlying partnership income allocated to the person or entity that receives carried interest.[58]

The funds that Blackstone sponsors engage in a variety of activities and earn a variety of different types of income. Blackstone's funds earn dividend income, capital gain income, and interest income, all of which is "qualifying income" for purposes of the 90% Gross Income Exception.[59] Blackstone's funds also earn break-up fees. When a private equity fund is planning to acquire a business, if the deal is not ultimately consummated, the private equity fund will likely receive a break-up fee from the current owner of the business. This break-up fee is likely non-qualifying income.[60] Moreover, depending on the facts, the break-up fee could be treated as income from operating a US business or as income from operating a non-US business.[61] Some Blackstone funds might earn other types of non-qualifying income. For example, if a Blackstone real estate fund owns and operates a hotel, it would receive non-qualifying income from providing services.[62] Furthermore, this services income could be treated as income from operating a US business or as income from operating a non-US business depending on where the hotel is located and other facts.[63] Thus, some of the carried interest allocated by Underlying Fund to its partners will be qualifying income (the portion of carried interest that consists of dividend income,

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[58] I.R.C. Section 702(b).
[59] I.R.C. Section 7704(d).
[60] *See*, *e.g*., Fleischer, supra note 1 at 108 (concluding that it would be difficult to characterize break-up fees as passive income; in other words, it would be difficult to characterize break-up fees as qualifying income). Furthermore, in PLR 200823012, the IRS concluded that a termination fee received by a taxpayer as a result of an abandoned merger agreement was ordinary income, rather than capital gain income. The IRS based its conclusion on an "origin-of-the-claim" analysis. In particular, because the fee was designed to compensate the taxpayer for profits it would have earned if the merger was consummated and because such profits would have been ordinary income, the termination fee was ordinary income. However, it should be noted that some would characterize break-up fees resulting from a failure to purchase stock as compensating a taxpayer for lost profits on a stock investment. *See*, *e.g*., TMFEDPORT No. 735 s VII ("The tax issue, therefore, is whether a break-up fee reimburses the fund for lost profits on a stock investment. If so, then the break-up fee is a surrogate for capital gain…") Under this view, at least some break-up fees could be qualifying income.
[61] Under an origin-of-the-claim analysis, the break-up fee could be treated as income from operating a US business if the company to be acquired operated a US business. If, instead, the company operated a non-US business, the break-up fee could be treated as income from operating a non-US business.
[62] Income from providing services is not a type of qualifying income. I.R.C. Section 7704(d).
[63] The source of income from providing services generally depends on where the services are performed. *See* IRC Sections 861(a)(3), 862(a)(3).

interest income, capital gain income, and other types of qualifying income), some will be non-qualifying income attributable to a US business (such as services income from operating a US hotel or break-up fees from failing to acquire a US business), and some will be non-qualifying income attributable to a non-US business (such as services income from operating a non-US hotel or break-up fees from failing to acquire a non-US business).

Underlying Fund allocates qualifying carried interest directly to Blackstone Group LP.[64] Because income allocated by a partnership to a partner retains its character in the hands of the partner, Blackstone Group LP recognizes qualifying income as a result of this allocation.[65] Underlying Fund allocates carried interest that consists of non-qualifying income that is US business income to US Subsidiary.[66] Underlying Fund also pays management fees to US Subsidiary.[67] As discussed above, US Subsidiary will be subject to entity-level tax on this income, possibly reduced by interest expense resulting from interest that may be paid to Blackstone Group LP.[68] Underlying Fund allocates carried interest that consists of non-qualifying income that is non-US business income to Non-US Subsidiary.[69] As discussed above, Non-US Subsidiary will not be subject to entity-level tax on this income.[70] Furthermore, as discussed above, the income Blackstone Group LP earns from US Subsidiary and Non-US Subsidiary will be dividend income, capital gain income, and, possibly, interest income, all of which is qualifying income.[71] As a result, all of the income recognized by Blackstone Group LP is qualifying income because its income consists only of allocations of qualifying carried interest from Underlying Fund, possibly interest income received from US Subsidiary, and dividend income or capital gain income received from US Subsidiary and Non-US Subsidiary.[72]

ii. Restrictions on Allocations

As discussed above, a partnership allocates among its partners tax items that the partnership recognizes. Partnerships are not free, however, to allocate items among partners in any manner whatsoever. This section will, first, explain the intuition behind the restrictions on partnership allocations and, second, describe the mechanics of the restrictions in more detail.

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[64] Blackstone S-1 at pages 202-204 and attached appendix.
[65] IRC Section 702(b).
[66] Blackstone S-1 at pages 202-204 and attached appendix.
[67] Blackstone S-1 at pages 202-204 and attached appendix.
[68] *See supra* Part II.c.
[69] Blackstone S-1 at pages 202-204 and attached appendix.
[70] *See supra* Part II.d.
[71] *See supra* Parts II.b and II.c.
[72] *See supra* text accompanying notes 65 and 71.

1. Intuition Underlying the Restrictions

If partnerships were completely unconstrained in their ability to allocate tax items, they could too easily allocate items in a manner that minimized the partners' aggregate tax liability. In order to demonstrate, consider the following example.

> **Example 1**. Assume Tom and Leslie, two unrelated individuals, form a partnership. Each individual contributes $100. The partnership acquires land for $200 at the beginning of year 1 and sells the land for $300 during year 1. In year 2, the partnership liquidates, distributing $150 cash to each partner.
>
> Regarding the tax consequences, in year 1, the partnership recognizes $100 of tax gain. The partnership does not pay entity level tax on this gain but, rather, allocates it between Tom and Leslie. Assume Tom would be subject to a tax rate of 50% on gain from sale of the land, while Leslie would be subject to a tax rate of 0% on gain from sale of the land.[73] If the partnership were allowed to do so, it would allocate $100 tax gain to Leslie (who pays no tax on the gain) and $0 tax gain to Tom.[74]

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[73] For example, Leslie could be subject to 0% tax if (i) Leslie recognized tax losses from other sources that would offset gain allocated to her from the partnership and (ii) she did not recognize other income from which the losses could be deducted.

[74] Even if the partnership were allowed to do this, Tom would not escape tax indefinitely because, in year 2, at the time of the liquidation, Tom would recognize $50 of tax gain and Leslie would recognize $50 of tax loss. Tom recognizes $50 of tax gain because Tom's basis in his partnership interest just prior to liquidation will be $100. His basis equals the $100 cash he contributed plus $0 tax gain allocated to him. *See* IRC Section 705(a). Because this basis is $50 lower than the amount of cash he receives on liquidation, he recognizes $50 of tax gain. *See* IRC Section 731(a)(1) . Leslie recognizes $50 tax loss on liquidation. Leslie's basis in her partnership interest just prior to liquidation is $200 which equals the $100 cash she contributed plus the $100 tax gain allocated to her by the partnership. *See* IRC Section 705(a). Because the amount of cash she receives on liquidation ($150) is $50 lower than her basis in the partnership, Leslie recognizes $50 tax loss on liquidation. *See* IRC Section 731(a)(2). However, although Tom eventually recognizes $50 tax gain, Tom nevertheless can benefit from the allocations for two reasons. First, Tom is able to defer tax liability until the year in which the partnership liquidates. Second, it is possible that the character of gain recognized by Tom on liquidation is different than gain from sale of the land and taxed more favorably than gain from sale of the land so that Tom may pay a rate of tax on the gain in year 2 that is less than 50%. *See* IRC Section 731(a) flush language (providing that gain recognized by Tom as a result of the partnership distributing cash to him will be treated as gain from sale of his interest in the partnership), IRC Section 741 (providing that gain from sale of a partnership interest is treated as

To address this, the rules governing partnership allocations require a closer link between tax and economics. To demonstrate, consider the following example.

> **Example 2**. Assume the same facts as Example 1. Given the restrictions on how partnerships can allocate tax items, the partnership could only allocate $50 more tax gain from sale of the land to Leslie than Tom if Leslie and Tom agreed that Leslie would receive $50 more cash than Tom. Thus, the partnership could allocate all $100 tax gain from the land to Leslie if the partnership distributed $200 cash to Leslie and $100 cash to Tom on liquidation.[75]

Tying tax allocations more closely to economic gains and losses discourages tax-motivated allocation schemes when the partners in a partnership are unrelated. In Example 1, when there were no restrictions on how a partnership could allocate tax items, the partnership could allocate less tax gain to Tom (resulting in tax savings) without distributing less cash to Tom. Stated differently, assume that, for business reasons, the partners have agreed to share all cash equally. In such a case and absent restrictions on partnership tax allocations, the partners would agree to the allocations in Example 1 purely for tax reasons because they could save taxes without disturbing their intended business deal.

By contrast, Example 2 reflects the current restrictions on tax allocations. Assume that, for business reasons, the partners have agreed that the partnership will distribute all cash equally between Tom and Leslie. In order to distribute cash in this manner, the partnership must also allocate tax gain from the land equally (or $50 to each partner). If, instead, the partnership allocated all tax gain to Leslie, Tom would save $25 in taxes ($50 times 50% tax rate), but Tom would also forgo $50 of cash on liquidation. Assuming Tom and Leslie are unrelated and have opposing economic interests, Tom would not agree

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capital gain subject to exceptions set forth in Section 751 which would not apply to a partnership that holds no assets other than cash).

[75] If the partnership distributes all $200 cash to Leslie on liquidation, neither Leslie nor Tom will recognize tax gain or loss on liquidation. Just prior to liquidation, Tom's basis in his interest in the partnership would be $100 (the $100 cash he contributed plus the $0 tax gain allocated to him by the partnership). *See* IRC Section 705(a). As a result, Tom recognizes no tax gain or loss when he receives $100 cash from the partnership on liquidation. *See* IRC Section 731(a). Just prior to liquidation, Leslie's basis in her interest in the partnership would be $200 (the $100 cash she contributed plus the $100 tax gain allocated to her by the partnership). *See* IRC Section 705(a). As a result, Leslie recognizes no tax gain or loss when she receives $200 cash from the partnership on liquidation. *See* IRC Section 731(a).

to an arrangement in which he loses $50 of cash merely to save $25 of tax because this arrangement makes him $25 less wealthy after tax. Thus, if Tom and Leslie are unrelated and do agree to allocate $50 more tax gain to Leslie and distribute $50 more cash to Leslie, they must *not* have agreed to this arrangement merely to save Tom $25 in taxes. Rather, the partners must have had a non-tax, business reason for agreeing to the arrangement. Perhaps, for example, Leslie was responsible for selecting the land that the partnership purchased, and, as a result, the partners agreed that she would benefit from any economic gain realized upon sale of the land and bear any economic loss realized upon sale of the land. Thus, Tom willingly parts with $50 cash from sale of the land in order to abide by the partners' business arrangement and not for the sole purpose of saving taxes.

2. Mechanics of the Restrictions

The examples in the preceding part illustrate the intuition underlying the restrictions on partnership allocations. In particular, the restrictions are generally designed to ensure that tax items are allocated in a way that is consistent with the economic arrangement of the partners so that tax allocations are business-motivated rather than tax-motivated. This part will explore the mechanics of the Treasury Regulations that contain the restrictions placed on partnership allocations.

The Treasury Regulations specify that allocations in a partnership agreement will be respected (in other words, will not be successfully challenged by the IRS) if the allocations are consistent with "the partners' interests in the partnership" ("PIP") or the allocations have "substantial economic effect".[76]

Partners' Interests in the Partnership ("PIP")

PIP is a vague concept that is intended to measure the manner in which the partners have agreed to share the economic benefit or burden to which a given tax allocation corresponds.[77] To determine the partners' interests in the partnership, one must examine all the facts and circumstances that relate to the economic arrangement of the partners, including: the partners' relative contributions to the partnership, the interests of the partners in economic profits and losses, the interests of the partners in cash flow and other non-liquidating distributions, and

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[76] *See* Treas. Reg. Section 1.704-1(b)(1)(i). This regulation provides that there are three ways that an allocation in a partnership agreement will be respected: (1) if the allocation has substantial economic effect, (2) if the allocation is in accordance with the partners' interests in the partnership or (3) if the allocation is deemed to be in accordance with the partners' interests in the partnership. The third possibility only applies to certain types of allocations not relevant to the analysis of the Blackstone structure. Thus, this possibility is not discussed above.

[77] Treas. Reg. Section 1.704-1(b)(3)(i).

the rights of the partners to distributions of capital upon liquidation.[78] Once a partner's economic share is determined, tax items must be allocated in a way that is consistent with that economic share to be respected under the PIP test.[79] Under the facts of Example 1, for instance, we could determine that Tom's interest in the partnership and Leslie's interest in the partnership were each 50% because each partner contributed 50% of the capital and received 50% of the distributions.[80] In that case, for the partnership agreement's allocations to be respected under the PIP test, the tax gain from sale of the land would have to be allocated equally between Tom and Leslie.

Substantial Economic Effect

For partnership agreement allocations to be respected under the substantial economic effect test, the allocations must overcome two hurdles.[81] First, the allocations must have "economic effect".[82] Second, the economic effect of the allocations must be "substantial".[83] This second hurdle is often called the "substantiality" requirement.[84]

Economic Effect

Partnership agreement allocations most commonly aim to overcome the "economic effect" hurdle by complying with the "alternate test for economic effect."[85] In order to comply with this test: (1) a partnership must maintain a capital account for each partner in a manner specified in the Treasury Regulations,[86] (2) the partnership must liquidate based

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[78] Treas. Reg. Sections 1.704-1(b)(3)(i) – (ii).
[79] Treas. Reg. Section 1.704-1(b)(1)(i).
[80] *See*, *e.g.*, Treas. Reg. Section 1.704-1(b)(5) Example 4 (i). In this example in the Treasury Regulations, G and H form a partnership contributing $75,000 and $25,000 respectively and the partnership makes all distributions 75% to G and 25% to H. The partnership agreement allocates tax items equally between G and H. The regulations conclude that the partners' interests in the partnership are 75%/25%. Thus, tax items are not allocated in accordance with the partners' interests in the partnership.
[81] Treas. Reg. Section 1.704-1(b)(2)(i) ("The determination of whether an allocation of income, gain, loss, or deduction (or item thereof) to a partner has substantial economic effect involves a two-part analysis…")
[82] *Id.* ("First, the allocation must have economic effect….")
[83] *Id.* ("Second, the economic effect of the allocation must be substantial….")
[84] *See* Treas. Reg. Section 1.704-1(b)(2)(iii) ("Substantiality").
[85] There are two other ways that an allocation can have economic effect – (1) if the allocations comply with the "basic test" for economic effect or (2) if the allocations have "economic effect equivalence". *See* Treas. Reg. Section 1.704-1(b)(2)(ii)(b) (describing the basic test for economic effect) and Treas. Reg. Section 1.704-1(b)(2)(ii)(i) (describing economic effect equivalence). Because these possibilities are not relevant to the Blackstone structure, they are not discussed in this Article.
[86] Treas. Reg. Section 1.704-1(b)(2)(ii)(d)(1) (providing that, to comply with the alternate test for economic effect, the allocations must comply with Treasury

on positive capital account balances,[87] and (3) the partnership must take steps to ensure that no partner's capital account balance becomes impermissibly negative.[88] As it is only necessary to understand the first

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Regulation Section 1.704-1(b)(2)(ii)(b)(1)); Treas. Reg. Section 1.704-1(b)(2)(ii)(b)(1) (providing that the partnership agreement must maintain a capital account for each partner in accordance with the rules in Treasury Regulation Section 1.704-1(b)(2)(iv)).

[87] Treas. Reg. Section 1.704-1(b)(2)(ii)(d)(1) (providing that, to comply with the alternate test for economic effect, the allocations must comply with Treasury Regulation Section 1.704-1(b)(2)(ii)(b)(2)); Treas. Reg. Section 1.704-1(b)(2)(ii)(b)(2) (providing that the partnership must make liquidating distributions in accordance with the positive capital account balances of the partners).

[88] Treas. Reg. Section 1.704-1(b)(2)(ii)(d)(3) and flush language following that section. Regarding this third requirement, a partner has a deficit restoration obligation (a "DRO") to the extent that the partner would have to contribute cash to the partnership on liquidation if that partner's capital account balance were negative. The third requirement consists of taking steps to ensure that no partner's capital account will become (or remain) negative in excess of that partner's DRO. In particular, under the third requirement: (1) the partnership must not allocate items to a partner that will cause the partner to have a negative capital account balance (after factoring in certain expected distributions to the partner and other expected future events) that exceeds that partner's DRO, if any, and (2) the partnership agreement must contain a qualified income offset (which provides that, if a partner's capital account balance does become negative in excess of that partner's DRO, the partnership will allocate income to the partner to eliminate the excess negative balance as quickly as possible). Treas. Reg. Section 1.704-1(b)(2)(ii) (d). This third requirement helps to ensure that net tax items allocated by the partnership to the partner over the life of the partnership correspond to the partner's net economic gain or loss. In order to demonstrate, imagine Tom and Leslie form a partnership. Each individual contributes $100. The partnership acquires land for $200 at the beginning of year 1 and sells the land for $50 during year 1. In year 2, the partnership liquidates. The partnership recognizes $150 of tax loss on sale of the land in year 1. Assume neither partner has a DRO. Without the third requirement, the partnership could allocate the entire $150 tax loss from sale of the land to Tom. As a result, capital accounts would become: $100 for Leslie ($100 cash contributed) and negative $50 for Tom ($100 cash contributed minus $150 tax loss allocated to Tom). The partnership has $50 cash to distribute on liquidation which will all be distributed to Leslie because she is the only partner with a positive capital account balance. As a result, tax items allocated by the partnership to the partners do not correspond to the partners' economic gains and losses. In particular, Leslie realized a $50 economic loss because she contributed $100 cash and received $50 cash, but Leslie was allocated no tax loss. Tom realized a $100 economic loss because he contributed $100 cash and received $0 cash, but Tom was allocated a $150 tax loss. Once the third requirement is taken into account, the partnership could allocate at most $100 tax loss to Tom (because that brings his capital account to $0 and his capital account cannot go below $0 as he has no DRO), and the partnership would have to allocate the remaining $50 tax loss to Leslie. As a result, capital accounts would become: $50 for Leslie ($100 cash contributed

and second requirements in order to understand Blackstone's structure, only these requirements will be discussed below.[89]

Capital Account Maintenance

To comply with the capital account maintenance prong of the alternate test for economic effect, a partnership must maintain a capital account for each partner according to specific rules.[90] In particular, each partner's capital account, at any point in time, must equal: (1) all cash contributed to the partnership by that partner[91] plus (2) the fair market value of all assets (net of liabilities) contributed to the partnership by that partner[92] plus (3) all items of tax gain or income allocated to that partner by the partnership[93] minus (4) all cash distributed to that partner by the partnership[94] minus (5) the fair market value of all assets (net of liabilities) distributed to that partner by the partnership[95] minus (6) all items of tax loss or deduction allocated to that partner by the partnership.[96]

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minus $50 tax loss allocated to Leslie) and $0 for Tom ($100 cash contributed minus $100 tax loss allocated to Tom). The partnership has $50 cash to distribute on liquidation which will all be distributed to Leslie because she is the only partner with a positive capital account balance. As a result, tax items allocated by the partnership to the partners do correspond to the partners' economic gains and losses. In particular, Leslie realized a $50 economic loss because she contributed $100 cash and received $50 cash, and Leslie was allocated a $50 tax loss. Tom realized a $100 economic loss because he contributed $100 cash and received $0 cash, and Tom was allocated a $100 tax loss.

[89] For discussion of the third requirement, *see supra* note 88.

[90] *See supra* note 86.

[91] Treas. Reg. Section 1.704-1(b)(2)(iv)(b)(1).

[92] Treas. Reg. Section 1.704-1(b)(2)(iv)(b)(2).

[93] Treas. Reg. Section 1.704-1(b)(2)(iv)(b)(3). Technically, the regulations refer to adjusting capital accounts by "income or gain" which means book income or book gain (rather than tax income or tax gain). *See* Treas. Reg. Section 1.704-1(b)(2)(iv)(d)(3). However, as long as the partnership recognizes the same amount of tax gain as book gain with respect to a transaction, one can think of this adjustment as referring to tax gain. *Id.*

[94] Treas. Reg. Section 1.704-1(b)(2)(iv)(b)(4).

[95] Treas. Reg. Section 1.704-1(b)(2)(iv)(b)(5).

[96] Treas. Reg. Sections 1.704-1(b)(2)(iv)(b)(6)-(7). Technically, the regulations refer to adjusting capital accounts by "loss and deduction" which means book loss or book deduction (rather than tax loss or tax deduction). *See* Treas. Reg. Section 1.704-1(b)(2)(iv)(d)(3). However, as long as the partnership recognizes the same amount of tax loss as book loss with respect to a transaction, one can think of this adjustment as referring to tax loss or deduction because tax loss or deduction will be allocated in the same manner as book loss or deduction when these items are equal. *Id*.

Thus, in Examples 1 or 2 above, the partnership would maintain a capital account for Tom and Leslie. Each partner's capital account would initially equal $100 because each partner initially contributed $100 cash to the partnership. When the partnership allocated $100 tax gain to Leslie and no tax gain to Tom, Leslie's capital account becomes $200 and Tom's capital account remains $100.

Liquidating Based on Capital Account Balances

In order to comply with the liquidation requirement, the partnership, upon liquidation, must distribute cash to the partners proportionately based on the positive balances in their capital accounts.[97]

Thus, in Examples 1 or 2 above, when the partnership distributes $300 cash to the partners in liquidation, it must distribute $200 to Leslie (who has a $200 capital account balance) and $100 to Tom. Consequently, because Leslie was allocated the entire $100 tax gain from sale of the land, Leslie also benefits from the entire $100 economic gain from sale of the land, as she receives $100 more cash than what she contributed. Assume, instead, the partnership intended to distribute the cash equally to the partners ($150 to each partner) on liquidation. In that case, in order for the tax allocations to have economic effect and be respected, the partnership would have to allocate the tax gain from sale of the land equally among the partners ($50 to each partner). As a result of this allocation, each partner's capital account just prior to liquidation would be $150 ($100 cash contributed + $50 tax gain allocation), and, if the partnership distributes $150 cash to each partner, the partnership will comply with the requirement to liquidate based on capital account balances. What the partnership cannot do is allocate all tax gain ($100) to Leslie (bringing capital account balances to: $200 for Leslie and $100 for Tom) but distribute the $300 cash equally among the partners ($150 to each partner).

More generally, the first two requirements of the alternate test for economic effect help to ensure that net tax items allocated to a partner over the life of the partnership will correspond to the net economic gain or loss realized by that partner over the life of the partnership.[98] If a partnership allocates more tax gain to a partner, his or her capital account increases, meaning that partner will receive more cash on

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[97] *See supra* note 87.

[98] William S. McKee, William F. Nelson & Robert L. Whitmire, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 11.02[1] ("The complexity and detail of these Regulations should not obscure the overriding principle of economic substance upon which they are based. If a partner will benefit economically from an item of partnership income or gain, that item must be allocated to him so that he bears the correlative tax burden. Conversely, if a partner will suffer the economic burden of an item of partnership loss or deduction, he must be allocated the associated tax benefit. In other words, tax must follow economics.")

liquidation of the partnership if not before. If a partnership allocates more tax loss to a partner, his or her capital account decreases, meaning that partner will receive less cash on liquidation of the partnership. Furthermore, as discussed above, linking tax allocations to economic gains and losses helps to deter allocation schemes that are purely tax motivated, as long as the partners in a partnership are unrelated.[99]

Substantiality

In order for allocations to be respected under the substantial economic effect test, the allocations must have economic effect (which will be true if the allocations meet the alternate test for economic effect just described), and the allocations must comply with the substantiality requirement. This second, substantiality requirement exists because the alternate test for economic effect alone does not prevent all tax-motivated allocation schemes. In order to demonstrate, consider the following example.[100]

> **Example 3**. Two individuals, Ron and Anne, form a partnership to provide legal services. Ron is a UK citizen and not a resident of the US. Anne is a US citizen. Ron and Anne each contribute $1000 cash to the partnership. The partnership provides some legal services in the UK out of its UK office and some legal services in the US out of its US office. Thus, in any given year, the partnership will recognize some income from providing legal services in the US and some income from providing legal services in the UK. Anne is subject to 35% US tax on income from legal services, regardless of where the services are performed. Ron is subject to 35% US tax on income from providing legal services in the US but no US tax on income from providing legal services in the UK. The partnership agreement provides that a capital account will be maintained for each partner in accordance with the rules described above and liquidating distributions will be made based on capital account balances. The partnership agreement further provides that each partner will be allocated 50% of total income recognized by the partnership, but the income allocated to Ron will consist

[99] *See supra* Part II.e.ii.1. For discussion of this purpose of allocation rules, *see*, *e.g.*, David Hasen, *Partnership Special Allocations Revisited* ("In enacting the current version of section 704(b) in 1976, Congress seems to have had in mind that income assignments among partners should be permissible as long as they are not, or are not unduly, tax-motivated.")

[100] Not all tax-motivated allocation schemes are prevented by the substantiality requirement. For further discussion, *see*, *e.g.*, Calvin H. Johnson, Partnership Allocations from Nickel-on-the-Dollar Substance, 134 Tax Notes 873 (February 13, 2012); Richard M. Leder, Tax-Driven Partnership Allocations with Economic Effect: The Overall After-Tax Present Value Test for Substantiality and Other Considerations, 54 Tax Law. 753 (2001).

> entirely of income from the UK to the extent possible. Thus, in year 1, for example, if the partnership recognizes $300 of income from the UK and $700 of income from the US, the partnership would allocate to Ron $300 of UK income and $200 of US income, and the partnership would allocate to Anne $500 of US income.[101]

The allocations in Example 3 have economic effect because the partnership maintains capital accounts and provides for liquidation based on capital account balances.[102] However, the allocations are, nonetheless, tax motivated. The allocations ensure that, regardless of the types of income earned by the partnership, each of Ron and Anne will receive 50% of cash distributed on liquidation. Each partner contributed $1000, so the partners' initial capital account balances are equal ($1000 each). Further, each partner is always allocated 50% of total income recognized by the partnership, so the partners' capital account balances will remain equal (in Example 3, above, for instance, each partner's capital account increases by $500 to become $1500). Thus, when the partnership liquidates based on capital account balances, the partnership will distribute cash equally between Anne and Ron.

Consequently, Anne and Ron receive the same amount of cash as what they would have received if the partnership allocated each item of income equally between the partners. In Example 3, above, for instance, if the partnership allocated US income equally ($350 to each) and UK income equally ($150 to each), each partner's capital account would still increase by $500 so that capital accounts would remain equal and cash would be distributed equally on liquidation.

However, the allocations contained in the agreement save Ron taxes compared to what would have resulted from allocating each item of income equally. In particular, if Ron were allocated 50% of each type of income, Ron would be subject to $122.50 US tax liability (35% times $350 US income). By contrast, under the agreement, Ron is allocated only $200 of US income and thus Ron is subject to only $70 of US tax liability (35% times $200). Anne's tax liability is the same under the agreement as it would be if Anne were allocated 50% of each type of income. Anne is subject to a 35% US tax rate on US income and UK income, so Anne incurs US tax liability of $175 (35% times $500) when

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[101] *See* Treas. Reg. Section 1.704-1(b)(5) Example (10) (ii) (providing a similar example).

[102] This analysis assumes that the partnership also takes steps to ensure that no partner's capital account balance becomes impermissibly negative. See *supra* note 88. *See* Treas. Reg. Section 1.704-1(b)(5) Example (10) (ii) (reaching the conclusion that allocations have economic effect in the context of a similar example).

she is allocated $500 of total income, regardless of how much of the income is US source and how much is UK source.[103]

In summary, the allocations in the agreement described in Example 3 allow Ron to save $52.50 of tax liability without affecting Anne's tax liability or the amount of cash received by either partner. Thus, the allocations are likely tax-motivated because the allocations have no effect other than to reduce Ron's tax liability.

The second prong of substantial economic effect (the substantiality requirement) is intended to disallow tax-motivated allocation schemes like the one demonstrated in Example 3 and other schemes that economic effect, alone, would not prevent.[104] In order to comply with substantiality, allocations in a partnership agreement must overcome a number of obstacles, the most stringent of which is contained in Treasury Regulation Section 1.704-1(b)(2)(iii)(a) which provides:

> "[T]he economic effect of an allocation… is not substantial if, at the time the allocation becomes part of the partnership agreement, (1) the after-tax consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation …were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation …were not contained in the partnership agreement."[105]

In short, an allocation lacks substantiality if it may make one partner better off (after tax) and is not likely to make any partner substantially worse off (after tax) compared to what would occur if the allocation were not in the partnership agreement. Furthermore, regarding what occurs if the allocation were not in the partnership agreement, the Treasury Regulations instruct us to determine what would occur if everything were allocated based on the Partners' Interests in the

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[103] This analysis ignores the effect of the allocations, if any, on Anne's ability to use foreign tax credits.

[104] Terence Floyd Cuff, *Proposed Regulations Try – Unsuccessfully – to Fix a Broken Set of Substantiality Rules*, 104 JOURNAL OF TAXATION 280, 282 (2006) ("The after-tax filter of 'substantiality' in the Regulations represents an effort to objectify what is an inherently subjective inquiry—whether the transaction is motivated by business profit as opposed to tax profit.")

[105] There are other hurdles that an allocation must overcome in order for the allocation to have substantiality. For example, the allocation cannot be a "shifting allocation" and the allocation cannot be a "transitory allocation". *See* Treas. Reg. Sections 1.704-1(b)(2)(iii)(b) and (c). Consideration of these tests, however, is not necessary for purposes of understanding the analysis described in this Article.

Partnership (PIP).[106] PIP is a facts and circumstances test, as described above,[107] but for purposes of determining PIP that is used as a baseline for testing allocations for substantiality, we must ignore the potentially suspect allocation that is being evaluated.[108]

Applying this test to Example 3 reveals that the allocations lack substantiality. Ignoring the allocations of US income and UK income, it is likely that each partner's interest in the partnership is 50% as each partner contributes 50% of the capital.[109] Thus, the baseline used for comparison is what would occur if US income and UK income were allocated 50% to each partner. At the time the partners agree to allocate items as described in Example 3, Ron's after-tax consequences may be enhanced compared to what would occur if he were allocated 50% of US income and 50% of UK income. In particular, his pre-tax consequences (in other words, the amount of cash he receives) will remain unchanged, but he will save taxes as long as the partnership recognizes at least some UK income and at least some US income (because rather than being allocated 50% of the US income, he will be allocated less US income and more UK income). Thus, Ron may be better off after tax (and is, indeed, better off after tax if the partnership, in fact, recognizes the amount and types of income shown in Example 3). Moreover, at the time the partners agree to allocate items as described in Example 3 there is a strong likelihood (in fact, there is

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[106] Treas. Reg. Section 1.704-1(b)(2)(iii)(a) ("References in this paragraph (b)(2)(iii) to a comparison to consequences arising if an allocation …were not contained in the partnership agreement mean that the allocation…is determined in accordance with the partners' interests in the partnership…disregarding the allocation…being tested under this paragraph (b)(2)(iii)")

[107] *See supra* notes 77 - 80 and accompanying text.

[108] Treas. Reg. Section 1.704-1(b)(2)(iii)(a) ("References in this paragraph (b)(2)(iii) to a comparison to consequences arising if an allocation …were not contained in the partnership agreement mean that the allocation…is determined in accordance with the partners' interests in the partnership…*disregarding the allocation…being tested under this paragraph (b)(2)(iii)*") (emphasis added)

[109] As described above, to determine the partners' interests in the partnership that is used as a baseline for purposes of testing whether or not allocations have substantiality, one must examine all the facts and circumstances that relate to the economic arrangement of the partners (including: the partners' relative contributions to the partnership, the interests of the partners in economic profits and losses, the interests of the partners in cash flow and other non-liquidating distributions, and the rights of the partners to distributions of capital upon liquidation), but one must ignore the allocation being test. *See supra* notes 107 - 108 and accompanying text. After ignoring allocations of US income and UK income (the allocations being tested) the only fact that remains is the fact that the partners made equal contributions to the partnership. Thus, it is likely that each partner's interest in the partnership is 50% for purposes of testing the substantiality of the allocations.

certainty) that Anne's after-tax consequences will not be substantially diminished (indeed they will not be diminished at all) compared to what would occur if Anne were allocated 50% of US income and 50% of UK income. Regardless of whether Anne is allocated 50% of each type of income or 50% of total income (with a mix that might involve more than 50% of US income), Anne experiences the same after-tax consequences because she receives the same amount of cash pre-tax (50% of all cash distributed by the partnership) and incurs the same amount of tax liability (35% times 50% of all income recognized by the partnership). Thus, the allocations in Example 3 lack substantiality and can be successfully challenged by the IRS.

The allocations in Example 3 are suspect because Anne has no reason not to go along with allocations that save Ron taxes as long as the allocations do not make Anne worse off. Thus, the allocations in Example 3 can be wholly tax-motivated. They allow one partner to save taxes without interfering with the partners' business deal or the tax liability incurred by another partner.

Like the economic effect test, the substantiality test relies on the assumption that partners in a partnership are unrelated so that they have opposing economic interests. The fact that the test depends on the assumption that partners have opposing economic interests can be further demonstrated by the following example.

> **Example 4**. Assume the same facts as Example 3 except that the partnership agreement provides that Anne will be allocated all US income, and Ron will be allocated all UK income. At the time the partners agree to these allocations, they do not know how much income the partnership will earn. As it turns out, the partnership earns $800 of income from the UK and $200 of income from the US.[110]

The allocations described in Example 4 pass the substantiality test and should be respected. Looking at the actual results realized by the partnership in Example 4, the allocations enhance Ron's after tax consequences, compared to what would occur if each type of income were allocated equally to each partner, but the allocations diminish Anne's after-tax consequences, compared to what would occur if each type of income were allocated equally to each partner.[111] The table

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[110] *See* Treas. Reg. Section 1.704-1(b)(5) Example (10) (i) (providing a similar example).

[111] The substantiality test requires examining what was likely to occur at the time the partners agreed to the allocation in question. *See* Treasury Regulation Section 1.704-1(b)(2)(iii)(a) (" [T]he economic effect of an allocation is not substantial if, *at the time the time the allocation becomes part of the partnership agreement* [the allocation may make one partner better off (after tax) and is not likely to make any partner substantially worse off (after tax) compared to what would occur if the allocation were not in the partnership

below compares the after-tax consequences of each partner under the agreement to the consequences that would follow if each type of income were allocated equally to each partner. As shown in this table, the allocations in the partnership agreement improve Ron's after-tax consequences ($800 compared to $465) but lessen Anne's after-tax consequences ($130 compared to $325).

	Results of Partnership Agreement		**Results if US and UK Income Were Allocated Equally**	
	Anne	**Ron**	**Anne**	**Ron**
Pre-Tax Profit[112]	$200	$800	$500	$500
US Tax Liability	$200 total income times 35% = $70	$0 US income times 35% = $0	$500 total income times 35% = $175	$100 US income times 35% = $35
After-Tax Profit	$200 - $70 = $130	$800 - $0 = $800	$500 - $175 = $325	$500 - $35 = $465

Because the allocations in the partnership agreement decrease Anne's after-tax profit, the allocations will pass the substantiality test. Moreover, the underlying rationale behind this result is that unrelated partners will not agree, for purely tax reasons, to allocate items in a way that worsens the after-tax economic position of at least one partner. In

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agreement]") (emphasis added). However, although the test requires examining what was likely to occur as of the time the partners agreed to the allocations, the actual results realized by the partnership provide important evidence of what was likely to occur as of the time the partners agreed to the allocations. Indeed, in the context of some of the substantiality tests (particularly, the shifting allocation test and the transitory allocation tests), the actual results realized by the partnership establish a rebuttable presumption regarding what was likely to occur as of the time the partners agreed to an allocation. *See* Treas. Reg. Section 1.704-1(b)(2)(iii)(b)(2) (providing the rebuttable presumption in the context of the shifting allocation test); *See* Treas. Reg. Section 1.704-1(b)(2)(iii)(c)(2) (providing the rebuttable presumption in the context of the transitory allocation test); *See supra* note 105 (describing the shifting allocation and transitory allocation tests).

[112] This amount is determined by the increase to each partner's capital account. If the partnership agreement allocates $200 US income to Anne and $800 UK income to Ron, for example, Anne's capital account will increase by $200 (so she will receive $200 more cash), and Ron's capital account will increase by $800 (so he will receive $800 more cash). If the partnership instead allocated each type of income equally to each partner, the partnership would allocate $400 UK income and $100 US income (or $500 total income) to each partner, and each partner's capital account would increase by $500.

other words, because the allocations make Anne worse off after tax, we no longer suspect that the allocations are solely tax-motivated. In Example 3, the allocations appear to be solely tax-motivated because the only effect of the allocations is to reduce Ron's tax liability. By contrast, in Example 4, in addition to lowering Ron's tax liability, the allocations have the effect of reducing the amount of cash received by Anne. Assuming the partners are unrelated and have opposing economic interests, Anne would be unwilling to forgo cash merely to lower Ron's tax liability. Thus, if the partners do agree to the allocations in Example 4, they must have non-tax business reasons for doing so. Perhaps, for example, Ron is responsible for managing the partnership's UK office, and Anne is responsible for managing the partnership's US office. In order to encourage each partner to manage his or her office well, the partners could agree that Ron will benefit from all profits generated by the UK office and Anne will benefit from all profits generated by the US office. Thus, in Example 4, when the US office is less profitable than the UK office, Anne agrees to receive less than half of the partnership's profits in order to abide by the partners' business deal and not to save Ron taxes.

Finally, the rationale underlying the substantiality test depends on the assumption that Ron and Anne have opposing economic interests. If this assumption does not hold true, substantiality does not adequately police tax-motivated allocations. For example, assume Ron and Anne are closely related so that, as far as each individual is concerned, a dollar distributed by the partnership to Ron is the same as a dollar distributed by the partnership to Anne. In that case, the partners could freely agree to the allocations in Example 4 solely to reduce their tax liability. If the partners are indifferent regarding how they share after-tax profit, they will look only to total after-tax profit in deciding how the partnership allocates items among the partners. In Example 4, the allocations result in a total after-tax profit of $930 (Anne's $130 plus Ron's $800) which is $140 higher than the $790 after-tax profit (Anne's $325 plus Ron's $465) that would have resulted if the partnership allocated each type of income equally to each partner. The $140 difference results solely from saving taxes paid by the partners (saving $105 taxes for Anne and $35 taxes for Ron). As long as the partners do not care how they share after-tax profit, they would agree to the allocations in Example 4 for the sole purpose of saving $140 in taxes, and the substantiality test would not prevent this type of tax-motivated allocation scheme, given that the test is designed only for partnerships in which the partners are unrelated and thus have opposing economic interests.

iii. Applying Restrictions on Allocations to Blackstone

As shown in Figure 1 above, three partners (in particular, Blackstone Group, LP, US Subsidiary and Non-US Subsidiary) receive allocations from Underlying Fund. Specifically, Underlying Fund allocates qualified carried interest to Blackstone Group LP, non-qualified US carried interest to US Subsidiary, and non-qualified non-US carried interest to Non-US Subsidiary.

In order for these allocations to have economic effect, Underlying Fund can simply maintain a capital account for each of the partners and liquidate based on capital account balances.[113] Likely Underlying Fund does both of these things, so the allocations will have economic effect.

Regarding substantiality, assume, for purposes of illustration, that each partner contributed an equal amount of capital to Underlying Fund.[114] As a result, the allocations would pass muster under the substantiality test as long as, at the time the partners agreed to the allocations, it was likely that the after-tax consequences of at least partner would, in present value terms, be substantially diminished compared to what would happen if that partner were allocated 1/3 of each type of income.[115] Given that the partners agreed to the allocations at a time when the partners did not know what type and amount of income Underlying Fund would earn in each year, this requirement is likely met.[116] For instance, at the time the partners agreed to the allocations, it could have been likely that Underlying Fund would earn $1.2 billion of total carried interest (consisting of $600 million of qualified carried interest, $300 million of non-qualified US carried interest, and $300 million of non-qualified non-US carried interest). Under these facts, the allocations in the agreement make US Subsidiary worse off, after tax,

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[113] This analysis assumes that Underlying Fund also takes steps to ensure that no partner's capital account balance becomes impermissibly negative. See *supra* note 88.

[114] This figure is used merely for illustrative purposes, and it could be that the partners did not contribute equal amounts to the partnership. However, the overall conclusion of the analysis above likely still holds true which is that if the allocations by Underlying Fund pass the substantiality tests they do so only because at least one of the partners in Underlying Fund (US Subsidiary, Non-US Subsidiary, or Blackstone Group LP) receives less after tax than what it would receive if all items of income were allocated among all three partners pro rata based on their capital contributions. Furthermore, the fact that the allocations make one partner worse off after tax should provide no assurance that the allocations are not tax-motivated given that all partners in the partnership are related.

[115] *See supra* text accompanying notes 105 - 106.

[116] *See also*, Treas. Reg. Section 1.704-1(b)(5) Example (10) (i) (providing an example in which a partnership agrees to allocate disproportionate amounts of non-US income to a non-US partner at a time when the partners could not predict with reasonable certainty the amount and type of income the partnership would earn and concluding that the allocations have substantial economic effect).

compared to what would happen if US Subsidiary were allocated 1/3 of all carried interest. In particular, as a result of the allocations in the agreement, US Subsidiary earns $195 million in after-tax profit ($300 million of non-qualified US carried interest – 35% tax rate times $300 million). If US Subsidiary were allocated 1/3 of all carried interest, US Subsidiary would earn $260 million in after-tax profit ($400 million carried interest – 35% tax rate times $400 million). Thus, the allocations pass the substantiality test.[117]

f. Summary: How the Pieces Come Together

If Blackstone Group LP earned directly the income to which it is entitled, less than 90% of Blackstone Group LP's income would consist of qualifying income, and, as a consequence, Blackstone Group LP would be treated like a corporation for tax purposes.[118] To avoid this result and, in the process, save substantial tax liability, Blackstone Group LP uses the structure illustrated above in Figure 1. In this structure, Underlying Fund allocates or pays any non-qualifying income to US Subsidiary or Non-US Subsidiary and allocates any qualifying income directly to Blackstone Group LP. As a result, Blackstone Group LP earns 100% qualifying income (either income allocated directly to it or dividend income, capital gain income, and, possibly, interest income received from US Subsidiary and Non-US Subsidiary). Consequently, Blackstone Group LP qualifies for the 90% Gross Income Exception, is treated like a partnership for US tax purposes, and avoids having to pay corporate level tax on all of its income. US Subsidiary pays corporate level tax on some of the income allocated to it, so corporate-level tax is not entirely avoided. However, qualifying income allocated to Blackstone Group LP and income allocated to Non-US Subsidiary escape corporate-level tax. Moreover, at least under a literal application of the substantial economic effect rules, the allocations by Underlying Fund will be respected. However, as discussed above, these substantial economic effect rules are premised on the assumption that the partners in a partnership are unrelated and have opposing economic interests. Thus, as discussed below, they are a poor fit for the Blackstone Group LP structure in which two of the partners (US Subsidiary and Non-US

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[117] This is true assuming that related entities should be treated as separate partners when applying the substantiality tests, a matter that is not entirely free from doubt because the IRS has suggested otherwise. *See* Leder, *supra* note 100 at 779 (mentioning a field service advisory in which the IRS suggested that related parties could be treated as one partner when applying the substantiality tests). For the field service advisory, see 1993 WL 1469410 ("Given the present facts, it is important to examine the economic relationship of the partners of the Partnership. While the substantiality regulations do not specifically address the issue of related partners, section 1.704-1(b)(2)(iii)(a) does require the Service to consider each partner's tax attributes.")
[118] *See supra* note 5 and accompanying text.

Subsidiary) are wholly-owned subsidiaries of the third partner (Blackstone Group LP).

III. Congressional Response

Following the announcement of the initial public offering of Blackstone Group LP, Senators Max Baucus and Charles Grassley proposed legislation that would have made Blackstone Group LP's structure ineffective.[119] In particular, under this legislation, the exception from corporate tax treatment for publicly traded partnerships that earn predominately passive income would not apply to Blackstone Group LP and similar entities because the exception effectively would not apply to any partnership that earned carried interest income, management fees, or similar income, directly or indirectly.[120] The legislation would not have immediately applied to Blackstone as it contained a grandfathering provision.[121] Specifically, the new legislation would not have applied for five years to any partnership that, as of June 14, 2007, was already publicly traded or had already filed a registration statement with the SEC in contemplation of an initial public offering.[122]

In addition to the proposal described above, proposals less squarely directed at the Blackstone structure would, if enacted, make the structure less effective. For example, in 2009, Congressman Levin introduced legislation that, among other things, would have treated all carried interest as non-qualifying income for purposes of the publicly-traded partnership rules.[123] The Blackstone structure is effective largely because qualified carried interest allocated directly to Blackstone Group LP is not subject to corporate level tax. If all carried interest were non-qualifying income, Underlying Fund would not earn any qualifying income that could be allocated directly to Blackstone Group LP. As a consequence, either Blackstone Group LP would have to abandon its current structure and resign itself to being treated as a corporation for tax purposes or Underlying Fund would have to modify its allocations so that almost all of its income was allocated to either US Subsidiary or Non-US Subsidiary.[124] The income allocated to US Subsidiary would be subject to corporate level tax.[125]

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[119] S. 1624, 110th Cong. (2007), For further discussion of the legislation, see Fleischer, *supra* note 1 at 104 - 120.
[120] S. 1624, 110th Cong. (2007)
[121] S. 1624, 110th Cong. (2007)
[122] S. 1624, 110th Cong. (2007)
[123] H.R. 1935, 111th Cong. (2009)
[124] The text refers to "almost all" income rather than "all" income because Blackstone Group LP could earn up to 10% non-qualifying income and still comply the 90% Gross Income Exception.
[125] This structure still has some benefits because of the potential use of interest expense to reduce US Subsidiary's tax liability and because Non-US Subsidiary is not subject to tax. *See supra* Parts II.c and II.d. *See*, *also*, Fleischer, *supra* note

Although none of the proposed reforms described above have been enacted, private equity has received renewed attention, in part because of the high profile of Mitt Romney's private equity firm, Bain Capital, in the recent presidential campaign.[126] Thus, it is possible that these reforms will be revisited. In fact, other aspects of private equity tax structuring have already received recent scrutiny. For example, in September 2012, the press began reporting on a new investigation by New York Attorney General Eric Schneiderman regarding how private equity fund sponsors convert management fees into carried interest in order to receive more favorable tax treatment.[127]

IV. <u>Are the results claimed by Blackstone appropriate under current law?</u>

Rather than consider potential reforms that would affect the results claimed by Blackstone Group LP, this article analyzes whether those results are appropriate under current law. This article concludes that, even under current law, the IRS could challenge the results claimed by Blackstone Group LP, and, in the process, this article provides an example of how standards in tax law should be interpreted.

a. <u>Rules and Standards in Tax Law</u>

As others have observed, lawmakers design rules, in tax law and elsewhere, to accommodate the most typical fact patterns.[128] Yet, as others have argued, lawmakers cannot rely exclusively on tax rules based on the most typical fact patterns because taxpayers will adjust

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1 at 105 ("The tax advantages of the Blackstone deal structure disappear if the tax treatment of carried interest changes. If carry is treated as ordinary income, then compliance with the PTP rules would require Blackstone to cleanse substantially all its income through the blocker structure, which may require paying a corporate-level tax (at least to the extent not zeroed out by deductible interest payments on debt in the blocker entity…).")

[126] *See supra* note 25.

[127] *See*, *e.g.*, *New York Probes Private-Equity Tax Practices*, WALL STREET JOURNAL, September 3, 2012; Victor Fleischer, What's at Issue in the Private Equity Tax Inquiry, NY Times Deal Book.

[128] *See*, *e.g.*, Martin J. McMahon Jr., *Beyond a GAAR: Retrofitting the Code to Rein in 21st Century Tax Shelters*, 98 TAX NOTES 1721, 1722 (March 17, 2003) ("Both the Internal Revenue Code and the Treasury regulations, with their myriad of detailed rules, are written on the general supposition that the specific rules will provide guidance regarding the proper calculation of the tax due as a result of virtually every imaginable transaction in the ordinary course of business or involving an investment."); Weisbach, *Formalism, supra* note 31 at 867-69. For a related point, see Louis Kaplow, *Rules vs. Standards: An Economic Analysis*, 42 Duke L.J. 557, 577 (1992) (suggesting that lawmakers should design rules to cover frequently occurring fact patterns by stating, "[T]he greater the frequency with which a legal command will apply, the more desirable rules tend to be relative to standards.")

their transactions to take the rules into account.[129] Standards can fill the gap left by tax rules that envision only the typical case.[130]

[129] *See*, *e.g*., Noöl B. Cunninghan & James R. Repetti, *Textualism and Tax Shelters*, 24 VA. TAX REV. 1, 33 (2004) ("[O]nce the new rule became effective, promoters could easily concoct new abusive transactions that literally complied with the rule."); Daniel I. Halperin, *Halperin Expresses Support for Partnership Anti-Abuse Reg*, 94 TAX NOTES TODAY 152-36 (August 4, 1994) ("[M]ore specific rules will invite taxpayers and advisors to devise approaches that will dodge the specific inhibitions."); Calvin H. Johnson, *H.R. ____, The Anti-Skunk Works Corporate Tax Shelter Act OF 1999*, 84 TAX NOTES 443, 445 (1999) ("Tax laws are made, moreover, not by engineers but by a Congress that represents a broad and diverse democracy. Loopholes can be created in any human tax system unless the system is defended and repaired. Shelters take razor-thin fissures of no material concern and turn them into gaping holes in the tax base."); Logue, *supra* note 31 at 366 ("[W]hatever tax rules are adopted, no matter how specific or detailed or comprehensive they are, sophisticated taxpayers with fancy tax lawyers and accountants will always find opportunities for aggressive or abusive tax avoidance. Put differently, it simply is not possible to write tax laws that are devoid of all unintended loopholes."); McMahon, *supra* note 128 at 1722 ("The mechanical terms of specific rules…provide a tremendous temptation to treat the rules as an instruction manual for creating and structuring transactions outside the ordinary course of business or normal investments in which the taxpayer would not engage except as a result of the tax avoidance potential of the inventive transaction"); Andrea Monroe, *What's in a Name: Can the Partnership Anti-Abuse Rule Really Stop Partnership Tax Abuse?*, 60 CASE W. RES. L. REV. 401, 409 (2010) ("Subchapter K [the rules governing taxation of partners and partnerships] includes a formidable patchwork of technical provisions …[and]… audit rates are low….Taken together, these flaws create a playground for those who engage in transactions that comply with subchapter K's literal language, yet result in tax consequences that Congress did not contemplate."); Daniel N. Shaviro & David A. Weisbach, *The Fifth Circuit Gets It Wrong In Compaq v. Commissioner*, 94 TAX NOTES 511, 512-13(Jan. 28, 2002) ("Inevitably, there will be some unforeseen interaction of the tax rules so that, if one arranges one's affairs in just the right manner, magic happens."); Weisbach, *Formalism*, *supra* note 31 at 869 ("Uncommon transactions that are taxed inappropriately become common as taxpayers discover how to take advantage of them."); Richardson speech ("As all of you know from experience, precise, mechanical rules cannot possibly cover ALL conceivable situations. Moreover, such rules tend to be the oil fields into which the perennial loophole seekers punch holes looking for a gusher").

[130] *See*, *e.g*., Cunningham & Repetti, *supra* note 129 at 6 ("[I]t is sound tax policy to use broad standards to administer the tax law….This approach allows the Service to use broad standards to administer the tax law in place of a collection of narrow rules that must be constantly changed in a hopeless attempt to keep pace with the latest tax gimmick."); Peter L. Faber, *Faber Offers Views on Partnership Anti-Abuse Reg*, 94 TAX NOTES TODAY 167-9 (August 25, 1994) ("General anti-abuse rules are needed because it is impossible for the Service to keep up with all of the new techniques that are dreamed up on Wall Street and elsewhere…"); Johnson, *supra* note 129 at 445 ("The court-made equitable doctrines such as substance over form, sham transaction, and step transaction give the law a vigor that helps the law defend against aggressive

Moreover, because standards fill the gap left by rules designed for the typical case, courts and the IRS should readily apply standards to atypical cases (or cases that the rules did not contemplate).[131]

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misinterpretations of the statute to avoid tax"); Monroe, *supra* note 129 at 413 (describing this role of a particular standard, namely the "Partnership Anti-Abuse Rule" and stating: "It had to be nimble enough to challenge partnership transactions in a constantly evolving market, broad enough to counterbalance subchapter K's overly technical rules, and strong enough to compel the magicians practicing within subchapter K to keep a safe distance from abusive transactions."); Shaviro & Weisbach, *supra* note 129 at 513 ("The antiabuse doctrines …interpret.. the tax law so that odd interactions will not produce tax benefits, at least when taxpayers purposefully try to exploit them by arranging deals that lack any significant economic significance and nontax rationale."); Weisbach, *Formalism*, *supra* note 31 at 876 ("[I]n crafting a tax law that includes an anti-abuse rule, drafters need not be terribly concerned with rare transactions that might be mistaxed because attempts to take advantage of them will be covered by the anti-abuse rule").

[131] *See*, *e.g.*, Deborah A. Geier, *Interpreting Tax Legislation: The Role of Purpose*, 2 FLA. TAX REV. 492, 493 (1995)("[T]ax law has a rich history of nonliteral interpretation in order to avoid results that one person or another has considered to be inconsistent with the purpose of the statute as a whole."); Alan Gunn, *The Use and Misuse of Anti-Abuse Rules*, 54 SMU L. REV. 159, 164 (2001) ("[A] transaction that tries to use a statutory (or regulatory) provision to achieve a goal that no sensible legislator would have approved of is abusive."); Weisbach, *Formalism*, *supra* note 31 at 880 ("The statute's purpose is relevant because it allows us to identify which transactions the drafters contemplated in designing the simple rules and which they did not; that is, which transactions were sufficiently common to be considered when the law was promulgated."). Along similar lines, others have observed that legislative intent or purpose is relevant for purposes of determining whether a transaction is a tax shelter, is abusive, or otherwise is subject to challenge. *See*, *e.g.*, Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5, 13-15 (2000); Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 TAX NOTES 1775, 1787 (June 21, 1999) ("The purchase of municipal bonds or depreciable property can be distinguished from the facts presented in a tax shelter context by reference to legislative intent: Congress deliberately sought to influence the purchase of municipal bonds or depreciable property through favorable tax laws and as a result, those transactions ought to be exempt from the business purpose doctrine."); Joshua D. Blank, *What's Wrong with Shaming Corporate Tax Abuse*, 62 TAX L. REV. 539, 539 (2009) (defining corporate tax abuse as "corporations' reliance on aggressive, though arguably 'legal' readings of the Code to claim valuable tax benefits that Congress never intended"); Sarah B. Lawksy, *Probably? Understanding Tax Law's Uncertainty*, 157 U. PA. L. REV. 1017, 1032 (2009)("[T]he essence of a tax shelter is that it technically complies with the law while nonetheless violating the substance or intent of the law, which is no easy thing to determine."); Leandra Lederman, *W(h)ither Economic Substance*, 95 IOWA L. REV. 389, 396 – 97 (2010) ("The question thus becomes what distinguishes tax-influenced transactions that simply accept government incentives from those that exploit the law (whether or not they constitute tax shelters). The dividing line is whether Congress intended to provide the claimed

b. <u>Partnership Allocation Rules Premised on Assumption of Unrelated Partners</u>

As discussed above, the rules restricting partnership allocations are premised on the assumption that the partners in a partnership are unrelated and, consequently, have opposing economic interests. Thus, as discussed above in Part II.e.iii, allocations by Underlying Fund may be respected under a literal application of the allocation rules because the allocations could lessen US Subsidiary's after-tax profit compared to what would occur if Underlying Fund allocated each type of income equally to each of its partners. Under the allocation rules, the fact that the allocations worsen US Subsidiary's after-tax position removes the allocations from suspicion. The rationale for this result is that no partner would agree to allocations that make him, her or it worse off after-tax absent a compelling, non-tax business reason for doing so. However, although this rationale may apply to a partnership in which the partners are unrelated and have opposing economic interests (such as the partnership described above in Example 4), this rationale simply does not apply when the economic interests of the partners are aligned (such as in the Blackstone Group LP structure). In the Blackstone Group LP structure, US Subsidiary and Non-US Subsidiary are wholly-owned by Blackstone Group LP. Thus, the economic interests of the partners in Underlying Fund are completely aligned, and all partners in Underlying Fund are indifferent regarding how after-tax profits are shared among the partners. Consequently, the fact that the allocations by Underlying

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benefit or not. While not necessarily an easy question to answer, it is the question that distinguishes abusive transactions from appropriate ones. Any other test is simply a proxy for that inquiry."); Michael L. Schler, *Ten More Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach*, 55 TAX L. REV. 325, 331 (2002) [hereinafter, Schler, *Ten More Truths*] ("[A] tax shelter should be defined as a transaction, or a portion of a transaction, that (1) arguably complies as a literal matter with the Code and regulations, (2) is accompanied by some level of tax motivation, and (3) reaches a tax result unintended by Congress or the regulations."). It should be noted that this view of how to interpret standards has not always convinced courts. *See*, *e.g*., Marvin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM L. REV. 1939, 1939 (2005) ("The aim [of every tax shelter] is to create a tax benefit in the form of a loss, expense, or exclusion from gross income that has no economic corollary but is simply the consequence, or the hoped-for consequence, of rule manipulation. It is beyond doubt that such manipulations are contrary to congressional intent, but that perception has not always been conclusive or even probative in the cases that have arisen. Recent litigation between taxpayers and the government has had mixed results, with taxpayers winning in more than a few instances by persuading the courts that 'rules are rules' and that Congress alone, and not the courts, must patch the leaky tire if Congress thinks a patch is needed."); David A. Weisbach, *The Failure of Disclosure as an Approach to Shelters*, 54 SMU L. REV. 73, 77 (2001)("[A] perusal of the cases shows that courts are often quite literal in their interpretation of the tax law….").

Fund make US Subsidiary (or any other partner in Underlying Fund) worse off after tax provides no assurance that the allocations are not tax-motivated. Indeed, as described in Part II above, the allocations are entirely motivated by the goal of saving corporate level tax that would be imposed on all of Blackstone Group LP's income if it were treated like a corporation for tax purposes.

c. **Thus, when partners are related, the IRS and courts should apply standards**

Because the partnership tax allocation rules are premised on the assumption that partners are unrelated and have opposing economic interests, the IRS and the courts should apply standards in cases in which that assumption does not hold true. If the IRS and the courts fail to do so, taxpayers like Blackstone Group LP can simply use the rules as a roadmap for how to save taxes in ways unintended by the existing rules. In the case of Blackstone Group LP, the IRS potentially could rely on either of two existing standards: (1) the Partnership Anti-Abuse Rule or (2) Internal Revenue Code Section 482.[132] Each of these standards is discussed, in turn, below.

i. **Partnership Anti-Abuse Rule**

In May 1994, the Treasury proposed regulations referred to as the "Partnership Anti-Abuse Rule".[133] The Treasury proposed the Partnership Anti-Abuse Rule as a response to the increasing prevalence of abusive partnership transactions.[134] As originally proposed, the Partnership Anti-Abuse Rule provided: "[I]f a partnership is formed or availed of in connection with a transaction …with a principal purpose of substantially reducing the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of [the partnership tax rules], the Commissioner can disregard the form of the transaction."[135] The originally proposed regulations provided that whether or not a transaction had such a prohibited purposes would be determined based on all the facts and circumstances, and the proposed

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[132] For discussion of how these standards might be used generally to challenge allocations that have substantial economic effect but that involve related partners, *see*, *e.g.*, Leder, *supra* note 100 at 769, 779 - 780 (2001).

[133] Prop. Treas. Reg. § 1.701-2, 59 Fed. Reg. 25,581 (May 17, 1994).

[134] *See*, *e.g.*, Monroe, *supra* note 129 at 408 – 413; Richardson speech ("Wall Street bankers regularly market partnership tax plays, rumors of clever transactions abound, and entire seminar presentations focus on strategies for 'running amok' in the area. Apparently for some, partnerships have become the tax shelters of the '90s. I submit that this is not what the original drafters of Subchapter K had in mind. In response to this situation, we proposed the anti-abuse regulation").

[135] Prop. Treas. Reg. § 1.701-2, 59 Fed. Reg. 25,581 (May 17, 1994).

regulations contained a small number of examples of transactions that violated or did not violate the Partnership Anti-Abuse Rule.[136]

The proposed regulations provoked intense criticism from practitioners.[137] They complained that the regulations were overly vague and beyond the scope of the Treasury's rulemaking authority.[138]

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[136] *Id.*

[137] *See*, *e.g*., Monroe, *supra* note 129 at 407 ("[P]ractitioners responded venomously, displaying a level of anger and outrage rarely seen in the tax world."); *Id.* at 415 ("'I'm gonna have a heart attack. You can print that.' This was a common practitioner reaction to the proposed [Partnership Anti-Abuse Rule].")

[138] *See*, *e.g*., Rep. Bill Archer & Sen. Bob Packwood, *Archer, Packwood Caution Treasury on Partnership Anti-Abuse Rule*, 94 TAX NOTES INTERNATIONAL 246-17 (December 16, 1994); Sheldon I. Banoff, *Partnership Anti-Abuse Regs Should be Rescinded, Banoff Asserts*, 94 TAX NOTES TODAY 106-24 (June 2, 1994); Elizabeth A. Case, *Price Waterhouse Says Existing Law is Sufficient to Curb Abusive Partnership Transactions*, 94 TAX NOTES TODAY 141-33 (July 21, 1994); Robert D. Comfort, *Philadelphia Bar Tax Section Calls for Partnership Rule's Withdrawal*, 94 TAX NOTES TODAY 140-31 (July 20, 1994); Harvey L. Coustan, *AICPA Calls for Changes in Partnership Anti-Abuse Reg*., 94 TAX NOTES TODAY 139 (July 19, 1994); Terence Floyd Cuff, *Los Angeles County Bar Urges Withdrawal of Anti-Abuse Reg; Notes Uncertainty of Partnerships Involving Foreigners and Domestic Partners*, 94 TAX NOTES INTERNATIONAL 150-14 (August 4, 1994); Alan H. Daniels, *Florida Bar Committee Calls for Anti-Abuse Rule's Overhaul*, 94 TAX NOTES TODAY 142-41 (July 22, 1994); Ernst & Young, *Ernst & Young Criticizes Partnership Anti-Abuse Reg*, 94 TAX NOTES TODAY 141-32 (July 21, 1994); Sheldon I. Fink, Louis S. Freeman, Richard M. Lipton & Thomas M. Stephens, *Partnership Anti-Abuse Reg Will Have 'Chilling Effect' on Legitimate Transactions, Attorneys Say*, 94 TAX NOTES TODAY 115-16 (June 15, 1994); Charles R. Levun, *Chicago Bar Calls Partnership Anti-Abuse Rule Invalid, Urges Withdrawal*, 94 TAX NOTES INTERNATIONAL 139-17 (July 20, 1994); Michael Lux, *Deloitte & Touche Says Reg Exceeds IRS's Authority*, 94 TAX NOTES TODAY 139-68 (July 19, 1994); Monroe, *supra* note 129 at 416 – 424; Michael E. Shaff & Jerome Busch, *Orange County Bar Association Criticizes Partnership Anti-Abuse Reg*, 94 TAX NOTES TODAY 142-40 (July 22, 1994); Ralph Weiland, *TEI Urges Withdrawal of Partnership Anti-Abuse Rule*, 94 TAX NOTES TODAY 140-21 (July 20, 1994); Robert J. Wells & Carolyn Wright, *ABA Tax Section Meeting: Subchapter K Anti-Abuse Reg Sparks Heated Discussions*, 63 TAX NOTES 933 (May 23, 1994); Michael S. Wolff, *Grant Thornton Calls Anti-Abuse Rule an Invitation to Unfairness*, 94 TAX NOTES TODAY 141-34 (July 21, 1994). Although most practitioners criticized the proposed regulations, some scholars and practitioners supported the Partnership Anti-Abuse Rule. *See*, *e.g*., Joseph Bankman, *Stanford Professor Rebuts Criticisms of Partnership Anti-Abuse Reg*, 94 TAX NOTES TODAY 140-33 (July 20, 1994); Peter L. Faber, *Faber Offers Views on Partnership Anti-Abuse Reg*, 94 TAX NOTES TODAY 167-9 (August 25, 1994); Daniel I. Halperin, *Halperin Expresses Support for Partnership Anti-Abuse Reg*, 94 TAX NOTES TODAY 152-36 (August 4, 1994); Michael L. Schler, *NYSBA Submits Report on Partnership Anti-Abuse Regulation*, 94 TAX NOTES INTERNATIONAL 130-8 (July 7, 1994) ("We strongly support the adoption of a general anti-abuse rule applicable to tax-motivated partnership transactions. We generally support the proposed regulation. However, we

Partially in response to criticisms, Treasury revised the regulations to include additional examples and a list of factors that may be relevant when determining whether or not a transaction is abusive.[139] Yet, despite the revisions made by Treasury, practitioners continue to criticize the regulations.[140]

In January 1995, Treasury issued the revised and final regulations.[141] As finally adopted, the Partnership Anti-Abuse Rule provides: "[I]f a partnership is formed or available of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of [the partnership tax rules], the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of [the partnership tax rules]."[142] The regulations further provide that, in order to determine whether a partnership was formed or availed of for such a prohibited purpose, the IRS must consider all relevant facts and circumstances.[143] Furthermore, the regulations contain a list of factors that may indicate, but do not necessarily establish, that a partnership was used for a prohibited purpose.[144] These factors include, among others: (1) the present value of the partners' aggregate tax liability is substantially less than the tax liability the partners would incur if they engaged in the partnership's activities and owned the partnership's assets directly;[145] (2)substantially all of the partners are related to one

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believe it is important that the regulation be revised in certain specific respects to narrow its scope and that additional examples be added clarifying that narrowed scope").

[139] *See*, *e.g*., Monroe, *supra* note 129 at 426 ("[T]he Treasury did revise the [Partnership Anti-Abuse Regulation], presumably to mollify the regulation's critics.")

[140] *See*, *e.g*., Sheldon I. Banoff, *Anatomy of an Anti-Abuse Rule: What's Really Wrong with Reg. Section 1.701-2*, 95 TAX NOTES TODAY 56-84 (March 22, 1995); Richard M. Lipton, *The Partnership Anti-Abuse Regs Revisited: Is There Calm After the Storm?*, 83 J. Tax'n. 68, 68 (1995); McKee, Nelson & Whitmire, *supra* note 98 at ¶1.05[5][a] (concluding that the Partnership Anti-Abuse Rule is invalid under a *Chevron* analysis); Monroe, *supra* note 129 at 436; Lee Sheppard, *Government Officials Discuss Partnership, Shelter Issues*, 2007 TAX NOTES TODAY 107-1 (June 4, 2007) (mentioning that practitioners think the Partnership Anti-Abuse Rule is invalid); Sheryl Stratton, *They're Back…Washington Lawyers Attack Anti-Abuse Rules*, 95 TAX NOTES TODAY 178-4 (September 12, 1995). However, for an argument that the anti-abuse rules are necessary and also valid under a *Chevron* analysis, *see*, *e.g*., Cunningham & Repetti, *supra* note 129 at 39 - 62.

[141] T.D. 8588, 1995-1 C.B. 109.

[142] Treas. Reg. Section 1.701-2(b).

[143] Treas. Reg. Section 1.701-2(c).

[144] *Id.*

[145] Treas. Reg. Section 1.701-2(c)(1).

another,[146] and (3) partnership items are allocated in compliance with the literal language of the substantial economic effect rules but with results that are inconsistent with the purpose of those rules.[147]

All three of the factors listed above are present in the Blackstone Group LP structure. Regarding the first factor, if each of Blackstone Group LP, US Subsidiary, and Non-US Subsidiary directly owned what they, under the current structure, own through Underlying Fund, Blackstone Group LP likely would fail to qualify for the 90% Gross Income Exception and, thus, likely would subject to corporate level tax on all of its income. Consequently, the partnership structure used by Blackstone Group LP substantially reduces the partners' aggregate tax liability. Regarding the second factor, all of the partners are related given that two of the partners (US Subsidiary and Non-US Subsidiary) are wholly-owned subsidiaries of the third partner (Blackstone Group LP). Regarding the third factor, as described above, Underlying Fund's allocations comply with the literal language of the substantial economic effect rules;[148] yet, the allocations are inconsistent with the purpose of those rules given that the allocations are entirely tax-motivated.[149]

Although meeting these factors does not conclusively establish that the Partnership Anti-Abuse Rule applies, it does provide strong evidence. Moreover, as discussed above, it would be appropriate to apply a standard like the Partnership Anti-Abuse Rule to the Blackstone Group LP structure given that it takes advantage of rules that were premised on the assumption that partners in a partnership are unrelated and have opposing economic interests.

If the Partnership Anti-Abuse Rule applies, the IRS could seek a number of remedies including re-allocating items allocated by Underlying Fund. Thus, for example, the IRS could adjust the allocations so that all income currently allocated to US Subsidiary and Non-US Subsidiary was, instead, allocated directly to Blackstone Group LP. This adjustment would result in Blackstone Group LP recognizing non-qualifying carried interest income, which could cause it to fail to comply with the 90% Gross Income Exception so that it would be treated like a corporation for tax purposes.

ii. <u>Section 482</u>

Partnership tax allocation rules are, by no means, the only tax rules that are based on the assumption that parties have opposing economic

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[146] Treas. Reg. Section 1.701-2(c)(4).
[147] Treas. Reg. Section 1.701-2(c)(5).
[148] *See supra* Part II.e.iii.
[149] *See supra* Part II.e.ii (discussing how the purpose of the rules is to prevent tax-motivated allocations) and *see supra* Part II.f (discussing the fact that the allocations made by Underlying Fund are entirely tax-motivated).

interests. Tax rules, generally, work best in a setting involving unrelated parties with opposing economic interests dealing at arms-length. For example, when a person or entity sells property to another person or entity, the tax gain or tax loss recognized by the seller generally depends on the amount received from the buyer.[150] Thus, if a seller disposes of property for a lower price, the seller will recognize less tax gain (or more tax loss) than the amount the seller would recognize if he or she sold the property for a higher price. This tax treatment relies on the assumption that the buyer and seller have opposing economic interests so that the price paid reflects economic reality. Assume, instead, the facts of the following example.

> **Example 5**. A US corporation (USCORP) owns 100% of the stock of a non-US corporation (NONUS). USCORP sells property to NONUS for a price determined by the parties.

In Example 5, the price established by the parties will not necessarily reflect economic reality. Rather, the parties might use a price lower than the market price if doing so minimizes the parties' aggregate tax liability. Section 482 of the Internal Revenue Code deals broadly with the ubiquitous problems arising from the fact that related parties do not deal at arms-length, and, thus, might manage their transactions in a way designed purely to minimize aggregate tax liability. Specifically, Section 482 provides:

> "In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses…."

In Example 5 above, the IRS could use Section 482 to challenge the results claimed by the parties if the price used is inconsistent with an arms-length price.[151]

In the context of partnership tax allocations, the Treasury Regulations specifically provide that the IRS may use Section 482 to challenge

[150] IRC Section 1001.
[151] Treas. Reg. Section 1.482-1(b)(1) ("In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer.")

partnership tax allocations when partners are related.[152] In particular, Treasury Regulation Section 1.704-1(b)(1)(iii) states: "[A]n allocation that is respected under [the substantial economic effect rules or the partners' interests in the partnership rules] nevertheless may be reallocated under other provisions, such as section 482…". This language is supplemented by the following example:

> "Example 28. (i) B, a domestic corporation, and C, a controlled foreign corporation, form BC, a partnership organized under the laws of country X. B and C each contribute 50 percent of the capital of BC. B and C are wholly-owned subsidiaries of A, a domestic corporation…. The BC partnership agreement provides that, for the first fifteen years, BC's gross income will be allocated 10 percent to B and 90 percent to C, and BC's deductions and losses will be allocated 90 percent to B and 10 percent to C. The partnership agreement also provides that, after the initial fifteen year period, BC's gross income will be allocated 90 percent to B and 10 percent to C, and BC's deductions and losses will be allocated 10 percent to B and 90 percent to C.
>
> (ii) Apart from the application of [the substantial economic effect rules and the partners' interests in the partnership rules], the Commissioner may reallocate or otherwise not respect the allocations under other sections…. For example, BC's allocations of gross income, deductions, and losses may be evaluated and reallocated (or not respected), as appropriate, if it is determined that the allocations result in the evasion of tax or do not clearly reflect income under section 482."[153]

Example 28 is very similar to the Blackstone Group LP structure. In Example 28, a partnership has two partners (B and C), both of which are corporations and both of which are wholly-owned by a third corporation (A). The partnership allocates items between B and C in a

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[152] For further discussion, see Leder, *supra* note 100 at 785 – 87; McKee, Nelson & Whitmire, *supra* note 98 at ¶ 3.07[4] ("While there is limited case law dealing with the application of § 482 to partnerships, the courts have not been reluctant to apply it to situations where partners are related or are under common control….. The scope of § 482 is broad enough to encompass …partnerships between corporations and their controlling shareholders,…assuming the controlling shareholders are viewed as 'organizations, trades or businesses' for purposes of § 482…"); *Id*. at ¶ 11.03 ("[A]n allocation provision, which is in substance a contract among the partners as to how they will share the partnership's income and loss, can distort the income of the partners vis-à-vis each other. Accordingly, § 482 should apply to permit the Service to correct such distortions where certain partners are under common control.").

[153] Treas. Reg. Section 1.704-1(b)(5) Example 28.

way the minimizes the partners' aggregate tax liability. Given that B and C are "organizations, trades or businesses" and are "owned or controlled, directly or indirectly, by the same interests", Example 28 concludes that the IRS could challenge the allocations under Section 482 even if the allocations comply with the substantial economic effect rules.[154] Furthermore, the IRS has successfully invoked Section 482 to challenge partnership tax allocations in the past. In *Rodebaugh v. Commissioner*,[155] the taxpayers (husband and wife) each owned stock in several corporations. The corporations, in turn, were partners in a partnership, and the partnership allocated tax items among the partners in a way that was designed to minimize the partners' aggregate tax liability. The IRS invoked Section 482 to challenge the manner in which the partnership allocated income among the corporations, and the court held in favor of the IRS.[156]

If Section 482 applies to Example 28 and the facts in *Rodebaugh*, it also could apply to the Blackstone Group LP structure. In the Blackstone Group LP structure, Underlying Fund allocates income among three partners – Blackstone Group LP, US Subsidiary and Non-US Subsidiary – all of which are "organizations, trades or business"[157] and all of which are "owned and controlled, directly or indirectly, by the same interests."[158] Thus, even though the allocations by Underlying Fund may

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[154] The IRS has also reiterated in Field Service Advisories the idea that Section 482 can apply in the partnership tax allocation context. *See*, *e.g.*, 1993 WL 1469410 ("It is the Service's position that section 1.704-1(b)(1)(iii) of the regulations permits the use of section 482 to reallocate a partner's distributive share of any partnership item despite the validity of the allocation under section 704(b), provided that the requirements of section 482 are met."); 1993 WL 1469438 (making a similar statement); 1993 WL 1469419 (making a similar statement). However, the IRS has also stated: "We note, however, that the scope of section 1.704-1(b)(1)(iii) vis-a-vis section 482 has not been clearly delineated…" 1993 WL 1469438.

[155] T.C. Memo 1974-36.

[156] *Id.*

[157] An "organization" includes a sole proprietorship, a partnership, a trust, an estate, an association, or a corporation. Treas. Reg. Section 1.482-1(i)(1). Thus, this term is broad enough to include all three partners.

[158] The regulations under Section 482 provide that the IRS may reallocate items among "controlled taxpayers". *See* Treas. Reg. Section 1.482-1(a)(2). The regulations define "controlled taxpayer" to include "any one of two or more taxpayers [which can include any person, organization, trade or business, whether or not subject to tax] owned or controlled directly or indirectly by the same interests". See Treas. Reg. Sections 1.482-1(i)(3) and (5). This part of the definition includes US Subsidiary and Non-US Subsidiary as both are wholly-owned by Blackstone Group LP. The regulations further state that "controlled taxpayer" also includes "the taxpayer that owns or controls the other taxpayers." Treas. Reg. Section 1.482-1(i)(5). Thus, Blackstone Group LP is also a "controlled taxpayer", and the IRS can reallocate income among Blackstone Group LP, US Subsidiary, and Non-US Subsidiary under Section 482.

literally comply with the substantial economic effect rules,[159] the IRS could challenge those allocations under Section 482. In particular, the IRS might reallocate additional amounts of non-qualifying carried interest income directly to Blackstone Group LP. Furthermore, the IRS might challenge the payment of management fees to US Subsidiary under Section 482 and conclude that Blackstone Group LP should be treated as if it received some portion of the management fees directly. As a result, Blackstone Group LP would earn non-qualifying income and, thus, could fail to qualify for the 90% Gross Income Exemption so that it would be treated like a corporation for tax purposes.

V. Why the IRS might fail to act

Despite the availability of means to challenge the results claimed by Blackstone Group LP, the IRS might fail to act for several reasons, each of which is described and evaluated below.

a. The IRS is reluctant to invoke controversial regulations.

The IRS might hesitate to challenge the consequences claimed by Blackstone Group LP because of the controversial nature of the Partnership Anti-Abuse Rule. Practitioners have criticized the Partnership Anti-Abuse Rule, arguing that it is vague and potentially beyond the scope of Treasury's rulemaking authority.[160] Perhaps in part because of the controversy surrounding the Partnership Anti-Abuse Rule, the IRS has rarely invoked it.[161]

However, although this concern might explain the IRS's hesitancy to invoke the Partnership Anti-Abuse Rule, it does not explain a reluctance to invoke Section 482. First, because Section 482 was enacted by Congress it does not raise the same authority concerns as the Partnership Anti-Abuse Rule. Second, although some might argue that Section 482 is vague and should be supplanted with the more detailed

[159] *See supra* Part II.e.iii.
[160] *See supra* note 140.
[161] *See*, *e.g*., Bankman, *supra* note 131 at 1788 ("[O]ne practitioner notes that, 'No one in the industry seems to take…the section 701 regulations very seriously."); Monroe, *supra* note 129 at 407 ("[The Partnership Anti-Abuse Rule] is a complete failure. Practitioners, the Service, and the courts regularly disregard the regulation when structuring and analyzing transactions."). *Id*. at 429 ("For a regulation earnestly compared to a weapon of mass destruction, the final [Partnership Anti-Abuse Rule] has had a surprisingly modest impact on subchapter K."). *Id.* at 429 – 436 (describing how the Partnership Anti-Abuse Rule has been raised by the IRS rarely in administrative guidance and cases and discussing how practitioners have come to view the rule as "toothless" and thus "simply ignore it".) *Id.* at 441 (speculating that the Service might hesitate to invoke the Partnership Anti-Abuse Rule because it wants to "avoid drawing further ire from the [rule's] powerful opponents" or because it fears that "litigation might lead to a successful challenge" of the rule's validity.)

substantial economic effect rules,[162] the vagueness argument is unpersuasive. The substantial economic effect rules are premised on the assumption that partners in a partnership have opposing economic interests.[163] The Blackstone Group LP structure, in which the partners are related, was designed to take advantage of rules that did not contemplate the structure used by Blackstone Group. Standards, rather than rules, should apply to a structure that takes advantage of rules that did not contemplate it, and a standard necessarily will be vague in order to be sufficiently flexible to fill gaps left by rules.[164]

b. <u>Challenging the current structure would lead to undesirable consequences.</u>

The IRS may hesitate to challenge Blackstone Group LP's claimed tax consequences because doing so would lead to undesirable consequences in two ways. First, current investors in Blackstone Group LP purchased their interests based on the assumption that Blackstone Group LP would be treated like a partnership for tax purposes. If it were treated like a corporation instead, those investors would lose significant wealth as a result of a decline in the value of the interests that they hold. Second, Blackstone Group LP provides an avenue for ordinary individuals to hold economic interests in private equity funds, real estate funds, and hedge funds, despite the fact that ordinary individuals cannot invest in these vehicles directly given the large minimum

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[162] *See*, *e.g.*, Leder, *supra* note 100 at 787 ("The purpose of Regulation section 1.704-1(b) was to provide a significant degree of certainty to taxpayers who diligently follow the detailed requirements for substantial economic effect. The use of section 482 to override it should be sharply limited to cases in which related taxpayers are not dealing at arm's length.")

[163] *See supra* notes 99 and 110 - 112 and accompanying text.

[164] For example, even while making the argument that the specific substantial economic effect rules should generally supplant Section 482 and other general standards, Richard Leder acknowledges that Section 482 or the Partnership Anti-Abuse Rule might apply when partners in a partnership are related. See Leder, *supra* note 100 at 785 ("the Service may seek to apply the [Partnership] Anti-Abuse Rule to plug 'leaky valves' in the [substantiality tests]. For example, the Service may seek to apply the [Partnership Anti-Abuse Rule to an example in which the allocations make one partner worse off, after-tax, but make a related party better off]"); *Id.* at 787("The use of section 482 to override [the substantial economic effect test] should be sharply limited to *cases in which related taxpayers are not dealing at arm's length*.") (emphasis added). For a similar argument, see Monroe, *supra* note 129 at 454 ("Although a comprehensive analysis of uncertainty's role in partnership taxation is well beyond this Article's scope, I posit that …the introduction of greater uncertainty into subchapter K might have a positive effect on partnership taxation….Subchapter K overflows with complex and technical statutory provisions…intended, at least in part, to increase certainty….[Yet, technical rules]…create fault lines ripe for exploitation by taxpayers at extraordinary public cost.")

investment required to purchase an interest in such funds.[165] Challenging Blackstone Group LP's claimed tax consequences could prevent other fund sponsors from engaging in initial public offerings in the future; thus, limiting the opportunities for ordinary individuals to acquire indirect economic interests in such funds. Furthermore, challenging Blackstone Group LP's tax consequences would have the effect of allowing ordinary individuals to invest in funds only if they do so through an entity that bears corporate level tax.

Although these concerns are legitimate, they represent not only reasons to hesitate challenging Blackstone Group LP under current law but also reasons to avoid Congressional reforms that would tax Blackstone Group LP as a corporation.[166] Furthermore, if it is desirable to allow ordinary individuals to invest in Blackstone Group LP and benefit from the tax treatment claimed by Blackstone Group LP, then Congress should reform the publicly-traded partnership rules so that the results claimed by Blackstone are, actually, consistent with law.[167] Taking the alternative approach of acquiescing to taxpayers' manipulation of the rules is an undesirable alternative.[168]

c. Blackstone's structuring produces a logical result despite illogical rules.

The 90% Gross Income Exception results in what is called a "cliff effect", meaning that small non-tax changes can produce drastic tax changes. In order to demonstrate, assume the following facts:

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[165] *See*, *also*, Fleischer, supra note 1 at 118 – 119 ("The Blackstone deal actually provides more meaningful egalitarian access to the capital markets by allowing public investors to participate, albeit indirectly, in alternative asset classes without forcing a financial intermediary to pay an entity-level tax.")

[166] Even if it contains a delayed effective date, legislative reform would still affect current investors, although to a somewhat lesser extent. *See*, *e.g.*, Michael J. Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revisions*, 126 U. PA. L. REV. 47, 49 (1977) ("A change in the tax law, made effective as of the date of enactment, may also have retroactive effect, most often by changing the value of assets that were acquired prior to 'any suggestion that the law might be changed.'"); *Id.* at 58 ("There is no substantial difference in enacting a change in either one of two years in the future, although delaying the change will, of course, lessen its impact…"); Louis Kaplow, An Economic Analysis of Legal Transitions, 99 Harv. L. Rev. 509, 518 (1986) ("The crucial yet simple conclusion is that changes in government policy—or, more generally, changes in the prospects for reforms—will affect the value of investments made prior to those changes to the extent that such changes were not fully anticipated. Many of the concerns raised by retroactive application of a new policy relate to all policy changes, suggesting that the scope of these concerns is far broader than has generally been recognized.")

[167] Regarding what such reform might provide, see *infra* Part V.c.

[168] *See infra* note 173 and accompanying text.

> **Example 6**. A publicly-traded partnership has earned $899 of qualifying income and $100 of non-qualifying income in a given year. The partnership will earn one more dollar of income before the year closes. If the additional dollar is non-qualifying income, the partnership will not meet the requirements of the 90% Gross Income Exception because less than 90% of its income will be qualifying income. As a result and assuming the partnership has no available deductions, the partnership will be subject to corporate level tax of 35% times $1000 or $350. If, instead, the additional dollar was qualifying income, then 90% of the partnership's gross income would be qualifying income and the partnership would be subject to $0 of entity level tax. Thus, $350 of potential tax liability depends on how merely $1 of income is earned.

Cliff effects are generally criticized.[169] As demonstrated by Example 6, two partnerships could be identical in all respects but for how $1 of income is earned. If that $1 is qualifying income, the partnership owes no tax liability, and if that $1 is non-qualifying income, the partnership owes significant tax liability. Such a result is arbitrary and unfair.[170]

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[169] For criticism of cliff effects in tax generally, see, e.g., Lily L. Batchelder, *What Should Society Expect from Heirs? The Case for a Comprehensive Inheritance Tax*, 63 TAX L. REV. 1, Footnote 303 (2009); Karen C. Burke, *Death Without Taxes?*, 20 VA. TAX REV. 499, 531 (2001); Glenn E. Coven, *Taxing Corporate Acquisitions: A Proposal for Mandatory Uniform Rules*, 44 TAX L. REV. 145, 174 – 75 (1989); Deborah L. Paul, *The Taxation of Distressed Debt Investments: Taking Stock*, 949 PLI/TAX 346A-1, 346A-10 (2011); David A. Stein, *UBIT Issues in Investment Partnerships: What Tax-Exempt Organizations (and their Taxable Partners) Should Know*, 920 PLI/TAX 198-1, 198-15 (2011); Clinton G. Wallace, *The Case for Tradable Tax Credits*, 8 N.Y.U. J. L. & BUS. 227, 234 (2011); Lawrence Zelenak, *Doing Something About Marriage Penalties: A Guide for the Perplexed*, 54 TAX L. REV. 1, 59 (2000); Lawrence Zelenak, *Taxing Gains at Death*, 46 VAND. L. REV. 361, 416 – 17 (1993).

[170] Rules that create cliff effects might also be criticized for distorting taxpayers' decisions. In Example 6, for instance, the partnership has a very strong tax motivation to earn $1 of qualifying income rather than $1 of non-qualifying income. This strong tax incentive could encourage the taxpayer to earn $1 of qualifying income even when there are good non-tax reasons to engage, instead, in the activity that would generate non-qualifying income. Although rules that produce cliff effects can distort taxpayers decisions, it is not clear that gradual rules would distort decisions to a lesser extent overall. Under a gradual rule that provides that all non-qualifying (and no qualifying income) is subject to entity-level tax, the decisions of a partnership under the facts of Example 6 will be less subject to distortion than such decisions would be under current law. Under current law, the taxpayer incurs $350 tax by earning $1 of non-qualifying income so tax consequences almost certainly will dissuade the taxpayer from engaging in the activity that generates that income. By contrast, under a gradual rule, the taxpayer would only incur an addition 35 cents of tax and thus might still undertake the activity despite the tax consequences.

A rule that causes a "cliff effect" can be contrasted with a rule under which tax results change gradually in response to incremental non-tax changes. For instance, instead of the current publicly-traded partnership rules (under which a publicly-traded partnership bears no entity-level tax if at least 90% of its gross income is qualifying income but bears entity level tax on all of its income if only 89.99% of its income is qualifying income), tax law could provide that every publicly-traded partnership pays entity-level tax on all of its non-qualifying income (less allowable deductions), but no publicly-traded partnership pays entity-level tax on its qualifying income.

Thus, in Example 6, if the additional $1 earned by the partnership is non-qualifying income, assuming no available deductions, the partnership's tax liability is $101 times 35% or ($35.35). If the additional $1 earned by the partnership is qualifying income, the partnership's tax liability is $100 times 35% or ($35). As a result, the only additional tax burden borne by the partnership as a result of earning an additional $1 of non-qualifying income is 35 cents (35% times the additional dollar). By contrast, under current law, the additional dollar results in an increase in tax liability from $0 to $350.

The Blackstone Group LP structure manufactures results that mimic the results of the gradual rule described above. In particular, under the Blackstone Group LP structure, non-qualifying income is subject to corporate-level tax (or at least most of it is)[171] but qualifying income is not subject to corporate-level tax. The same result follows from the gradual rule described above. Thus, Blackstone Group LP effectively

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However, compared to current law, a gradual rule could cause even greater distortions in the decisions of partnerships that earn well over 90% qualifying income, for example. Under current law, such partnerships can earn $1 of non-qualifying income or $1 of qualifying income without incurring any entity level tax. Thus, the decision between the two types of income will not be distorted by tax consequences. Under a gradual rule, such partnerships could earn $1 of qualifying income without incurring any entity level tax but would incur 35 cents of entity level tax as a result of earning $1 non-qualifying income. Thus, as compared to current law, a gradual rule could cause greater distortions in the decisions made by partnerships with well over (or well under) 90% qualifying income. For similar discussion, see Weisbach, *Formalism*, supra note 31 at 873 – 74 ("A discontinuous law, a cliff, may have very different behavioral effects than a continuous law, although one cannot say which will be more efficient without more information….Where there is a discontinuity, taxpayers sufficiently near the discontinuity will shift to the lower taxed regime, if transaction costs are less than the tax savings. The deadweight loss will be the sum of the losses from this shifting. When the law changes continuously, there is no particular line that the shifting centers around. All taxpayers potentially benefit from shifting.")

[171] It is not all subject to corporate level tax because of the potential use of interest expense to reduce US Subsidiary's tax liability and because Non-US Subsidiary is not subject to tax. *See supra* Parts II.c. and II.d.

planned around a rule that causes an undesirable "cliff effect". For this reason, the IRS might not challenge the results claimed by Blackstone given that they may be more sensible and less arbitrary than the results that follow from the laws that currently exist.[172]

The problem with this rationale for inaction is that, although it might justify changing the publicly-traded partnership rules so that they include a gradual rule like the one described above, it does not justify allowing Blackstone to remedy the problem through tax planning. Allowing Blackstone to work around current law erodes the integrity of the tax system and contributes to the perception that sophisticated taxpayers are not subject to the same tax rules that apply to the rest of us.[173]

d. The damage is contained.

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[172] Along similar lines, Professor Fleischer suggested that Blackstone might argue that its structure leads to more sensible results than what the law provides because the structure brings its tax treatment closer to pass-through tax treatment enjoyed by similar entities. See, Fleischer, *supra* note 1 at 111 ("Blackstone's strongest argument is to push for a principled distinction between firms that are subject to the corporate tax and firms that are not.…Many active oil and gas, timber, and other energy companies can operate as PTPs under the passive income exception, and some do. Similarly, many real estate firms operate without paying a corporate level tax, either through the PTP rules (which allow certain rental activities to qualify as passive income) or the REIT rules. Congress created a special rule for REITs… which allows them to 'cleanse' small amounts of 'bad' income through a taxable REIT subsidiary, much like the blocker entity in the [Blackstone] structure. Insurance companies, cooperatives, and other industry groups have their own methods of managing corporate tax liability. Why not Blackstone?").

[173] For a similar argument in the context of Blackstone, see Fleischer, *supra* note 1 at 114 ("The more powerful 'rule of law' argument relates to the gamesmanship of the deal. Rather than lobby for a legislative change, Blackstone thumbed its nose at Congress, cleverly structuring its way around the corporate tax. It relied on self-help…. While certainly not a crime, there is something to be said for responding swiftly to new structures that erode the corporate tax base. The bill, in other words, has some independent merit as a matter of protecting the integrity of the tax system, however theoretically flawed that system may be.") For a similar argument regarding tax planning generally, see David A. Weisbach, Ten Truths About Tax Shelters, 55 Tax L. Rev. 215, 225 (2002) [hereinafter, Weisbach, *Ten Truths*] ("The most difficult case is where there is an obvious wart on the tax system and tax lawyers help clients plan around the problem. For example, a given transaction might be grossly overtaxed relative to others, creating economic distortions. For various reasons, including the difficulty of drafting the law precisely, planning may reduce the tax to the appropriate amount more cheaply than actually amending the law. But this is a dangerous path because it depends on judgments about the merits of the underlying law. It is generally not a defense to a violation of the law that the law is stupid (try this next time you get pulled over for speeding). It is, therefore, not clear that we should think that planning around warts in the law is socially valuable.")

The IRS might refrain from challenging Blackstone Group LP's claimed tax consequences because there is a somewhat limited universe of publicly-traded entities that can effectively engage in the type of structuring used by Blackstone Group LP for at least two reasons. First, the structure reduces Blackstone Group LP's tax liability primarily by allowing qualifying income to escape corporate level tax.[174] Thus, a business that earns insignificant amounts of qualifying income cannot save substantial tax liability by using the structure. For example, a business that earns income primarily from operating an active business in the United States could not make effective use of the structure used by Blackstone Group LP. Second, if a business is already organized under state law as an incorporated entity, the business would automatically be treated as a corporation for tax purposes regardless of the type of income that it earns.[175] Such a business would have to undertake a restructuring to use the Blackstone structure, and the restructuring itself could trigger adverse tax consequences.[176]

Although not all businesses can effectively utilize the Blackstone structure, many other businesses could potentially use the structure, particularly new businesses that are not dissuaded by the costs of restructuring.[177] As a result, challenging the structure could still raise significant tax revenue from businesses that do or could use the structure.[178] Consequently, the somewhat limited scope of the problem

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[174] The structure also reduces tax imposed on non-qualifying income because of the potential use of interest expense to reduce US Subsidiary's tax liability and because Non-US Subsidiary is not subject to tax. *See supra* Parts II.c. and II.d.
[175] Treas. Reg. Section 301.7701-2(b)(1).
[176] For example, the shareholders of the corporation could contribute corporate stock to a partnership, and the corporation could, in turn, distribute some of its assets (assets that produce qualifying income) to the partnership. If the fair market value of these assets exceeded the corporation's tax basis in the assets, the corporation would recognize tax gain as a result of the distribution. I.R.C. Section 311 (b)(1).
[177] See, Fleischer, *supra* note 1 at 115 ("It's unclear whether the Blackstone structure…might create a domino effect beyond investment fund managers. Blackstone's business closely resembles the merchant banking and, to some extent, the investment banking activities of Goldman Sachs, Morgan Stanley, Merrill Lynch, and other Wall Street firms. If Congress fails to act, it puts these banks at a competitive disadvantage, which may encourage them to spin-off their merchant banking and other asset management activities into separate entities.")
[178] This assumes that the increased tax revenue collected from Blackstone Group and other, existing publicly-traded partnerships would not be offset by decreased tax revenue resulting from the fact that challenging the structure could discourage other, similar entities from engaging in initial public offerings. This assumption is not necessarily unfounded. *See*, *e.g.*, Fleischer, *supra* note 1 at 113 ("[I]t is difficult to predict the behavior of other private equity firms considering going public. KKR and others have proceeded with plans to go

does not represent a persuasive justification for the IRS's inaction, particularly at a time when the U.S. Treasury desperately needs increased tax revenue.

e. Blackstone Group LP did not engage in egregious tax abuse.

The IRS might fail to act because the structure used by Blackstone Group LP was not overly abusive. In particular, the underlying transaction (the initial public offering) was a legitimate business transaction, and Blackstone simply structured the transaction in a manner designed to achieve optimal tax consequences.

Although it is true that many transactions involve more egregious tax abuse than the Blackstone Group LP structure,[179] that fact and the fact that the underlying business transaction is legitimate should not immunize from challenge the structure used by Blackstone Group LP.[180] In tax law, entire doctrines are built around the idea that there are limits on the ways in which taxpayers can arrange legitimate business transactions.[181] Under these doctrines, if a taxpayer arranges the

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public following the introduction of the Blackstone Bill; it seems likely that, as with investment banks, private investment fund managers will seek the permanent capital and liquidity that public equity provides. On the other hand, it is certain that the Blackstone Bill will increase the cost of doing so and affect the decision at the margin.")

[179] For example, the Blackstone structure is not as egregious as the examples provided in the Treasury Regulations of transactions that violate the Partnership Anti-Abuse Rule. As Professor Gunn states, "The regulations' three examples of abuses present nothing that endangers ordinary tax planning. They involve temporary partners and the temporary holding of property by a partnership. Taxpayers contemplating conducting ordinary business affairs through a partnership have nothing to fear from the intent-of-subchapter-K regulations". Gunn, *supra* note 131 at 169.

[180] *See*, *e.g.*, Lederman, supra note 131 at 402 ("[T]he fact that a strategy is integrated into the taxpayer's business, rather than existing alongside it, should not affect the determination of whether that strategy is abusive. If the activity is abusive, it is socially wasteful regardless of how connected it is to the taxpayer's business."); Schler, *Ten More Truths*, supra note 131 at 339 (suggesting that "real business transactions done in a funny way" should be impermissible when they reach results unintended by Congress); Shaviro & Weisbach, supra note 129 at 513 ("[W]e should always keep in mind that even the most mundane tax planning is not the same as, say, curing sick people, inventing a new product, or even driving a bus."); Weisbach, *Ten Truths*, supra note 173 at 222 ("But tax planning, all tax planning, not just planning associated with traditional notions of shelters, produces nothing of value. Nothing is gained by finding new ways to turn ordinary income into capital gain, to push a gain offshore, or to generate losses. No new medicines are found, computer chips designed, or homeless housed through tax planning.")

[181] For example, the step transaction doctrine limits how taxpayers can arrange legitimate business transactions. Discussion of this doctrine is beyond the

transaction in a way not contemplated by existing tax rules, the transaction is subject to challenge. Moreover, there are good reasons for placing limits on structuring legitimate business transactions because, without such limits, taxpayers can take advantage of the unintended tax consequences of existing tax rules.

VI. Conclusion

Blackstone Group LP takes advantage of tax rules that are ill-suited for the structure used by Blackstone. Thus, Blackstone Group LP claims tax results that are arguably inappropriate under current law, and the IRS could challenge the results under available standards that are designed to fill gaps left by existing tax rules. The IRS has yet to challenge the transaction under these standards, and some of the reasons why the IRS might fail to act may, at first glance, appear legitimate. However, a closer examination reveals that, although some of these reasons might justify legislative reform to the publicly-traded partnership rules, they do not excuse a failure to challenge tax structures that flout current law.

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scope of this article. For some discussion, *see*, *e.g.*, Boris I. Bittker & Lawrence Lokken, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 4.3.5; Jeffrey C. Glickman & Clark R. Calhoun, *The "States" of the Federal Common Law Tax Doctrines*, 61 TAX LAW. 1181, 1187 (2008) (quoting Smith v. Commissioner and stating, "The step transaction doctrine generally applies in cases where a taxpayer seeks to get from point A to point D and does so stopping in between at points B and C. The whole purpose of the unnecessary stops is to achieve tax consequences differing from those which a direct path from A to D would have produced. In such a situation, courts are not bound by the twisted path taken by the taxpayer, and the intervening stops may be disregarded or rearranged.")

Appendix

I. As shown in the Blackstone S-1,[182] the actual structure used is reflected in Figure 2 below.

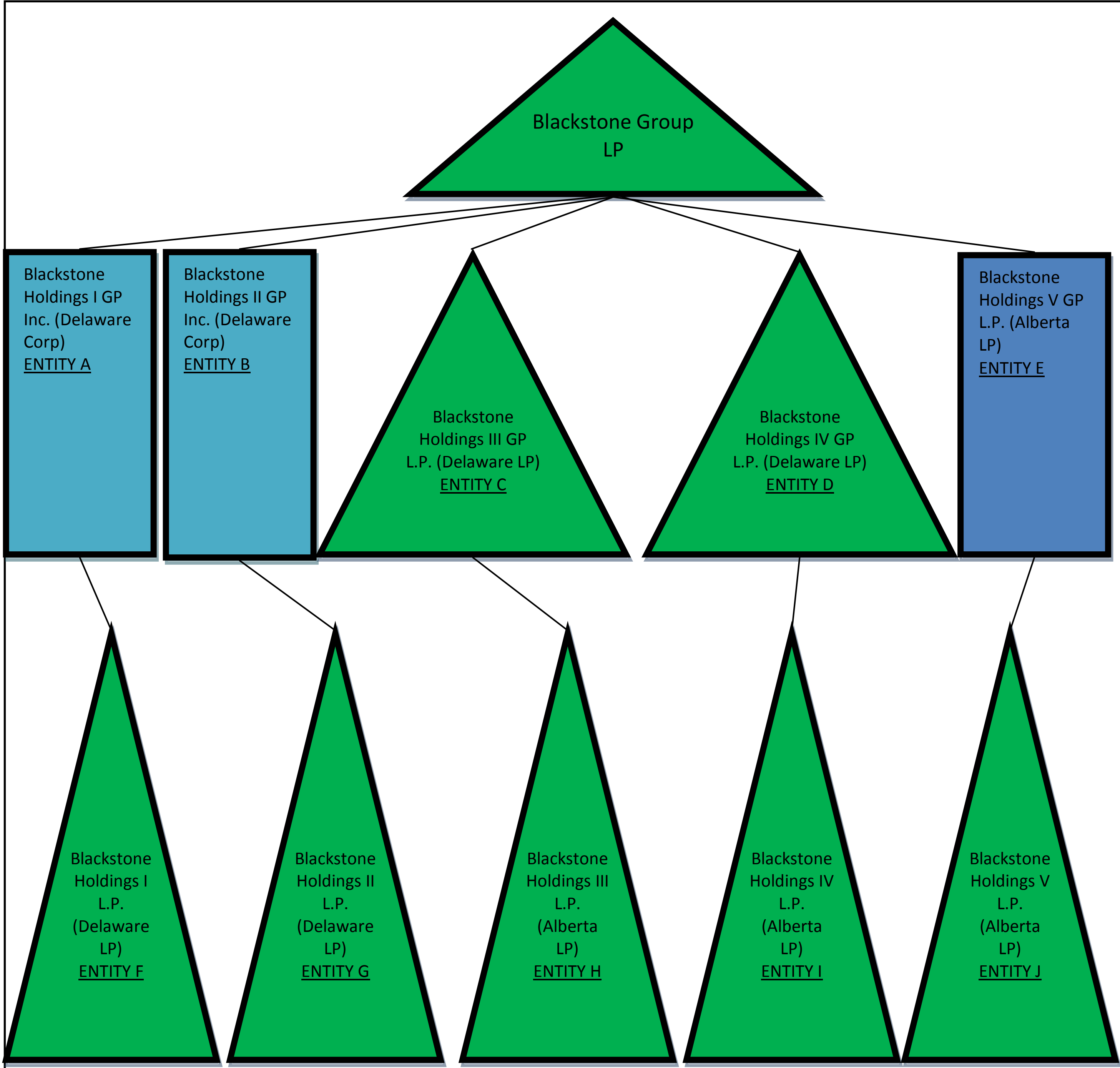

Figure 2 Blackstone Structure from S-1

[182] Blackstone S-1 at page 11.

II. Simplifying Adjustments

In Figure 2, the entities labeled Entities F, G, H, I and J, indirectly, receive management fees and carried interest from funds sponsored by Blackstone.[183] Furthermore, entities F, G, H, I and J are treated as partnerships for tax purposes. Because partnerships are pass-through entities for tax purposes, from a tax perspective, the results of the structure would be the same if Entities A, B, C, D, and E directly owned assets and directly received income that Entities A, B, C, D, and E own or receive, indirectly, through Entities F, G, H, I, and J, respectively. Further, according to the S-1, the structure is designed so that income received by Entities C and D will be qualifying income.[184] Thus, all non-qualifying carried interest and management fees (which are non-qualifying) must be allocated or paid, indirectly, to Entities A, B, or E. Finally, according to the S-1, Entity E is not expected to earn any income that is effectively connected with a US trade or business.[185] Thus, only non-qualifying carried interest income that is not effectively connected with a US trade or business is allocated, indirectly, to Entity E. Figure 3 below shows the structure in Figure 2 simplified to take into account the discussion in this Part II.

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[183] The Blackstone S-1 refers to these entities, collectively, as "Blackstone Holdings" and states that subsidiaries of Blackstone Holdings will be entitled to management fees and carried interest. See Blackstone S-1 at page 10.
[184] Blackstone S-1 at page 203.
[185] Blackstone S-1 at page 204 ("Blackstone Holdings V GP L.P. is expected to be operated so as not to produce [effectively connected income].")

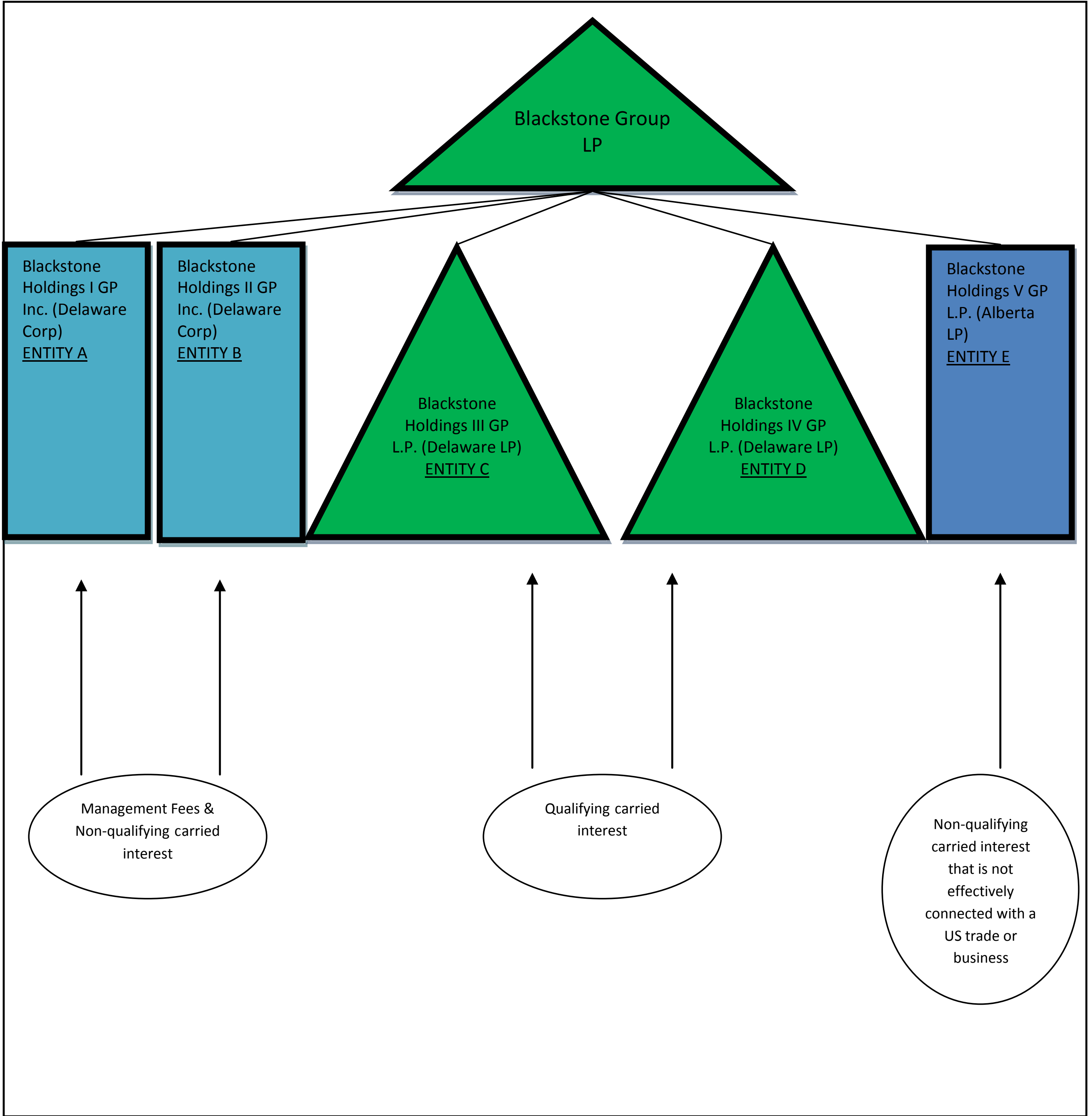

Figure 3 Blackstone Structure from S-1 with Simplifying Adjustments

III. Further Simplifying Adjustments

As shown in Figure 3 above, Blackstone Group LP holds interests in five subsidiaries (labeled Entity A, Entity B, Entity C, Entity D, and Entity E above). Entities A and B are U.S. entities treated like corporations for tax purposes. From a tax perspective, the results of the structure would be the same if Entities A and B were combined into one corporation. Thus, the structure discussed in this Article, and shown above in Figure 1, combines Entities A and B into one entity ("US Subsidiary"). Entity E is a non-U.S. entity treated as a corporation for tax purposes. In the structure discussed in this Article, and shown in Figure 1, Entity E is labeled "Non-US Subsidiary". Entities C and D are treated as partnerships for tax purposes. Because partnerships are pass-through entities for tax purposes, from a tax perspective, the results of the structure would be the same if Blackstone Group LP directly owned and received what it owns and receives, indirectly, through Entities C and D. Figure 4 below shows the structure in Figure 3 simplified to take into account the discussion in this Part III.

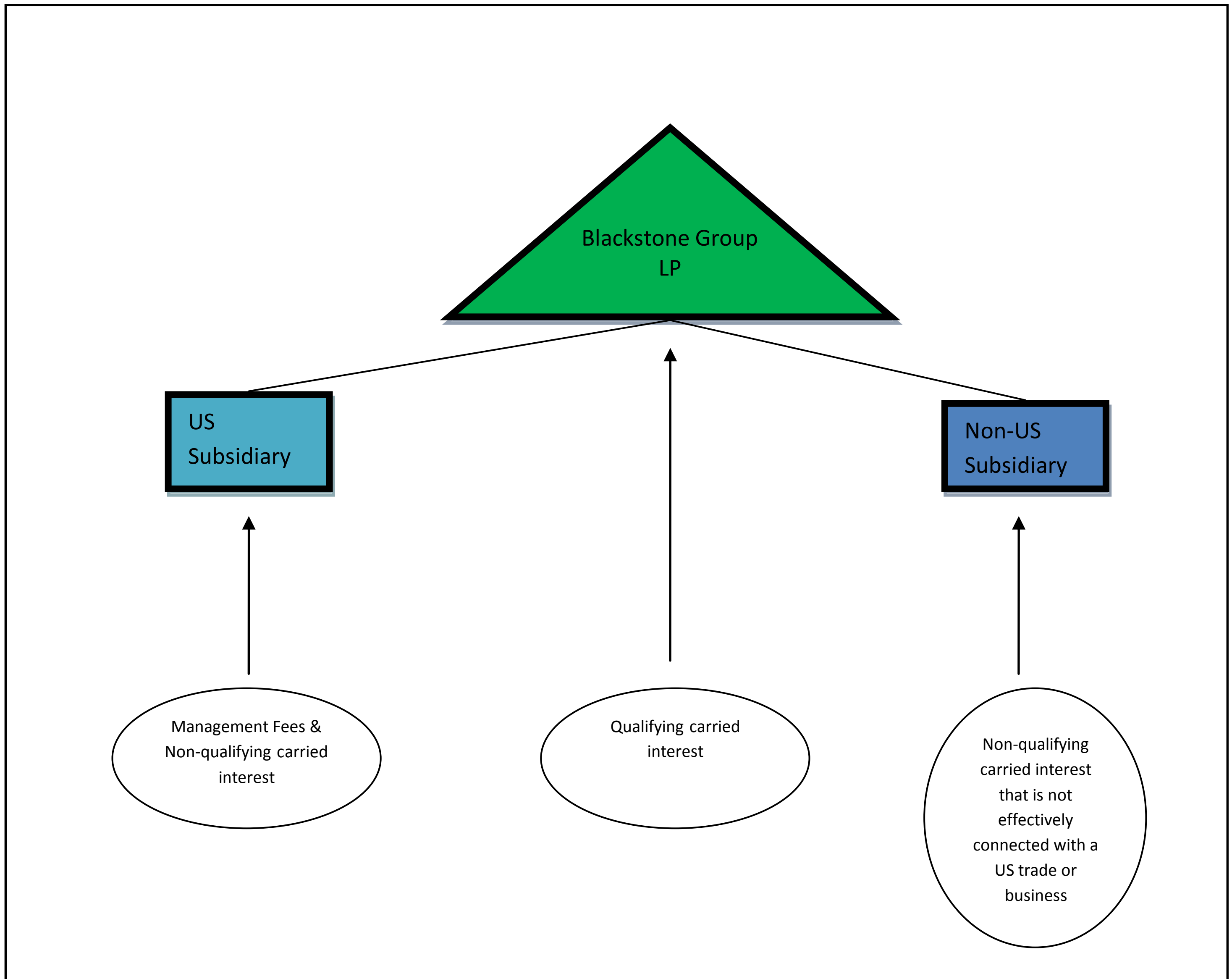

Figure 4 Blackstone Structure from S-1 with Further Simplifying Adjustments

IV. How Income Reaches the Various Entities

According to the Blackstone S-1, prior to the initial public offering, various entities ("Contributed Businesses") were entitled to receive management fees and carried interest from Blackstone funds.[186] In particular, with respect to each fund, an Investment Advisor was entitled to receive management fees, and a Managing Member was entitled to carried interest.[187] Following the restructuring

[186] Blackstone S-1 at page 57.
[187] *Id.*

undertaken prior to the initial public offering, the Contributed Businesses have been owned by subsidiaries of US Subsidiary, Blackstone Group LP, and Non-US Subsidiary.[188] Furthermore, because the subsidiaries that own the Contributed Businesses are pass-through entities for tax purposes, from a tax perspective, the results of the structure would be the same as if Blackstone Group LP, US Subsidiary, and Non-US Subsidiary owned the Contributed Businesses directly. Given the information provided in the Blackstone S-1 and discussed in this appendix, there are three ways that Blackstone Group LP and its subsidiaries might earn income from the Contributed Businesses so as to ensure that Blackstone Group LP qualifies for the 90% Gross Income Exception. The three possible structures are discussed below.

Possibility One

The first possible structure is shown in Figure 5 below. As Figure 5 shows, each fund sponsored by Blackstone (each, "Underlying Fund") pays management fees to an Investment Advisor that is owned by US Subsidiary. Each Underlying Fund also allocates carried interest to a Managing Member. The Managing Member, in turn, allocates some carried interest (in particular, carried interest that is qualifying income) directly to Blackstone Group LP, allocates some carried interest (in particular, non-qualifying carried interest that is U.S. source income or is effectively connected with a US trade or business) to US Subsidiary, and allocates some carried interest (in particular, non-qualifying carried interest that is not U.S. source income and is not effectively connected with a US trade or business) to Non-US Subsidiary.

This structure is similar to Figure 1 because Underlying Fund pays management fees, indirectly, to US Subsidiary, and Underlying Fund, indirectly, allocates some carried interest to each of Blackstone Group LP, US Subsidiary, and Non-US Subsidiary. If Blackstone Group LP uses this structure, the IRS could challenge the income allocations by the Managing Member of each Underlying Fund under the Partnership Anti-Abuse Rule or Section 482, and the IRS could invoke Section 482 to challenge the payment of management fees entirely to the Investment Advisor.

[188] *Id.*

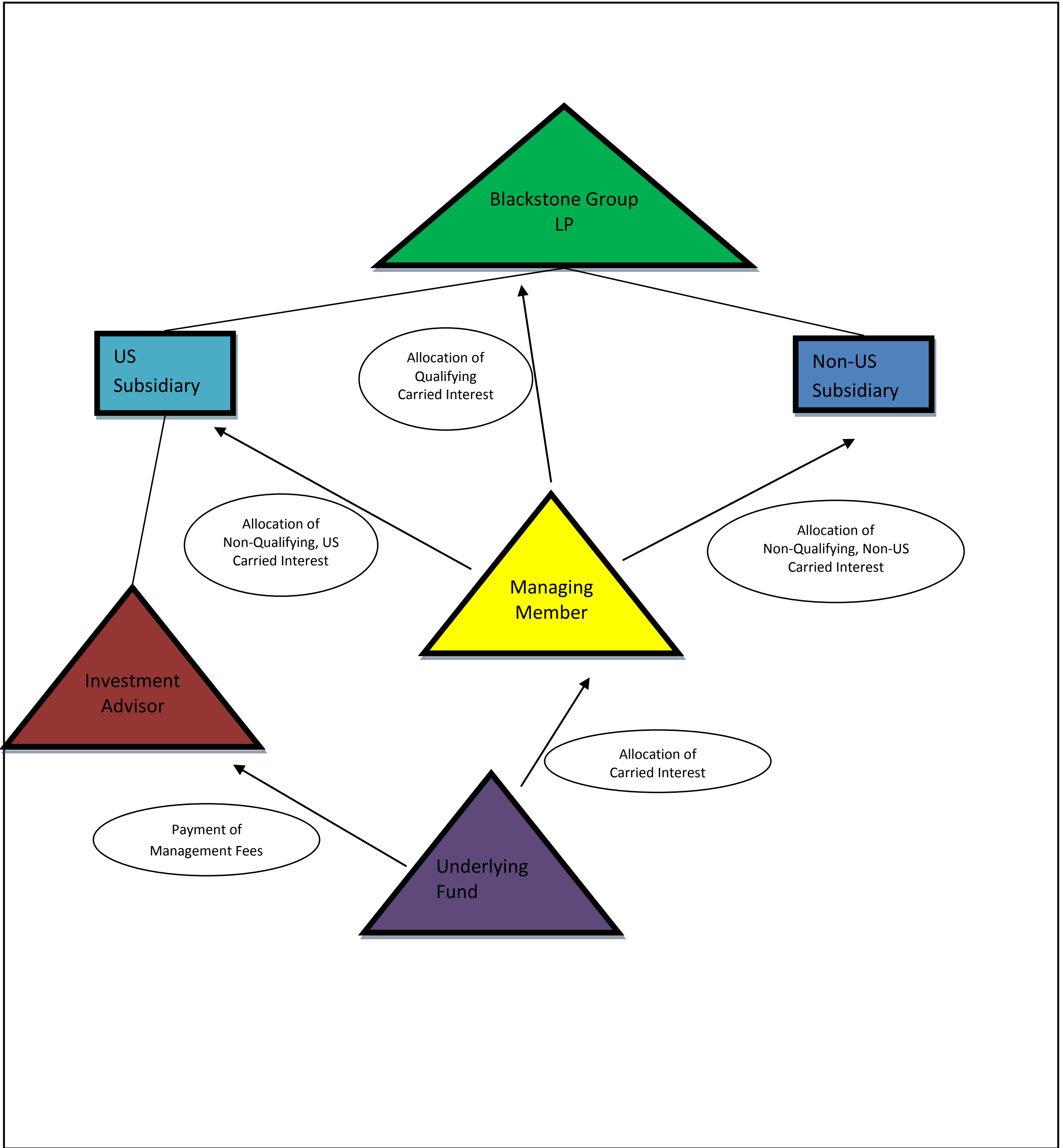

Figure 5 Possibility One

Possibility Two

The second possible structure is shown in Figure 6 below. As Figure 6 shows, in the second possible structure, like in the first possible structure, each fund sponsored by Blackstone (each "Underlying Fund") pays management fees to an Investment Advisor that is owned by US Subsidiary. However, unlike the first possible structure, in the second possible structure, the Managing Member of each Underlying Fund (which receives allocations of all carried interest from that fund) is owned entirely by only one of US Subsidiary, Non-US Subsidiary, or Blackstone Group LP. In order to implement this structure, with respect to each Underlying Fund, Blackstone would have to predict whether the Underlying Fund would generate carried interest that is predominately qualifying income, predominately US non-qualifying income, or predominately non-US non-qualifying income. Blackstone's predictions would determine whether the Managing Member of the Underlying Fund would be owned by US Subsidiary (if carried interest were expected to be predominately US non-qualifying income), Non-US Subsidiary (if carried interest were expected to be predominately non-US non-qualifying income), or Blackstone Group LP (if carried interest were expected to be predominately qualifying income).

If Blackstone Group LP uses the structure shown in Figure 6, the discussion in this Article of challenges to partnership tax allocations would be irrelevant because no partnership specially allocates different types of carried interest to different partners. However, the IRS could, nevertheless, invoke Section 482 to challenge the payment of management fees entirely to the Investment Advisor. Moreover, the structure shown in Figure 6 is the least likely of the three possible structures discussed in this Part IV of the Appendix because it relies on Blackstone's ability to accurately forecast the types of income that will be earned by a given Underlying Fund. Furthermore and more significantly, this structure would inappropriately constrain Blackstone's ability to select investments on behalf of a given Underlying Fund. For example, assume Blackstone predicted that an Underlying Fund would generate predominately qualifying income so that Blackstone Group LP directly owned the fund's Managing Member. Once this decision was made, Blackstone's obligation to the investors in the Underlying Fund to select beneficial investments could be at odds with its obligation to seek to ensure that Blackstone Group LP qualified for

the 90% Gross Income Exception. In particular, a conflict would arise if Blackstone identified a beneficial investment for this fund that would generate non-qualifying income.

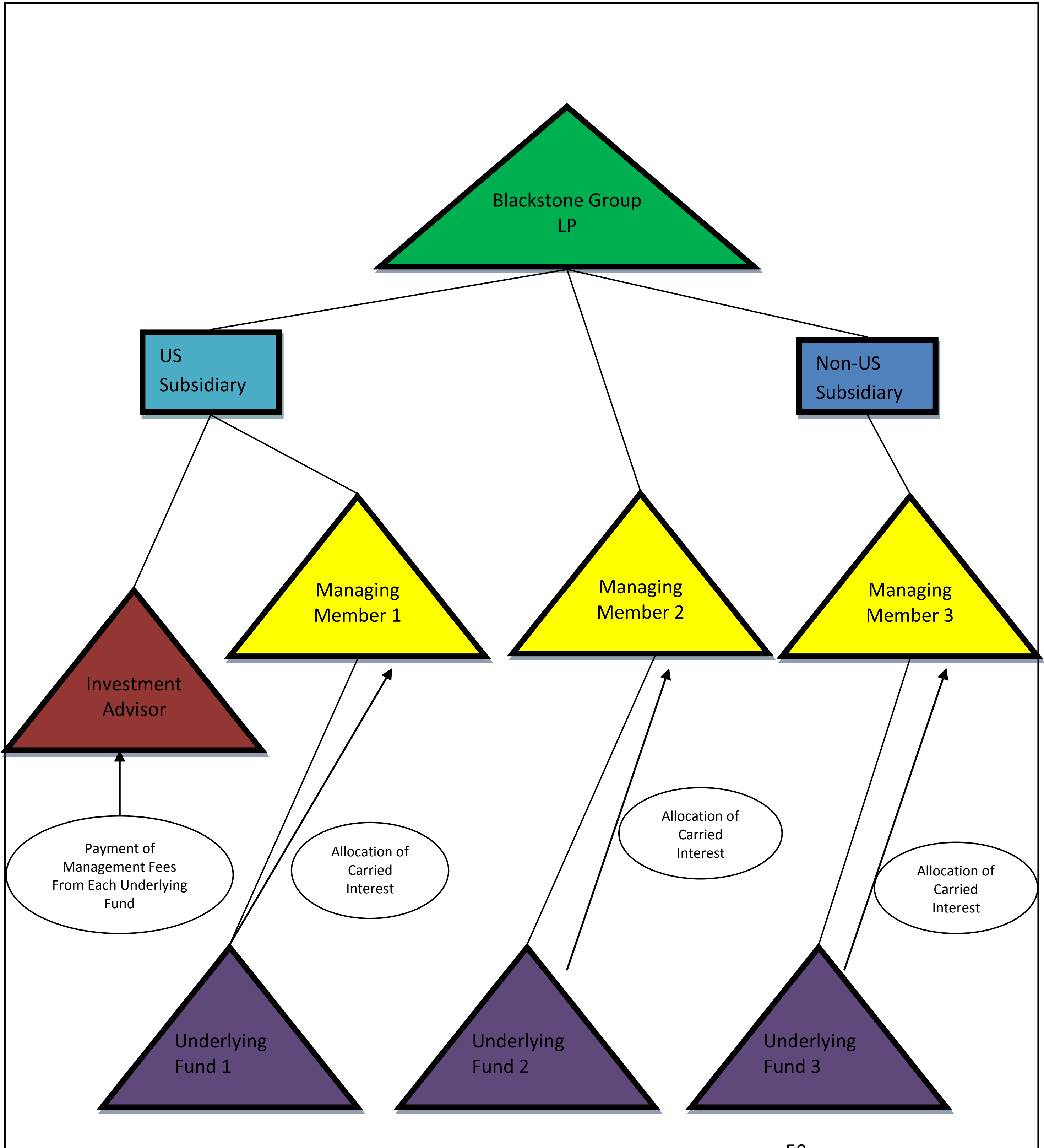

Figure 6 Possibility Two

Possibility Three

The third possible structure is shown in Figure 7 below. As Figure 7 shows, in the third possible structure, like in the first two possible structures, each fund sponsored by Blackstone (each "Underlying Fund") pays management fees to an Investment Advisor that is owned by US Subsidiary. Unlike in the previous structures, in the third structure, each Underlying Fund would form a number of subsidiaries treated like partnerships for tax purposes. When each Underlying Fund acquired an asset that was expected to generate non-qualifying, US income, the Underlying Fund would hold that asset through a subsidiary ("Sub 1" in Figure 7) that would allocate carried interest to Managing Member 1, which would be owned by US Subsidiary. When each Underlying Fund acquired an asset that was expected to generate qualifying income, the Underlying Fund would hold that asset through a subsidiary ("Sub 2" in Figure 7) that would allocate carried interest to Managing Member 2 which would be owned by Blackstone Group LP. Finally, when each Underlying Fund acquired an asset that was expected to generate non-qualifying, non-US income, the Underlying Fund would hold that asset through a subsidiary ("Sub 3" in Figure 7) that would allocate carried interest to Managing Member 3, which would be owned by Non-US Subsidiary.

If Blackstone, indeed, uses the structure shown in Figure 7, the IRS likely could challenge the structure and re-characterize it as the structure shown in Figure 8. Figure 8 shows the results of the IRS challenging Figure 7 and claiming that Sub 1, Sub 2, Sub 3, and Underlying Fund should be treated as one partnership for tax purposes. The IRS could base this challenge on the fact that all entities have the same owners and the fact that the economic arrangements of the entities are interdependent.[189] Regarding the second fact, investors in each Underlying Fund will insist that the carried interest received from Sub 1 may not depend, solely, on how the assets of Sub 1 have performed but

[189] *See*, *e.g.*, Gregory May, *Wrongs and Remedies: The U.S. Tax Treatment of Multinational Partnerships of Individuals*, 924 PLI/TAX 306, 306-29 – 306-31 (2011) (describing how the IRS could collapse parallel partnerships into a single partnership particularly if the partnerships "set distributions by reference to their combined profits.")

must instead, depend, on the performance of all assets held, directly or indirectly, by the Underlying Fund.

Finally, once the third possibility is re-characterized as shown in Figure 8, it is similar to the structure shown in Figure 1 because Underlying Fund pays management fees, indirectly, to US Subsidiary, and Underlying Fund, indirectly, allocates some carried interest to each of Blackstone Group LP, US Subsidiary, and Non-US Subsidiary. Thus, if Blackstone Group LP uses this structure, the IRS could challenge the income allocations by the Underlying Fund under the Partnership Anti-Abuse Rule or Section 482, and the IRS could invoke Section 482 to challenge the payment of management fees entirely to the Investment Advisor.

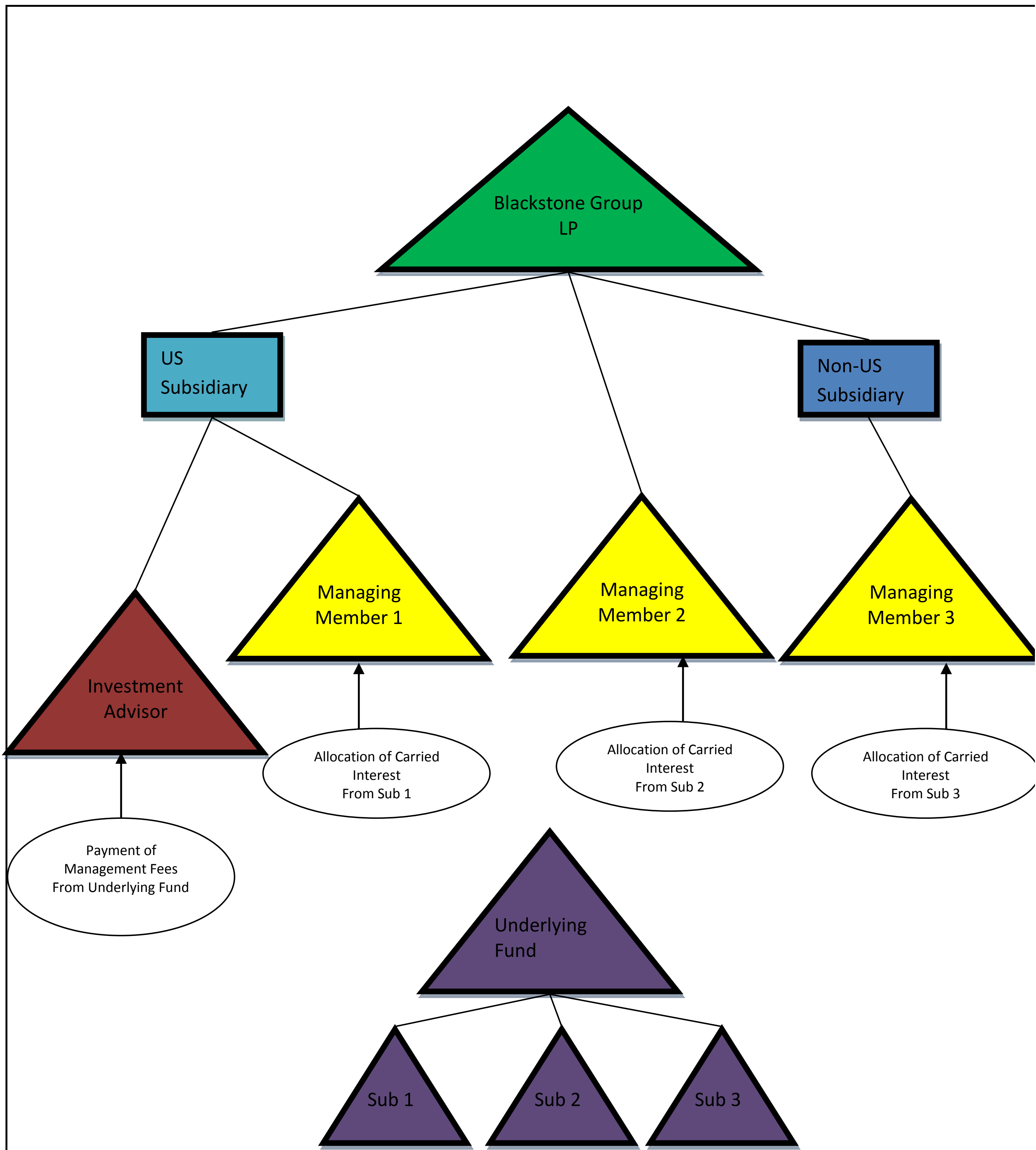

Figure 7 Possibility Three

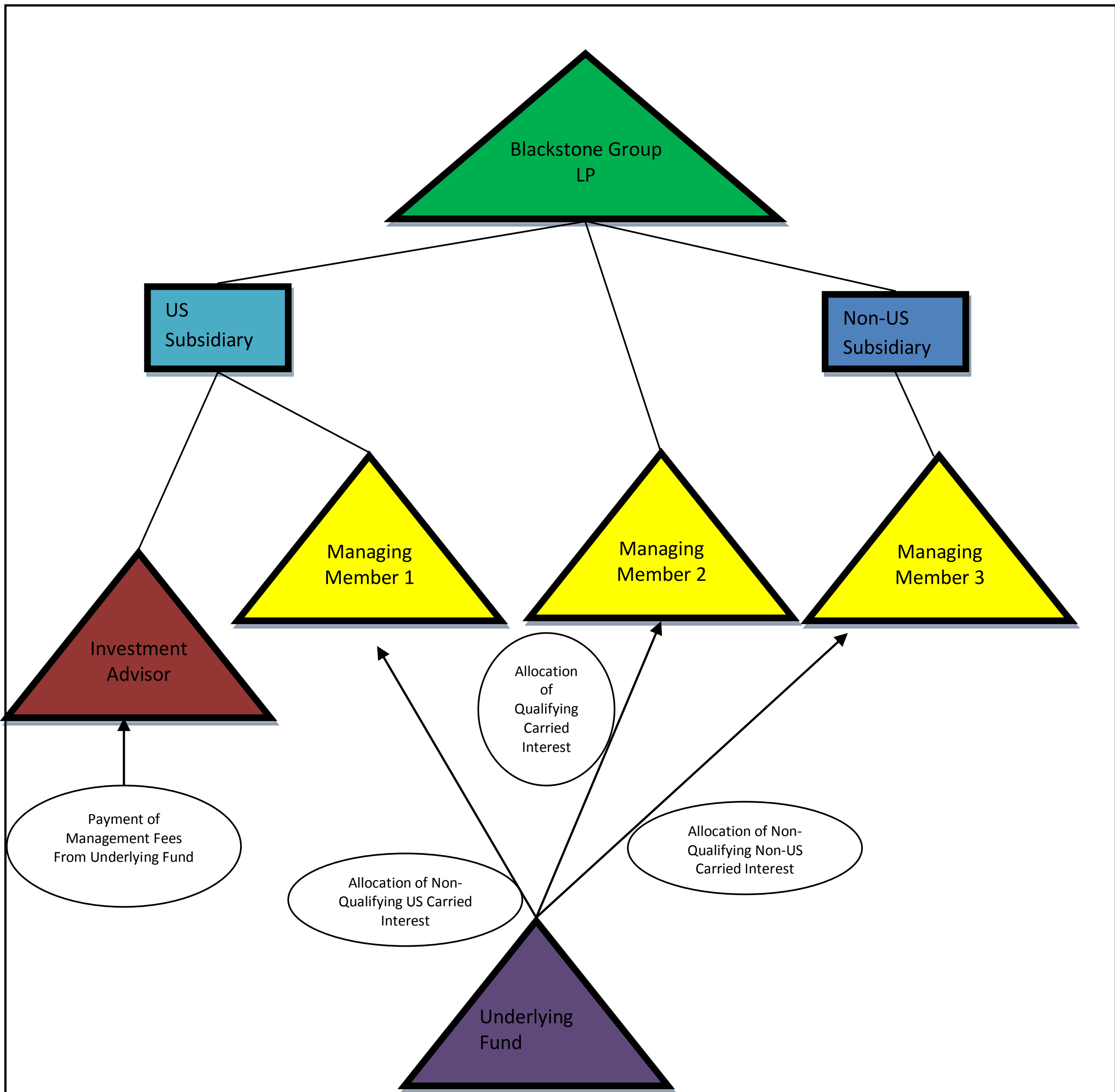

Figure 8 Possibility Three Re-Characterized