# Taxing Private Equity Funds as Corporate 'Developers'

By Steven M. Rosenthal


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Private equity funds buy stock in companies that they intend to develop and resell. Rosenthal recommends that the IRS write regulations to treat the gains and losses on the sale of those companies (or their stock) as ordinary.

> If something is a capital gain, it should be treated as a capital gain. If something is ordinary income, it should be treated as ordinary income. I would look at each type of income, and I'm sure the IRS would do the same, to determine is this really a capital gain or is it ordinary income.
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> — Mitt Romney, interviewed in *Fortune*, Aug. 15, 2012

Mitt Romney is not directing tax policy, but his advice is sensible: The IRS should look at the character of the profits of private equity funds. Private equity funds make their money by acquiring new or struggling companies (generally buying a controlling block of stock) at a low price, developing (or improving) the companies, and reselling them at a high price.

Private equity funds manage vast amounts of money: $2.5 trillion in 2010, much more than the $100 billion in 1994.[1] They earn immense profits, largely from selling the stock of acquired and improved companies.[2] The funds allocate a large share of those profits to their managers as reward for their services, which the IRS accepts.[3] Commentators accept the funds' profits as capital gains but question whether the managers' allocation should be capital.[4] In the summer of 2007, Congress held hearings on the capital gains of private equity managers, but it still has not enacted legislation.[5]

This article focuses instead on the character of the funds' profits. It recommends that the IRS write new regulations to treat the funds' profits as ordinary income in light of the law, Congress's original intent, and tax policy.

**The Business of Private Equity Funds**

Private equity funds typically are organized as limited partnerships, with a general partner (often itself a partnership that is owned by managers like Romney) and limited partners (some wealthy individuals, but mainly institutional and foreign investors). In most cases, the general partner makes a small capital contribution and promises management services in exchange for a "profits" (or carried) interest in the partnership and a stream of

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[1]Andrew Metrick and Ayako Yasuda, "Venture Capital and Other Private Equity: A Survey," 17 *Eur. Fin. Mgmt.* 619 (2011).

[2]A sample of 837 funds outperformed the S&P 500 over the period 1984-2010 by an average of 1.5 percent per year, net of fees. David T. Robinson and Berk A. Sensoy, "Private Equity in the 21st Century: Cash Flows, Performance, and Contract Terms from 1984-2010" (2011). After restoring the fees, and extrapolating the above-market return to the total capital of the fund industry, the funds' profits are immense.

[3]*See* Rev. Proc. 2001-43, 2001-2 C.B. 191, section 4.01, *Doc 2001-20855, 2001 TNT 150-11*, which permits income from a carried interest to be treated as capital.

[4]Victor Fleischer, "Two and Twenty: Taxing Partnership Profits in Private Equity Funds," 83 *N.Y.U. L. Rev.* 1 (2008). Fleischer's "two" refers to the annual management fee of 2 percent of the capital that investors have committed to the fund. The "twenty" refers to a 20 percent share of the futures profits of the fund (the carried interest). This article does not focus on the fund's allocation of fees and profits to the general partner, but on the fund's entire profits from selling stock.

[5]"Carried Interest: Hearings Before the S. Fin. Comm.," 110th Cong. (July 11, July 31, and Sept. 6, 2007); "Carried Interest: Hearings Before the H. Ways and Means Comm., 110th Cong. (Sept. 6, 2007).

fees.[6] The limited partners commit to larger capital contributions, which the fund calls on after identifying an investment opportunity.

The private equity funds use that capital to buy the stock of a company. They then improve ''the operations, governance, capital structure, and strategic position'' of the company.[7] From the start, a fund plans to resell the stock, often identifying a potential buyer or class of buyers for the company.[8] Alternatively, the fund might sell the stock through an initial public offering, often through a firm underwriting in which the fund sells the stock to one or more underwriters who in turn resell the stock to the public (and the underwriters take the financial risk if the stock cannot be resold to the public). The fund distributes the sales proceeds to its general and limited partners and almost always dissolves within seven to 10 years, which reflects the expected holding period of the fund's last investment.[9]

The fund treats the profits from the sale of the stock as capital gains. It then allocates the capital gains to its general partner (which, in turn, allocates them to its partners, the managers) and the limited partners. But should a private equity fund treat those profits as capital gains or ordinary income?

**Capital Gains and Losses: The Statute**

In 1921 Congress first added a preference for the gains from the sale of capital assets, taxing the gains at 12.5 percent rather than 58 percent, the top rate for the year.[10] Congress intended the preference largely to reduce what is known now as a lock-in effect of high tax rates:

> The sale of farms, mineral properties, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum (and the amount of surtax greatly enhanced thereby) in the year in which the profit is realized. Many such sales, with their possible profit taking and consequent increase of the revenue, have been blocked by this feature of the present law.[11]

The definition of capital asset quickly became critical. At first, in 1921, Congress defined a capital asset as ''property acquired and held by the taxpayer for profit or investment,'' but it excluded inventory.[12]

However, the limited scope of the inventory exclusion permitted taxpayers to resell, for example, real estate (which was not inventory) in a business for capital gains.[13] To block those advantages, Congress in 1924 also excluded property held ''primarily for sale in the course of a trade or business.''[14] Thus, ''property held primarily for resale did not constitute a capital asset, regardless of whether it was the type of property included in inventory under good accounting practice.''[15]

As the Supreme Court later explained, Congress intended ''that profits and losses arising from the everyday operation of a trade or business be considered as ordinary income or loss rather than capital gain or loss.''[16] However, Congress soon discovered that permitting more property to be ordinary created a new problem: It allowed taxpayers to selectively recognize losses from their businesses.

Now, for example, traders of stock could deduct their ordinary losses in full, because Congress had limited only capital losses.[17] Congress realized that

[6]The fund generally pays the 2 percent management fee to the general partner, which often redirects the fee to a management company to render management services on behalf of the partnership. Also, the general partner or management company may collect fees directly from the portfolio companies, but in those cases generally will reduce the fees it collects from the partnership (*e.g.*, through a fee offset).

[7]Testimony of Bruce Rosenblum, Chairman of the board, the Private Equity Council, before the Senate Finance Committee (July 31, 2007), *Doc 2007-17819*, *2007 TNT 148-41*.

[8]*See* Metrick and Yasuda, *supra* note 1, at 625.

[9]*See* Andrew W. Needham, ''A Guide to Tax Planning for Private Equity Funds and Portfolio Investments,'' *Tax Notes*, May 20, 2002, p. 1215, at 1216, *Doc 2002-12742*, or *2002 TNT 103-36*.

[10]*See* Anita Wells, ''Legislative History of the Treatment of Capital Gains Under the Federal Income Tax, 1913-1948,'' 11 *Nat'l Tax J*. 12, 15 (1948). The top rate in the prior two years was 73 percent. *Id*. at 15.

[11]H.R. Rep. No. 67-350, at 10-11 (1921).

[12]That is, ''stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year.'' Section 206(a)(6) of the Revenue Act of 1921.

[13]*See, e.g.*, *Keeney v. Commissioner*, 17 B.T.A. 560 (1929) (under pre-1924 law, the taxpayer could claim capital gains on land that was subdivided and sold).

[14]Revenue Act of 1924, section 208(a)(8). *See* William A. Friedlander, '''To Customers': The Forgotten Element in the Characterization of Gains on Sales of Real Property,'' 39 *Tax L. Rev*. 31, 32 (1983).

[15]S. Rep. No. 68-398 at p. 22 (1924). At the same time, Congress also limited the deduction for capital losses. Revenue Act of 1924, ch. 234, section 208(c).

[16]*Corn Products Co. v. Commissioner*, 360 U.S. 46, 52 (1955) The Supreme Court left this part of *Corn Products* undisturbed in *Arkansas Best v. Commissioner*, 486 U.S. 212 (1988). Rather, the Court merely clarified that a taxpayer's motivation in purchasing an asset is irrelevant to the question of whether the asset is ''property held by a taxpayer (whether or not connected with his business),'' but is relevant to determine the applicability of the inventory and other exceptions to capital asset.

[17]''A trader on an exchange, who makes a living in buying and selling securities or commodities may be said to carry on a 'business.''' *Bedell v. Commissioner*, 30 F.2d 622, 624 (2d Cir. 1929), J. Hand.

"many taxpayers have been completely or partially eliminating from their tax their income from salaries, dividends, rents, etc., by deducting therefrom losses sustained in stock and bond markets with serious effect upon the revenue."[18] Those taxpayers reportedly included former Treasury Secretary Andrew Mellon and several other prominent Wall Street investment bankers.[19]

In response, in 1934 Congress revised the noninventory exclusion: It excluded only "property held primarily for sale *to customers* in the ordinary course of a trade or business." By adding the words "to customers," Congress made it "impossible to contend that a stock speculator trading on his own account" could treat his losses as ordinary.[20]

Today the definition of capital asset continues to serve two purposes: a preference for capital gains and a limit on capital losses. It excludes:

> [1] property of a kind which would properly be included in the inventory of the taxpayer . . . or [2] property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.[21]

The first category, inventory, is well understood, but the second, stock that is held "primarily for sale *to customers*," is not. The second category is not inventory but still is property resold in a business. And Congress added "to customers" to the second category to deny deductions to Wall Street bankers. It did not seek to create tax advantages for private equity funds. However, the funds treat their stock gains as capital, largely because they do not consider their stock held for sale to customers. That unintended preference fuels the explosive growth of the private equity industry.

**When Is Stock a Capital Asset?**

Over time, tax treatment of stock drifted away from Congress's original statutory framework for capital assets. Now practitioners often follow unduly mechanical tests to classify stockholders as either dealers, traders, or, by default, investors. Dealers have ordinary income and losses on selling their stock, while traders and investors have capital gains and losses.

Dealers are taxpayers who hold stock as inventory. A dealer purchases securities "to create a stock of securities to take care of future buying orders in excess of selling orders."[22] For purposes of *inventory* accounting, a dealer in securities is "a merchant of securities . . . regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom."[23] Market makers and floor specialists are classified as dealers, whether they purchase and sell their securities on or off exchanges. Their inventory is excluded from the definition of a capital asset (and thus, their gains and losses from sales are ordinary).

Traders are taxpayers that engage in a large number of stock transactions (that is, substantial enough to rise to a trade or business). In general, to reach that level, a taxpayer must satisfy the general test for a trade or business: (1) continuous, regular, and substantial activity, and (2) a primary purpose of income or profit.[24]

Although traders are in a trade or business, they do not have customers. They merely speculate on the short-term rise and fall in prices.[25] Stock traders treat their gains and losses as capital, as Congress originally intended.[26]

Finally, the remaining taxpayers are investors. Investors may devote "managerial attention" to their stocks and bonds, for example by keeping records and collecting dividends and interest.[27] But managerial attention is not a trade or business, "no matter how large the estate or how continuous or extended the work required may be."[28] Investors also treat their stock as capital assets.

**Dealer, Trader, Investor, or Developer?**

Private equity funds, however, slip through the cracks of this framework. That is, private equity funds are not easily categorized as dealers, traders, or investors in stocks. They do not hold their stock as inventory.[29] They do not sell stock regularly and

[18]H.R. Rep. No. 72-708, at 12-13 (1932). Initially, in 1932, Congress limited short-term stock losses to short-term stock gains, but later, in 1934, it addressed the loss selection problem more comprehensively. Section 23(r)(1) of the Revenue Act of 1932.

[19]Dana Latham, "Taxation of Capital Gains, Tax Avoidance and Other Problems under the Revenue Act of 1934," 23 *Cal. L. Rev*. 30, 34, n.13 (1935).

[20]H.R. Rep. No. 73-1385, at 22 (1934).

[21]Section 1221(a)(1). Section 1221(a) also excludes depreciable property, copyrights, and other miscellaneous items, none of which are discussed in this article.

[22]*Schaefer v. Helvering*, 299 U.S. 171, 174 (1936).

[23]Reg. section 1.471-5.

[24]*Commissioner v. Groetzinger*, 480 U.S. 23 (1987).

[25]*See Kemon v. Commissioner*, 16 T.C. 1026, 1051 (1951).

[26]Section 475(f) now allows some stock traders to elect ordinary treatment.

[27]*See Higgins v. Commissioner*, 312 U.S. 212 (1941).

[28]*Id*. at 218. But Higgins "did not participate directly or indirectly in the management of the corporation in which he held stock or bonds." *See also Commissioner v. Burnett*, 118 F.2d 659, 661 (5th Cir. 1941) (taxpayer was a stock investor, in part, because taxpayer did not take an "active part in the management of the corporations or other enterprises whose securities she held").

[29]That is, they do not purchase securities to create a stock of securities to take care of future buying orders that exceed selling

**(Footnote continued on next page.)**

continuously enough to be classified as traders of stocks.[30] And they devote more than managerial attention to their investments.[31] Nevertheless, practitioners commonly classify private equity funds as investors, by default.[32]

But we must look closely at the definition of capital asset to properly classify private equity funds. That is, private equity funds can still hold their stock ''primarily for sale to customers in the ordinary course of their trade or business,'' which is not a capital asset. Real estate developers, for example, often take many years to buy, develop, and resell real estate.[33] Yet they still treat their real estate as held for sale to customers in the course of their trade or business. Similarly, the IRS should require private equity funds that buy, develop, and resell companies in the course of their trade or business to treat their companies (or, more precisely, the stock in their companies) as held for sale to customers in the course of their business.[34]

The principal inquiry is the term ''customers.'' For stock, the courts often use a merchant analogy to determine whether there are customers, which creates ambiguity.[35] A merchant holds inventory with the:

> expectation of reselling at a profit, not because of a rise in value during the interval of time between purchase and resale, but merely because they have or hope to find a market of buyers who will purchase from them at a price in excess of their cost. This excess or mark-up represents, remuneration for their labors as a middle man bringing together buyer and seller, and performing the usual services of retailer or wholesaler of goods.[36]

Yet the merchant is only an analogy; there are other middlemen (like real estate developers or private equity funds) who plan to buy property, develop the property, and resell the property at a profit as remuneration for their efforts.[37] Also, some middlemen expect general or specific market forces to increase the value of their property by a small amount, in addition to the value they plan to add. The IRS should treat these middlemen as holding property for sale to customers.[38]

Many practitioners understandably are misled by the words ''to customers.'' They believe the phrase requires the vendor to have a relationship with the vendee or to expect regular or repeated contact. But Congress added those words in 1934 merely to prevent stock speculators from culling their losses. As the Board of Tax Appeals wrote contemporaneously, Congress was ''characterizing not the vendee but the type of business'' by adding those words[39] — that is, the business of being a middleman in the purchase and sale of property. That business includes developers (including a private equity fund) that plan to buy property, develop the property, and sell the property at a profit as remuneration for their efforts. In that middleman

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orders. *See Stephens v. United States*, 464 F.2d 53 (8th Cir. 1972) (a dealer in securities — within the meaning of reg. section 1.471-5 — could not inventory controlling blocks of stock of companies that were not held for sale to its regular customers).

[30]And their source of supply, private companies (or public companies that are taken private), is different from the source of supply of other market participants.

[31]While all ''active'' investment fund managers — mutual funds, hedge funds, and private equity funds — buy, track, and sell their stocks carefully, only private equity funds assist and manage the business of the companies they invest in. Metrick and Yasuda, *supra* note 1, at 623. *See also* Chris William Sanchirico, ''The Tax Advantage to Paying Private Equity Fund Managers with Profit Shares: What Is It? Why Is It Bad?'' 75 *U. Chi. L. Rev*. 1071, 1102 (2008) (''It is one thing to manage one's investments in businesses. It is another to manage the businesses in which one invests'').

[32]*See, e.g.*, Needham, *supra* note 9, at n.89.

[33]*See, e.g.*, *Gruver v. Commissioner*, 142 F.2d 363 (4th Cir. 1944) (real estate developer that bought unimproved land, subdivided a portion of the land, and resold lots after seven and eight years recognized ordinary income).

[34]The stock represents ownership of the company, just as a deed represents ownership of real estate or a patent represents ownership of an invention. Congress, however, now permits capital gains for patents that are held for sale to customers in the ordinary course of a trade or business under section 1235, which was enacted in 1954. *See* reg. section 1.1235-2(d)(3).

[35]*Kemon*, 16 T.C. at 1032-1033 (1951) (taxpayer that held securities for speculation and investment was a trader, not a dealer).

[36]*Id*.

[37]For real estate, the customer requirement is sometimes thin. *See Black v. Commissioner*, 45 B.T.A. 204, 210 (1941) (''Where, as here, one is regularly engaged in the business of buying and selling real estate, as was petitioner, any person who can be found to buy such property is a customer, as that term is ordinarily understood''). However, the existence of a customer in real estate cases, like the existence in stock cases, should turn on the nature of the seller's business. *See* Friedlander, *supra* note 14, at 40 (''The Congress added the words 'to customers' precisely because the courts had not limited the term 'business' to those situations where profits originated predominantly from activities such as improvement or the rendition of services to purchasers'').

[38]If a taxpayer holds property with a mixed motive (*i.e.*, for sale or investment), the taxpayer's purpose that is ''principal'' or ''of first importance'' determines the character of the asset. *See Malat v. Riddell*, 383 U.S. 569, at 570 (1966) (whether gains on the sale of real estate by a real estate developer were ordinary or capital turned on whether the property was developed primarily for sale or for rental purposes).

[39]*Farr v. Commissioner*, 44 B.T.A. 683, 691 (1941) (partnership in a trade or business of buying and selling securities for its own account had capital, not ordinary losses). For a different perspective on the term ''customer,'' see David H. Shapiro and Jeff Maddrey, ''The Importance of a 'Customer Relationship' in Loan Origination,'' *Tax Notes*, Feb. 1, 2010, p. 659, at 663, *Doc 2010-1182*, or *2010 TNT 20-5*.

business, the developers will have customers, whether the developers can identify them, by name or by profile, or not.[40]

Finally, private equity funds are active enough to be in a trade or business. That is, their activities are continuous, regular, and substantial. They raise and return capital; they acquire, develop, and finally sell businesses. The funds' large fees and immense profits reflect the size of these efforts. Those activities should readily satisfy the tests for a trade or business.

Recently, the Tax Court examined the trade or business of the general partner of a private equity fund to determine whether an owner of the general partner of the fund had made a loan in connection with that trade or business.[41] (The owner had made the loan to a third party who had provided investment leads to the general partner.) The court observed that "the activity 'of promoting, organizing, financing, and/or dealing in corporations . . . for a fee or commission or with the immediate purpose of selling the corporations at a profit in the ordinary course of that business' is a business. . . . as is 'developing . . . corporations as going businesses for sale to customers.'"[42] And the court found that the owner had made the loan in connection with the trade or business of the general partner to render management services on behalf of the fund.

The Tax Court, however, stopped short: It attributed the general partner's trade or business activity only upward (to the general partner's owners, including the taxpayer). By contrast, the court did not attribute the general partner's activity downward to the private equity fund itself. That was because the IRS and the taxpayer had stipulated that the activity of the private equity fund was investment and not a trade or business — presumably to allow the fund to treat its gains as capital. The court may need to address the downward attribution question later.[43]

## Business Profits Should Be Ordinary Income

As described above, Congress enacted the preference for capital gains to relieve the lock-in effect of holding appreciated property (and to prevent stock speculators from selectively recognizing losses). Congress also sought to exclude profits arising from the everyday operation of a business from preferred treatment. Under those standards, the gains and losses of private equity funds should be ordinary.[44]

Private equity funds are not subject to a substantial lock-in effect because they must sell their stock in the near term. They plan to buy private companies, develop those companies, and resell them at a profit as remuneration for their efforts. They must return their investors' money, with profits, and liquidate within seven to 10 years. As a result, funds must turn over their stock in the near term, even though their stock is not inventoried. Congress did not intend preferences for these types of businesses.[45]

Similarly, private equity funds cannot selectively recognize losses to offset their ordinary income to any appreciable extent. Private equity funds may occasionally sell stock at a loss (before selling stock

[40]As noted earlier, private equity funds often sell to underwriters or to private parties in negotiated transactions, not through anonymous exchanges. By privately placing their stock, the funds might be able to identify some of their potential or actual customers, but identifying these customers is not necessary. As discussed above, a taxpayer should be classified based on the nature of the taxpayer's business, not the identity of potential purchasers. And a market maker or floor specialist that buys and sells only on anonymous exchanges still has customers.

[41]*Dagres v. Commissioner*, 136 T.C. 263 (2011), *Doc 2011-6506, 2011 TNT 60-14*. The Tax Court actually considered a series of general partners associated, respectively, with a series of funds, rather than just one general partner and one fund. The court did not attach any significance to the separate structuring, since it found that each general partner was in a trade or business.

[42]*Id.* at 281 (citations omitted).

[43]The general partner is an agent of a limited partnership under section 402(a) of the Uniform Limited Partnership Act. And the actions of an agent on behalf of the principal are attributed to the principal to determine whether the principal is engaged in a trade or business. *See, e.g.*, *Commissioner v. Boeing*, 106 F.2d 305 (9th Cir. 1939) ("One may conduct a business through others, his agents, representatives, or employees") (taxpayer, with his co-owners, that entered contracts with two logging companies to develop his land and remove and sell his timber was in a trade or business even though the taxpayer gave practically no time or attention to the operations under those contracts). *See also Inverworld Inc. v. Commissioner*, T.C. Memo. 1996-301, *Doc 96-18802, 96 TNT 127-14* (attributing activities of a U.S. corporation to a foreign corporation). *But compare Bd. of Trs., Sheet Metal Workers' Nat'l Pension Fund v. Palladium Equity Partners LLC*, 722 F. Supp.2d 854 (E.D. Mich. 2010) (private equity fund was in a trade or business for purposes of the ERISA rules), *with Sun Capital Partners II LP v. New England Teamsters & Trucking Indus. Pension Fund*, No. 10-10921 (D. Mass. 2012) (private equity fund was not in a trade or business for purposes of the ERISA rules). *Sun Capital* refused to attribute the trade or business of an agent (in this case, the general partner) to the principal (the fund). However, in my view, the court must attribute the *activities* of an agent that is acting on behalf of a principal to the principal, to determine whether there are sufficient activities of the principal to constitute a trade or business (which perhaps will be corrected on the *Sun Capital* appeal).

[44]Congress also was sensitive to the "bunching" of income (*i.e.*, the recognition of gains that have been accreted over several years). However, bunching is smaller in today's relatively flat tax rate structure. Moreover, the tax disadvantages of bunching are offset by the tax advantages of deferring taxes.

[45]That capital is invested does not alone justify capital gains. For example, capital invested with a bank is ordinary (*i.e.*, interest).

with unrealized gains), but they must still accommodate their investors by selling their positions and dissolving in the near term. Also, private equity funds hold relatively few companies to sell, so their selectivity is limited. Thus, private equity funds, unlike stock speculators, are greatly limited in their ability to selectively recognize losses.

Finally, and fundamentally, private equity funds make their money from the everyday operation of a business: raising and returning capital; and finding, managing, and selling companies. The funds add considerable value through those activities, which they plan to recover on sale. As the Supreme Court noted, gains from the regular operation of a business should be *ordinary*. The tax law should not permit private equity funds to transform their income from everyday operations of a business into capital gains through the sale of stock of the improved company.

**Taxing a 'Developer'**

Although the public has expressed widespread astonishment at the low tax rate that private equity owners pay on their immense earnings, our lawmakers are frozen in response. Six years ago, Rep. Sander M. Levin, D-Mich., first introduced legislation to recharacterize the gains allocated to private equity managers as ordinary income.[46] But his legislation stalled. Instead Congress has struggled to separate (and tax) only the labor, and not the capital, component of the private equity managers' returns. But trying to separate the labor from the capital return to the managers is inherently flawed.[47] The approach is overly complex and now has been riddled with exclusions for ''enterprise value'' and other novel concepts.

And during these last six years, many private equity managers have accelerated their unrealized gains in anticipation of higher tax rates.[48] Some, for example, have made taxable transfers of their carried interest to an affiliate. Others have developed new structures and compensation arrangements to preserve their capital gains in the future. All of this tax planning suggests that sophisticated taxpayers are outpacing our lawmakers again. And much of the potential revenue from the pending legislation presumably has been lost.

The IRS should now focus squarely on the profits of the funds, and not the managers, without waiting any longer for Congress to act. This approach will address the problem directly: The profits from the purchase, development, and sale of property, with a plan to be remunerated for these efforts, should be ordinary. The IRS, through regulations, should clarify that developers, including private equity funds, hold their property primarily for sale to customers.[49] Developers would have ordinary gains and losses on the sale of their property.[50]

The definition of developers should cover two key concepts: (1) customers and (2) trade or business. As noted earlier, Congress added the term ''customers'' to describe the vendor's business (that is, the business of intermediation), not to identify a vendee.[51] Developers intermediate: They buy and improve property intending to resell it in the near term. Developers include private equity funds but not small business owners or executives. Small business owners and executives might acquire and develop a business for a variety of reasons (for income, security, estate purposes, etc.), but they do not buy and develop a business intending to resell it in the near term.[52]

Moreover, regulations should describe the nature and amount of activities that establish a trade or business to develop property. For private equity funds, the regulations should focus on the finding, developing, and selling of companies. They might also consider the raising and returning of capital.

However, virtually all other stockholders (mutual funds, hedge funds, insurance companies, and individual investors) could not establish a trade or business of developing property. These investors rarely manage or develop the business of their companies. When they undertake a modest amount of that activity (for example, by voting proxies or

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[46]H.R. 2834 (June 22, 2007).

[47]*See, e.g.*, Howard E. Abrams, ''The Carried Interest Catastrophe,'' *Tax Notes*, Aug. 2, 2010, p. 523, *Doc 2010-15748*, or *2010 TNT 149-6*.

[48]James R. Brown and Hillel N. Jacobson, ''Preparing for the Possible Enactment of Carried Interest Legislation,'' *The Metropolitan Corporate Counsel*, at 12 (Dec. 2012).

[49]In these regulations, the IRS should exclude taxpayers that strip dividends from a company and sell the company's stock to arbitrage the current rate difference for dividends and ordinary losses. Stripping dividends from a company and selling the company's stock is not development.

[50]This article recommends that the IRS issue these regulations only for purposes of defining capital assets and not for purposes of the unrelated business income tax for tax-exempt institutions or the tax on effectively connected income for foreigners. The tax policy for tax-exempt institutions and foreigners is beyond this article's scope.

[51]The term ''customers'' also includes ''customer,'' since the plural includes the singular for purposes of the code. *See* section 7701(o)(1)-(2). *See also Nielsen v. Commissioner*, 333 F.2d 615 (6th Cir. 1964) (a large block of stock that was sold to a single customer was ''for sale to customers in the ordinary course of a trade or business'' of a securities dealer under section 1236).

[52]In theory, these stockholders might hold their stock for mixed purposes (*e.g.*, for dividends, salary, sale, etc.). However, only stock that is ''primarily'' held for sale to customers is excluded from capital assets. ''Primarily'' means ''of first importance'' or ''principally.'' *See Malat*, 383 U.S. at 570.

taking on board positions), their activity is not regular, continuous, and substantial.

### *Mayo*'s Deference to Tax Regulations

Recently, the Supreme Court unanimously held that tax regulations, like other regulations, are entitled to great deference.[53] That is, a court must defer to a regulation that interprets an ambiguous statute, unless the regulation is "arbitrary or capricious in substance, or manifestly contrary to the statute." The age of the statute, or whether the regulation is a reversal of IRS policy, is irrelevant to the question of whether the regulation is valid.

From the start, there has been ambiguity on the scope of capital asset. However, as the Supreme Court often reminds us, the definition of capital asset "must be narrowly applied and its exclusions interpreted broadly" because the preference for capital gains is an "exception from the normal tax requirements of the Internal Revenue Code."[54] The IRS should now use its enhanced regulatory power to deny preferences for corporate developers, just as it denies preferences for other developers.

### Conclusion

Romney correctly focused our attention on the nature of private equity income. For too long, this income has simply been considered gain from the sale of stock and treated as capital (and immense profits have been taxed at reduced rates). On closer examination, these profits arise from the everyday operation of a business and should be treated as ordinary.

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[53]*Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704 (2011), *Doc 2011-609*, *2011 TNT 8-10*.

[54]*Corn Products Refining Co. v. Commissioner*, 350 U.S. at 52 (excluding corn futures that were an integral part of an inventory-purchase system from the definition of capital asset, although the corn futures were not "actual inventory"). *See also Arkansas Best Corp. v. Commissioner*, 485 U.S. at 223 (approving a broad reading of the inventory exclusion in *Corn Products*).