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by Thomas D. Sykes

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The 'Corporation' Exception to Carried Interest: A Litigator's View

by Thomas D. Sykes

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In this article, Sykes argues that the IRS has taken an untenable position in saying the corporate exception in section 1061 does not encompass S corporations. He bases his arguments on recent court opinions, the Justice Department's previous position in cases, and the long-standing definitional Treasury regulation.

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Section 1061(c)(4)(A) provides an exception for "corporations" in its recharacterization of carried interest paid to investment fund managers from long-term capital gains to ordinary income. Within three months of that section's enactment as part of the Tax Cuts and Jobs Act, the IRS issued Notice 2018-18, 2018-12 IRB 443, stating that this corporation exception would not apply to S corporations, and that this would apply to returns filed for tax periods beginning after December 31, 2017. The notice also stated that retroactive regulations setting out the same interpretation would be issued. On July 31, 2020 the Treasury Department, as promised, issued proposed regulations[1] and asserted that this regulatory interpretation would apply retroactively as set out in Notice 2018-18.

Notice 2018-18 and the proposed regulations (setting out extensive interpretations of section 1061's various provisions) have generated a fair amount of comment from tax practitioners and journalists. Much of the commentary has focused on the IRS's interpretation of the corporation exception and has been remarkably critical of the notion that the exception's unadorned "corporation" allows an administrative interpretation that the term somehow does not encompass subchapter S corporations. Some commentary, however, simply ignores this dispute. Nonetheless, in view of the abundant critical commentary over the last 2½ years, the Treasury Department is unlikely to back away from its position.

Investment fund managers negatively affected by section 1061 — that is, those receiving carried interest for specified assets held for more than one year but less than four — should consider whether Treasury and the IRS's interpretation of the corporate exception is supportable in view of the plain text of the statute. Questions about the validity of the government's interpretation arise in connection with:

- investment funds' decisions about how to structure, and whether to elect subchapter S status for, a limited liability company or corporation formed to hold assets addressed by section 1061;
- federal income tax returns already filed by fund managers that treated carried interest addressed by section 1061 in the manner specified by Notice 2018-18 — specifically, whether, when, and how fund managers should file claims for refunds regarding those returns as required by section 6511; and

[1] REG-107213-18, 85 F.R. 49754-49795 (Aug. 10, 2020).

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- federal income tax returns that fund managers will file in the future for carried interest addressed by the restrictions set out in section 1061 — and whether, when, and how fund managers should file refund claims regarding those future returns.

Although not addressed by Notice 2018-18, a new exclusion from section 1061's corporation exception emerged in the proposed regulations — one for passive foreign investment companies. As Treasury is likely to issue final regulations providing that the corporation exception excludes both S corporations and PFICs, my perspective — as a tax litigator who recently spent six years in litigation against the Justice Department over the scope and meaning of "corporation" (as that term appears in both section 6621(a)(1) and in the code-wide definitional provisions set out in section 7701(a)(3) and its regulations) — may be useful. Three considerations are key:

(1) the subchapter S argument based on recent published court opinions and the check-the-box regulations is powerful;

(2) collateral estoppel and res judicata may multiply the monetary recovery available to fund managers; and

(3) the subchapter S argument appears far cleaner for a taxpayer than arguments based on a carry waiver.

The Powerful Subchapter S Argument

The question whether "corporation," a term used about 600 times in the code, defaults to a meaning that encompasses all types of corporations has been litigated repeatedly over the last six years. That litigation resulted in published opinions from the Second, Sixth, Seventh, Tenth, and Federal circuits. These opinions each addressed disputes over whether a tax-exempt, nonprofit corporation comes within the "corporation" term used in section 6621 governing the payment of statutory interest upon a refund. (Under section 6621(a)(1), a corporation receives a lower rate of interest than a non-corporation on overpayments of tax.) In these cases, the Justice Department, in over a dozen briefs, argued that the term corporation, used throughout the code, defaults to a meaning that plainly encompasses all types of corporations. Representing the IRS in court, the Justice Department successfully persuaded five federal courts of appeals that the unadorned term corporation defaults to an all-encompassing meaning.

Nonetheless, in Notice 2018-18, issued while two of those five cases were pending, the IRS took a position inconsistent with the arguments set out in the Justice Department's own briefs: that the unadorned term corporation found in section 1061(c)(4)(A) does not encompass S corporations. The notice took this position even though the TCJA, of which that provision is a part, uses, in other places, the terms "C corporation" and "S corporation." In my briefs for the *Charleston Area Medical Center* case,[2] I emphasized that the notice was inconsistent with the position being taken by the Justice Department in its briefs. In response, the Federal Circuit nonetheless held that the term has a plain meaning that encompasses an incorporated nonprofit.[3] This was consistent with the holding of the Court of Federal Claims, quoted in the Federal Circuit's opinion, which held that the term corporation in section 6621 "*plainly* encompasses both for for-profit and not-for-profit corporations."[4] The Federal Circuit reasoned that the code uses the term corporation in a broad, expansive manner[5] and that the code refers to each of code's three types of corporations — one of which is an S corporation, the court emphasized[6] — as a corporation.[7]

Especially important to investment fund managers is that the Federal Circuit addressed Notice 2018-18 and its promised regulations as follows:

> While we question whether the regulations described in the Notice, if

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[2] *Charleston Area Medical Center Inc. v. United States*, 940 F.3d 1362 (Fed. Cir. 2019).

[3] *Id*. at 1370.

[4] *Id*. at 1367 (emphasis added).

[5] *Id*. at 1368.

[6] *Id*. at 1369.

[7] *See* section 1361(a), (b) (provision in subchapter S referring to an S corporation as a "small business corporation," which in turn is defined as a corporation meeting specific requirements); *United States v. Detroit Medical Center*, 833 F.3d 678 (6th Cir. 2016) ("Nor is the Medical Center correct that the default meaning of 'corporation' is C corporation throughout the Internal Revenue Code.").

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> codified, would be proper in view of the government's position in this case that the Code incorporates the broad, common law meaning of corporation, we leave that issue for another day.[8]

The TCJA, enacting section 1061, used the term "S corporation" in 37 places. But it did not use that term in the corporation exception. The TCJA also uses, and knows how to use, the term "C corporation."[9] Nonetheless, Treasury now proposes that section 1061(c)(4)(A) should be read as follows (substance of proposed regulatory interpretation in italics):

> (4) EXCEPTIONS. — The term 'applicable partnership interest' shall not include —
>
> > (A) any interest in a partnership directly or indirectly held by a corporation *other than an S corporation*, or

Or, alternatively, that it be read as follows (substance of proposed regulatory interpretation in italics):

> (4) EXCEPTIONS. — The term 'applicable partnership interest' shall not include —
>
> > (A) any interest in a partnership directly or indirectly held by a *C* corporation, or[10]

Treasury's effort to rewrite the statute is indefensible in view of the TCJA's use, elsewhere, of the terms S corporation and C corporation. In *Russello*, the Supreme Court stated: "Where Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion."[11] *Russello* was wielded early and often by the Justice Department in its briefs, and four of the five federal courts of appeals cited itin their published opinions.

Section 1061(c)(4)(A), using the pervasive code-wide term, corporation, likewise speaks plainly.[12] However, in the background and overview and in the explanation of provisions sections of the proposed regulations, Treasury cites sections 7805(b)(3) and 1061(f) as authority for its rewriting of section 1061(c)(4)(A). Section 7805(b)(3), of course, authorizes the IRS and Treasury to issue regulations that are "needful" and "necessary." Section 1061(f) authorizes "regulations or other guidance as is necessary or appropriate to carry out the purposes of this section."

As the Supreme Court taught in *Mayo*, however, a Treasury regulation issued in the exercise of authority delegated to the Treasury Department is invalid if it either (1) is inconsistent with the plain meaning of a statute, or (2) reflects an unreasonable interpretation of the statute.[13] And as the Court stated in *Rodgers,* "The evident intention of Congress [is] to be collected from the words it employed."[14] And in *Schein*, "We are not at liberty to rewrite the statute passed by Congress and signed by the President."[15] "We must interpret the Act as written."[16] Under *Mayo Foundation* and its parent *Chevron*, Treasury regulations cannot override a statutory text that speaks plainly.

The proposed regulations assert that their interpretation of section 1061(c)(4)(A)'s corporation is designed to prevent abuse — an asserted purpose of section 1061(f)'s authorization. For this assertion, the proposed regulations rely on the TCJA conference report and the Joint Committee on Taxation's blue book.[17]

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[8] *Charleston Area Medical Center*, 940 F.3d at 1371.

[9] *See also Maimonides Medical Center v. United States*, 809 F.3d 93 (2d Cir. 2015) ("Ultimately, [taxpayer's] position founders because there was another, much simpler way for Congress to achieve the result MMC seeks here: it could simply have added the qualified 'C' to the word 'corporation' wherever it appears" in the statute.).

[10] *See* prop. reg. section 1.1061-3(b)(2)(i); REG-107213-18.

[11] *Russello v. United States*, 464 U.S. 23 (1983).

[12] *See Charleston Area Medical Center*, 940 F.3d at 1370 (viewing the term "corporation" as "plain text" encompassing all types of corporations). *See also Charleston Area Medical Center v. United States*, 138 Fed. Cl. 631 (2018) (opinion of the Court of Federal Claims below, viewing the term corporation in section 6621 as "plainly encompassing" both for-profit and not-for-profit corporations).

[13] *See Mayo Foundation for Medical Education and Research v. United States*, 562 U.S. 52 (2011) (addressing regulations issued under section 7805(b)(3), and applying the *Chevron* test for validity).

[14] *United States v. Rodgers*, 150 U.S. 276 (1893).

[15] *Henry Schein Inc. v. Archer & White Sales Inc.*, 139 S. Ct. 528 (2019) (Kavanaugh, J., writing for a unanimous court).

[16] *Id*. at 529.

[17] H.R. Rep. No. 115-466 at 422, 115th Cong., 1st Sess. (2017) (Conf. Rep.); JCT, "General Explanation of Public Law 115-97," JCS-1-18, at 203 (2018). (The proposed regulations mistakenly assert that the blue book came out in 2017; actually, the blue book came out in December 2018 — a year after the passage of the TCJA.)

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There are several things wrong with Treasury's reliance on preventing abuse as its justification for rewriting section 1061(c)(4)(A).

First, no regulation can override statutory text that speaks plainly.

Second, the proposed regulations would also *sub silentio* and impermissibly override a long-standing definitional regulation that also speaks plainly. Reg. section 301.7701(a)(3)-2(b)(7), part of the check-the-box regulations issued in 1997, defines corporation as "a business entity that is taxable as a corporation under a provision of the Internal Revenue Code other than section 7701(a)(3)." S corporations must report and pay income tax on built-in gain.[18] These definitional regulations, defining corporation for purposes of the *entire code*, go unmentioned in the proposed regulations and in Notice 2018-18. This regulatory provision has acquired the force of law, in view of the plethora of amendments to the code using the term corporation since the provision took effect. Under the doctrine of legislative reenactment, this long-standing definition can be changed only by legislation — and there's nothing in the TCJA that does that. Nor do the proposed regulations even mention this long-standing regulation.[19] Under these cases, regulations interpreting section 1061(c)(4)(A) could never alter the on-point, long-standing, now-solidified regulatory definition found in reg. section 301.7701(a)(3)-2(b)(7).

Third, as the court stated in *Charleston Area Medical Center*, "principles of symmetry cannot override the plain text of the statute."[20] Treasury's conclusion that the plain text must be altered to prevent abuse appears to be grounded in the notion that the tax rates applicable to fund managers receiving carried interest from S corporations should be more in sync with the tax rates applicable to carried interest received from other types of entities. But as the court stated in *Maimonides Medical Center* "it is well within the power of Congress to make distinctions based on whether a taxable entity qualifies as a 'corporation' under section 7701(a)(3), and Congress has unambiguously done so here, regardless of whatever incongruity [the taxpayer] may perceive in that decision."[21] In *Detroit Medical Center* the court opined, "We have considerable sympathy for the Medical Center on this score. Congress has created a regime in which a nonprofit hospital receives a lower interest rate on its FICA tax overpayments than Warren Buffett does on his individual tax returns." Further, "our unwillingness to soften the import of Congress' chosen words even if we believe the words lead to a harsh outcome is longstanding."[22] These appellate cases, and three others, were won by the Department of Justice, which argued for ignoring the glaring, senseless incongruity between how incorporated nonprofits were treated on interest received on overpayments and interest they owed on underpayments.[23] A mere incongruity or lack of symmetry in the code, occurring under text that speaks plainly, is not abuse.

The five published appellate opinions are a veritable treasure trove of analysis that cuts against the Treasury Department's effort to rewrite section 1061(c)(4)(A).[24] Another treasure trove is the dozen or so briefs that the Justice Department filed in successfully asserting that "corporation," as used in the code, defaults to a meaning that encompasses all types of corporations.[25]

Nor is a taxpayer's election to use an S corporation an abuse; there is a statutory right to make that election, even when that election is motivated by considerations of tax efficiency, as is typically the case.

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[18] *See* section 1374 (built-in gain provision referring to S corporations as corporations).

[19] *See, e.g.*, *Lorrilard v. Pons*, 434 U.S. 580-581 (1978); *Cottage Savings Association v. Commissioner*, 499 U.S. 561 (1991); *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120 (2000).

[20] *Charleston Area Medical Center*, 940 F.3d at 1370.

[21] *Maimonides Medical Center*, 809 F.3d 93. *See also id*. at 88 n.2 (viewing section 6621's "corporation" term as "unambiguous").

[22] *Detroit Medical Center*, 833 F.3d 679.

[23] *See also Medical College of Wisconsin Affiliated Hospitals Inc. v. United States*, 854 F.3d 930 (7th Cir. 2017); *Wichita Center for Graduate Medical Education Inc. v. United States*, 917 F.3d 1221 (10th Cir. 2019); and *Charleston Area Medical Center*, 940 F.3d at 1370.

[24] *Maimonides Medical Center*, 809 F.3d 93; *Detroit Medical Center*, 833 F.3d 679; *Wichita Center*, 917 F.3d 1221; *Medical College of Wisconsin*, 854 F.3d 930; and *Charleston Area Medical Center*, 940 F.3d at 1370.

[25] Each of these cases, under sections 6621(a)(1) and 7701(a)(3), controlling an estimated $500 million in the aggregate, were first-chaired, in both the district court and in the court of appeals, by myself. The first of these cases was commenced in October 2013, and the last was concluded in October 2019 — a span of six years during which I drafted and filed over 20 briefs and the Justice Department drafted and filed about a dozen.

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The proposed regulations also provide, in section 1.1061-3(b)(2)(ii), that a PFIC[26] for which a shareholder has a qualified electing fund (QEF) election in place is not a corporation for purposes of section 1061(c)(4)(A)'s corporation exception. The explanation of provisions section for the proposed regulations provides the following rather cursory statement:

> The Treasury Department and the IRS believe it is inappropriate for a PFIC with respect to which the shareholder has elected to receive passthrough treatment to be treated as a corporation for purposes of section 1061. Therefore, the proposed regulations clarify that a PFIC with respect to which the shareholder has a QEF election in effect is not treated as corporation for purposes of section 1061(c)(4)(A).[27]

This "clarification" would take effect only after the final regulations are published in the *Federal Register*, presumably because no mention of the PFIC exclusion was made in Notice 2018-18 or the blue book. It would seem that the proposed regulations' PFIC exclusion would be invalid for many of the same reasons that the clarification excluding S corporations from the corporation exception would be invalid.

Finality Multiplies Recoveries

In a federal income tax dispute, each tax year is the origin of a separate claim or cause of action.[28] Res judicata and collateral estoppel, the application of which are predicated on a final court judgment, are relevant, as follows:

> Under the doctrine of res judicata, a judgment on the merits in a prior suit bars a second suit involving the same parties or their privies based on the same cause of action. Under the doctrine of collateral estoppel, on the other hand, the second action is upon a different cause of action and the judgment in the prior suit precludes relitigation of issues actually litigated and necessary to the outcome of the first action.[29]

Under collateral estoppel, if an investment fund manager (or a group of managers) who received carried interest that is addressed by the restrictions found in section 1061 goes to court in a tax refund suit addressing their 2018 and 2019 returns, and wins a final judgment, that judgment will collaterally estop the IRS in future cases from raising the same issues as were actually and necessarily decided in the earlier suit. For example, if investment managers won a final judgment for tax years 2018 and 2019 predicated on the successful assertion that the Treasury regulation is not permitted to exclude S corporations from the coverage of the corporation exception, those managers will be entitled, in a subsequent suit addressing other tax years (say, 2020 and 2021), to a summary judgment (or judgment on the pleadings) in their favor on that same issue.

The only way that the IRS can avoid being collaterally estopped on the S corporation issue is if (1) Congress were later to amend the statutory corporation exception so that it does not encompass S corporations and (2) the amendment occurred before the taxpayer won her tax case.

The stage is thus set for a race of sorts between taxpayers and Congress, assuming, arguendo, that a future Congress views the plain meaning of the corporate exception as ill-conceived. The more tax years that a taxpayer addresses with a final judgment based on the text of section 1061(c)(4)(A) as written, the more that particular taxpayer will be protected from a legislative amendment in a subsequent suit. It is likely that any amendment would purport to be retroactive, particularly in view of the notice provided by the blue book, Notice 2018-18, and the regulation, all of which asserted retroactivity. A supervening change in the legal landscape would make collateral estoppel unavailable.[30] Taxpayers are well advised to bring all completed tax years into court as quickly as possible so that a collateral

[26] *See* instructions for Form 8621.

[27] REG-107213-18, 85 F.R. at 49761.

[28] *Commissioner v. Sunnen*, 333 U.S. 598 (1948).

[29] *Parklane Hosiery Co. Inc. v. Shore*, 439 U.S. 326 n.5 (1979) (citations omitted).

[30] *Sunnen*, 333 U.S. at 601.

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estoppel defense is available before a statutory amendment makes that defense unavailable.

This means that fund managers should not attempt to ride the coattails of other fund managers who are in court. The res judicata effect attached to a final judgment reflects a powerful interest in finality.[31] The only way for a fund manager to protect herself from a legislative amendment with purported retroactive effect is to obtain her own final judgment — the predicate for collateral estoppel to apply.

The IRS might — or might not — be permitted to apply a retroactive statutory amendment in a tax year if that year has not been addressed by a taxpayer's final judgment having collateral estoppel effects. The arguments of a taxpayer not owning a final judgment would include: (1) that the Justice Department took the position in court that the term corporation plainly encompassed all types of corporations and did not default to a C corporation; and (2) reg. section 301.7701(a)(3)-2(b)(7), a definitional provision applicable code-wide, defined an S corporation as a "corporation."

A taxpayer must be careful about choosing the court in which she will bring suit. A refund suit may be brought in either the district court where the taxpayer resides, or in the Court of Federal Claims in Washington. If the taxpayer has not paid the tax (in disregard of Notice 2018-18) and the IRS audits and issues a notice of deficiency, a taxpayer could bring her suit in the Tax Court. To enhance the odds of winning, a taxpayer must take into account the states controlled by the five "treasure trove" cases. Most notably, New York, Connecticut, and Vermont are all in the Second Circuit; Illinois, Indiana, and Wisconsin are in the Seventh Circuit; and appeals from the Court of Federal Claims in Washington, a trial court with nationwide jurisdiction, go to the Federal Circuit. Appeals from the Tax Court go to the regional, numerical court of appeals with jurisdiction over the state in which the taxpayer lives.

A taxpayer contemplating suit must take into account whether and where other taxpayers have suits pending that tee up the same subchapter S issue. If another taxpayer loses the subchapter S argument in the court of appeals controlling the trial court in which one has sued, the doctrine of *stare decisis* will be most unhelpful: It will dictate a loss for the taxpayer in its "footsteps" suit, unless the second taxpayer somehow can show that her case is materially different from the case that went before.

A taxpayer should not assume that the IRS will abandon its position — which rewrites the text of section 1061(c)(4)(A) — if it merely loses a case or two. Historically, the IRS has continued to litigate cases unless and until it loses five appellate cases in a row — a process that could take many years. Treasury will likely ask Congress to amend the corporation exception only after its final regulation has been repeatedly invalidated.

In sum, a taxpayer with the subchapter S argument should take care to file timely and sufficient claims for refund, choose her forum carefully, and then file and pursue her tax case with dispatch. If she wins that suit, collateral estoppel would apply to multiply her recovery, even if Congress enacts a purportedly retroactive amendment to section 1061(c)(4)(A) (at least if the second suit has been reduced to judgment based on collateral estoppel).

A 'Cleaner' Argument

Some investment fund managers have structured the carried interest provisions of their investment agreements so that carried interest is paid only after three years have passed, even if the underlying assets were disposed of earlier. These taxpayers apparently will argue that these carry waiver provisions should make section 1061's new restrictions inapplicable to the carried interest paid under the so-called carry waiver.

The explanation of provisions section of the proposed regulations makes the following comments about carry waiver arrangements:

> The Treasury Department and the IRS are aware that taxpayers may seek to circumvent section 1061(a) by waiving their rights to gains generated from the disposition of a partnership's capital assets held for three years or less and substituting for these amounts gains

[31] *See id.* at 597 ("The judgment puts an end to the cause of action, which cannot again be brought into litigation between the parties *upon any ground whatever*, absent fraud or some other factor invalidating the judgment."). (Emphasis added.)

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> generated from capital assets held for more than three years. Alternatively, taxpayers may waive their rights to API Gains and substitute gains that are not taken into account for purposes of determining the Recharacterization Amount. Some arrangements also may include the ability for an API Holder to periodically waive its right to an allocation of capital gains from all assets in favor of an allocation of capital gains from assets held for more than three years and/or a priority fill up allocation designed to replicate the economics of an arrangement in which the API Holder shares in all realized gains over the life of the fund. These arrangements are often referred to as carry waivers or carried interest waivers. *Taxpayers should be aware that these and similar arrangements may not be respected and may be challenged under section 707(a)(2)(A), reg. sections 1.701-2 and 1.704-1(b)(2)(iii), and/or the substance over form or economic substance doctrines.*[32] [Emphasis added.]

From a tax-litigator's perspective, the doctrines and arguments that Treasury identifies here resemble doctrines and arguments that the IRS deployed against tax shelter arrangements that were widely marketed in the last decade of the 20th century and the early years of the 21st. Those doctrines and arguments as applied by the courts displayed extraordinary flexibility, allowing the courts to disallow arrangements in which the tax benefits seemed "too rich" or the arrangements "too contrived." (I played a substantial role in the extensive litigation that erupted over these tax shelter arrangements.) Taxpayers won very few of those extensively litigated tax shelter cases.

These cases typically involved extensive documentary discovery (including extensive discovery of email communications) and testimony from competing experts addressing how the arrangements worked, how risk was transferred, where the risk came to rest, and the magnitude of the risk in relation to the taxpayer's investment.

It occurs to me, having perhaps 250 to 300 federal tax cases under my belt, that a carry waiver arrangement might well result in a hard-fought battle involving considerable discovery and competing expert testimony. Expert testimony may remove the case from the realm of those cases that are susceptible to a summary judgment disposition: The fact-finder should evaluate each expert's credibility. It is conceivable that the Justice Department would demand a jury trial in a fact-based case if it were brought in federal district court. The Justice Department demanded (but did not receive) a jury trial in one of the five treasure trove cases I handled.

This tableau should be contrasted with the ease with which a fund manager could present a subchapter S argument by way of a motion for summary judgment or for judgment on the pleadings. That argument is purely about statutory interpretation and whether the Treasury's final regulation is inconsistent with the statute's plain meaning. Importantly, the five treasure trove cases were all resolved upon summary judgment or judgment on the pleadings — and all were reviewed on appeal under a *de novo* standard of review. No formal discovery was sought by the Justice Department in any of the five cases; in a couple of the cases (but not *Charleston Area Medical Center*) informal discovery was done. It is likely that the dispute over the meaning of corporation in section 1061(c)(4)(A) could be resolved in a similarly abbreviated manner. The argument for a summary disposition is enhanced by the discussion found in the five published opinions — and by the arguments made by the Justice Department in the dozen or so briefs it filed in those cases. But those published opinions and Justice Department briefs would be of no assistance to a taxpayer in connection with a court challenge based on a carry waiver argument.

Beyond this, it is not only the discussion in the opinions and the Justice Department's briefs that are helpful, but also the particular context of, and equities present in, those cases. They arose when the IRS denied about $500 million in interest owed to about 300 of the nation's tax-exempt teaching hospitals that previously received refunds of

[32] REG-107213-18, 85 F.R. at 49758.

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FICA tax that the IRS for decades had incorrectly insisted had to be paid. Few taxpayers are more worthy than tax-exempt teaching hospitals. But their effort to recover interest under an imperfectly drafted statute, that was applied in a way the courts acknowledged made no policy sense, was met with Justice Department briefs that intransigently took a position that was inconsistent with the IRS's position in Notice 2018-18. The courts allowed the inconsistent position. This inconsistency, blocking recoveries by teaching hospitals of $500 million, yields powerful optics favoring investment fund managers if properly highlighted during the fund managers' cases.

A victory in a carry waiver case will be much more difficult to use as a predicate for collateral estoppel because of factual variations and the flexibility of the IRS's legal doctrines. Collateral estoppel is available only if the facts and law involved in the successive cases display no material variation. Put simply, the S corporation argument is cleaner than the carry waiver argument, and this comparative simplicity paves the way not only for easier presentation of an investment fund manager's first case, but also for easier application of collateral estoppel in subsequent cases.

Conclusion

The argument against the IRS's position that section 1061(c)(4)(A)'s corporation exception does not encompass S corporations is powerful in view of the opinions published in recent years by five federal courts of appeals; in view of the positions that the Justice Department took during briefing of those cases; and in view of the long-standing definitional Treasury regulation. Collateral estoppel provides an opportunity for an investment fund manager to multiply her initial recovery by extending the effect into future tax years. But a favorable final judgment is essential for collateral estoppel to apply — it will not be applied to a situation in which a taxpayer sits back and lets another taxpayer litigate. The argument based on Treasury's impermissible rewriting of the corporation exception is much more straightforward to litigate and much more powerful than any argument based on a fact-intensive, expert-laden, and novel carry waiver argument. Investment managers should keep these considerations in mind as they consider whether the entities set up to hold partnership assets should be the subject of an S corporation election; and whether income tax returns they have already filed, and will file, should be addressed with an administrative claim and then a lawsuit, which will be necessary to overturn the Treasury's regulatory overreach. The overreach has become more important for investment fund managers with the recent accelerating pace of pandemic-related business failures. We hope this article will be of assistance in charting a path forward. ■

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