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WAS BLACKSTONE'S INITIAL PUBLIC OFFERING TOO GOOD TO BE TRUE?: A CASE STUDY IN CLOSING LOOPHOLES IN THE PARTNERSHIP TAX ALLOCATION RULES

by

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ABSTRACT

Typically, publicly traded entities must be treated as corporations for tax purposes. Blackstone Group LP is publicly traded, yet it is not treated as a corporation for tax purposes. Why not? Blackstone Group LP utilizes complex tax structuring in order to qualify for an exception from the typical corporate tax treatment and, in the process, saves millions of dollars in tax liability annually.

Members of Congress have proposed reforms that would have prevented Blackstone Group LP from reducing its tax liability in this manner. However, these reforms were not enacted. This Article takes a different approach. It argues that existing law already provides the IRS with the tools needed to challenge the legitimacy of the results claimed by Blackstone Group LP.

In the process, this Article highlights an important and unintended loophole in existing partnership tax allocation rules — specifically, the failure of the rules to adequately address allocations among related partners. Finally, this Article proposes that the IRS use general tax law standards to close this unintended loophole.

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I. INTRODUCTION

From time to time, journalists, lawmakers, and scholars have discussed and criticized the tax treatment of various aspects of the private equity industry. Over the past year, publicity regarding Bain Capital, the private equity firm founded by Mitt Romney, has dragged the private equity industry back into the public spotlight. Particularly in light of the ongoing budgetary crisis, this attention will likely reignite debate over possible reforms to the tax treatment of private equity. The likelihood that actual reform will occur seems slim, given that lawmakers have proposed and failed to enact reform in the past. Thus, rather than propose legislative reform, this Article advocates a different approach. In particular, this Article focuses on one particular transaction in which some private equity firms have engaged — initial public offerings — and argues that the IRS could challenge the tax treatment of these transactions under current law rather than wait for Congress to act. This Article will discuss one such initial public offering, which was undertaken in 2007 by Blackstone, and demonstrate how the IRS could challenge Blackstone's claimed tax consequences. More significantly, this Article will use the Blackstone transaction and other initial public offerings to illustrate a broader tax problem and its solution.

Blackstone (the "Blackstone Firm"), a private equity firm like Bain Capital, sponsors various private equity funds, real estate funds, and hedge funds. When the Blackstone Firm sponsors a fund, outside investors such as pension plans, educational endowments, financial institutions, and wealthy individuals agree to invest money in the fund. The Blackstone Firm selects projects and securities in which the fund will invest, and, in exchange for its efforts, the Blackstone Firm receives a management fee plus a percentage of the profits earned by the fund (referred to as "carried interest").

Blackstone Group LP trades on the New York Stock Exchange (NYSE).¹ Blackstone Group LP is an entity that earns a portion of what the Blackstone Firm 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 the Blackstone Firm receives as a fund sponsor.

Blackstone Group LP is publicly traded, yet unlike many publicly traded companies, it manages to avoid being treated as a corporation for tax purposes. Consequently, Blackstone Group LP is not required to pay corporate-level tax on any of its income, avoiding millions of dollars in tax

1. The Blackstone Group L.P., *Registration Statement (Form S-1)* (Mar. 22, 2007), <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 Victor Fleischer, *Taxing Blackstone*, 61 TAX L. REV. 89 (2008) [hereinafter Fleischer, *Taxing Blackstone*].

liability annually.² Complex tax structuring enables Blackstone Group LP to benefit from this atypical 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 percent 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.³ Without complex structuring, Blackstone Group LP would earn some qualifying income and some non-qualifying income and could very easily fail to meet this 90 percent gross income test.⁴ To avoid this result, Blackstone Group LP uses the structure shown in Figure 1 below to ensure that it always meets the 90 percent gross income test.⁵ In this structure, the Underlying Partnership, an entity treated as a partnership for tax purposes, allocates all qualifying income directly to Blackstone Group LP and allocates all non-qualifying income to subsidiaries of Blackstone Group LP that are treated as corporations for tax purposes. Allocating qualifying income directly to Blackstone Group LP ensures that such income retains its qualifying nature, and allocating all non-qualifying income to corporate subsidiaries transforms such income into qualifying income before it reaches Blackstone Group LP. As a result, Blackstone Group LP earns 100 percent qualifying income and avoids being treated as a corporation for tax purposes.

Blackstone Group LP is not the only entity that has benefited from this structure. Other private equity groups, including Fortress, KKR, and Carlyle, are publicly traded and use a similar approach. These publicly traded entities avoid enormous amounts of tax liability by using such structuring. For instance, by one estimate, Blackstone Group LP and its owners save \$150 million in taxes annually.⁶ Likewise, KKR and its owners save an

2. See *infra* note 6 and accompanying text.

3. I.R.C. § 7704(a) (stating general rule that publicly traded entities must be treated as corporations); I.R.C. § 7704(c) (providing exception).

4. See *infra* note 26 and accompanying text.

5. See *infra* Part II.

6. Fleischer, *Taxing Blackstone*, *supra* note 1, at 96–97. These estimates compare the tax liability resulting from the actual structure to the tax liability that Blackstone Group and its owners would incur if Blackstone Group LP earned all income directly. If Blackstone Group LP's structure were challenged, it is possible that private equity firms engaging in initial public offerings (IPOs) would change the terms of the IPOs so that the publicly traded entities were entitled to earn only qualifying carried interest income and no management fees. As a result, the Treasury might collect little additional tax revenue because the publicly traded entities would still be treated as partnerships for tax purposes. However, private equity firms could not make this adjustment without significantly changing the underlying economic

estimated \$277 million in taxes annually.⁷ 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 technique.⁸

Members of Congress proposed reforms that would have put an end to the tax advantages claimed by Blackstone Group LP and similar companies.⁹ However, these reforms sought to change the publicly traded partnership rules rather than address the root of the problem — the manner in which tax items are allocated by the Underlying Partnership. Moreover, the proposed reforms were not enacted. Unlike the reforms proposed by Congress, this Article focuses on the allocations by the Underlying Partnership.

Existing tax regulations restrict how a partnership, like the Underlying Partnership, can allocate income among its partners. Lawmakers intended for these regulations to deter excessively tax-motivated allocations, believing that they could achieve the objective of disallowing tax-motivated allocations by requiring partnerships to follow technical, mechanical rules.¹⁰ However, although the mechanical rules might have a chance of preventing a partnership from utilizing tax-motivated allocations if its partners are unrelated and, thus, have opposing economic interests, the rules are ill-suited for restricting the allocations of a partnership when its partners are related and their economic interests are aligned.¹¹

The structure used by Blackstone Group and numerous other taxpayers takes advantage of this significant unintended loophole in the partnership tax allocation rules. In particular, because the partners in the Underlying Partnership are related, the Underlying Partnership is able to allocate income in a tax-motivated manner without running afoul of the literal language of the partnership tax allocation rules.

Fortunately, existing tax law offers a tool that can be used to close the unintended loophole in the partnership tax allocation rules highlighted by this Article. Perhaps because it is not unusual for technical tax rules to contain unintended gaps, existing tax law provides general standards that the IRS can use to challenge taxpayers who abuse the gaps. This Article

deal so that investors in the publicly traded entities were no longer entitled to receive a share of management fees.

7. John D. McKinnon, *More Firms Enjoy Tax Free Status*, WALL ST. J., Jan. 10, 2012, <http://online.wsj.com/article/SB10001424052970203733504577026361246836488.html>.

8. *Id.*

9. *See infra* Part IV.

10. *See infra* notes and accompanying text.

11. I use the term “unrelated” to refer to partners with opposing economic interests, and I use “related” to refer to partners with economic interests that are aligned. For further discussion of when partners would be “related,” see *infra* note.

proposes that the IRS use such a standard to protect the tax system from taxpayers, like Blackstone Group, who exploit the partnership tax rules' unintended failure to police allocations among related partners. In particular, this Article proposes that the IRS invoke section 482 to challenge the results claimed by Blackstone Group. Section 482 deals broadly with the ubiquitous problems arising from the fact that related parties do not negotiate at arms-length and, in turn, might manage their transactions in a way designed purely to minimize aggregate tax liability.¹²

This Article contributes to the existing literature in two significant ways. First, rather than discuss legislative reforms that would alter the results claimed by Blackstone Group and other taxpayers, this Article argues that these transactions are vulnerable to challenge under current law. This conclusion is significant because it suggests that steps could be taken to address the transactions even if Congress fails to act. Second, this Article highlights an important shortcoming of the partnership tax allocation rules that has received little attention by scholars.¹³ This Article begins to fill this void in the existing literature by discussing the failure of the partnership tax allocation rules to regulate allocations among related partners and suggesting how the IRS could use existing tax-law standards to compensate for the current partnership tax rules' shortcomings. The IRS could use this proposed solution broadly because it would apply whenever related entities form a partnership and engage in tax-motivated allocations.

Finally, because recent publicity regarding Bain Capital, the private equity firm founded by Mitt Romney, has once again focused public attention on the private equity industry,¹⁴ now is a particularly opportune time to examine tax structuring used by private equity funds. Further, this topic is especially timely given the nation's fiscal problems and the search for additional sources of tax revenue.¹⁵

12. For further discussion of section 482, *see infra* Part V.

13. One article does briefly discuss the fact that the partnership tax allocation rules, when literally applied, may permit tax-motivated allocations among related partners. *See* 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, 769, 779–80 (2001) [hereinafter Leder, *Tax-Driven Partnership Allocations*]. However, Leder's article does not demonstrate in detail how the partnership tax allocation rules are implicitly premised on the assumption that partners are unrelated and have opposing economic interests.

14. *See, e.g.*, Mark Maremont, *Tax Rule Opens Rich Vein for Debate: Romney's Favorable Treatment for Some Bain Income Draws Attention to Murky Reaches of IRS Code*, *WALL ST. J.*, Jan. 28, 2012, at A6, <http://online.waj.com/article/SB10001424052970203363504577187100058632034.html>.

15. *See, e.g.*, Jane Sasseen, *With Tax Advantages Looking Shaky, Private Equity Seeks a New Path*, *N.Y. TIMES DEAL BOOK*, Jan 21, 2013, <http://dealbook.nytimes.com/2013/01/21/with-tax-advantages-looking-shaky-private-equity-seeks-a>

This Article proceeds as follows: Part II describes the structure used by Blackstone Group LP. Part III highlights a dangerous, unintended loophole in the partnership tax allocation rules — namely their inability to prevent tax-motivated allocations among related partners. Part IV discusses congressional responses to the Blackstone Group LP structure. Part V proposes that the IRS should invoke existing tax-law standards to close the loophole in the partnership tax allocation rules, enabling the IRS to challenge the tax consequences claimed by Blackstone Group and other taxpayers. Part VI considers and responds to potential objections to the proposal in Part V. Part VII concludes that none of the objections discussed in Part VI justify the IRS's inaction, and, as a result, the IRS should challenge the results claimed by Blackstone Group LP.

II. BACKGROUND: WHAT DOES THE BLACKSTONE GROUP STRUCTURE ATTEMPT TO ACCOMPLISH?

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 percent 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.¹⁶ "Qualifying income" includes dividend income, interest income, capital gain income, and other types of investment income.¹⁷ With regard to the purpose of this 90 percent qualifying income rule, legislative history indicates that Congress thought it was inappropriate to impose corporate-level tax on dividend income, interest income, and other types of investment income because owners of the publicly traded partnership could earn such income directly rather than through a publicly traded intermediary.¹⁸

Maintaining partnership tax status is advantageous. If an entity is treated as a corporation for tax purposes, generally the entity itself will be subject to tax ("entity-level tax").¹⁹ Furthermore, owners of the entity may be subject to tax when they sell ownership interests in the entity or receive certain distributions from the entity.²⁰ If an entity is treated as a partnership for tax purposes, the entity will not be subject to tax. Instead, any items of

new-path/ ("As Washington grapples with the country's fiscal woes, the private equity industry is grudgingly facing a new reality: its long-held tax advantages are likely to disappear.").

16. I.R.C. § 7704(a) (providing general rule that publicly traded entities must be treated as corporations); I.R.C. § 7704(c) (providing exception).

17. I.R.C. § 7704(d).

18. *See infra* note 164.

19. *See* I.R.C. § 11.

20. *See* I.R.C. § 301 (addressing distributions from corporations); I.R.C. § 1001 (regarding gain from sale of ownership interests).

tax income, gain, loss, or deduction recognized by the entity will be passed through to the entity's owners for the owners to take into account directly when computing their own taxable income.²¹ Thus, treatment as a corporation generally involves two levels of tax — both an entity-level tax and an owner-level tax.²² By contrast, treatment as a partnership involves only one level of tax, the tax imposed at the owner level.²³

Blackstone Group LP earns management fees and carried interest income received by the Blackstone Firm from the funds that it sponsors. Management fees are not qualifying income. Carried interest income may be, in part, qualifying income but also, in part, non-qualifying income depending on the types of activities in which the Blackstone Firm's funds engage, as discussed in more detail below.²⁴ 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 percent 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.²⁵ Judging from its actual historical earnings, Blackstone Group LP likely would fail this 90 percent test but for the tax structuring it uses. 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 income.²⁶ As a result, even assuming all carried interest income was qualifying income, Blackstone Group LP would have failed the 90 percent gross income test because only 40 percent (or \$1.2 billion divided by (\$1.2 billion plus \$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 uses the structure shown in Figure 1 below to ensure that it meets the 90 percent gross income test in all years.²⁷

21. See I.R.C. § 701.

22. See *supra* notes 19 and 20 and accompanying text.

23. See *supra* note 21 and accompanying text.

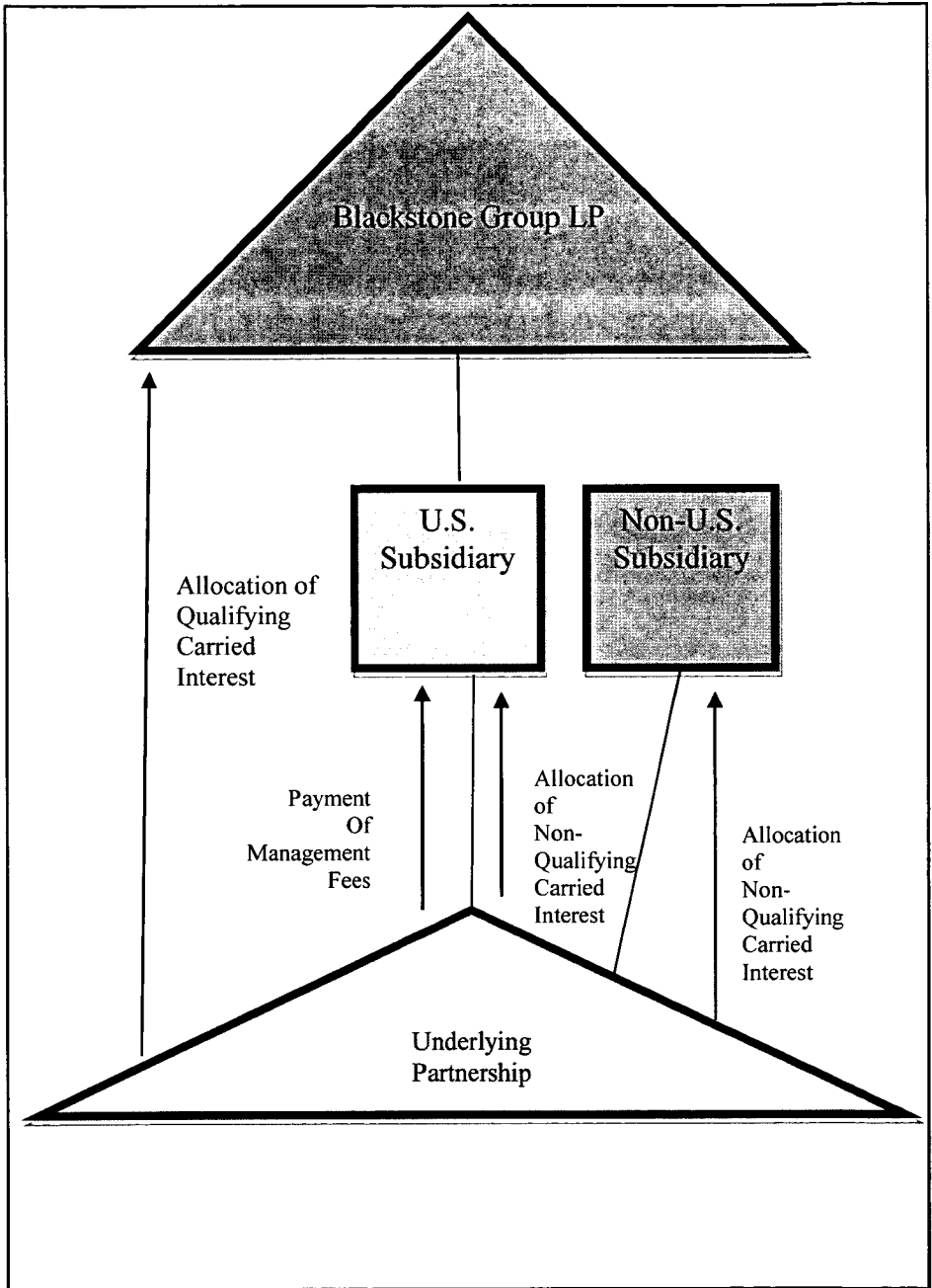
24. See *infra* Part II.E.

25. I.R.C. § 7704(c). This is true assuming that Blackstone Group LP would not be entitled to relief for inadvertent failure to comply with the 90 percent gross income test. See I.R.C. § 7704(e) (describing such relief).

26. The Blackstone Group L.P., *Annual Report (Form 10-K)*, 77 (Feb. 28, 2012), <http://www.sec.gov/Archives/edgar/data/1393818/000119312512085636/d232355d10k.htm>.

27. This is a somewhat simplified version of the actual structure, which can be seen in Blackstone S-1, *supra* note 1, at 11. For a detailed discussion of how this structure is derived from the facts in Blackstone's registration statement, see the attached Appendix.

Figure 1. Blackstone Structure Simplified



In this structure, the Underlying Partnership is an entity treated as a partnership for tax purposes. The Underlying Partnership allocates qualifying carried interest income directly to Blackstone Group LP.²⁸ 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 the Underlying Partnership is qualifying income.²⁹

The Underlying Partnership pays management fees and allocates non-qualifying carried interest income to either “U.S. Subsidiary” (an entity formed in the United States) or “Non-U.S. Subsidiary” (an entity formed in Canada).³⁰ Both of these entities are treated as corporations for U.S. tax purposes.³¹ Because they are corporations, when these entities distribute cash to Blackstone Group LP, Blackstone Group LP recognizes dividend income or capital gain income.³² Dividend income and capital gain income are types of qualifying income.³³ Thus, non-qualifying income allocated or paid to U.S. Subsidiary and Non-U.S. Subsidiary is converted into qualifying income before it reaches Blackstone Group LP, which is the only reason non-qualifying income is allocated or paid to these entities.³⁴ As a result, Blackstone Group LP earns 100 percent qualifying income because its income consists of qualifying income received directly from the Underlying Partnership, dividend income received from U.S. Subsidiary or Non-U.S. Subsidiary, and capital gain income received from U.S. Subsidiary or Non-U.S. Subsidiary.³⁵ 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 percent of its income (more specifically, 100 percent of its income) will be qualifying income.³⁶ Finally, U.S. Subsidiary will pay corporate-level

28. See Blackstone S-1, *supra* note 1, at 202–04. See also *infra* Appendix.

29. “Character” of income refers to the type of income. For instance, if the Underlying Partnership earned dividend income and allocated such income to Blackstone Group LP, Blackstone Group LP would recognize dividend income. For further discussion of the Underlying Partnership’s allocations, see *infra* Part II.E.

30. Blackstone S-1, *supra* note 1, at 202–04. See also Appendix.

31. Blackstone S-1, *supra* note 1, at 202–04 (“U.S. 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-U.S. Subsidiary” in the simplified structure is the counterpart to “Blackstone Holdings V GP LP” in the actual structure.).

32. See I.R.C. § 301.

33. I.R.C. § 7704(d).

34. See *id.*

35. See *supra* notes 29, 34 and accompanying text.

36. See Blackstone S-1, *supra* note 1, at 202 (“We intend to manage our affairs so that we will meet the [90 percent Gross] Income Exception in each taxable year. We believe we will be treated as a partnership and not as a corporation for U.S.

tax on income it earns, so corporate-level tax is not completely avoided.³⁷ However, although U.S. Subsidiary pays corporate-level tax on the non-qualifying income it earns, no entity in the structure pays corporate-level tax on the qualifying income allocated directly to Blackstone Group LP, and Non-U.S. Subsidiary pays no corporate-level tax on the non-qualifying income allocated to it, as discussed in more detail below.³⁸ By contrast, if Blackstone Group LP did not employ this structure and were treated as a corporation for tax purposes, it would be subject to corporate-level tax on all income (qualifying income and non-qualifying income).³⁹

A complete understanding of this structure requires some knowledge of multiple areas of tax law. In turn, this section will discuss each necessary building block 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 elect to be treated as partnerships or corporations for tax purposes, certain entities must be treated as corporations.⁴⁰ For example, entities that are publicly traded typically must be treated as corporations for tax purposes.⁴¹ An entity that is listed on an established securities exchange, like the New York Stock Exchange, is publicly traded.⁴² 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.⁴³

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.”).

37. However, the structure may also be designed to reduce the amount of taxable income recognized by U.S. Subsidiary. *See infra* Part II.C.

38. *See infra* Part II.D.

39. *See supra* notes 26–27 and accompanying text.

40. Regs. §§ 301.7701-3(a) (providing ability to elect tax classification to many entities); 301.7701-2(b)(1), (3)–(8) (describing entities that must be treated as corporations).

41. I.R.C. § 7704.

42. *See* I.R.C. § 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).” I.R.C. § 7704(b)(2).

43. *See infra* Part II.F. (summarizing how the structuring accomplishes this objective).

Regarding the exception (the “90 Percent Gross Income Exception”), publicly traded entities nevertheless may be eligible for partnership tax treatment if at least 90 percent of their income consists of certain types of “qualifying income.”⁴⁴ “Qualifying income” includes dividend income, interest income, capital gain income, and other types of investment income.⁴⁵

B. Distributions by a Corporation

When a corporation distributes cash to its shareholders, the shareholders may recognize dividend income or capital gain income.⁴⁶ In particular, to the extent that the distribution does not exceed the corporation’s available earnings and profits, shareholders will recognize dividend income.⁴⁷ If the distribution does exceed earnings and profits, shareholders could potentially recognize gain from the sale of stock in the corporation, which will be capital gain income in most cases.⁴⁸ Thus, the income recognized by Blackstone Group LP as a result of receiving distributions from U.S. Subsidiary and Non-U.S. Subsidiary will be dividend income or capital gain income.⁴⁹

C. Tax Treatment of a U.S. Corporation

A U.S. entity treated as a corporation for tax purposes is subject to tax, generally at a rate of 35 percent, on all of its taxable income.⁵⁰ Thus, if Blackstone Group LP were treated as a corporation, it would owe a 35 percent tax on all of its taxable income.

44. I.R.C. § 7704(c). For more on the purpose for this qualifying income exception, see *infra* note 164.

45. I.R.C. § 7704(d).

46. This assumes the shareholders are receiving distributions because they are shareholders and not because of some other relationship they have with the corporation, such as an employment relationship. See I.R.C. § 301 (providing that the treatment described applies only to distributions made by a corporation to a shareholder “with respect to its stock”).

47. I.R.C. §§ 301(c)(1), 316.

48. I.R.C. § 301(c)(3)(A).

49. See Blackstone S-1, *supra* note 1, at 202–04. See also *infra* Appendix. The tax treatment of a shareholder of a non-U.S. corporation could differ from what is described in the text if the non-U.S. corporation earned passive income. In this case, special “anti-deferral” rules could apply. However, assuming only active income is allocated to Non-U.S. Subsidiary, the anti-deferral rules would not apply to the Blackstone Group LP structure.

50. I.R.C. § 11.

Furthermore, in the structure used by Blackstone Group LP, U.S. Subsidiary is subject to 35 percent tax on all of its taxable income.⁵¹ Its taxable income consists of management fees and allocations of non-qualifying income received from the Underlying Partnership less allowable expenses. In order to increase the deductible expenses incurred by U.S. Subsidiary, Blackstone Group LP might loan funds to U.S. Subsidiary and charge U.S. Subsidiary interest.⁵² As a result, U.S. Subsidiary could deduct this interest expense, reducing its taxable income.⁵³ Moreover, the interest income received by Blackstone Group LP from U.S. Subsidiary would be qualifying income and, consequently, would not jeopardize its ability to comply with the 90 Percent Gross Income Exception.⁵⁴

D. *Tax Treatment of a Non-U.S. Corporation*

A non-U.S. corporation is subject to U.S. tax only on U.S. source income and income effectively connected with a U.S. trade or business.⁵⁵ Furthermore, a corporation is considered a non-U.S. corporation simply by virtue of the fact that it is formed outside of the United States.⁵⁶ Non-U.S. Subsidiary, shown in Figure 1, was formed in Alberta, Canada and elected to

51. *Id.*; see also Blackstone S-1, *supra* note 1, at 202–04 (“U.S. Subsidiary” in the simplified structure is the counterpart to “Blackstone Holdings I GP Inc.” and “Blackstone Holdings II GP Inc.” in the actual structure); *infra* Appendix.

52. From Blackstone’s documents, it is not entirely clear whether they used debt to reduce U.S. 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., Susan Beck, *The Transformers*, AM. LAW. Nov. 1, 2007, at 94 (“The blocker [(the counterpart to U.S. 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, *supra* note 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 refer to using debt to reduce corporate-level tax paid by U.S. Subsidiary).

53. See I.R.C. § 163 (providing for an interest deduction). The ability to deduct interest would be subject to certain limitations. For example, if U.S. 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.

54. I.R.C. § 7704(d)(1)(A).

55. I.R.C. §§ 881–882.

56. I.R.C. § 7701(a)(4), (5).

be treated as a corporation for U.S. tax purposes.⁵⁷ Thus, Non-U.S. Subsidiary is a non-U.S. corporation. Presumably, the Underlying Partnership allocates to Non-U.S. Subsidiary only income that is not U.S. source and is not effectively connected with a U.S. trade or business.⁵⁸ As a result, Non-U.S. Subsidiary has no U.S. tax liability. Moreover, although special anti-deferral rules can apply to non-U.S. corporations in some circumstances, as long as Non-U.S. Subsidiary earns only active income, these rules would not apply to Non-U.S. Subsidiary. Finally, Non-U.S. Subsidiary likely owes no Canadian tax because it is formed as an Alberta limited partnership that is likely a flow-through entity for Canadian tax purposes,⁵⁹ despite its elective treatment as a corporation for U.S. tax purposes.

E. Partnership Allocations

Entities treated as partnerships for tax purposes are not subject to tax at an entity level.⁶⁰ 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.⁶¹ Moreover, the character of income allocated to a partner is the same as the character of the income earned by the partnership.⁶²

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.⁶³ Moreover, because the character of income allocated to a partner depends on the character of income earned by the

57. Blackstone S-1, *supra* note 1, at 204 (“Blackstone Holdings V GP L.P. [(the counterpart to Non-U.S. Subsidiary in the actual structure)] is taxable as a foreign corporation for U.S. federal income tax purposes.”).

58. *See id.* (“Blackstone Holdings V GP L.P. [(the counterpart to Non-U.S. Subsidiary in the actual structure)] is expected to be operated so as not to produce [effectively connected income].”).

59. *Id.* at 60 (stating that Blackstone Holdings V GP L.P. (the counterpart to Non-U.S. Subsidiary in the actual structure) is an Alberta limited partnership); ABA SECTION OF TAXATION, CHOICE OF ENTITY OWNERSHIP OF REAL ESTATE INCLUDING CROSS BORDER INVESTMENTS 28–29 (2007), http://www.americanbar.org/content/dam/aba/events/real_property_trust_estate/joint_fall/2007/choice_of_entity_ownersh_ip_of_real.authcheckdam.pdf (table indicating that limited partnerships receive flow-through tax treatment in Canada).

60. I.R.C. § 701.

61. *Id.*

62. I.R.C. § 702(b).

63. I.R.C. §§ 701–702.

partnership, the character of carried interest depends on the type of underlying partnership income allocated to the person or entity that receives carried interest.⁶⁴

The Blackstone Firm sponsors funds that engage in a variety of activities and earn a variety of different types of income. In particular, the Blackstone Firm's funds earn dividend income, capital gain income, and interest income, all of which are types of "qualifying income" for purposes of the 90 Percent Gross Income Exception.⁶⁵ The Blackstone Firm'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 may receive a break-up fee from the current owner of the business. This break-up fee is likely non-qualifying income.⁶⁶ Some funds sponsored by the Blackstone Firm 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.⁶⁷

Some of the non-qualifying income earned by the Blackstone Firm's funds will be treated as income from operating a U.S. business, and some non-qualifying income will be treated as income from operating a non-U.S.

64. I.R.C. § 702(b).

65. I.R.C. § 7704(d).

66. *See, e.g.,* Fleischer, *Taxing Blackstone*, *supra* note 1, at 108 (concluding that 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., Other Pass Through Entities*, 735-2d Tax Mgmt. (BNA) VII-C ("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.

67. Income from providing services is not a type of qualifying income. I.R.C. § 7704(d). If the Blackstone Firm's funds hold interests in hotels through entities treated as corporations for tax purposes, however, carried interest received with respect to the hotels could be qualifying income (in particular, dividend income and capital gain income received from the corporations). Yet, if the Blackstone Firm's funds hold interests in hotels through corporations, it is possible that the Blackstone Firm receives carried interest with respect to the hotel through an entity formed between the corporation and the hotel that is treated as a partnership for tax purposes. In that case, the carried interest would be treated as services income and, in turn, non-qualifying income.

business. For instance, depending on the facts, break-up fees could be treated as non-qualifying income from operating a U.S. business or as non-qualifying income from operating a non-U.S. business.⁶⁸ Likewise, non-qualifying services income from operating a hotel could be treated as income from operating a U.S. business or as income from operating a non-U.S. business depending on where the hotel is located and other facts.⁶⁹

In summary, first, some of the carried interest allocated by the Underlying Partnership to its partners will be qualifying income. Carried interest in this first category includes, for instance, the portion of carried interest that consists of dividend income, interest income, and capital gain income. Second, some of the carried interest will be non-qualifying income attributable to a U.S. business. Carried interest in this second category includes services income from operating a U.S. hotel or break-up fees from failing to acquire a U.S. business. Third, some of the carried interest will be non-qualifying income attributable to a non-U.S. business. Carried interest in this third category includes services income from operating a non-U.S. hotel or break-up fees from failing to acquire a non-U.S. business.

The Underlying Partnership allocates qualifying carried interest directly to Blackstone Group LP.⁷⁰ 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.⁷¹ The Underlying Partnership allocates carried interest that consists of non-qualifying income that is U.S. business income to U.S. Subsidiary.⁷² The Underlying Partnership also pays management fees to U.S. Subsidiary.⁷³ As discussed above, U.S. Subsidiary will be subject to entity-level tax on this income, possibly reduced by interest expense resulting from interest that it may pay to Blackstone Group LP.⁷⁴ The Underlying Partnership allocates carried interest that consists of non-qualifying income that is non-U.S. business income to Non-U.S. Subsidiary.⁷⁵ As discussed above, Non-U.S. Subsidiary will not be subject to entity-level tax on this income.⁷⁶

68. Under an origin-of-the-claim analysis, the break-up fee could be treated as income from operating a U.S. business if the company to be acquired operated a U.S. business. If, instead, the company operated a non-U.S. business, the break-up fee could be treated as income from operating a non-U.S. business.

69. The source of income from providing services generally depends on where the services are performed. *See* I.R.C. §§ 861(a)(3), 862(a)(3).

70. Blackstone S-1, *supra* note 1, at 202–04. *See also infra* Appendix.

71. I.R.C. § 702(b).

72. Blackstone S-1, *supra* note 1, at 202–04. *See also infra* Appendix.

73. Blackstone S-1, *supra* note 1, at 202–04. *See also infra* Appendix.

74. *See supra* Part II.C.

75. Blackstone S-1, *supra* note 1, at 202–04. *See also infra* Appendix.

76. *See supra* Part II.D.

F. Summary: How the Pieces Come Together

If Blackstone Group LP directly earned the income to which it is entitled, less than 90 percent of Blackstone Group LP's income would consist of qualifying income, and, as a consequence, Blackstone Group LP would be treated as a corporation for tax purposes.⁷⁷ 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, the Underlying Partnership allocates or pays any non-qualifying income to U.S. Subsidiary or Non-U.S. Subsidiary and allocates any qualifying income directly to Blackstone Group LP. As a result, Blackstone Group LP earns 100 percent qualifying income (either income allocated directly to it or dividend income, capital gain income, and, possibly, interest income received from U.S. Subsidiary and Non-U.S. Subsidiary). Consequently, Blackstone Group LP qualifies for the 90 Percent Gross Income Exception, is treated as a partnership for U.S. tax purposes, and avoids having to pay corporate-level tax on all of its income. Corporate-level tax is not entirely avoided, as U.S. Subsidiary pays corporate-level tax on some of the income allocated to it. However, qualifying income allocated to Blackstone Group LP and income allocated to Non-U.S. Subsidiary escape corporate-level tax.

These results hinge on the Underlying Partnership's tax allocations. Hence, Part III will demonstrate that the Underlying Partnership's tax allocations exploit a loophole in the current partnership tax allocation rules.

III. THE BLACKSTONE GROUP STRUCTURE TAKES ADVANTAGE OF AN OF AN UNINTENDED LOOPHOLE IN THE PARTNERSHIP TAX ALLOCATION RULES

As discussed above, a partnership allocates among its partners tax items that the partnership recognizes.⁷⁸ Partnerships are not free, however, to allocate items among partners in any manner whatsoever. 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.

77. See *supra* notes 26–27 and accompanying text.

78. See *supra* Part II.E.

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 percent on gain from the sale of the land, while Leslie would be subject to a tax rate of 0 percent on gain from the sale of the land.⁷⁹ 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.⁸⁰

As numerous other commentators have observed, the purpose of the rules governing partnership tax allocations is to prevent excessively tax-

79. For example, Leslie could be subject to 0 percent tax if (1) Leslie recognized tax losses from other sources that would offset gain allocated to her from the partnership, and (2) she did not recognize other income from which the losses could be deducted.

80. 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* I.R.C. § 705(a). Because this basis is \$50 lower than the amount of cash he receives on liquidation, he recognizes \$50 of tax gain. *See* I.R.C. § 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* I.R.C. § 705(a). Because the amount of cash she receives on liquidation (i.e., \$150) is \$50 lower than her basis in the partnership, Leslie recognizes \$50 tax loss on liquidation. *See* I.R.C. § 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 the sale of the land, and it is taxed more favorably than gain from the sale of the land so that Tom may pay a rate of tax on the gain in year 2 that is less than 50 percent. *See* I.R.C. § 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 the sale of his interest in the partnership); I.R.C. § 741 (providing that gain from the sale of a partnership interest is treated as capital gain subject to the exceptions set forth in section 751 which would not apply to a partnership that holds no assets other than cash).

motivated allocations.⁸¹ Moreover, the rules strive to accomplish this goal by requiring a link between tax allocations and the partners' economic benefits and burdens.⁸² 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 the 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

81. See, e.g., 1 ARTHUR B. WILLIS & PHILIP F. POSTLEWAITE, PARTNERSHIP TAXATION ¶ 10.01[3][b] (7th ed. 2011) [hereinafter WILLIS & POSTLEWAITE, PARTNERSHIP TAXATION] (discussing how the purpose of the restrictions on partnership tax allocations is to prevent using partnership tax allocations for tax avoidance purposes); David Hasen, *Partnership Special Allocations Revisited*, 13 FLA. TAX REV. 349, 350 (2012) ("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."); Andrea Monroe, *Too Big to Fail: The Problem of Partnership Allocations*, 30 VA. TAX REV. 465, 487 (2012) [hereinafter Monroe, *Too Big to Fail*] ("[T]he substantiality requirement . . . became the Treasury's chief tool for distinguishing legitimate from abusive allocations."). This is not to say that the Treasury Regulations contain a requirement that allocations have a business purpose. Rather, the point is simply that the technical rules in the Treasury Regulations exist for a reason, and that reason is to sort between allocations that are excessively tax-motivated and allocations that have at least some non-tax effect.

82. See, e.g., 1 WILLIAM S. MCKEE, WILLIAM F. NELSON & ROBERT L. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 10.02[1] (3d ed. 2004) [hereinafter MCKEE, NELSON & WHITMIRE, PARTNERSHIPS AND PARTNERS] ("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."); WILLIS & POSTLEWAITE, PARTNERSHIP TAXATION, *supra* note 81, ¶10.01[2] ("[U]nder the statutory scheme, the items of partnership tax income and loss must be allocated to the partners who realize the economic benefits or bear the economic burdens associated with those items."); Monroe, *Too Big to Fail*, *supra* note 81, at 487 (stating that the partnership tax allocation rules require that "if a partner receives an allocation for tax purposes, then she must also bear the economic benefit or burden corresponding to such allocated item"); Gregg D. Polsky, *Deterring Tax-Driven Partnership Allocations*, 64 TAX LAW. 97, 97 (2010) [hereinafter Polsky, *Deterring*] (describing the purpose of one part of the allocation rules as "requiring that allocations be consistent with the economic deal").

to Leslie if the partnership distributed \$200 cash to Leslie and \$100 cash to Tom on liquidation.⁸³

Tying tax allocations more closely to economic gains and losses discourages tax-motivated allocation schemes. 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.⁸⁴ 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 percent tax rate), but Tom would also forgo \$50 of cash on liquidation. Assuming Tom and Leslie are unrelated and, thus, have opposing economic interests, Tom would not agree to an arrangement in which he loses \$50 of cash merely to save \$25 of tax liability because this arrangement makes him \$25 less wealthy after tax.⁸⁵ Thus, if Tom and Leslie have opposing economic interests and do agree to allocate \$50 more tax gain to Leslie and distribute \$50 more cash to Leslie, one can infer that they did *not* agree to this arrangement merely to save Tom \$25 in taxes. Therefore, one would assume that the partners had a non-tax business reason for agreeing to the arrangement.⁸⁶ Perhaps, for example, Leslie was responsible for selecting

83. See Regs. § 1.704-1(b)(2)(ii)(d). 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 I.R.C. § 705(a). As a result, Tom recognizes no tax gain or loss when he receives \$100 cash from the partnership on liquidation. See I.R.C. § 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 I.R.C. § 705(a). As a result, Leslie recognizes no tax gain or loss when she receives \$200 cash from the partnership on liquidation. See I.R.C. § 731(a).

84. See Regs. § 1.704-1(b)(2)(ii)(d).

85. This is true unless the year of the partnership's liquidation is sufficiently far in the future that saving \$25 of tax liability today is worth more than losing \$50 of cash on liquidation.

86. See *supra* note 81.

the land that the partnership purchased, and, as a result, the partners agreed that she would benefit from any economic gain realized upon the sale of the land and bear any economic loss realized upon the sale of the land. Thus, Tom willingly parts with \$50 cash from the sale of the land in order to abide by the partners' business arrangement and not for the sole purpose of saving taxes.

The foregoing analysis hinges completely on the fact that Tom and Leslie are unrelated and, thus, have opposing economic interests. If, instead, Tom and Leslie were closely related so that they were indifferent regarding the manner in which they shared in economic gain and loss, then the current restrictions on tax allocations would do nothing to prevent Tom and Leslie from designing tax allocations with the sole objective of saving tax. In Example 2, for instance, Tom might gladly agree to an arrangement in which he parts with \$50 of cash merely to save \$25 of tax if the cash he relinquishes winds up in the hands of a close relative, Leslie. Thus, when the partners are related, the allocation rules do nothing to prevent entirely tax-motivated allocations.⁸⁷

In order to more fully demonstrate how the allocation rules depend, implicitly, upon the assumption that partners are unrelated, Part III.A will describe the mechanics of the partnership tax allocation rules in more detail. The essential points of the analysis are as follows: first, lawmakers intended for the partnership tax allocation rules to deter overly tax-motivated

87. Special rules are provided for allocations among individuals in certain cases. See, e.g., I.R.C. § 704(e). The special rules can apply if one partner (the "donor") provides a gift of a partnership interest to another partner (the "donee"), directly or indirectly, such as by giving the donee property that the donee, subsequently, contributes to the partnership. In addition, the special rules apply if one family member sells a partnership interest to another family member. When the special rules apply, the IRS can reallocate income among the affected partners if the allocations in the partnership agreement do not adequately compensate these partners for the services and capital they contribute. For further discussion, see MCKEE, NELSON & WHITMIRE, *PARTNERSHIPS AND PARTNERS*, *supra* note 82, ¶ 14.05. The special rules, however, do not require reallocation of income among family members who were not parties to a gift or sale of a partnership interest. *Id.* ¶ 14.059[c][2]. For more information on allocations among family members in situations not covered by section 704(e), see *id.* ("[I]t is unclear whether the Commissioner can reallocate partnership income among related persons who are admittedly partners . . . but who are not subject to § 704(e)(2). Prior to the enactment of § 704(e), the Service argued on a number of occasions that partnership income could be so reallocated. The courts generally were reluctant to remake the partners' contract except in situations of clear abuse. In general, it seems that family partners who are not subject to § 704(e)(2) should have the same freedom to allocate partnership income among themselves as unrelated partners. On the other hand, because of the lack of adversity that may exist among family partners, allocations that are palpably unreasonable may be subject to attack.").

allocations;⁸⁸ second, although the allocation rules might achieve this objective when partners are unrelated, because of how the rules are designed they do nothing to discourage related partners from engaging in entirely tax-motivated allocations; and, third, from these first two observations, one can infer that the partnership tax allocation rules are, implicitly, premised on the assumption that partners are unrelated. As a result, Blackstone Group LP and other partnerships formed by related partners can utilize entirely tax-motivated allocations and technically comply with the letter, but not the spirit, of the existing regulations. They do so by exploiting an unintended loophole in the partnership tax allocation rules — specifically, the rules’ failure to police allocations among related partners.

A. *The Partnership Tax Allocation Rules*

The Treasury Regulations provide that allocations in a partnership agreement will be respected (i.e., they will not be successfully challenged by the IRS) if the allocations are consistent with “the partners’ interests in the partnership” or the allocations have “substantial economic effect.”⁸⁹ The following discussion focuses on the substantial economic effect test.⁹⁰

For partnership agreement allocations to be respected under the substantial economic effect test, the allocations must overcome two hurdles.⁹¹ “First, the allocation[s] must have economic effect.”⁹² “Second, the

88. See *supra* note 81 and accompanying text.

89. See Regs. § 1.704-1(b)(1)(i). An allocation will also be respected if the allocation is deemed to be in accordance with the partners’ interests in the partnership. *Id.* This rule only applies to certain types of allocations not relevant to the analysis of the Blackstone Group structure.

90. An understanding of the partners’ interests in the partnership (“PIP”) is not essential for purposes of understanding the Blackstone Group LP structure. 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. Regs. § 1.704-1(b)(3)(i). 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 the rights of the partners to distributions of capital upon liquidation. Regs. § 1.704-1(b)(3)(i)–(ii). 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. Regs. § 1.704-1(b)(1)(i). For further discussion of PIP, see Bradley T. Borden, *The Allure and Illusion of Partners’ Interests in a Partnership*, 79 U. CIN. L. REV. 1077 (2011).

91. Regs. § 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 . . .”).

economic effect of the allocation[s] must be substantial.”⁹³ This second hurdle is often called the “substantiality” requirement.⁹⁴

1. *Economic Effect: The Rules*

Partnership agreement allocations most commonly aim to overcome the “economic effect” hurdle by complying with the “alternate test for economic effect.”⁹⁵ 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;⁹⁶ (2) the partnership must liquidate based on positive capital account balances;⁹⁷ and (3) the partnership must take steps to ensure that no partner’s capital account balance becomes or remains impermissibly negative.⁹⁸ As it is only necessary to understand the first and second

92. *Id.*

93. *Id.*

94. *See* Regs. § 1.704-1(b)(2)(iii).

95. There are two other ways that an allocation can have economic effect: (1) if the allocation complies with the “basic test” for economic effect; or (2) if the allocation has “economic effect equivalence.” *See* Regs. § 1.704-1(b)(2)(ii)(b) (describing the basic test for economic effect); Regs. § 1.704-1(b)(2)(ii)(i) (describing economic effect equivalence). Because these possibilities are not relevant to the Blackstone Group structure, they are not discussed in this Article.

96. Regs. §§ 1.704-1(b)(2)(ii)(d)(1) (providing that to comply with the alternate test for economic effect, the allocations must comply with Regulations section 1.704-1(b)(2)(ii)(b)(1)); 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 Regulations section 1.704-1(b)(2)(iv)).

97. Regs. §§ 1.704-1(b)(2)(ii)(d)(1) (providing that, to comply with the alternate test for economic effect, the allocations must comply with Regulations section 1.704-1(b)(2)(ii)(b)(2)); 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).

98. Regs. § 1.704-1(b)(2)(ii)(d)(3). 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

requirements in order to understand Blackstone Group's structure, only these requirements will be discussed below.⁹⁹

(i) *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.¹⁰⁰ In particular, each partner's capital account, at any point in time, must equal: (1) all cash contributed to the partnership by that partner,¹⁰¹ plus (2) the fair market value of all assets (net of liabilities) contributed to the partnership by that partner,¹⁰² plus (3) all items of tax gain or income allocated to that partner by the partnership,¹⁰³ minus (4) all cash distributed to that partner by the partnership,¹⁰⁴ minus (5) the fair market value of all assets (net of liabilities) distributed to that partner by the partnership,¹⁰⁵ minus (6) all items of tax loss or deduction allocated to that partner by the partnership.¹⁰⁶

Thus, in Example 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.

eliminate the excess negative balance as quickly as possible). Regs. § 1.704-1(b)(2)(ii)(d).

99. For discussion of the third requirement, *see supra* note 98.

100. *See supra* note 96.

101. Regs. § 1.704-1(b)(2)(iv)(b)(1).

102. Regs. § 1.704-1(b)(2)(iv)(b)(2).

103. Regs. § 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* Regs. § 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 or income because tax gain or income will be allocated in the same manner as book gain or income when these items are equal. *Id.*

104. Regs. § 1.704-1(b)(2)(iv)(b)(4).

105. Regs. § 1.704-1(b)(2)(iv)(b)(5).

106. Regs. §§ 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* Regs. § 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.*

(ii) *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.¹⁰⁷

Thus, in Example 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 plus \$50 tax gain allocation), and, if the partnership distributes \$150 cash to each partner, the partnership will comply with the requirement of liquidating 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 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.¹⁰⁸ If a partnership allocates more tax gain to a partner, his or her capital account increases, meaning that partner will receive more cash on 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.

2. *Economic Effect: The Implicit Assumption: Unrelated Partners*

Ensuring that tax allocations correspond to economic gains and losses might deter tax-motivated allocations among unrelated partners but does nothing to prevent related partners from allocating items in a manner

107. See *supra* note 97.

108. See *supra* note 82.

designed solely to reduce tax liability.¹⁰⁹ To demonstrate, consider again the facts of Example 2. If the partnership complies with the economic effect requirement, the partnership can allocate \$50 less tax gain to Tom (saving him \$25 in taxes) only if the partners agree that Tom will receive \$50 less cash. Losing \$50 cash will deter Tom from agreeing to the allocations for the sole purpose of saving \$25 in taxes if the \$50 cash lost by Tom benefits an unrelated partner. If, however, the partner who receives \$50 cash is closely related to Tom, he may readily agree to the allocations for the exclusive purpose of reducing his tax liability.

3. *Substantiality: The Rules*

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 described above), and the allocations must comply with the substantiality requirement. This substantiality requirement exists because the alternate test for economic effect alone does not prevent many potential tax-motivated allocation schemes, *even in partnerships with unrelated partners*.¹¹⁰ In order to demonstrate, consider the following example.

Example 3. Two individuals, Ron and Anne, form a partnership to provide legal services. Ron is a U.K. citizen and not a resident of the United States. Anne is a U.S. citizen. Ron and Anne each contribute \$1,000 cash to the partnership. The partnership provides some legal services in the United Kingdom out of its U.K. office and some legal services in the United States out of its U.S. office. Thus, in any given year, the partnership will recognize some income from providing legal services in the United States and some income from providing legal services in the United Kingdom. Anne is subject to 35 percent U.S. tax on income

109. Even among unrelated partners, some entirely tax-motivated allocations will slip through the cracks. *See infra* note 110 and accompanying text. Therefore, this Article does not claim that the substantial economic effect rules function flawlessly when partners are unrelated. Rather, this Article argues that the substantial economic effect rules have no chance of restricting, in any meaningful way, allocations among related partners whose economic interests are aligned.

110. Not all tax-motivated allocation schemes are prevented by the substantiality requirement even when partners are unrelated. For further discussion, see Mark P. Gergen, *Reforming Subchapter K: Special Allocations*, 46 TAX L. REV. 1 (1990) [hereinafter Gergen, *Reforming Subchapter K*]; Calvin H. Johnson, *Partnership Allocations from Nickel-on-the-Dollar Substance*, 134 TAX NOTES 873 (Feb. 13, 2012); Leder, *Tax-Driven Partnership Allocations*, *supra* note 13.

from legal services, regardless of where the services are performed. Ron is subject to 35 percent U.S. tax on income from providing legal services in the United States but no U.S. tax on income from providing legal services in the United Kingdom. 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 the partnership will allocate to each partner 50 percent of total income recognized by the partnership, but the income allocated to Ron will consist entirely of income from the United Kingdom to the extent possible. Thus, in year 1, for example, if the partnership recognizes \$300 of income from the United Kingdom and \$700 of income from the United States, the partnership would allocate to Ron \$300 of U.K. income and \$200 of U.S. income, and the partnership would allocate to Anne \$500 of U.S. income.¹¹¹

The allocations in Example 3 have economic effect because the partnership maintains capital accounts and provides for liquidation based on capital account balances.¹¹² However, the allocations are, nonetheless, entirely tax-motivated. The allocations ensure that, regardless of the types of income earned by the partnership, each of Ron and Anne will receive 50 percent of the cash distributed on liquidation. Each partner contributed \$1,000, so the partners' initial capital account balances are equal (\$1,000 each). Further, each partner is always allocated 50 percent of the 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 \$1,500). 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 they would have received if the partnership had allocated each item of income equally between the partners. In Example 3, above, for instance, if the partnership allocated U.S. income equally (\$350 to each) and U.K. income equally (\$150 to each), each partner's capital account would still

111. See Regs. § 1.704-1(b)(5) Ex. (10)(ii) (providing a similar example).

112. This analysis assumes that the partnership also takes steps to ensure that no partner's capital account balance becomes or remains impermissibly negative. See Regs. § 1.704-1(b)(5) Ex. (10)(ii) (reaching the conclusion that allocations have economic effect in the context of a similar example); see also *supra* note 98.

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 percent of each type of income, Ron would be subject to \$122.50 U.S. tax liability (35 percent times \$350 U.S. income). By contrast, under the agreement, Ron is allocated only \$200 of U.S. income, and therefore, Ron is subject to only \$70 of U.S. tax liability (35 percent times \$200). Anne's tax liability is the same under the agreement as it would be if Anne were allocated 50 percent of each type of income. Anne is subject to a 35 percent U.S. tax rate on U.S. income and U.K. income, so Anne incurs U.S. tax liability of \$175 (35 percent times \$500) when she is allocated \$500 of total income, regardless of how much of the income is U.S. source and how much is U.K. source.¹¹³

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 entirely 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 described in Example 3 and other schemes that economic effect, alone, would not prevent.¹¹⁴ 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 Regulations section 1.704-1(b)(2)(iii)(a) which provides:

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

114. Terence Floyd Cuff, *Proposed Regulations Try — Unsuccessfully — to Fix a Broken Set of Substantiality Rules*, 104 J. TAX'N 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."); Gergen, *Reforming Subchapter K*, *supra* note 110, at 15 (an allocation that violates substantiality is "likely to be tax driven since the partner who benefits from the allocation will seek it for tax reasons and the other partner will be (at worst) indifferent to it"); Monroe, *Too Big to Fail*, *supra* note 81, at 487; Polsky, *Deterring*, *supra* note 82, at 99 ("If a partnership expects to receive different types of income or gain, or different types of deduction or loss, the partnership could — consistent with the economic effect prong — still allocate the items in a tax-advantaged way while not changing the real, overall economic deal The second prong of the substantial economic effect test (substantiality) is intended to inhibit this type of tax planning.").

[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.¹¹⁵

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.¹¹⁶

Applying this test to Example 3 reveals that the allocations lack substantiality. In order to apply the test, we compare what each partner is likely to receive, after tax, as a result of the allocations to what each partner would have received if the partnership allocated each type of income to each partner pro rata based on the capital each partner contributed (or 50 percent to each partner).¹¹⁷ At the time the partners agree to allocate items as

115. There are other hurdles that an allocation must overcome in order for the allocation to pass substantiality. For example, the allocation cannot be a “shifting allocation” and the allocation cannot be a “transitory allocation.” See Regs. §§ 1.704-1(b)(2)(iii)(b), (c). Consideration of these tests, however, is not necessary for purposes of understanding the analysis described in this Article.

116. 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 PIP. Regs. § 1.704-1(b)(2)(iii)(a). PIP is a facts and circumstances test, as described above. See *supra* note 90. Furthermore, 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. Regs. § 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).

117. 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 following: 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 tested). See *supra* notes 90,

described in Example 3, Ron's after-tax consequences may be enhanced compared to what would occur if he were allocated 50 percent of U.S. income and 50 percent of U.K. 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 U.K. income and at least some U.S. income (because rather than being allocated 50 percent of the U.S. income, he will be allocated less U.S. income and more U.K. 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, it is certain) 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 percent of U.S. income and 50 percent of U.K. income. Regardless of whether Anne is allocated 50 percent of each type of income or 50 percent of total income (with a mix that might involve more than 50 percent of U.S. income), Anne experiences the same after-tax consequences because she receives the same amount of cash pre-tax (50 percent of all cash distributed by the partnership) and incurs the same amount of tax liability (35 percent times 50 percent 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 tax liability without interfering with the partners' business deal or the tax liability incurred by another partner.

4. *Substantiality: The Implicit Assumption: Unrelated Partners*

Like the economic effect test, the substantiality test implicitly relies on the assumption that partners in a partnership are unrelated and, thus, have opposing economic interests. The fact that the test depends on this assumption can be further demonstrated by the following examples.

Example 4A. Assume the same facts as Example 3 except that the partnership agreement provides that Anne will be allocated 90 percent of the U.S. income and 10 percent of

116. After ignoring allocations of U.S. income and U.K. income (the allocations being tested) the only fact that remains is that the partners made equal contributions to the partnership. Thus, it is likely that each partner's interest in the partnership is 50 percent for purposes of testing the substantiality of the allocations.

the U.K. income, and Ron will be allocated 10 percent of the U.S. income and 90 percent of the U.K. 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 \$1,000 of income from the United Kingdom and \$100 of income from the United States.¹¹⁸ Ron and Anne are unrelated.

The allocations described in Example 4A pass the substantiality test and should be respected. Looking at the actual results realized by the partnership in Example 4A, 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.¹¹⁹ The table 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 increase Ron's after-tax profit (\$906.50 compared to \$532.50) but lessen Anne's after-tax profit (\$123.50 compared to \$357.50).

118. See Regs. § 1.704-1(b)(5), Ex. (10)(i) (providing a similar example).

119. The substantiality test requires examining what was likely to occur at the time the partners agreed to the allocation in question. See Regs. § 1.704-1(b)(2)(iii)(a) (“[T]he economic effect of an allocation . . . is not substantial if, *at 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 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 Regs. §§ 1.704-1(b)(2)(iii)(b)(2) (providing the rebuttable presumption in the context of the shifting allocation test); 1.704-1(b)(2)(iii)(c)(2) (providing the rebuttable presumption in the context of the transitory allocation test); see also *supra* note 115 (mentioning the shifting allocation and transitory allocation tests).

Table 1

	Results of Partnership Agreement		Results if U.S. and U.K. Income Were Allocated Equally	
	Anne	Ron	Anne	Ron
Pre-Tax Profit ¹²⁰	\$190	\$910	\$550	\$550
U.S. Tax Liability	\$190 total income x 35% = \$66.50	\$10 U.S. income x 35% = \$3.50	\$550 total income x 35% = \$192.50	\$50 U.S. income x 35% = \$17.50
After-Tax Profit	\$190 - \$66.50 = \$123.50	\$910 - \$3.50 = \$906.50	\$550 - \$192.50 = \$357.50	\$550 - \$17.50 = \$532.50

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 with opposing economic interests will not agree, for purely tax reasons, to allocate items in a way that could worsen the after-tax economic position of at least one partner. In other words, because the allocations make Anne worse off after tax, it is no longer suspected that the allocations are solely tax-motivated. In Example 3, the allocations appear to be solely tax-motivated because the only possible effect of the allocations is to reduce Ron's tax liability. By contrast, in Example 4A, 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 have opposing economic interests, Anne would be unwilling to risk forgoing cash merely to lower Ron's tax liability. Thus, if the partners do agree to the allocations in Example 4A, one can infer that the partners had non-tax business reasons for doing so.¹²¹ Perhaps, for example, Ron is responsible for managing the

120. This amount is determined by the increase to each partner's capital account. If the partnership agreement allocates to Anne \$90 of U.S. income and \$100 of U.K. income, her capital account will increase by \$190 so she will receive \$190 more cash. If the partnership agreement allocated to Ron \$10 of U.S. income and \$900 of U.K. income, his capital account will increase by \$910 so he will receive \$910 more cash. If the partnership instead allocated each type of income equally to each partner, the partnership would allocate \$500 of U.K. income and \$50 of U.S. income (or \$550 total income) to each partner, and each partner's capital account would increase by \$550.

121. See *supra* note 81.

partnership's U.K. office, and Anne is responsible for managing the partnership's U.S. office. In order to encourage each partner to manage his or her office well, the partners could agree that Ron will benefit disproportionately from profits generated by the U.K. office, and Anne will benefit disproportionately from profits generated by the U.S. office. Thus, in Example 4A, when the U.S. office is less profitable than the U.K. 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.

Now consider a slightly different example.

Example 4B. Assume the same facts as Example 4A except that Anne and Ron are close relatives.

Because all other facts are the same as Example 4A, Table 1 above again illustrates the after-tax profit realized by each partner under the agreement compared to what would have occurred if the partnership allocated each type of income equally to each partner. Still, the allocations make Anne worse off after tax. However, now that Anne and Ron are close relatives, this result provides no assurance that the allocations are not purely tax-motivated.

If Ron and Anne are closely related, as far as each individual is concerned, a dollar distributed by the partnership to Ron may be the same as a dollar distributed by the partnership to Anne. In that case, the partners could freely agree to the allocations in Example 4B 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 4B, the allocations result in a total after-tax profit of \$1,030 (Anne's \$123.50 plus Ron's \$906.50), which is \$140 higher than the \$890 after-tax profit (Anne's \$357.50 plus Ron's \$532.50) 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 \$126 in taxes for Anne and \$14 in 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 4B for the sole purpose of saving \$140 in taxes, and the substantiality test would not prevent this type of tax-motivated allocation scheme.¹²²

In other words, the substantiality test implicitly depends on the assumption that partners are unrelated and, thus, have opposing economic

122. Even under these facts, it is possible that Anne and Ron may have agreed to the allocations for business reasons and not just tax reasons. However, the fact that the allocations pass the substantiality test provides no assurance that they agreed to the allocations for non-tax reasons.

interests. If this assumption does not hold true, substantiality does not adequately police tax-motivated allocations.

B. The Blackstone Group Structure Takes Advantage of the Partnership Tax Allocation Rules' Inability to Prevent Tax-Motivated Allocations Among Related Partners

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

In order for these allocations to have economic effect, the Underlying Partnership can simply maintain a capital account for each of the partners and liquidate based on capital account balances.¹²³ It is likely the Underlying Partnership 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 the Underlying Partnership.¹²⁴ 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 one partner would, in present value terms, be substantially diminished compared to what would happen if that partner were allocated one-third of each type of income.¹²⁵ Assuming that the partners agreed to the allocations at a time when the partners did not know what type and amount of income the Underlying Partnership would earn in each year, this requirement is likely met.¹²⁶

123. This analysis assumes that the Underlying Partnership also takes steps to ensure that no partner's capital account balance becomes or remains impermissibly negative. See *supra* note 98.

124. As discussed below, even if this assumption is incorrect, the overall conclusion of the analysis above still holds true. See *infra* note 128 and accompanying text.

125. See *supra* notes 115–117 and accompanying text.

126. See also Regs. § 1.704-1(b)(5), Ex. (10)(i) (providing an example in which a partnership agrees to allocate disproportionate amounts of non-U.S. income to a non-U.S. 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). If, instead, the partners knew the type and amount of income that the Underlying Partnership would earn, then it is likely the partners contributed capital in a given ratio intended to guarantee that at least one partner would be worse off, after tax, as a result of the Underlying Partnership's allocations. The partners would have done this to ensure that the

For instance, at the time the partners agreed to the allocations, it could have been likely that the Underlying Partnership would earn \$1.2 billion of total carried interest (consisting of \$600 million of qualified carried interest, \$300 million of non-qualified U.S. carried interest, and \$300 million of non-qualified non-U.S. carried interest). Under these facts, the allocations in the agreement make U.S. Subsidiary worse off after tax compared to what would happen if U.S. Subsidiary were allocated one-third of all carried interest. In particular, as a result of the allocations in the agreement, U.S. Subsidiary earns \$195 million in after-tax profit (\$300 million of non-qualified U.S. carried interest minus 35 percent tax rate times \$300 million). If U.S. Subsidiary were allocated one-third of all carried interest, U.S. Subsidiary would earn \$260 million in after-tax profit (\$400 million carried interest minus 35 percent tax rate times \$400 million). Thus, the allocations comply with the literal language of the substantiality test.¹²⁷

The assumption that each partner contributed an equal amount of capital to the Underlying Partnership was used merely for illustrative purposes, and it could be that the partners did not contribute equal amounts to the Underlying Partnership. However, the overall conclusion of the analysis above still holds true. Specifically, if the allocations by the Underlying Partnership pass the substantiality test, they do so only because at least one of the partners in the Underlying Partnership receives less after taxes than what it would receive if all items of income were allocated among all three partners pro rata based on their capital contributions.¹²⁸

The Underlying Partnership's allocations comply with the literal language of the substantial economic effect rules because, under these rules, the fact that the allocations worsen U.S. Subsidiary's (or another partner'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

allocations complied with the technical requirements of the substantial economic effect test.

127. 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, Tax-Driven Partnership Allocations, supra* note 13, 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 advisory, see Field Serv. Advisory (Sept. 10, 1993), 1993 WL 1469410, stating: "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."

128. If the allocations do not result in at least one partner in the Underlying Partnership receiving less, after tax, than what it would receive if all items of income were allocated pro rata among the partners, then the IRS could easily challenge the Underlying Partnership's allocations for lacking substantial economic effect.

it worse off after-tax absent a compelling non-tax business reason for doing so.¹²⁹ However, although this rationale may apply to a partnership in which the partners have opposing economic interests (such as the partnership described above in Example 4A), this rationale simply does not apply when the economic interests of the partners are aligned (such as in the Blackstone Group LP structure or in Example 4B). In the Blackstone Group LP structure, U.S. Subsidiary and Non-U.S. Subsidiary (two of the partners in the Underlying Partnership) are wholly-owned by Blackstone Group LP (the third partner in the Underlying Partnership). Thus, the economic interests of the three partners in the Underlying Partnership are completely aligned, and all three partners in the Underlying Partnership are indifferent regarding how after-tax profits are shared among them. Consequently, the fact that the allocations by the Underlying Partnership make U.S. Subsidiary (or any other partner in the Underlying Partnership) 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 as a corporation for tax purposes.

IV. 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.¹³⁰ 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.¹³¹ The legislation would not have immediately applied to Blackstone Group as it contained a grandfathering provision.¹³² 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

129. See *supra* Part III.A.

130. S. 1624, 110th Cong. (2007). For further discussion of the legislation, see Fleischer, *Taxing Blackstone*, *supra* note 1, at 104–20.

131. S. 1624, 110th Cong. (2007). For further discussion of the legislation, see Fleischer, *Taxing Blackstone*, *supra* note 1, at 104–20.

132. S. 1624, 110th Cong. (2007). For further discussion of the legislation, see Fleischer, *Taxing Blackstone*, *supra* note 1, at 104–20.

already filed a registration statement with the SEC in contemplation of an initial public offering.¹³³

In addition to the proposal described above, proposals less squarely directed at the Blackstone Group 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 income as non-qualifying income for purposes of the publicly traded partnership rules.¹³⁴ The Blackstone Group structure is potent largely because qualified carried interest income allocated directly to Blackstone Group LP is not subject to corporate-level tax. If all carried interest income were non-qualifying income, the Underlying Partnership would not earn any qualifying income that it could allocate 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 the Underlying Partnership would have to modify its allocations so that almost all of its income was allocated to either U.S. Subsidiary or Non-U.S. Subsidiary.¹³⁵ The income allocated to U.S. Subsidiary would be subject to corporate-level tax.¹³⁶

None of the proposed reforms described above address the unintended loophole in the partnership tax allocation rules — specifically, the rules' inability to police adequately allocations among related partners. Moreover, none of the proposed reforms have been enacted. However, recent publicity regarding Bain Capital has once again focused public attention on the private equity industry.¹³⁷ Thus, it is possible that lawmakers will revisit these reforms or that the IRS will consider other ways of challenging the results claimed by Blackstone Group LP. This Article proposes a way for the IRS to do precisely that.

133. S. 1624, 110th Cong. (2007). For further discussion of the legislation, see Fleischer, *Taxing Blackstone*, *supra* note 1, at 104–20.

134. H.R. 1935, 111th Cong. (2009). There are many other ways in which existing law could be changed to alter the results claimed by Blackstone Group LP. Rather than focus on potential legislative or regulatory changes, however, this Article considers a way in which the results claimed by Blackstone Group could be challenged under current law.

135. The text refers to “almost all” income rather than “all” income because Blackstone Group LP could earn up to 10 percent non-qualifying income and still comply with the 90 Percent Gross Income Exception.

136. This structure still has some benefits because of the potential use of interest expense to reduce U.S. Subsidiary's tax liability and because Non-U.S. Subsidiary is not subject to tax. *See supra* Parts II.C and II.D; *see, also*, Fleischer, *Taxing Blackstone*, *supra* note 1, at 105.

137. *See supra* notes 14–15 and accompanying text.

**V. PROPOSAL: USING EXISTING STANDARDS TO CLOSE THE
UNINTENDED LOOPHOLE IN THE PARTNERSHIP
TAX ALLOCATION RULES**

Even under current law, the IRS could challenge the results claimed by Blackstone Group LP. Thus, rather than wait and hope for Congress to reconsider reforms that were not enacted in the past, the IRS could take action now. In particular, the IRS could rely on existing standards to close the unintended loophole in the partnership tax allocation rules that Blackstone Group LP's structure exploits.

As discussed above in Part III, the technical partnership tax allocation rules are incapable of restricting allocations among related partners, resulting in this often-abused loophole.¹³⁸

To address this shortcoming of the partnership tax allocation rules, the IRS could invoke existing standards. Doing so would not be unprecedented because it is not unusual for tax rules to have gaps or for the IRS and courts to rely on standards to fill gaps. As others have observed, lawmakers design rules, in tax law and elsewhere, to accommodate the most typical fact patterns.¹³⁹ Furthermore, as others have argued, tax rules based on the most typical fact patterns leave gaps that taxpayers can exploit by adjusting their transactions to take the rules into account.¹⁴⁰ Luckily, a

138. One might argue that Blackstone Group LP's structure actually exploits the shortcomings of a standard rather than a rule. Blackstone Group LP's structure takes advantage of failings of the substantiality test, and the substantiality test has some standard-like qualities given that, in some respects, it is a vague test. Vague aspects of the substantiality test include the fact that it is not entirely clear when one should conclude that a partner's after-tax consequences "may" be enhanced by allocations or when one should conclude that there is a "strong likelihood" that no partner will be worse off after tax. For purposes of the analysis above, it is not crucial to classify substantiality as a rule or a standard. Either way, the substantiality test is implicitly based on the assumption that partners are unrelated and, therefore, is ill-equipped to address allocations among related partners.

139. 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) [hereinafter McMahon, *Beyond a GAAR*]; David A. Weisbach, *Formalism in the Tax Law*, 66 U. CHI. L. REV. 860, 867-69 (1999) [hereinafter Weisbach, *Formalism*]. For a related point, see Louis Kaplow, *Rules Versus 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."

140. See, e.g., Noël B. Cunningham & James R. Repetti, *Textualism and Tax Shelters*, 24 VA. TAX REV. 1, 33 (2004) [hereinafter Cunningham & Repetti, *Textualism*]; Daniel I. Halperin, *Halperin Expresses Support for Partnership Anti-*

solution to this pervasive problem exists. In particular, standards can fill gaps left by tax rules that envision only the typical case.¹⁴¹ 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).¹⁴²

Abuse Reg., Public Comment on Regulations, 94 TNT 152-36 (Aug. 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 (July 19, 1999) [hereinafter Johnson, *The Anti-Skunk Works*] (“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.”); Kyle D. Logue, *Tax Law Uncertainty and the Role of Tax Insurance*, 25 VA. TAX REV. 339, 366 (2005) (“[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, *Beyond a GAAR*, *supra* note 139, at 1722; 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) [hereinafter Monroe, *What's in a Name*]; 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) [hereinafter Shaviro & Weisbach, *The Fifth Circuit*]; Weisbach, *Formalism*, *supra* note 139, at 869 (“Uncommon transactions that are taxed inappropriately become common as taxpayers discover how to take advantage of them.”).

141. *See, e.g.*, Cunningham & Repetti, *Textualism*, *supra* note 140, at 6; Johnson, *The Anti-Skunk Works*, *supra* note 140, 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 misinterpretations of the statute to avoid tax.”); Monroe, *What's in a Name*, *supra* note 140, at 413; Shaviro & Weisbach, *The Fifth Circuit*, *supra* note 140, at 513; Weisbach, *Formalism*, *supra* note 139, 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.”).

142. *See, e.g.*, Deborah A. Geier, *Interpreting Tax Legislation: The Role of Purpose*, 2 FLA. TAX REV. 492, 493 (1995); Alan Gunn, *The Use and Misuse of Anti-Abuse Rules: Lessons from the Partnership Antiabuse Regulations*, 54 SMU L. REV. 159, 164 (2001); Weisbach, *Formalism*, *supra* note 139, 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

Applying these general ideas to the partnership tax allocation rules leads to the conclusion that the IRS and the courts should rely on standards when partners are related because the existing rules, implicitly, assume that partners are unrelated and have opposing economic interests.¹⁴³ In the case of Blackstone Group LP, and other partnerships formed by related partners, the IRS could rely on a number of standards to challenge the claimed results.¹⁴⁴

Bankman, *The New Market in Corporate Tax Shelters*, 83 TAX NOTES 1775, 1787 (June 21, 1999); Joshua D. Blank, *What's Wrong with Shaming Corporate Tax Abuse*, 62 TAX L. REV. 539, 539 (2009); Sarah B. Lawksy, *Probably? Understanding Tax Law's Uncertainty*, 157 U. PA. L. REV. 1017, 1032 (2009); Leandra Lederman, *W(h)ither Economic Substance?*, 95 IOWA L. REV. 389, 396–97 (2010) [hereinafter Lederman, *W(h)ither*]; 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*]. 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, 1940 (2005) (“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).

143. For purposes of analyzing the Blackstone Group structure, it is not necessary to decide precisely when partners should be considered “related” because, under any plausible definition, the partners of Blackstone Group are “related.” This is true because two of Blackstone Group’s three partners are wholly-owned by the third partner. This Article does not address when allocations among less closely related entities should be challenged nor does this Article address when allocations among family members should be challenged. In the case of family members, the IRS might argue that, in some situations, family members could be treated as one partner when applying the substantiality tests. *See supra* note 127. Furthermore, in some cases allocations among family members could be subject to section 704(e). *See supra* note 87.

144. For instance, the IRS might argue that related partners should be treated as one partner when applying the substantial economic effect test. *See supra* note 127. The IRS could also invoke the Partnership Anti-Abuse Rule contained in Regulations section 1.701-2. For further discussion of the Partnership Anti-Abuse Rule, see Monroe, *What's in a Name*, *supra* note 140. The Partnership Anti-Abuse Rule provides:

[I]f a partnership is formed or availed 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]

This Article will focus on section 482 particularly because it represents the IRS's most promising grounds for challenging the legitimacy of the Underlying Partnership's allocations.¹⁴⁵

Regarding section 482, the partnership tax allocation rules are, by no means, the only tax rules that work most effectively when parties have opposing economic interests. Tax rules, generally, function best in a setting involving unrelated parties with opposing economic interests dealing at arm's 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.¹⁴⁶ 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 U.S. corporation (USCORP) owns 100 percent of the stock of a non-U.S. 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 deals broadly with the ubiquitous problems arising from the fact that related parties do not negotiate at arm's 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)

Regs. § 1.701-2(b). The Regulations contain a list of factors that may indicate, but do not necessarily establish, that a partnership was used for a prohibited purpose. *Id.* These factors include, among others, whether substantially all of the partners are related to one another. In the Blackstone Group LP structure, all of the partners are related given that two of the partners (U.S. Subsidiary and Non-U.S. Subsidiary) are wholly-owned subsidiaries of the third partner (Blackstone Group LP).

145. For further discussion of how the IRS might invoke section 482 to challenge allocations that have substantial economic effect but that involve related partners, see Leder, *Tax-Driven Partnership Allocations*, *supra* note 13, at 769, 779–80.

146. I.R.C. § 1001.

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 arm's-length price.¹⁴⁷

In the context of partnership tax allocations, the Treasury Regulations specifically provide that the IRS may use section 482 to challenge partnership tax allocations when partners are related.¹⁴⁸ In particular, Regulations section 1.704-1(b)(1)(iii) states: "[A]n allocation that is respected under [the substantial economic effect 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

147. Regs. § 1.482-1(b)(1) ("[T]he standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer.").

148. For further discussion, see Leder, *Tax-Driven Partnership Allocations*, *supra* note 13, at 785–87. See also MCKEE, NELSON & WHITMIRE, PARTNERSHIPS AND PARTNERS, *supra* note 82, ¶ 3.04[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.* ¶ 10.03[3] ("[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.").

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], 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 482.¹⁴⁹

Example 28 is 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 way that 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.

In addition, the IRS has successfully invoked section 482 to challenge partnership tax allocations in the past. In *Rodebaugh v. Commissioner*,¹⁵⁰ 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.¹⁵¹ Furthermore, although *Rodebaugh* was decided before the adoption of the current partnership tax allocation rules, since the adoption of the current rules, the IRS has continued to assert that section 482 can apply in the partnership tax allocation context.¹⁵²

149. Regs. § 1.704-1(b)(5), Ex. 28.

150. 33 T.C.M. (CCH) 169, T.C.M. (RIA) ¶ 1974-36 (1974).

151. *Id.*

152. *See, e.g.*, Field Serv. Advisory (Sept. 10, 1993), available at 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."); Field Serv. Advisory (May

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, the Underlying Partnership allocates income among three partners — Blackstone Group LP, U.S. Subsidiary, and Non-U.S. Subsidiary — all of which are “organizations, trades, or business”¹⁵³ and all of which are “owned and controlled, directly or indirectly, by the same interests.”¹⁵⁴ Thus, even though the allocations by the Underlying Partnership may literally comply with the substantial economic effect rules,¹⁵⁵ 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 U.S. Subsidiary under section 482 and conclude that Blackstone Group LP should be treated as if it received some portion of the management fees directly. Management fee income and other non-qualifying income reallocated to Blackstone Group LP under section 482 should be treated as non-qualifying income. When applying section 482 in other contexts, if the IRS determines that a party should have earned more income of a given character, the additional income the party must report is deemed to have that character.¹⁵⁶ For instance, if a

14, 1993), available at 1993 WL 1469438 (making a similar statement); Field Serv. Advisory (Jan. 1, 1993), available at 1993 WL 1469419 (making a similar statement). 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” Field Serv. Advisory (Sept. 10, 1993), available at 1993 WL 1469410.

153. An “organization” includes “a sole proprietorship, a partnership, a trust, an estate, an association, or a corporation.” Regs. § 1.482-1(i)(1). Thus, this term is broad enough to include all three partners.

154. The Regulations under section 482 provide that the IRS may reallocate items among “controlled taxpayers.” See Regs. § 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.” Regs. §§ 1.482-1(i)(3), (5). This part of the definition includes U.S. Subsidiary and Non-U.S. 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.” Regs. § 1.482-1(i)(5). Thus, Blackstone Group LP is also a “controlled taxpayer,” and the IRS can reallocate income among Blackstone Group LP, U.S. Subsidiary, and Non-U.S. Subsidiary under section 482.

155. See *supra* Part III.B.

156. See, e.g., *Krueger Co. v. Commissioner*, 79 T.C. 65 (1982); *Proctor and Gamble Co. v. Commissioner*, 95 T.C. 323 (1990) (IRS argued that when a corporation should have additional royalty income under section 482, the additional income should be treated as royalty income for purposes of the Subpart F rules; although the court held in favor of the taxpayer, it did so on other grounds and concluded section 482 should not require the taxpayer to report additional income at

party is required to report additional interest income, the party is treated as earning additional interest income.¹⁵⁷ As a result, if the IRS invokes section 482 to re-allocate additional management fee income and other non-qualifying income directly to Blackstone Group LP, Blackstone Group LP would be treated as earning non-qualifying income. Thus, depending on the amount of income re-allocated to it, Blackstone Group LP could fail to meet the requirements of the 90 Percent Gross Income Exception so that it would be treated as a corporation for tax purposes.

VI. RESPONDING TO POSSIBLE OBJECTIONS

Despite the availability of means to challenge the results claimed by Blackstone Group LP, one might argue that the IRS should refrain from initiating a challenge for several reasons (each of which is described and evaluated below).¹⁵⁸ As discussed in the following, none of the potential objections justify inaction by the IRS.

all); Regs. § 1.482-1(g)(2)(ii) (stating that applying section 482 could cause a corporation to earn additional Subpart F income); Rev. Rul. 78-133, 1978-1 C.B. 171 (concluding that a corporation that failed to charge interest on loans made to related corporations should have additional income under section 482 and the additional income should be interest income for purposes of applying the personal holding company tax provisions).

157. See, e.g., *Krueger Co.*, 79 T.C. 65; Rev. Rul. 78-133, 1978-1 C.B. 171.

158. One might also argue that the Blackstone Group structure is no different than the blocker corporation structure used by many tax-exempt entities when investing in real estate funds, hedge funds, and private equity funds. For further discussion of this structure, see Emily Cauble, *Harvard, Hedge Funds and Tax Havens: Reforming the Tax Treatment of Investment Income Earned by Tax-Exempt Entities*, 29 VA. TAX REV. 695 (2010). This structure has been sanctioned by the IRS in private letter rulings. See Priv. Ltr. Rul. 2002-51-016 (Dec. 30, 2002); Priv. Ltr. Rul. 2002-51-018 (Dec. 20, 2002). The Blackstone Group structure, however, is different than the blocker corporation structure used in the private letter rulings. In the private letter rulings, a charitable remainder trust indirectly owned an interest in a blocker corporation that, in turn, owned an interest in a partnership ("lower-tier partnership"). All income that the charitable remainder trust received from lower-tier partnership was funneled through the blocker corporation. The lower-tier partnership did not allocate or pay some income to the blocker corporation while allocating or paying other income to the charitable remainder trust directly. By contrast, the Underlying Partnership in the Blackstone Group structure allocates and pays only some income to U.S. Subsidiary and Non-U.S. Subsidiary. As a result, the IRS could challenge the Blackstone Group structure by challenging the underlying payments and allocations. Thus, the IRS would not need to change its position regarding blocker corporations, generally, in order to challenge the Blackstone Group structure.

A. *The IRS Should Not Invoke a Standard Like Section 482 in an Area Covered by Specific Rules*

Some might argue that section 482 is vague and should be supplanted with the more detailed substantial economic effect rules.¹⁵⁹ If the detailed rules do not work properly when partners are related, the Treasury should revise the rules. Although revising the rules may be advisable, this vagueness argument is unpersuasive. The substantial economic effect rules are premised on the assumption that partners in a partnership are unrelated and, thus, have opposing economic interests.¹⁶⁰ 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.¹⁶¹ 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 in gaps left by rules.¹⁶² Moreover, in this instance, the specific rules explicitly state that they do not supplant section 482, the more general standard.¹⁶³ Given that this warning is contained within the specific rules, taxpayers cannot persuasively argue that they relied on the specific rules' certainty to provide a safe harbor from the vague standard of section 482.

159. See, e.g., Leder, *Tax-Driven Partnership Allocations*, *supra* note 13, 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.”).

160. See *supra* Parts III.A.2, III.A.4.

161. See *supra* Part III.B.

162. 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 might apply when partners in a partnership are related. See Leder, *Tax-Driven Partnership Allocations*, *supra* note 13, 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, *What’s in a Name*, *supra* note 140, at 454 (“Although a comprehensive analysis of uncertainty’s role in partnership taxation is well beyond this Article’s scope [T]he introduction of greater uncertainty into subchapter K might have a positive effect on partnership taxation Subchapter K overflows with complex and technical statutory provisions Although intended, at least in part, to increase certainty of partnership taxation [Yet, technical rules] . . . create new fault lines ripe for exploitation by taxpayers at extraordinary public cost.”).

163. See *supra* note 148 and accompanying text.

B. *Challenging the Current Structure Would Lead to Undesirable Consequences*

Challenging Blackstone Group LP's structure could lead to undesirable consequences in two ways.¹⁶⁴ First, current investors in Blackstone Group LP purchased their interests based on the assumption that Blackstone Group LP would be treated as a partnership for tax purposes.¹⁶⁵ If it were treated as a corporation instead, those investors would lose 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 typically invest in these vehicles directly given the large minimum investment required to purchase an interest in such funds.¹⁶⁶ Challenging Blackstone Group LP's

164. Blackstone Group might also argue that the structure achieves results that are consistent with the purpose of providing a special rule for publicly traded partnerships that earn predominately qualifying income. However, such an argument is unpersuasive. Regarding the purpose for the special qualifying income rule, legislative history indicates that Congress thought it was inappropriate to impose corporate-level tax on dividend income, interest income, and other types of investment income because owners of the publicly traded partnership could earn such income directly, rather than through a publicly traded intermediary. *See, e.g.,* Fleischer, *Taxing Blackstone*, *supra* note 1, at 109–10. In Blackstone Group, the qualifying income is a portion of carried interest that the Blackstone Firm receives from the funds that it manages. Thus, as Professor Fleischer argues, because investors in Blackstone Group could not directly acquire a right to receive carried interest from a Blackstone fund, the rationale for the qualifying income exception does not apply to the qualifying income earned by Blackstone Group. *Id.*

165. Investors may not have been entirely justified in making this assumption given that Blackstone's S-1 warns of the risk that Blackstone Group LP could be treated as a corporation for tax purposes. *See* Blackstone S-1, *supra* note 1, at 52 (stating in the Risk Factors section: "The value of your investment in us depends largely on our being treated as a partnership for U.S. federal income tax purposes, which requires that 90% or more of our gross income for every taxable year consist of qualifying income We may not meet these requirements or current law may change so as to cause, in either event, us to be treated as a corporation for U.S. federal income tax purposes or otherwise subject to U.S. federal income tax.").

166. *See, also,* Fleischer, *Taxing Blackstone*, *supra* note 1, at 118–19 ("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."). Furthermore, one could argue that Congress's failure to enact reform that would have altered the results claimed by Blackstone Group suggests that the IRS should not challenge those results.

claimed tax consequences could prevent other fund sponsors from engaging in public offerings in the future, thereby limiting the opportunities for ordinary individuals to acquire indirect economic interests in such funds. Furthermore, challenging Blackstone Group LP's tax consequences could cause it to be treated as a corporation for tax purposes so that ordinary individuals could invest in funds only if they did so through an entity subject to corporate-level tax.¹⁶⁷

These concerns may have merit.¹⁶⁸ However, 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 Group are actually consistent with law. For example, Congress could provide that every publicly traded partnership must pay 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.¹⁶⁹ Taking the approach of acquiescing to taxpayers' manipulation of the partnership tax allocation rules is an undesirable alternative to reforming the publicly traded partnership rules if lawmakers want to sanction the results claimed by Blackstone Group.¹⁷⁰

C. *Blackstone Group's Structuring Produces a Logical Result Despite Illogical Rules*

The 90 Percent 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:

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 Percent Gross Income Exception because less than 90 percent of its income will be qualifying income. As a result, assuming the partnership has no

167. *Id.*

168. If these concerns do have merit, they would also represent reasons to avoid congressional reforms that would tax Blackstone Group LP as a corporation. Even if legislative reform contained a delayed effective date, it 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, 57-58 (1977); Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 HARV. L. REV. 509, 518 (1986).

169. For further discussion, see *infra* Part VI.C.

170. See *infra* note 175 and accompanying text.

available deductions, the partnership will be subject to corporate-level tax of 35 percent times \$1,000 or \$350. If, instead, the additional dollar was qualifying income, then 90 percent 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 one dollar of income is earned.

Cliff effects are generally criticized.¹⁷¹

As demonstrated by Example 6, two partnerships could be identical in all respects but for how one dollar of income is earned. If that one dollar is qualifying income, the partnership owes no tax liability, and if that one dollar is non-qualifying income, the partnership owes significant tax liability. Such a result is arbitrary and, therefore, potentially unfair.¹⁷²

171. For criticism of cliff effects in tax generally, see Lily L. Batchelder, *What Should Society Expect from Heirs? The Case for a Comprehensive Inheritance Tax*, 63 TAX L. REV. 1, 91 n.303 (2009); Karen C. Burke & Grayson M.P. McCouch, *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*, TAX LAW. 37, 40 (2010); David A. Stein, *UBIT Issues in Investment Partnerships: What Tax-Exempt Organizations (and Their Taxable Partners) Should Know*, in 11 THE PARTNERSHIP TAX PRACTICE SERIES: PLANNING FOR DOMESTIC AND FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES & STRATEGIC ALLIANCES 2012 198-1, 198-15 (Louis S. Freeman ed., 2012); 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).

172. 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 one dollar of qualifying income rather than one dollar of non-qualifying income. This strong tax incentive could encourage the taxpayer to earn one dollar 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 one dollar 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 additional thirty-five cents of tax and thus might still undertake the activity despite the tax consequences. However, compared to current law, a gradual rule could cause even greater distortions in the decisions of partnerships that

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 percent of its gross income is qualifying income but bears entity-level tax on all of its income if only 89.99 percent 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 one dollar earned by the partnership is non-qualifying income, assuming no available deductions, the partnership’s tax liability is \$101 times 35 percent (or \$35.35). If the additional one dollar earned by the partnership is qualifying income, the partnership’s tax liability is \$100 times 35 percent or (\$35). Consequently, the only additional tax burden borne by the partnership as a result of earning an additional one dollar of non-qualifying income is 35 cents (35 percent 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),¹⁷³ 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 planned around a rule that causes an undesirable “cliff effect.” For this reason, the results claimed by Blackstone Group may be more sensible and less arbitrary than the results that follow from the laws that currently exist.¹⁷⁴

earn well over 90 percent qualifying income, for example. Under current law, such partnerships can earn one dollar of non-qualifying income or one dollar of qualifying income without incurring any entity-level tax. Thus, tax consequences will not distort the decision between the two types of income. Under a gradual rule, such partnerships could earn one dollar of qualifying income without incurring any entity-level tax but would incur thirty-five cents of entity-level tax as a result of earning one dollar 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 percent qualifying income. For a similar discussion, see Weisbach, *Formalism*, *supra* note 139, at 873–74.

173. It is not all subject to corporate-level tax because of the potential use of interest expense to reduce U.S. Subsidiary’s tax liability and because Non-U.S. Subsidiary is not subject to tax. See *supra* Parts II.C., II.D.

174. Along similar lines, Professor Fleischer suggested that Blackstone Group 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, *Taxing Blackstone*, *supra* note 1,

The problem with this rationale for the IRS's 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 Group to remedy the problem by using a structure that takes advantage of unintended consequences of the partnership tax allocation rules. Allowing Blackstone Group to work around the current partnership tax allocation rules 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.¹⁷⁵ Moreover, it may embolden

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 Group] structure. Insurance companies, cooperatives, and other industry groups have their own methods of managing corporate tax liability. Why not Blackstone?").

175. For a similar argument in the context of Blackstone, see Fleischer, *Taxing Blackstone*, *supra* note 1, at 114, stating:

"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*], stating:

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.

taxpayers to take advantage of the partnership tax allocation rules in other situations involving related partners with consequences that could be even more objectionable than the results of the Blackstone Group structure.

D. The Damage is Contained

One might argue that challenging Blackstone Group is unnecessary because the universe of publicly traded entities that can effectively engage in the type of structuring used by Blackstone Group is limited for two reasons. First, the structure reduces Blackstone Group LP's tax liability primarily by allowing qualifying income to escape corporate-level tax.¹⁷⁶ 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.¹⁷⁷ Such a business would have to undertake a restructuring to use the Blackstone Group structure, and the restructuring itself could trigger adverse tax consequences.¹⁷⁸

Although not all businesses can effectively utilize the Blackstone Group structure, many other businesses could potentially use the structure, particularly new businesses that are not dissuaded by the costs of restructuring.¹⁷⁹ As a result, challenging the structure could still raise

176. The structure also reduces tax imposed on non-qualifying income because of the potential use of interest expense to reduce U.S. Subsidiary's tax liability and because Non-U.S. Subsidiary is not subject to tax. *See supra* Parts II.C., II.D.

177. Regs. § 301.7701-2(b)(1).

178. 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. § 311(b)(1).

179. *See* Fleischer, *Taxing Blackstone*, *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.").

significant tax revenue from businesses that do or could use the structure.¹⁸⁰ Furthermore, challenging this transaction could prevent other taxpayers from establishing partnerships in order to take advantage of the partnership tax allocation rules' failure to adequately constrain allocations among related partners. Thus, because the damage is not as contained as it may first appear to be, the IRS should take action, particularly at a time when the U.S. Treasury desperately needs increased tax revenue.

E. Blackstone Group Did Not Engage in Egregious Tax Abuse

One might argue that the structure used by Blackstone Group LP was not overly abusive. In particular, the underlying transaction (i.e., the initial public offering) was a legitimate business transaction, and Blackstone Group simply structured the transaction in a manner designed to achieve very favorable tax consequences.

Although it is true that many transactions involve more egregious tax abuse than the Blackstone Group LP structure, that fact and the fact that the underlying business transaction is legitimate should not immunize the structure from challenge.¹⁸¹ 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.¹⁸² Under these doctrines, if a taxpayer

180. 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, Taxing Blackstone, 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 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.”).

181. *See, e.g., Lederman, W(h)ither, supra* note 142, 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 142, at 337–39 (suggesting that “real business transactions done in a funny way” should be impermissible when they reach results unintended by Congress); Shaviro & Weisbach, *The Fifth Circuit, supra* note 140, 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.”).

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

arranges 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.

VII. CONCLUSION

Blackstone Group LP uses a structure that inappropriately exploits a loophole in the current partnership tax allocation rules. The IRS could and should challenge Blackstone Group's results under available standards that are designed to close loopholes in tax rules. Some of the arguments against the IRS taking action may, at first glance, appear legitimate. However, a closer examination reveals that although some of these arguments might justify legislative reform to the publicly traded partnership rules, they do not excuse a failure to challenge tax structures that flout current law. This is particularly true because Blackstone Group's structure represents merely one example of the manner in which related partners can exploit a loophole in the partnership tax allocation rules. Therefore, challenging Blackstone Group's structure will deter other taxpayers from manipulating the existing rules at a large cost to the public.

scope of this Article. For more information on this topic, see Boris I. Bittker & Lawrence Lokken, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 4.3.5 (2012) and 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."

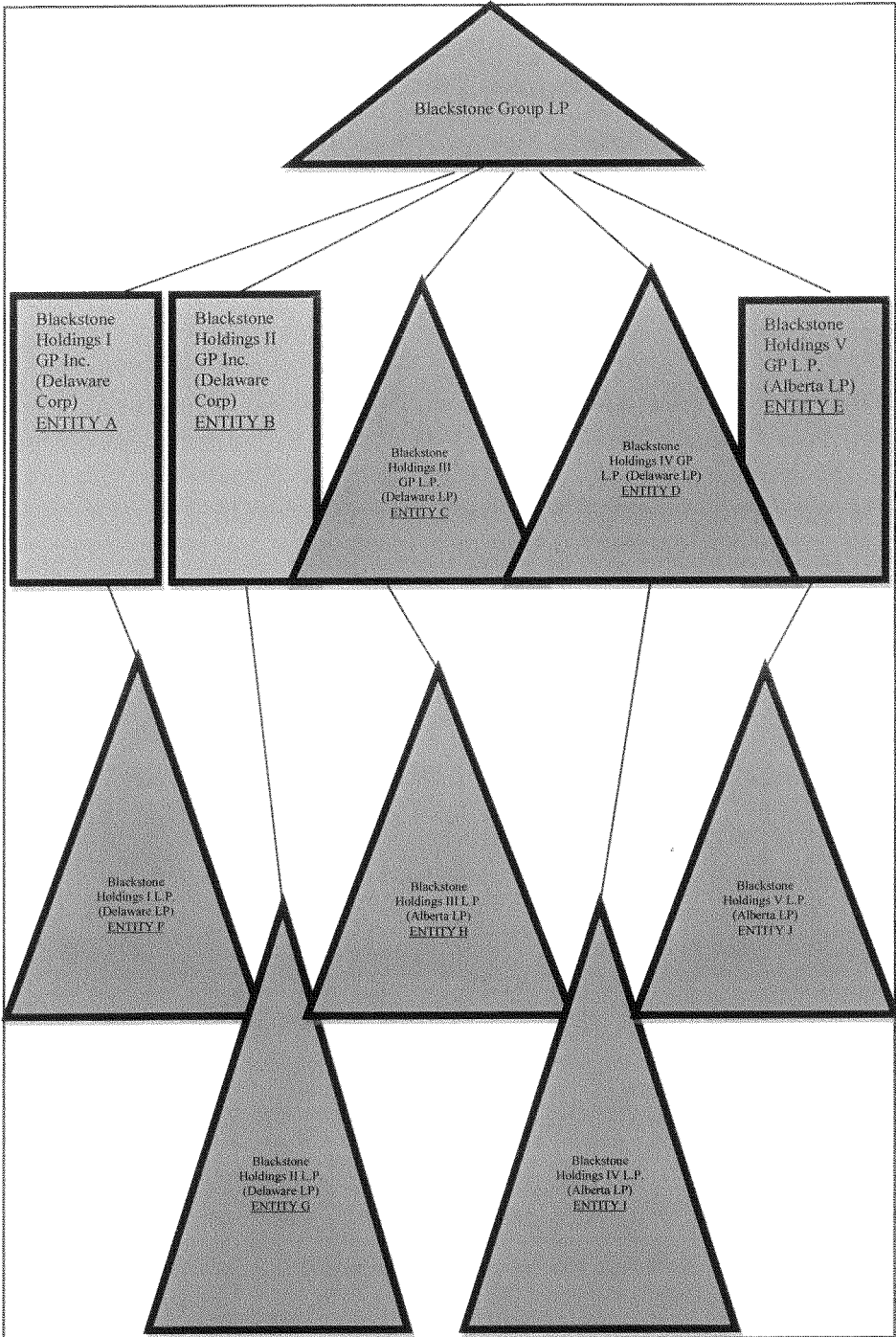
APPENDIX

I. ACTUAL BLACKSTONE STRUCTURE

As shown in the Blackstone S-1,¹⁸³ the actual structure used is reflected in Figure 2 below.

183. Blackstone S-1, *supra* note 1, at 11.

Figure 2. Blackstone Structure from S-1



II. SIMPLIFYING ADJUSTMENTS

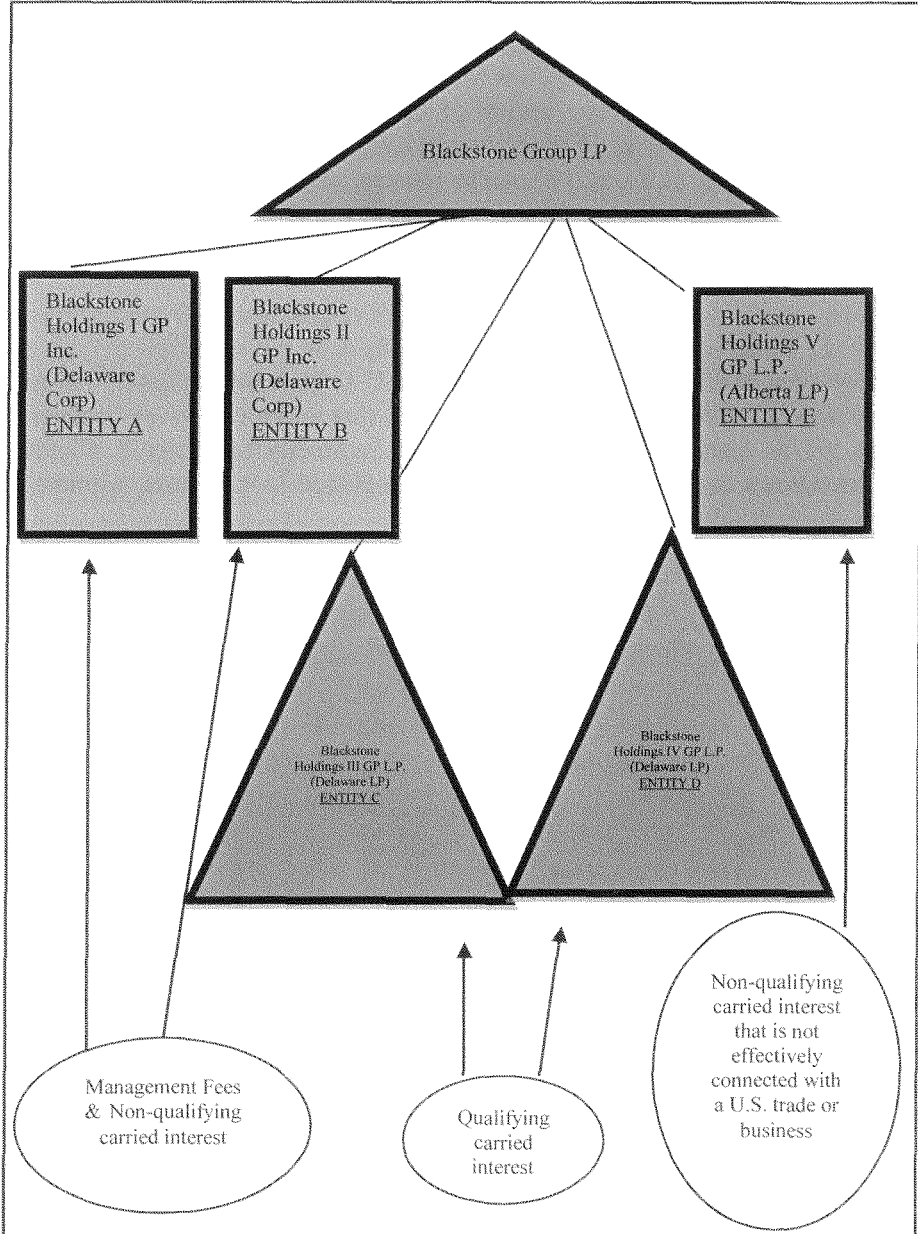
In Figure 2, the entities labeled Entities F, G, H, I, and J, indirectly receive management fees and carried interest from funds sponsored by the Blackstone Firm.¹⁸⁴ Entities F, G, H, I, and J are treated as partnerships for tax purposes. Because partnerships are pass-through entities for tax purposes, 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. Moreover, according to the S-1, the structure is designed so that income received by Entities C and D will be qualifying income.¹⁸⁵ 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 U.S. trade or business.¹⁸⁶ In turn, only non-qualifying carried interest income that is not effectively connected with a U.S. 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.

184 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, *supra* note 1, at 10.

185. *Id.* at 203.

186. *Id.* at 204 (“Blackstone Holdings V GP L.P. is expected to be operated so as not to produce [effectively connected income].”).

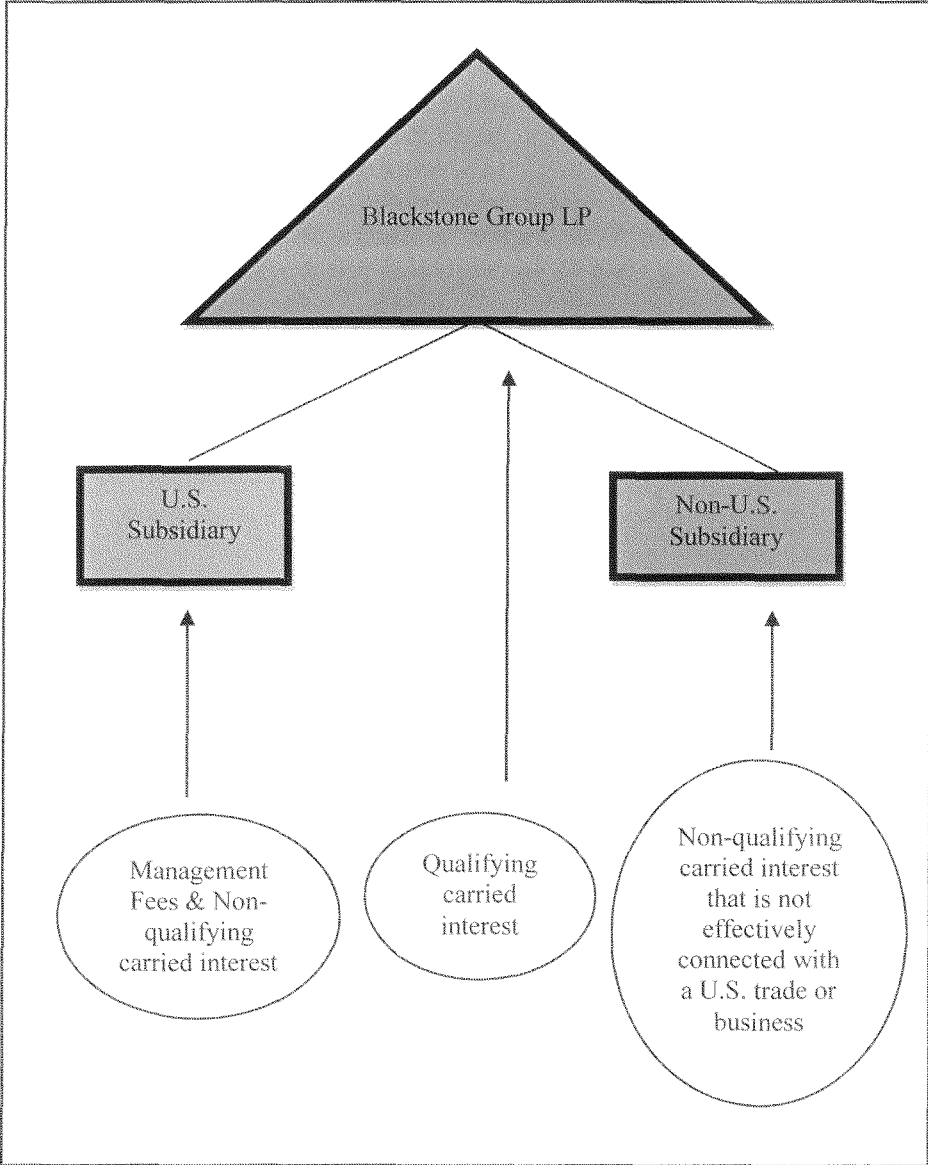
Figure 3. Blackstone Structure from S-1 with Simplifying Adjustments



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 as 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 ("U.S. 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-U.S. 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.¹⁸⁷ 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.¹⁸⁸ Following the restructuring undertaken prior to the initial public offering, the Contributed Businesses have been owned by subsidiaries of U.S. Subsidiary, Blackstone Group LP, and Non-U.S. Subsidiary.¹⁸⁹ 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, U.S. Subsidiary, and Non-U.S. 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 Percent Gross Income Exception. The three possible structures are discussed below.

A. *Possibility One*

The first possible structure is shown in Figure 5 below. As Figure 5 shows, each fund (“Underlying Fund”) sponsored by the Blackstone Firm pays management fees to an Investment Advisor that is owned by U.S. 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 U.S. trade or business) to U.S. 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 U.S. trade or business) to Non-U.S. Subsidiary.

This structure is similar to Figure 1 because the Underlying Fund pays management fees, indirectly, to U.S. Subsidiary, and the Underlying Fund, indirectly, allocates some carried interest to each of Blackstone Group LP, U.S. Subsidiary, and Non-U.S. Subsidiary. If Blackstone Group LP uses this structure, the IRS could invoke section 482 to challenge the income

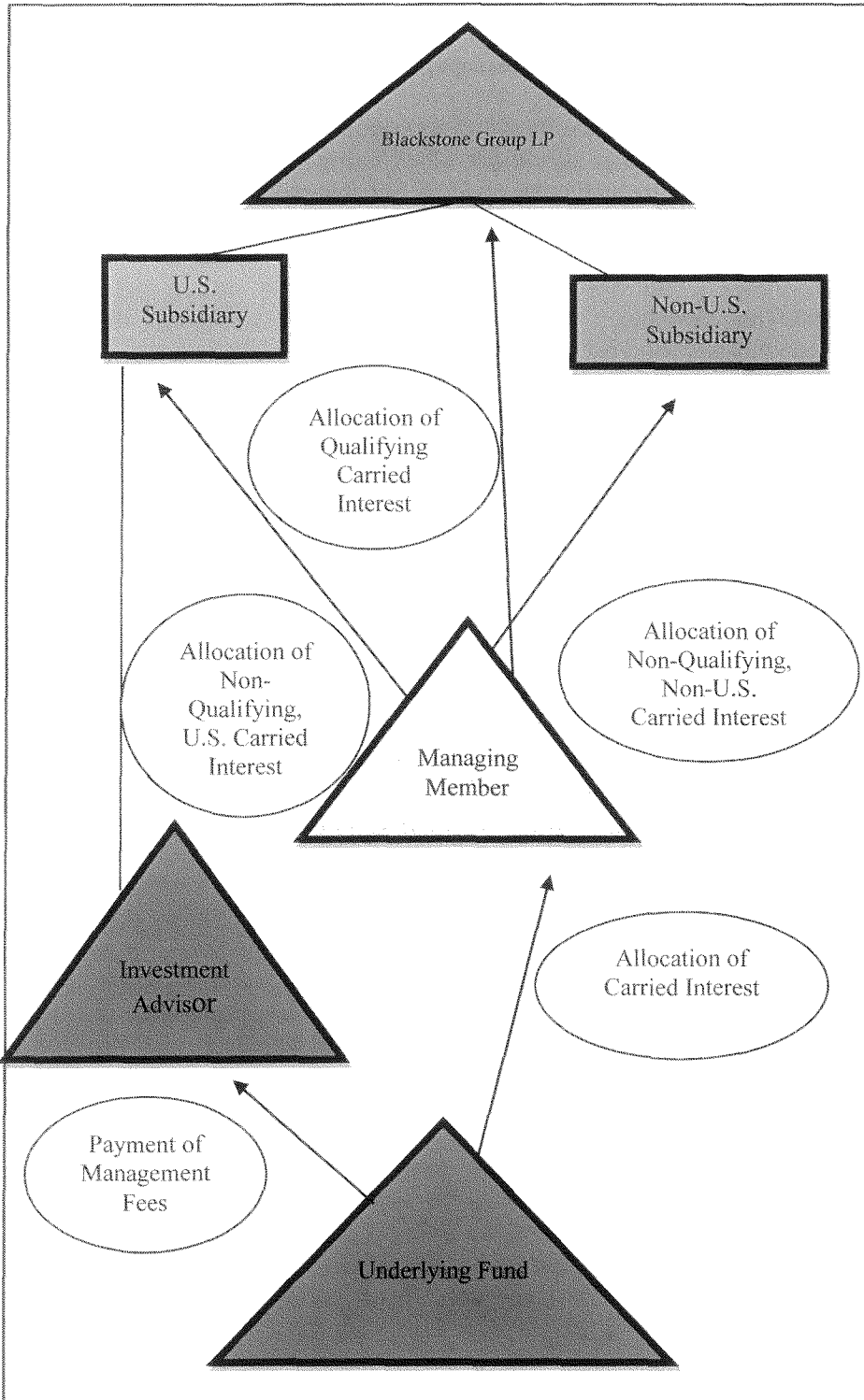
187. *Id.* at 57.

188. Blackstone S-1, *supra* note 1, at 57.

189. *Id.*

allocations by the Managing Member of each Underlying Fund and the payment of management fees entirely to the Investment Advisor.

Figure 5. Possibility One



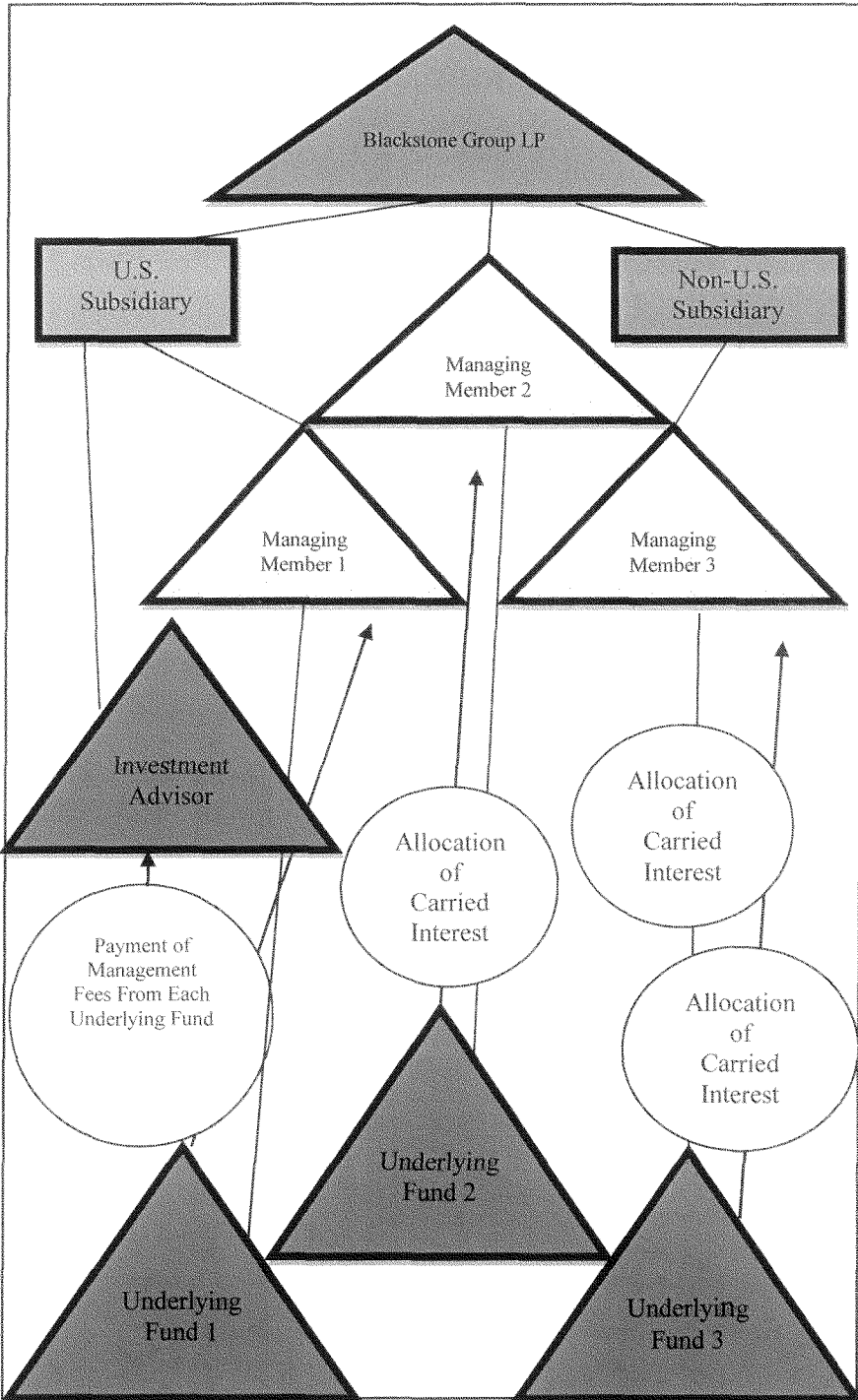
B. *Possibility Two*

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 Underlying Fund pays management fees to an Investment Advisor that is owned by U.S. 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 U.S. Subsidiary, Non-U.S. 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 U.S. non-qualifying income, or predominately non-U.S. non-qualifying income. Blackstone's predictions would determine whether the Managing Member of the Underlying Fund would be owned by U.S. Subsidiary (if carried interest were expected to be predominately U.S. non-qualifying income), Non-U.S. Subsidiary (if carried interest were expected to be predominately non-U.S. 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 the Blackstone Firm's ability to accurately forecast the types of income that will be earned by a given Underlying Fund. More significantly, this structure would inappropriately constrain the Blackstone Firm's ability to select investments on behalf of a given Underlying Fund. For example, assume the Blackstone Firm 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, the Blackstone Firm's obligation to the investors in the Underlying Fund to select investments that generate favorable after-tax returns could be at odds with its obligation to seek to ensure that the Blackstone Group LP qualified for the 90 Percent Gross Income Exception. This is true because the investors in the Underlying Fund do not own an interest in Blackstone Group LP. Rather, they invest either directly in the Underlying Fund or they invest through other entities that invest in the Underlying Fund. As a result, the after-tax return realized by these investors does not depend on whether or not Blackstone Group LP qualifies for the 90 Percent Gross Income Exception. Thus, a conflict could arise if the

Blackstone Firm identified a beneficial investment that would generate non-qualifying income. Acquiring this investment could be beneficial for investors in the Underlying Fund but detrimental for investors in Blackstone Group LP.

Figure 6. Possibility Two



C. *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 Underlying Fund pays management fees to an Investment Advisor that is owned by U.S. Subsidiary. Unlike in the previous structures, in the third structure, each Underlying Fund would form a number of subsidiaries treated as partnerships for tax purposes. When each Underlying Fund acquired an asset that was expected to generate non-qualifying, U.S. 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 U.S. 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-U.S. 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 Group LP 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 each 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.¹⁹⁰ Regarding the second fact, investors in each Underlying Fund will insist that the carried interest received from Sub 1 may not solely depend on how the assets of Sub 1 have performed but 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 each Underlying Fund pays management fees indirectly to U.S. Subsidiary, and each Underlying Fund indirectly allocates some carried interest to each of Blackstone Group LP, U.S. Subsidiary, and Non-U.S. Subsidiary. Therefore, if Blackstone Group LP uses this structure, the IRS could challenge the

190. See, e.g., Gregory May, *Wrongs and Remedies: The U.S. Tax Treatment of Multinational Partnerships of Individuals*, 104 TAX NOTES 1509, 1522–24 (June 21, 2004) (describing how the IRS could collapse parallel partnerships into a single partnership particularly if the partnerships "set distributions by reference to their combined profits").

income allocations by each Underlying Fund under 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

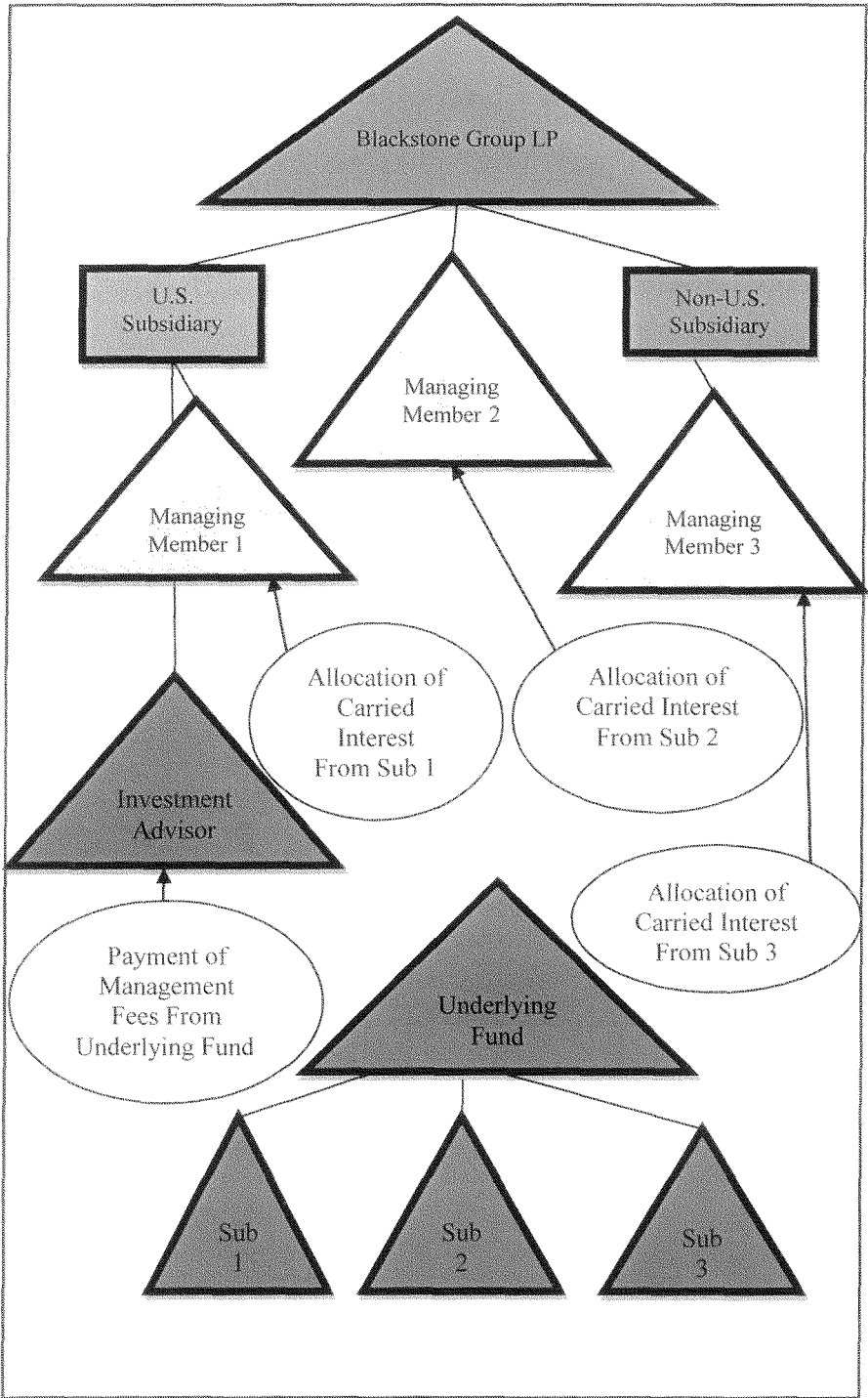
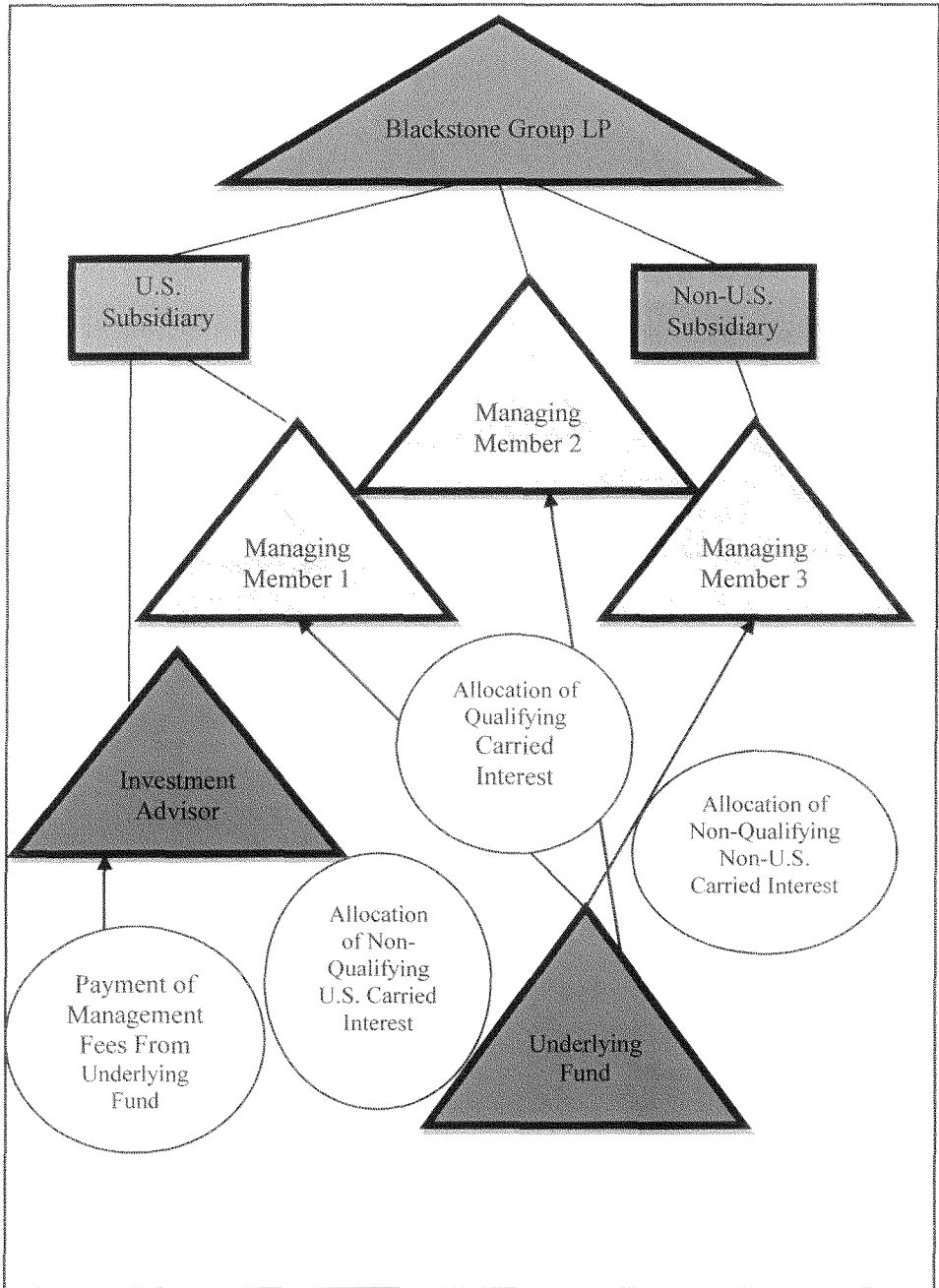


Figure 8. Possibility Three Re-Characterized



FLORIDA TAX REVIEW

ARTICLE

WATCHING THE WATCHERS:
PREVENTING I.R.S. ABUSE OF THE TAX SYSTEM

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