

NOTE

SEARCHING FOR *DIAMOND* IN THE TWO-AND-TWENTY ROUGH: THE TAXATION OF CARRIED INTERESTS

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This Note starts from the premise that preferential capital gains treatment presupposes actual invested capital. It argues that a carried interest comprises an aggregation of income from services and income from invested capital and that each respective component should be taxed accordingly. This Note introduces the mathematical bifurcation model for disaggregating a carried interest into its service and investment components, representing the first rigorous attempt to distinguish those components mathematically. It demonstrates that the current debate over the taxation of carried interests is largely conjectural, because each side focuses myopically on arguments with little foundation in tax theory. Taking assumptions most favorable to the taxpayer fund manager, including unusually high growth rates in longer-term funds, mathematical bifurcation indicates that, as a theoretical matter, the service component of a carried interest exceeds—by several multiples—the component from actual invested capital. This Note does not seek to provide a practicable alternative for taxing carried interests. Rather, it aims to offer a theoretically superior starting point for the carried interest debate, derived from the premise that only income from actual invested capital should receive preferential capital gains treatment.

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INTRODUCTION

The debate over how to tax carried interests hinges on whether we treat private equity profits distributions as income from services or as income from invested capital. By design, carried interests perform two functions: first, carried interests compensate private equity fund managers for services rendered in managing the fund; and second, carried interests incentivize fund managers to achieve certain levels of fund performance by placing some of their compensation at risk and by allowing them to participate in the fund’s profits. The dual function of a carried interest makes distinguishing the service component from the investment component an inherently difficult task—perhaps impossible in practice.

Ideally, a carried interest would have ascertainable value upon its receipt by the fund manager. We could straightforwardly treat its receipt as income to the fund manager,¹ and the fund manager would have an equity share in the fund with a basis equal to the initial value of the carried interest. Then, upon later distribution of fund profits, the fund manager would receive capital gains treatment on any change in value of that equity share. This scenario tracks the seminal—yet quirky—case of *Diamond v. Commissioner*.² *Diamond* involved a

1. See I.R.C. § 61 (2012) (“[G]ross income means all income from whatever source derived . . .”).

2. 492 F.2d 286 (7th Cir. 1974).

carried interest with ascertainable value upon receipt. The Seventh Circuit treated the interest as such and taxed its recipient accordingly.³

In reality, a carried interest—because it entails a future profits interest—will rarely have ascertainable value upon receipt, especially in the private equity context examined here. Future profits necessarily embody some element of risk, and any attempt to quantify the present value of a future profits interest would thus prove inherently speculative. Conceding this reality, the IRS responded in the wake of *Diamond* with Revenue Procedure 93-27, the safe harbor provision on which all contemporary carried interest arrangements rely.⁴ Commentators broadly agree that the initial grant of a carried interest does not qualify as a realization event.⁵

As a consequence, we tax carried interests on the “back end,” upon the final distribution of fund profits. But the question remains: should we tax a carried interest as income from services or as income from invested capital? The current treatment of carried interests taxes them entirely as capital gains. The debate features voices from both ends of the spectrum. Opponents to reform argue that a carried interest is properly taxed entirely as a capital gain.⁶ Reform proponents, on the other hand, argue for a variety of alternative approaches. Proposals for reform include approaches that would tax carried interests entirely as service income,⁷ as well as approaches that would attempt to distinguish the service component of a carried interest from the investment component.⁸ Finally, some defenders of the status quo argue that any change in the treatment of carried interests would prove at best avoidable by sophisticated tax planners and at worst difficult to administer in practice.⁹

This Note starts from the premise that preferential capital gains treatment presupposes actual invested capital. It argues that a carried interest comprises an aggregation of income from services and income from invested capital and

3. See *id.* at 290-92.

4. Rev. Proc. 93-27, 1993-2 C.B. 343.

5. See Philip F. Postlewaite, *Fifteen and Thirty-Five—Class Warfare in Subchapter K of the Internal Revenue Code: The Taxation of Human Capital upon the Receipt of a Proprietary Interest in a Business Enterprise*, 28 VA. TAX REV. 817, 870 (2009) (“There appears to be broad agreement among tax policy theorists for deferring the tax consequences on certain transfers of compensatory equity interests.”).

6. See, e.g., Steve Judge, *Why Carried Interest Is a Capital Gain*, N.Y. TIMES DEALBOOK (Mar. 4, 2013, 3:03 PM), <http://dealbook.nytimes.com/2013/03/04/why-carried-interest-is-a-capital-gain>.

7. See, e.g., Carried Interest Fairness Act of 2012, H.R. 4016, 112th Cong. (2012).

8. See, e.g., Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 52-54 (2008); Note, *Taxing Partnership Profits Interests: The Carried Interest Problem*, 124 HARV. L. REV. 1773, 1774-76 (2011).

9. See, e.g., David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 VA. L. REV. 715, 718-19 (2008).

that each respective component should be taxed accordingly. This Note introduces the mathematical bifurcation model for disaggregating a carried interest into its service and investment components, representing the first rigorous attempt to distinguish those components mathematically. In doing so, this Note hopes to provide a theoretical basis that closely approximates the scenario at issue in *Diamond*. This Note demonstrates that the current debate over the taxation of carried interests is largely conjectural, because each side focuses myopically on arguments with little foundation in tax theory. Supporters of the status quo point to “entrepreneurial risk” and “operational expertise” of fund managers as the rationale for capital gains treatment.¹⁰ Reform proponents emphasize principles of “fairness and common sense,” and depict fund managers as “an already privileged sliver of financiers” receiving a “huge tax benefit.”¹¹ Neither argument answers the relevant theoretical question with regard to capital gains treatment: whether a carried interest represents income from services or income from invested capital. Taking assumptions most favorable to the taxpayer fund manager, including unusually high growth rates in longer-term funds, mathematical bifurcation shows that, as a theoretical matter, the service component of a carried interest exceeds—by several multiples—the component from actual invested capital. This Note does not seek to provide a *practicable* alternative for taxing carried interests. Rather, it aims to offer a *theoretically* superior starting point for the carried interest debate, derived from the premise that only income from actual invested capital should receive preferential capital gains treatment.

Part I of this Note provides a structural overview of private equity partnerships and profits distribution fee arrangements, as well as a brief introduction to the so-called “capital gains preference.” That Part includes an analysis of the current tax treatment of carried interests and the contours of the modern carried interest debate. Part II explores four prominent proposals for reform and considers each alternative in turn. Part III introduces mathematical bifurcation as a theoretical alternative to the other proposals and incorporates a mathematical model to illustrate how a simple fee arrangement would be treated under math-

10. *Carried Interest Explained in Latest PEGCC Whiteboard Video*, PRIVATE EQUITY GROWTH CAPITAL COUNCIL (Feb. 6, 2013), <http://www.pegcc.org/newsroom/in-the-news/carried-interest-explained-in-latest-pegcc-whiteboard-video>; see also Judge, *supra* note 6 (“Because [fund managers] develop strategic business plans, sit on boards and work to strengthen the companies they own over many years, the income they receive is a capital gain.”).

11. Lynn Forester de Rothschild, Op-Ed., *A Costly and Unjust Perk for Financiers*, N.Y. TIMES (Feb. 24, 2013), <http://www.nytimes.com/2013/02/25/opinion/carried-interest-an-unjust-privilege-for-financiers.html>; see also Noël B. Cunningham & Mitchell L. Engler, *The Carried Interest Controversy: Let's Not Get Carried Away*, 61 TAX L. REV. 121, 121 (2008) (suggesting that “multi-millionaire investment fund managers pay tax on their hefty compensation at [a lower rate than] hard-working ordinary folks”).

ematical bifurcation. Part IV acknowledges the practical limits of reform and engages the line-drawing argument for status quo treatment advocated by David Weisbach.

This Note concludes by likening the carried interest debate to the Heisenberg uncertainty principle: as we hold certain aspects of the problem constant through assumption, our observations and predictions become fundamentally imprecise because other aspects move and change.¹² We must pick our battles between theory and practice. Mathematical bifurcation, while arguably unfeasible in practice, offers a valuable new theoretical starting point for the debate over how to tax carried interests.

I. THE CARRIED INTEREST PROBLEM

A. *Structure of Private Equity Partnerships and “Two-and-Twenty” Fee Arrangements*

Private equity firms raise capital from private investors and use that capital to buy and sell companies on the investors’ behalf.¹³ This approach, which involves specific blocks of “private” capital from a “limited number of wealthy investors or institutions,” differs from that of “public” capital markets, by which firms seek capital “from unlimited numbers of investors holding exchange-traded, SEC-regulated securities.”¹⁴ Private equity funds primarily target “underperforming public companies, divisions of public companies, or privately held businesses,”¹⁵ and they use the invested capital, along with debt borrowed from banks and other lenders, to “buy companies that they believe could achieve significantly greater growth and profitability with the right infusion of talent and capital.”¹⁶

Fund managers seek to “align the interests of owners and managers . . . over the long term” by “changing the business strategy [of a company], investing new capital or injecting new managerial talent.”¹⁷ To this end, private equity funds purchase companies with fund capital and typically hold a given company for about three to seven years before selling.¹⁸ The life cycle of a private

12. See *Uncertainty Principle*, MERRIAM-WEBSTER, <http://www.merriam-webster.com/dictionary/uncertainty%20principle> (last visited Mar. 26, 2014).

13. PRIVATE EQUITY COUNCIL, PUBLIC VALUE: A PRIMER ON PRIVATE EQUITY 8 (2007), available at http://www.pegcc.org/wordpress/wp-content/uploads/PEC_Primer_2007.pdf.

14. Note, *supra* note 8, at 1776 (internal quotation marks omitted).

15. Fleischer, *supra* note 8, at 8.

16. PRIVATE EQUITY COUNCIL, *supra* note 13, at 8.

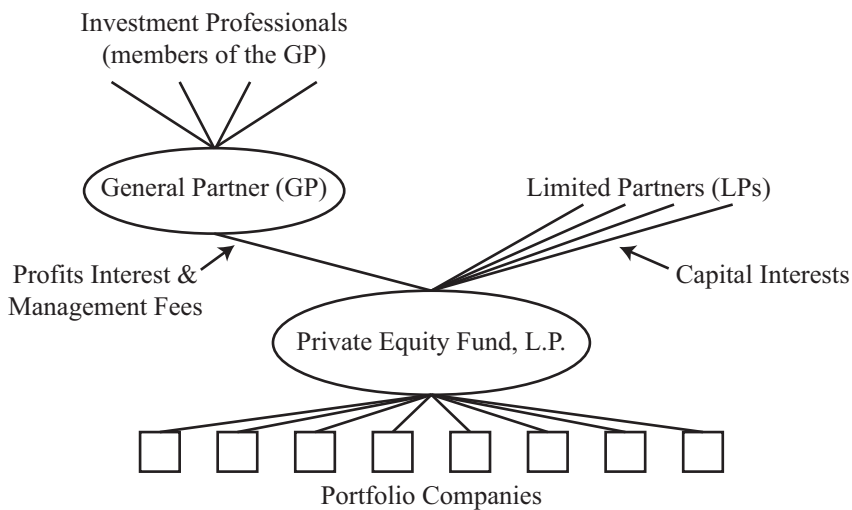
17. *Id.* at 6.

18. See DAVID P. STOWELL, AN INTRODUCTION TO INVESTMENT BANKS, HEDGE FUNDS, AND PRIVATE EQUITY: THE NEW PARADIGM 214 (2010).

equity fund typically spans about ten years from initial investment to profits distribution.¹⁹ Correspondingly, investors in private equity funds must commit to a fixed, long-term period of illiquidity.²⁰

Most private equity funds are organized as private partnerships under state law, with the fund manager acting as the general partner (GP) and private investors acting as limited partners (LPs).²¹ In a typical private equity partnership arrangement, the GP manages the partnership in exchange for compensation from the LPs via a future profits interest and regular interim fee payments out of the invested capital. As a rule, the GP commits between one and two percent of the fund's capital. This commitment is sometimes described as the GP's "skin in the game," and it represents the entirety of the GP's up-front, at-risk capital interest in the fund.²² Figure 1 provides a simplified illustration of the typical private equity fund structure.

FIGURE 1²³



After formation, the GP directs the partnership to invest the fund's capital, comprised of the LPs' capital interests and the GP's "skin in the game," in port-

19. See JOHN GILLIGAN & MIKE WRIGHT, PRIVATE EQUITY DEMYSTIFIED: AN EXPLANATORY GUIDE 31 (2008), available at <http://www.icaew.com/~media/Files/Technical/Corporate-finance/Corporate-finance-faculty/private-equity-demystified-an-explanatory-guide-thought-leadership-icaew.pdf>.

20. See *id.*

21. Fleischer, *supra* note 8, at 8; see also PRIVATE EQUITY COUNCIL, *supra* note 13, at 8.

22. See Fleischer, *supra* note 8, at 8, 24.

23. *Id.* at 9.

folio companies. Members of the GP might also take a more active role in the management and direction of a fund's portfolio companies by serving on boards of directors, orchestrating the election of new directors, or working with corporate managers to develop strategic business plans for operations.²⁴ Ignoring—temporarily—more complicated midstream forms of compensation from the LPs to the GP, the LPs primarily make three types of transfers to the GP as consideration for the GP's direction of the fund. Collectively, this is known as a “two-and-twenty” compensation arrangement:

Transfer of “profits” interest from the LPs to the GP, via the fund. First, upon initial formation of the fund, the LPs transfer an interest in the fund's future profits to the GP. This is referred to as a “profits” or “carried” interest. A typical carried interest conveys to the GP a right to 20% of the fund's profits upon future fund liquidation, subject to a 5%-8% “hurdle rate.” The LPs receive a return on invested capital plus all profits up to 5%-8%, but if profits exceed the hurdle, the partners split all profits—typically 80% to the LPs and 20% to the GP.²⁵ If profits do not exceed the hurdle rate, the GP does not receive any “carry” upon liquidation. This “mak[es] carried interest both a risk-sharing mechanism [for the GP] and an incentive mechanism to deliver returns for investors.”²⁶

Transfer of annual or semiannual “management fee” from the LPs to the GP, via the fund. Second, during the fund's life, the LPs transfer an annual or semiannual “management fee” to the GP.²⁷ The management fee, which usually comprises 1%-2% of the value of capital under management,²⁸ finances “administrative overhead, diligence, and operating costs and pays the managers' salaries.”²⁹ In contrast to the carried interest, and because it is contractually conveyed to the GP at regular intervals, the management fee “is fixed and does not depend on the performance of the fund.”³⁰ GPs have used a number of techniques to defer portions of the management fee in order to convert those portions into carry for tax planning purposes (discussed below in Part I.C.3).³¹

Transfer of profits distribution from the fund to the GP, via the fund. Third, upon fund liquidation, and in satisfaction of the future profits interest discussed

24. See Judge, *supra* note 6.

25. For example, consider a fund with \$100 of initial capital, a 20% carried interest for the GP, and an 8% hurdle rate. If the fund liquidates with a value of \$105, profits will not have exceeded the hurdle rate, and therefore the LPs will receive all \$105 upon distribution. If, however, the fund liquidates with a value of \$110, profits will have exceeded the hurdle rate, and the LPs will split all profits with the GP—\$108 to the LPs and \$2 to the GP.

26. PRIVATE EQUITY COUNCIL, *supra* note 13, at 9.

27. *Id.* at 8.

28. This management fee is the “two” in “two-and-twenty.”

29. Fleischer, *supra* note 8, at 9.

30. *Id.*

31. See, e.g., *id.* at 24.

above, the LPs transfer a portion of the fund's profits to the GP. The profits distribution ordinarily represents 20% of fund profits,³² contingent on whether fund performance has exceeded the previously agreed upon hurdle rate. Although a fund can make interim profits distributions, and some funds do, the profits distribution often results in deferred receipt of profits for the LPs and the GP for the entire period of illiquidity, which typically spans about ten years.³³

B. *The Capital Gains Preference*

Following the enactment of the capital gains provision with the Revenue Act of 1921,³⁴ an individual's net capital gain has generally been taxed at a lower rate than the rate applicable to his ordinary income.³⁵ The Internal Revenue Code currently imposes a maximum marginal tax rate for ordinary income of 39.6%, compared with a maximum rate of 20% for net capital gain.³⁶ This disparity is commonly referred to as the "capital gains preference."³⁷

Commentators have identified a lack of "systematic exposition [of the capital gains preference] in any official source," and many have criticized "[t]he absence of a clearly articulated set of policy objectives" behind the regime.³⁸ Nevertheless, the Supreme Court has interpreted the purpose of the capital gains preference as one aimed "to relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to re-

32. This profit distribution is the "twenty" in "two-and-twenty."

33. See GILLIGAN & WRIGHT, *supra* note 19, at 31.

34. See Roy G. Blakey, *The Revenue Act of 1921*, 12 AM. ECON. REV. 75, 85-87 (1922).

35. See MARVIN A. CHIRELSTEIN, *FEDERAL INCOME TAXATION: A LAW STUDENT'S GUIDE TO THE LEADING CASES AND CONCEPTS* 358-59 (11th ed. 2009).

36. Compare American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 101(b)(1), 126 Stat. 2313, 2316 (2013) (to be codified at I.R.C. § 1(i)), with *id.* § 102(b)(1), 126 Stat. at 2318 (to be codified at I.R.C. § 1(h)). The term "capital asset" generally means any property held by the taxpayer, except: (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business; (2) depreciable or real property used in the taxpayer's trade or business; (3) specified literary or artistic property; (4) business accounts or notes receivable; (5) certain U.S. publications; (6) certain commodity derivative financial instruments; (7) hedging transactions; and (8) business supplies. See I.R.C. § 1221(a) (2012). Capital gain or loss is treated as "long-term" if the capital asset sold is held for more than one year. See *id.* § 1222(3)-(4). Net capital gain is the excess of the net long-term capital gain for the tax year over the net short-term capital loss for the year. See *id.* § 1222(11).

37. See generally Noël B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319 (1993) (describing the "capital gains preference" and evaluating its merits).

38. CHIRELSTEIN, *supra* note 35, at 359 (citing Stanley S. Surrey, *Definitional Problems in Capital Gains Taxation*, 69 HARV. L. REV. 985 (1956)).

move the deterrent effect of those burdens on such conversions.”³⁹ Congress’s motivation for enacting and maintaining the capital gains preference notwithstanding, much hangs in the balance over its application to carried interests: the Congressional Budget Office predicts that eliminating the capital gains preference for carried interests and taxing them at ordinary income rates would raise an estimated \$21.4 billion in revenue over the next decade.⁴⁰

C. *Current Tax Treatment of Two-and-Twenty Fee Arrangements*

Because they allow fund managers to characterize the lion’s share of income from fund management as capital gain, two-and-twenty fee arrangements represent “the single most tax-efficient form of compensation available without limitation to highly paid executives.”⁴¹ Currently, the initial transfer of a future profits interest to the GP is treated as a nontaxable event, the annual management fee paid to the GP is taxed as ordinary income, and the carry received by the GP is taxed entirely as capital gain, deferred until fund liquidation.⁴² The history behind the current treatment of carried interests, which begins in earnest with the case of *Diamond v. Commissioner*, merits exposition in some detail. This Subpart will trace the development of the modern approach to taxing carried interests, from its origins in *Diamond* through the IRS response in Revenue Procedures 93-27 and 2001-43, up to the status quo treatment at issue today.

1. *Diamond v. Commissioner*

Diamond, decided in 1974, involved a real estate partnership in which the service provider—effectively the GP—received a future profits interest resembling a modern carried interest. A real estate investor, Kargman, enlisted the services of a mortgage broker, Diamond, to assist him in obtaining a loan to acquire a property asset and to manage the financing transactions.⁴³ Diamond, the GP, contributed no capital to the partnership up front but instead brought his service ability—through industry expertise, connections, and dealmaking—to obtain favorable financing for the purchase.⁴⁴ Kargman, who functioned as a passive investor, or LP, contributed the requisite capital and agreed to supple-

39. *Burnet v. Harmel*, 287 U.S. 103, 106 (1932) (citing H.R. REP. NO. 67-350, at 10 (1921)).

40. CONG. BUDGET OFFICE, REDUCING THE DEFICIT: SPENDING AND REVENUE OPTIONS 157 (2011), available at <http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/120xx/doc12085/03-10-reducingthedeficit.pdf>.

41. Fleischer, *supra* note 8, at 4.

42. *See id.* at 3-4.

43. *See Diamond v. Comm’r*, 492 F.2d 286, 286 (7th Cir. 1974).

44. *See id.* at 286-87.

ment any cash necessary for operations.⁴⁵ In exchange for Diamond's "services" to the partnership, Kargman agreed to split with Diamond any profits or losses from eventual sale—40% to Kargman and 60% to Diamond.⁴⁶ The acquisition succeeded and the partnership closed on the purchase of the building.⁴⁷ Under the partnership agreement, Diamond stood to reap 60% of any appreciation in the value of the asset above any cash expended for operations by Kargman.⁴⁸

Up to this point, Diamond's partnership agreement with Kargman parallels the carried interest component of the private equity partnership agreements discussed above—like the GP in a private equity partnership, Diamond had not invested any actual capital. The partnership agreement in *Diamond* reflects an interest in future profits in exchange for industry expertise, connections, and dealmaking, arising in an exclusively investment context. But the *Diamond* story has one further wrinkle. Three weeks after the partnership closed on the property, and a mere three weeks after Diamond had initially received his interest in the property's future gains or losses, Diamond agreed to sell his profits interest to a third party, Liederman, for \$40,000.⁴⁹

Diamond reported no tax consequence from his initial receipt of the profits interest, and he reported the \$40,000 in proceeds from the sale of his partnership profits interest as a short-term capital gain.⁵⁰ The Commissioner argued that Diamond's profits interest had a fair market value of \$40,000 at time of receipt, prior even to Diamond's transfer of the interest, and that it represented ordinary income under § 61 upon receipt.⁵¹ Diamond relied on two alternative theories in support of his position: first, by reason of § 721, that he had received only an interest in a partnership—limited to a percentage of its future earnings—for his services and that he realized no income thereby; and second, that in any event the interest had no ascertainable value upon receipt.⁵²

First, Diamond argued that § 721 provided that his initial receipt of the future profits interest was a nonrecognition, nontaxable event. As that section provides, "No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership."⁵³ Diamond relied specifically on the interpretive language contained in Treasury Regulations § 1.721-1:

45. *Id.*

46. *Id.*

47. *See id.*

48. *Id.*

49. *Id.* at 287.

50. *Id.*

51. *See Diamond v. Comm'r*, 56 T.C. 530, 544 (1971), *aff'd*, 492 F.2d 286.

52. *Id.*

53. I.R.C. § 721 (1954) (current version at I.R.C. § 721(a) (2012)).

To the extent that any of the partners gives up any part of his right to be repaid his contributions (*as distinguished from a share in partnership profits*) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the [service] partner under section 61.⁵⁴

Based on the parenthetical exception for profits interests under this regulation, Diamond

contend[ed] that when a taxpayer receives a partnership interest as compensation for services he is required to account for that interest at once as ordinary income if he acquires an interest in partnership capital, *but not if he receives only the right to share in the partnership's future profits and losses*.⁵⁵

Diamond sought to distinguish between *capital* interests, which qualified for nonrecognition under § 721 if received in exchange for money or property, but not if received in exchange for services, and *profits* interests, which, Diamond argued, qualified for nonrecognition under § 721 regardless of the form of contribution the recipient partner had exchanged. Without clearer direction, however, neither the Tax Court nor the Seventh Circuit was willing to read into § 721 an affirmative inclusion of profits interests received in exchange for services under the nonrecognition provision.⁵⁶ The Seventh Circuit rejected Diamond's first argument, noting that "a valuable property interest received in return for services is compensation, and income."⁵⁷

In reviewing academic commentary on the question, however, the Seventh Circuit found unequivocal agreement that "the present value of a right to participate in future profits is usually too conjectural to be subject to valuation . . . [and] the service partner is taxable on his distributive share of partnership income [only] as it is realized by the partnership."⁵⁸ Recognizing that "in many if not the typical situations [a future profits interest] will have wholly speculative value, if any," the court called upon the IRS to clarify the Internal Revenue Code's ambiguity with regard to the treatment of the receipt of future profits interests with no discernable market value: "[T]he resolution of these practical

54. Treas. Reg. § 1.721-1 (1960) (as amended in 2011) (emphasis added).

55. 56 T.C. at 545 (emphasis added).

56. See 492 F.2d at 288-89 ("[Regulations § 1.721-1] does not specify that if a partner contributing property agrees that, in return for services, another shall be a partner with a profit-share only, the value of the profit-share is not income to the recipient."); 56 T.C. at 545-46 ("[T]he effect of the first parenthetical clause in . . . [Regulations § 1.721-1], '(as distinguished from a share in partnership profits),' upon which [Diamond] place[s] [his] sole reliance, is obscure. . . . [N]othing in the foregoing regulations explicitly states that a partner who has received a partnership interest . . . in exchange for services already performed comes within the provisions of section 721.").

57. 492 F.2d at 288-89.

58. *Id.* at 289 (quoting ARTHUR B. WILLIS, WILLIS ON PARTNERSHIP TAXATION 84-85 (1971)).

questions makes clearly desirable the promulgation of appropriate regulations, to achieve a degree of certainty.”⁵⁹

Second, Diamond argued in the alternative that his “interest in the venture had no value at the time he acquired it” and that his receipt of it could not constitute a taxable event.⁶⁰ The Tax Court rejected this argument, emphasizing that Liederman was willing to pay \$40,000 for the interest “less than [three] weeks after [Diamond] received it.”⁶¹ In upholding the Tax Court’s decision, the Seventh Circuit identified, importantly, that “the prospect of earnings from the real estate under Kargman’s management was evidently very good . . . [such that] [t]he profit-share had determinable market value.”⁶²

The Seventh Circuit’s decision in *Diamond* represented the seminal case on the taxation of partnership interests, and it was “loudly criticized” by commentators, practitioners, and even the Office of Chief Counsel of the IRS for its shortsightedness in favoring taxability upon receipt.⁶³ No other appeals court reached a decision on whether the receipt of a profits interest constituted a realization event for seventeen years.⁶⁴ Nevertheless, the uncertainty evinced in *Diamond* eventually resurfaced in the analogous case of *Campbell v. Commissioner*, in which the Eighth Circuit distinguished the profits interest at issue from that received by Diamond and came down with a result opposite to that reached by the Seventh Circuit.⁶⁵ In holding that the receipt of the instant profits interest did *not* constitute a realization event, the *Campbell* court emphasized the uniqueness of Diamond’s profits interest having discernible value, as well as the litany of commentators questioning the applicability of *Diamond* to typical profits interests more broadly.⁶⁶ *Campbell* identified the infeasibility of the *Diamond* approach in most profits interest arrangements, effectively forcing the IRS to take action to clear the haze.

59. *Id.* at 291.

60. 56 T.C. at 546.

61. *Id.*

62. 492 F.2d at 290.

63. Laura E. Cunningham, *Taxing Partnership Interests Exchanged for Services*, 47 TAX L. REV. 247, 247 (1991) (describing how critics “sought to narrow the application of the [ruling] to the particular facts of the case”).

64. See *Campbell v. Comm’r*, 943 F.2d 815, 818-23 (8th Cir. 1991); Thomas O. Wells & Samantha B. Carter, *Profits Interest—Converting Compensation to Capital Gains and Other Planning Ideas*, 81 FLA. B.J. 52, 54 (2007). In the interim, the Commissioner conceded in several Tax Court cases that receipt of a profits interest by a service provider created no tax liability. See, e.g., *Nat’l Oil Co. v. Comm’r*, 52 T.C.M. (CCH) 1223, 1228 (1986); *Kenroy, Inc. v. Comm’r*, 47 T.C.M. (CCH) 1749, 1755-58 (1984).

65. See 943 F.2d at 822-23.

66. See *id.* at 819.

2. IRS response: Revenue Procedures 93-27 and 2001-43

The IRS responded to the *Diamond-Campbell* split in 1993 with Revenue Procedure 93-27,⁶⁷ later clarified in Revenue Procedure 2001-43.⁶⁸ Revenue Procedure 93-27 provides a safe harbor for profits-only interests, exempting them from immediate taxation upon receipt.⁶⁹ It states that “if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity . . . the receipt of such an interest [will not be treated] as a taxable event for the partner or the partnership.”⁷⁰ Notably, though, it specifies three instances where the nonrecognition rule does not apply: (1) if the interest has an ascertainable value upon receipt based on a predictable income stream; (2) if the recipient partner disposes of the interest within two years of receipt; and (3) if the interest is a limited partnership interest in a publicly traded partnership under § 7704(b).⁷¹ Although commentators generally found Revenue Procedure 93-27 “welcome guidance,” some foresaw “[n]umerous interpretive questions . . . bound to arise in applying [its] standards.”⁷² Correspondingly, Revenue Procedure 2001-43 was later promulgated to clarify that the same exemption from immediate taxation holds where the profits interest is unvested upon receipt.⁷³ Nevertheless, “much ink has been spilled” in debating the applicability of the nonrecognition rule to profits interests in the wake of these Revenue Procedures.⁷⁴

3. Current treatment: “two” as ordinary income and “twenty” as capital gain

The current treatment of carried interests considers each transfer from the LPs to the GP as distinct for tax purposes. First, in line with Revenue Proce-

67. Rev. Proc. 93-27, 1993-2 C.B. 343.

68. Rev. Proc. 2001-43, 2001-2 C.B. 191.

69. Note, *Taxing Private Equity Carried Interest Using an Incentive Stock Option Analogy*, 121 HARV. L. REV. 846, 850 (2008); Note, *supra* note 8, at 1778.

70. Rev. Proc. 93-27, 1993-2 C.B. 343.

71. *See id.*

72. Charles H. Egerton, *Rev. Proc. 93-27 Provides Limited Relief on Receipt of Profits Interest for Services*, 79 J. TAX’N 132, 132, 137 (1993).

73. Note, *supra* note 69, at 850.

74. Note, *supra* note 8, at 1778 & n.42 (citing TAX SECTION, N.Y. STATE BAR ASS’N, REPORT ON PROPOSED CARRIED INTEREST AND FEE DEFERRAL LEGISLATION 27 n.72 (2008), available at <http://old.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1166Report.pdf>; Howard E. Abrams, *Taxation of Carried Interests: The Reform That Did Not Happen*, 40 LOY. U. CHI. L.J. 197, 207 (2009); Karen C. Burke, *The Sound and Fury of Carried Interest Reform*, 1 COLUM. J. TAX L. 1, 10 (2010); Andrew W. Needham, *A Guide to Tax Planning for Private Equity Funds and Portfolio Investments (Part 1)*, 95 TAX NOTES 1215, 1222 (2002)).

dures 93-27 and 2001-43, the initial transfer of a profits interest from LPs to the GP is currently treated as a nonrealization, nontaxable event. This treatment is widely accepted by commentators on both sides of the current debate.⁷⁵ Consensus on nonrealization stems largely from the fact that a profits interest has unascertainable value, but it stems also from liquidity concerns about taxing the GP before any cash has actually changed hands between the parties.⁷⁶ This treatment has been consistent since the promulgation of Revenue Procedure 93-27. Profits interests have not been subject to tax upon receipt of the interest, and the GP has been able to defer recognition until a later distribution of profits.⁷⁷

Second, the annual management fee transferred from the LPs to the GP is currently treated as ordinary income to the GP in the year received and taxed accordingly. Although treatment of the annual management fee is relatively straightforward, fund managers have increasingly utilized aggressive strategies to transform management fees into additional carried interest, deferring some ordinary income while simultaneously converting it into capital gain.⁷⁸ In a management fee conversion strategy, the fund manager waives a portion of future management fees in exchange for an increase in carried interest.⁷⁹ Often, the fund manager will waive the annual fee merely to receive an enhanced mid-stream allocation of fund profits during the next fiscal year of the fund,⁸⁰ and the manager will receive a priority allocation on the additional carried interest.⁸¹ Interestingly, this strategy adds little economic risk for the GP, but it promises a huge tax reward.⁸² In the extreme case, the GP will seek, *ex ante*, to convert management fees into priority allocations in order to offset *capital* contributions (intended as “skin in the game” to provide downside risk and align the GP’s incentives with those of the LPs).⁸³ This technique, known as a “cash-

75. See Postlewaite, *supra* note 5, at 845.

76. See, e.g., Fleischer, *supra* note 8, at 36 (“[L]iquidity poses a problem; if a tax is assessed before the increase in wealth is realized, you might not have the cash to pay the tax.”).

77. See *id.* at 11.

78. Fleischer, *supra* note 8, at 23; see also Gregg D. Polsky, *Private Equity Management Fee Conversions*, 122 TAX NOTES 743, 752-53 (2009). As explained below, carry distributions are taxed as capital gains.

79. See Polsky, *supra* note 78, at 749.

80. Fleischer, *supra* note 8, at 23.

81. Polsky, *supra* note 78, at 749 (“Priority allocations allocate the first dollars of any net gain realized by the fund in any of the fund’s fiscal periods to the general partner. Net losses realized in prior accounting periods or in later ones have no impact on the priority allocation of net gains received in the current quarter.”).

82. See Fleischer, *supra* note 8, at 24; Polsky, *supra* note 78, at 756.

83. Fleischer, *supra* note 8, at 24 (internal quotation marks omitted).

less capital contribution,” allows the GP to achieve even greater preferential capital gains treatment while investing even less actual capital up front.⁸⁴

Third, and finally, the ultimate distribution of a carried interest in fund profits to the GP is currently taxed entirely as capital gain under the “pass-through” treatment of partnership profits.⁸⁵ In other words, if the fund recognizes long-term capital gains (which ordinarily comprise most, or all, of a profits distribution), the manager recognizes long-term capital gains as well. This treatment led Victor Fleischer to observe that a carried interest represents “the single most tax-efficient form of compensation available without limitation to highly paid executives.”⁸⁶ Moreover, this treatment has given rise to intense debate⁸⁷ over the taxation of carried interests in arenas ranging from the academy⁸⁸ to the public sphere⁸⁹ to the floor of Congress.⁹⁰ The remainder of this Note will focus on the taxation of carried interest distributions. Specifically, it will consider whether and to what extent a carried interest should qualify for capital gains treatment.

D. *Modern Debate over Carried Interests: A Battle of Analogies*

On the continuum between “service” income and “investment” income, carried interests arguably fall somewhere in the middle.⁹¹ Certain aspects of a carried interest could qualify for characterization as ordinary income, but other aspects could qualify as capital gain. For instance, a carried interest’s primarily compensatory function could support treatment as service income, but its interim capital components and entrepreneurial context could support treatment as investment income. The modern debate over the tax treatment of carried interests essentially boils down to a battle of analogies. In framing the debate, commentators liken carried interests to a subject of settled tax consequence and

84. *Id.* (internal quotation marks omitted).

85. See I.R.C. § 702(b) (2012) (providing a general rule that the character of income included in a partner’s distributive share is determined as if that item of income were realized at the partnership level).

86. Fleischer, *supra* note 8, at 4.

87. See Cunningham & Engler, *supra* note 11, at 121 (stating that press attention on carried interest taxation “raised a firestorm in the legal academy and on Capitol Hill”).

88. Compare Fleischer, *supra* note 8 (proposing reformed treatment), and Note, *supra* note 8 (same), with Weisbach, *supra* note 9 (defending the status quo).

89. Compare Judge, *supra* note 6 (advocating in favor of the status quo), with Rothschild, *supra* note 11 (calling for reform).

90. See, e.g., Carried Interest Fairness Act of 2012, H.R. 4016, 112th Cong. (2012).

91. See Christopher Livingston, *Finding the Right Balance: A Critical Analysis of the Major Proposals to Reform the Taxation of Carried Interests in Private Equity*, 62 TAX LAW. 241, 248-49 (2008) (“Under the current tax regime, carried interest income is being undertaxed, but it would be overtaxed if it were treated entirely as ordinary income. Taxing carried interest as a combination of the two would be an appropriate compromise.”).

argue for parallel treatment. For example, a significant number of commentators posit that compensatory carried interest income is simply indistinguishable from income earned from “teaching or working in a factory”⁹²—suggesting that carried interests should be taxed similarly, meaning entirely as ordinary income. Other commentators draw somewhat more intricate (and likely more accurate) analogies. This Subpart highlights three prevalent competing analogies: sweat equity, qualified incentive stock options (ISOs) under § 422, and non-qualified stock options (NQSOs) under § 83. Further analogical arguments will surface below in Part II as the bases for alternative proposals for reform.

The sweat equity analogy, advanced primarily on behalf of private equity partners and the private equity lobby, argues for taxation entirely as capital gain. As this analogy goes, a carried interest in fund profits is identical to sweat equity in a business built from the ground up. The analogy’s proponents use the example of a restaurateur who forms a partnership and raises third-party capital to finance the creation of a restaurant under an agreement to split future profits upon sale.⁹³ Thus, after years of laboring in the kitchen (and contributing “sweat”), the restaurateur will receive capital gains treatment on her share of any profits, *even though she contributed no capital up front*. Similarly to the restaurateur, GPs “contribute[] sweat equity”⁹⁴ to partnerships by “develop[ing] strategic business plans, sit[ting] on boards and work[ing] to strengthen the companies they own over many years.”⁹⁵ Therefore, the sweat equity analogy suggests, a carried interest should receive parallel capital gains treatment in its entirety.

One important detail militates against the proffered justifications for the sweat equity analogy: there are many corporate employees—CEOs and other executives—who serve the same functions as GPs, but their labor is not regarded as sweat equity for tax purposes.⁹⁶ Corporate executives develop strategic business plans, they often serve as inside directors on boards, and they work to maximize the value of the company to shareholders. Executive salaries are clearly taxed as ordinary income, suggesting a serious flaw in the sweat equity analogy. But other compensatory vehicles for executives provide interesting alternatives. For example, some firms seek to incentivize performance by issu-

92. Press Release, Representative Sander Levin, Carried Interest Fairness Act of 2012 (Feb. 14, 2012), <http://levin.house.gov/press-release/carried-interest-fairness-act-2012>.

93. See, e.g., *Carried Interest Explained in Latest PEGCC Whiteboard Video*, *supra* note 10.

94. *Id.*

95. Judge, *supra* note 6.

96. To the extent that executive compensation qualifies for treatment as an incentive stock option under § 422 (discussed below in this Subpart), it receives more favorable treatment than ordinary income, but that favorable treatment is severely limited relative to the sweat equity context.

ing equity to executives in lieu of a salary. This alternative compensation also forms the basis for a second prevalent analogy for carried interests: ISOs.

The ISO analogy, advanced primarily by academics and reform-minded legislators, argues for more limited capital gains treatment. An ISO, like a carried interest, represents a form of incentive compensation whereby the recipient holds an option to purchase shares of stock at some fixed price,⁹⁷ commonly referred to as the “strike price.”⁹⁸ Section 422 provides a list of requirements for a stock option to qualify for favorable ISO treatment; those requirements include an extended holding period, a good faith effort to value the stock upon receipt, restrictions on transfers and dispositions, and an annual cap on qualifying exercisable stock.⁹⁹ If the value of the underlying stock exceeds the strike price, the option holder can exercise the option, acquiring the stock with ordinary income, and thus a basis, equal to the strike price and receiving capital gains treatment on any gain (or loss).¹⁰⁰ If the stock’s value does not exceed the strike price during the option period, the holder recognizes no gain or loss.¹⁰¹ Under the ISO comparison, commentators consider “an ISO with a strike price of zero [to be] the corporate world’s closest analogy to carried interest in terms of both economics and taxation.”¹⁰²

ISOs receive favorable treatment relative to other forms of compensation, but their form differs significantly from that of carried interests. Two of § 422’s requirements in particular render the ISO analogy unworkable in this context. First, an ISO cannot be issued with a strike price below the fair market value of the underlying stock; in other words, “[a] stock option with a strike price of zero cannot be an ISO.”¹⁰³ The ISO approach would require a carried interest to have a “strike price” equal to its fair market value in order to qualify for favorable treatment. As discussed above in Part I.C, however, ascertaining the value of a carried interest upon receipt is virtually impossible. Second, the amount of compensation eligible for ISO treatment in a given year is limited under an annual maximum.¹⁰⁴ Any compensatory stock option that “becomes exercisable in any calendar year cannot be an ISO to the extent that the underlying stock was worth more than \$100,000 at the time the option was granted.”¹⁰⁵ Although that cap “reflect[s] a congressional intent to limit the subsidy” for favor-

97. I.R.C. § 422(b) (2012).

98. See Note, *supra* note 69, at 851 (internal quotation marks omitted).

99. I.R.C. § 422.

100. See Note, *supra* note 69, at 851.

101. See *id.*

102. *Id.* at 855; see also Fleischer, *supra* note 8, at 4.

103. Note, *supra* note 69, at 855.

104. I.R.C. § 422(d).

105. Note, *supra* note 69, at 856.

able ISO treatment,¹⁰⁶ a similar limit on carried interest compensation “would be nonsensically low given the size and scale of modern-day private equity funds and investments.”¹⁰⁷

The treatment of NQSOs provides another potential analogy. An NQSO—defined as a stock option that does not qualify for ISO treatment under § 422—receives ordinary income treatment to the extent that the fair market value of the stock exceeds the strike price in accordance with § 83.¹⁰⁸ If the recipient holds the stock, any further appreciation is capital gain (or loss). In other words, if the option “has a readily ascertainable fair market value . . . at the time [it] is granted,” it is taxed as ordinary income upon receipt.¹⁰⁹ In that case, exercise of the option is a nonevent, and sale of the underlying stock gives rise to capital gain (or loss). If the option cannot be valued upon receipt—like a carried interest—realization is postponed until the option is exercised. At that time, the recipient has ordinary income equal to the difference between the strike price (of zero) and the fair market value of the stock.¹¹⁰ Perhaps this treatment is based on the normative idea that there is no invested capital, and therefore no capital gain, until after the service provider has been taxed on the portion of the interest representing compensation. In any event, although carried interests are “economically equivalent” to an NQSO with a strike price of zero, they are not tax equivalent.¹¹¹ The corporation issuing an NQSO receives an ordinary deduction in the same amount of the option under § 83(h).¹¹² Because partnerships do not pay an entity-level tax, and LPs in private equity funds are often tax exempt, the NQSO analogy is ultimately “inapt.”¹¹³

Inevitably, no analogy provides an entirely sound or successful argument for parallel treatment. Most analogies rely heavily on the ascertainable value of a carried interest *ex ante*—the *Diamond* scenario—and their shortcomings demonstrate the need to *approximate* *ex ante* valuation through an alternative method. Regardless, an examination of the competing analogies sets the stage for a discussion of prominent alternative proposals for reform in Part II.

106. Fleischer, *supra* note 8, at 26.

107. Note, *supra* note 69, at 856-57.

108. See Treas. Reg. § 1.83-7 (as amended in 2004); Note, *supra* note 69, at 853-54.

109. Treas. Reg. § 1.83-7(a).

110. See Note, *supra* note 69, at 853-54.

111. *Id.* at 854.

112. See I.R.C. § 83(h) (2012); Note, *supra* note 69, at 854.

113. Note, *supra* note 69, at 854 (explaining that, whereas “the exercise of [an NQSO] . . . merely shifts a tax liability from the corporation to the option holder . . . in most cases,” treating carried interests as NQSOs would serve to *generate* taxes by increasing them in the private equity context). *But see* Michael S. Knoll, *The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of Taxing Profit Interests as Ordinary Income*, 50 WM. & MARY L. REV. 115, 129 (2008).

II. PROMINENT ALTERNATIVE PROPOSALS FOR REFORM

Alternative approaches for taxing carried interests vary in complexity and theoretical foundation, among other dimensions. Aside from the “All Ordinary Income” approach suggested by some commentators,¹¹⁴ most proposals would characterize carried interests as an aggregation of service income and investment income. This Part will introduce and briefly analyze four prominent alternative proposals for reform: (1) complete recharacterization;¹¹⁵ (2) the proposed § 710 approach;¹¹⁶ (3) Fleischer’s Cost-of-Capital Method;¹¹⁷ and (4) the modified Cost-of-Capital approach.¹¹⁸ In short, complete recharacterization and the proposed § 710 approach have little justification in tax theory—the proposed § 710 approach avoids grappling with the difficulties of explicit disaggregation by applying a fixed-ratio, one-size-fits-all solution, and complete recharacterization ignores the existence of an investment component altogether. The Cost-of-Capital Method and the modified Cost-of-Capital approach, both of which seek to approximate explicit disaggregation through alternative means, have stronger theoretical footing, but neither method reaches an ideal approximation of the *Diamond* scenario—both suffer from the arbitrariness of externally applied substitutes for actual bifurcation.

A. *Complete Recharacterization: All Ordinary Income*

Mark Gergen first suggested treating carried interests entirely as ordinary income more than twenty years ago.¹¹⁹ Since then, Representative Sander Levin has introduced a number of legislative proposals to treat carried interests along the same lines.¹²⁰ Most recently, Representative Levin introduced the Carried Interest Fairness Act of 2012, which sought to exclude from pass-through treatment and tax as ordinary income “specified carried interest income . . . [from] an investment services partnership interest.”¹²¹ That bill died

114. E.g., Mark. P. Gergen, *Reforming Subchapter K: Compensating Service Partners*, 48 TAX L. REV. 69, 103 (1992).

115. See Carried Interest Fairness Act of 2012, H.R. 4016, 112th Cong. (2012).

116. See Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong. (2007).

117. Fleischer, *supra* note 8, at 39.

118. Note, *supra* note 8, at 1795.

119. *Id.* at 1786 (citing Gergen, *supra* note 114). See generally Fleischer, *supra* note 8, at 51.

120. See H.R. 4016; H.R. 1935, 111th Cong. (2009); H.R. 2834, 110th Cong. (2007); see also *Timeline of Action on Carried Interest Legislation*, WAYS & MEANS COMMITTEE DEMOCRATS, <http://democrats.waysandmeans.house.gov/sites/democrats.waysandmeans.house.gov/files/media/pdf/112/CarriedInterestFairnessAct-Timeline.pdf> (last visited Mar. 26, 2014).

121. H.R. 4016 § 3(c).

in committee, along with every one of its predecessors,¹²² but the concept of all-ordinary-income treatment nonetheless represents the extreme reform position: “complete recharacterization.”¹²³

Complete recharacterization would be easy to administer, and although it would allow the LPs to deduct salary expenses paid to the GP, it would likely generate revenue overall.¹²⁴ From a theoretical perspective, however, complete recharacterization would not adequately capture the dual nature of a carried interest. In reality, fund managers “do have the kind of ‘at-risk’ capital . . . that justifies *at least some* capital gains . . . treatment.”¹²⁵ Complete recharacterization is therefore theoretically unsatisfactory, because it “lacks any hint of disaggregation, completely ignoring the existence of an investment component.”¹²⁶

B. *The Proposed § 710: 75/25 Compromise*

In 2007, Representative Charles Rangel introduced a comprehensive tax reform bill that included a proposed new and complex § 710.¹²⁷ Proposed § 710 would apply to all “investment services partnership interest[s]” (ISPIs).¹²⁸ In relevant part, this proposal would essentially treat a fixed percentage (75%) of any ISPI distribution as ordinary income, but it would exempt a fixed percentage (25%) from recharacterization.¹²⁹ Proposed § 710 would also (appropriately) exempt entirely from recharacterization any distributive share “reasonably allocated by the partnership to the ‘invested capital’ of the [service] partner.”¹³⁰

122. See *H.R. 4016 (112th): Carried Interest Fairness Act of 2012*, GOVTRACK.US, <http://www.govtrack.us/congress/bills/112/hr4016> (last visited Mar. 26, 2014).

123. Note, *supra* note 8, at 1788; see also *id.* at 1786-88.

124. Many institutional LPs are tax-exempt nonprofits that would be unable to claim an offsetting deduction. *But see* Knoll, *supra* note 113, at 129 (“After such a change, the economic terms of the deal might change to share the burden between the general partner and limited partners.”).

125. Note, *supra* note 8, at 1785.

126. *Id.* at 1788.

127. Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong. (2007).

128. Abrams, *supra* note 74, at 212 (internal quotation marks omitted). An “investment services partnership interest” would be defined to include an interest received in exchange for any of the following services: (1) advice “as to the advisability of investing in, purchasing, or selling any specified asset” (including securities, commodities, and real estate); (2) “[m]anaging, acquiring, or disposing of any specified asset”; or (3) “[a]rranging financing with respect to acquiring specified assets.” H.R. 3970 § 1201(a). It would also include “[a]ny activity in support of any service described [above].” *Id.*

129. See Note, *supra* note 8, at 1775.

130. Abrams, *supra* note 74, at 213.

The proposed § 710 approach has been widely criticized as a “blunt solution to . . . a complicated problem” and a “crude, fixed-ratio disaggregation.”¹³¹ Commentators have described it as “a provision . . . so flawed that it should not be enacted even if taxation of carried interests should be modified.”¹³² Although proposed § 710 correctly identifies the need for disaggregation, it is devoid of any theoretical basis for arriving at the 75/25 ratio. Rather, it represents a heavy-handed, politically convenient solution to an exceedingly nuanced issue.

C. *Fleischer’s Cost-of-Capital Method: Imputed Interest as Ordinary Income*

Victor Fleischer introduced a method to approximate the GP’s service income in the form of an interest-free loan from the LPs to the GP.¹³³ Coined the “Cost-of-Capital Method,”¹³⁴ Fleischer’s approach borrows from § 7872 principles (for below-market-interest loans) as an alternative to taxing profits interests. The Cost-of-Capital Method imputes an annual interest rate to an implicit loan, treating the foregone interest as ordinary income to the GP, taxed annually. The GP’s eventual profits share is taxed as capital gain to the extent that it exceeds the GP’s “basis,” derived from the sum of its annual “interest” payments. As Fleischer concludes, “We can separate the return to capital and labor by calculating the size of the implicit loan from investors to the GP in order to reasonably estimate the value of the contribution of labor based on the opportunity cost to investors.”¹³⁵

By using an imputed loan as proxy for actual invested capital, the Cost-of-Capital Method represents progress toward a theoretically sound approximation of the *Diamond* scenario. Despite its theoretical benefits, however, the Cost-of-Capital Method runs into two important difficulties in practice. First, it requires determination of a “fair” interest rate to capture the value of the GP’s service efforts, ex ante—a determination that proves arbitrary in practice, because it is impossible to apply a theoretically “correct” annual rate of interest, ex ante, if we cannot ascertain the actual present value of profits or risk until actual distribution.¹³⁶ In fact, choosing an imputed interest rate might rapidly devolve into

131. Note, *supra* note 8, at 1775, 1789.

132. Abrams, *supra* note 74, at 214.

133. See Fleischer, *supra* note 8, at 40.

134. See *id.* at 6 (internal quotation marks omitted).

135. *Id.* at 41.

136. Such an interest rate would be fixed for the life of the fund, whereas actual fund performance—and ultimate distribution—would be inherently variable. See *supra* Part I.C-D. Thus, the GP would be liable for an arbitrarily fixed stream of annual taxation, regardless of fund performance. Cf. Note, *supra* note 8, at 1793-94 (“The § 7872 rate . . . is clearly below-market for the level of risk of most investment partnerships and could be viewed as a

the same bluntness that plagued fixed-ratio disaggregation in the proposed § 710. And second, the rigid timing of forced annual taxation raises issues of liquidity and uncertainty of future profits for the GP. Under the Cost-of-Capital Method, the GP is liable annually for taxes even though his profits distribution will not arrive until years later (if ever). Collectively, these difficulties render the Cost-of-Capital Method unsatisfactory.

D. *The Modified Cost-of-Capital Approach: Recognition Deferred Until Distribution*

Taxing Partnership Profits Interests: The Carried Interest Problem, an unsigned note published in 2011 in the *Harvard Law Review*, modifies and improves Fleischer's Cost-of-Capital Method.¹³⁷ That note's proposal, the "modified Cost-of-Capital approach,"¹³⁸ targets the liquidity and uncertainty concerns inherent in the Cost-of-Capital Method by retaining an imputed annual interest rate as a proxy for service income but simultaneously deferring taxation until the distribution of profits.¹³⁹ Under this approach, "the GP would pay cost-of-capital charges only up to the amount of partnership profits he is allocated through his profits interest."¹⁴⁰ This modification, which represents an incremental step toward explicit disaggregation, would provide for closer approximation of *Diamond* and would fit more seamlessly into the existing partnership tax structure.

Nevertheless, the first drawback to Fleischer's Cost-of-Capital Method remains entrenched in the modified Cost-of-Capital approach: determining a "fair" interest rate to capture the value of the GP's service efforts still proves illusory. Even when applied "only up to the amount of partnership profits . . . allocated [to the GP],"¹⁴¹ an externally mandated and applied interest rate will never perfectly reflect a theoretically explicit disaggregation between service income and investment income.

giveaway to the GP. Conversely, if private equity partnerships are priced correctly when sold to LPs, the 'perfect-information' market rate for a loan from the LP to the GP is the rate of return of the fund itself. Thus, charging the GP perfect-information market rates on the imputed LP loan would wipe out any later profit the GP expected to realize. Any *arbitrary* interest rate between those two extremes casts doubt on the essential assumption that the interest rate has meaning as a proxy for the GP's labor." (citations omitted)).

137. See Note, *supra* note 8, at 1795.

138. See *id.* at 1776.

139. *Id.*

140. *Id.*

141. *Id.*

III. MATHEMATICAL BIFURCATION: DISAGGREGATING A CARRIED INTEREST

A. *Theoretical Underpinnings*

Ample precedent supports the proposition that preferential capital gains treatment presupposes actual invested capital.¹⁴² Notwithstanding the safe harbor of Revenue Procedure 93-27, § 721 and its progeny illustrate an enduring theoretical distinction between capital partners and service partners. Those provisions pertain exclusively to contributions of property to partnerships, which courts have treated as fundamentally different from contributions of services, construing the latter to constitute neither property nor invested capital.¹⁴³ Under this line of reasoning, only returns on capital actually invested in a private equity partnership should receive preferential capital gains treatment.

But even despite a lack of up-front capital investment by the service provider, a carried interest clearly possesses some attributes of actual invested capital.¹⁴⁴ Due to its riskiness and longer-term illiquidity vis-à-vis traditional forms of ordinary service income, a carried interest theoretically assumes that the service provider will forego some midstream service income by shifting a

142. See *Prebola v. Comm'r*, 482 F.3d 610, 611-12 (2d Cir. 2007) (noting that a taxpayer's right to receive future lottery payments did not constitute a capital asset under § 1221 because it represented future income rather than accretion due to investment); *Watkins v. Comm'r*, 447 F.3d 1269, 1272-73 (10th Cir. 2006) (supporting application of substitute-for-ordinary income doctrine in lump-sum lottery sales case "where there [had] been no underlying investment of capital and where sale of asset did not reflect accretion in value over cost of underlying asset" (citing *United States v. Maginnis*, 356 F.3d 1179, 1182-83 (9th Cir. 2004))); see also *Burnet v. Harmel*, 287 U.S. 103, 106 (1932) ("The provisions of the 1921 revenue act for taxing capital gains at a lower rate . . . were adopted to relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions." (citing H.R. REP. NO. 67-350, at 10 (1921))); cf. *Lattera v. Comm'r*, 437 F.3d 399, 409 (3d Cir. 2006) (coming to the same conclusion as the above cases, but reasoning instead under the "family resemblance" test for determining whether an asset more closely resembles a "capital asset" (e.g., stocks, bonds, or land) or an "income item[]" (e.g., rental income or interest income) (internal quotation marks omitted)). Compare *Corn Prods. Ref. Co. v. Comm'r*, 350 U.S. 46, 52-54 (1955) (construing the definition of "capital assets" narrowly for purposes of capital gain treatment by distinguishing between activities with "business" purposes and those with "hedging," or investment, purposes (internal quotation marks omitted)), with *Ark. Best Corp. v. Comm'r*, 485 U.S. 212, 223 (1988) (rejecting the *Corn Products* "business purpose" doctrine in favor of asking whether an asset falls within the "broad" definition of "capital asset" in § 1221 (internal quotation marks omitted)).

143. See *Campbell v. Comm'r*, 943 F.2d 815, 819 (8th Cir. 1991); *Diamond v. Comm'r*, 492 F.2d 286, 288 (7th Cir. 1974) ("Only if, by a strained construction, 'property' were said to include services, would § 721 say anything about the effect of furnishing services.").

144. See *supra* Part I.D; see also Note, *supra* note 8, at 1785.

portion of that income into the pool of invested capital. The important question from a theoretical perspective is, how much?

The Carried Interest Problem admits that, “[a]s a mathematical matter, it is possible to take a known amount of carry . . . and work backwards to determine the annual percentage required to produce that outcome.”¹⁴⁵ Nevertheless, “[s]uch an approach has yet to be seriously considered,” the note continues, “even though it brings all the benefits of pure disaggregation, including a strong theoretical foundation and seamless integration with existing partnership tax law.”¹⁴⁶ Ultimately, *The Carried Interest Problem* concludes that bifurcation, “while alluring and perhaps the most theoretically sound way to tax carried interests, is not compatible with the current compensation structure of most private equity and real estate partnerships.”¹⁴⁷ Incompatibility with the existing compensation structure, however, is a weak reason to discard the prospect of exploring a theoretical approach to disaggregation—and this Note takes up *The Carried Interest Problem*’s challenge.

This Part introduces the mathematical bifurcation model, designed to explicitly disaggregate a carried interest into its service and investment components, ex post, calling for taxation of each component accordingly and with deferral until distribution. This approach eliminates both the liquidity and uncertainty issues inherent in the Cost-of-Capital Method *and* the arbitrariness of the imputed interest rate used by both the Cost-of-Capital Method and modified Cost-of-Capital approach. Mathematical bifurcation takes a profits distribution, paired with the rate of accretion over the life of the fund, and works backward to determine—theoretically—what portion of that distribution represents gain from actual invested capital due to foregone midstream service income; in other words, mathematical bifurcation seeks an answer to the question, how much? As a proxy for foregone midstream service income, the model assumes that the GP receives an annual profits distribution (representing service income for that year) over the life of the fund and then immediately reinvests each annual “carry” in the underlying pool of capital. This Note posits that the GP should theoretically receive capital gains treatment only on the portion of a carried interest representing gains on actual invested capital. Mathematical bifurcation identifies that portion of a carried interest.

Granted, when analyzed ex post, a fund could hypothetically have appreciated at any number of different rates across a continuously varying time period. The assumptions made about how quickly a fund grew and when it did will affect the theoretical composition of the carry.¹⁴⁸ As it turns out, the assumption

145. Note, *supra* note 8, at 1791.

146. *Id.*

147. *Id.*

148. For instance, consider a three-year fund that grows at a total rate of 10% and distributes all profits to the GP. If we assume that the fund grew 10% in year one, we would

that maximizes that portion of a carry characterized as capital gain, and thus the most favorable assumption from the taxpayer GP's perspective, is straight-line growth over the life of the fund.¹⁴⁹ In addition to assuming straight-line growth, this Part incorporates all reasonable assumptions most favorable to the taxpayer to demonstrate the implications of explicit disaggregation in the best-case scenario for the GP.

B. *The Mathematical Bifurcation Model*

Mathematical bifurcation disaggregates a carried interest into two components: service income and investment income—that is, income from actual invested capital. The model simulates a world in which the GP receives a profits distribution each year, as service income, and then reinvests that service income as capital in the fund, earning investment income from growth on that capital each year for the remainder of the fund's life (and then, in the process, further reinvesting the investment income as capital). The GP's invested capital represents foregone midstream income to the GP, which accumulates over the fund's life, alongside an increasing return of investment income. Upon fund liquidation, the GP receives a lump profits distribution in accordance with its carried interest, consisting of service income plus investment income. Mathe-

treat the GP as having received ordinary income in year one and zero income of any kind in years two and three—consequently, all of the carry would be taxed as ordinary income and deferred to the end of year three, and none would be taxed as capital gain. We reach the same result if we assume the fund experienced no growth in years one and two, and then grew 10% in year three. Varying the interim growth pattern of the fund will vary the composition of the carried interest between service income and investment income.

149. Straight-line growth maximizes annual invested capital relative to annual growth in each year, thus maximizing the investment component relative to the service component overall. Consider a \$100 fund that grows 33.1% over three years with a 20% carried interest under various interim growth patterns:

Growth Pattern	Year 1	Value at Year 2	Year 3	Total Growth	Total Carry	Service Component	Investment Component
<i>Straight-Line</i>	\$110.00 (10.0%)	\$121.00 (10.0%)	\$133.10 (10.0%)	\$33.10 (33.1%)	\$6.62	\$6.496	\$0.124
<i>Front-Heavy</i>	\$120.73 (20.7%)	\$126.76 (5.0%)	\$133.10 (5.0%)	\$33.10 (33.1%)	\$6.62	\$6.525	\$0.095
<i>Back-Heavy</i>	\$105.00 (5.0%)	\$110.25 (5.0%)	\$133.10 (20.7%)	\$33.10 (33.1%)	\$6.62	\$6.525	\$0.095
<i>Middle-Heavy</i>	\$105.00 (5.0%)	\$126.76 (20.7%)	\$133.10 (5.0%)	\$33.10 (33.1%)	\$6.62	\$6.524	\$0.095
<i>Middle-Light</i>	\$115.00 (15.0%)	\$115.74 (0.6%)	\$133.10 (15.0%)	\$33.10 (33.1%)	\$6.62	\$6.521	\$0.098

mathematical bifurcation offers a theoretical basis for characterizing some specific portion of that lump distribution as service income and some specific portion as investment income.

The mathematical bifurcation model consists of the following three equations, where A represents the GP's aggregate income, S represents the GP's service income, and I represents the GP's investment income, for any year y , with carried interest rate C , on initial fund capital pool P , and at annual fund growth rate r :

$$\begin{aligned} A[y] &= C \times P((1+r)^y - (1+r)^{y-1}) \\ S[y] &= C \times r \left(P \left(1 + (r(1-C)) \right)^{y-1} + \left(\sum_{n=1}^{y-1} A[n] \right) (r(1-C)) \right) \\ I[y] &= C \times r \left(\sum_{n=1}^{y-1} A[n] \right) \end{aligned}$$

The first equation represents the GP's aggregate income A , for a given year y . That equation takes the total change in fund value during year y , denoted by $P((1+r)^y - (1+r)^{y-1})$,¹⁵⁰ multiplied by the GP's carried interest rate C , to arrive at aggregate income to the GP. This makes sense, because the GP is entitled to a carried interest (usually 20%) of total fund profits, which equal the total change in fund value over the life of the fund. The first equation simply provides a year-by-year breakdown of the GP's carried interest income in the aggregate—meaning service income plus investment income. The sum of the GP's accumulated invested capital from all previous years, calculated in year y , is represented by:

$$\sum_{n=1}^{y-1} A[n]$$

The second equation represents the GP's service income S , for a given year y . The service component consists of the total profits earned by the LPs in a given year y , multiplied by the GP's carried interest rate C . Once the fund is bifurcated, the LPs have two profit streams: first, the LPs enjoy a portion¹⁵¹ of the growth on the initial capital pool, denoted by $r(P(1 + (r(1-C)))^{y-1})$; and second, under the terms of the fee arrangement, the LPs also enjoy a portion¹⁵² of the growth on the GP's capital,¹⁵³ denoted by:

150. When we distribute initial fund value P , the left side of this portion, $P(1+r)^y$, corresponds to total fund value at the end of year y . The right side, $P(1+r)^{y-1}$ corresponds to total fund value at the end of the preceding year. The difference between these values equals total fund growth in year y .

151. The LPs' share in profits is equal to one minus the carried interest rate, or $(1-C)$.

152. Again, the LPs' share is $(1-C)$.

153. The LPs transfer to the GP a carried interest C , in *all fund profits*, including profits attributable to capital representing the GP's foregone (reinvested) midstream income. Prior considerations of bifurcation have overlooked this critical step. *See, e.g.,* Burke, *supra* note

$$r \left(\left(\sum_{n=1}^{y-1} A[n] \right) (r(1-C)) \right)$$

The second equation takes the sum of these two annual profit streams, representing total LP profits in a given year, multiplied by the GP's carried interest rate C , to arrive at the GP's total service income in a given year.

The third equation represents the GP's investment income I , for a given year y . That equation takes the sum of the GP's accumulated invested capital from all previous years, denoted by:

$$\sum_{n=1}^{y-1} A[n]$$

multiplied by the annual growth rate r , and the GP's carried interest rate C .

To illustrate mathematical bifurcation, this Subpart will borrow a simplified hypothetical fee arrangement from *The Carried Interest Problem*:

The GP is a pure service partner that contributes no capital to the fund but receives a 20% profits interest in the \$100 million of capital that the LPs contribute. The GP does not charge a 2% management fee, have a hurdle rate, or receive any midstream distributions. The partnership holds capital assets that appreciate at 10% annually for seven years. There are no midstream realization events, but the partnership realizes and distributes all gains at the end of the seventh year. At the liquidation, the partnership assets are worth \$195 million and the GP is entitled to \$19 million as a result of his 20% profits interest.¹⁵⁴

Thus, for the purposes of the model, C equals 0.2, P equals \$100,000,000, and r equals 0.1. For year one, the GP's aggregate income A , equals \$2,000,000,¹⁵⁵ the GP's service income S , also equals \$2,000,000,¹⁵⁶ and the

74, at 36-37. Burke sketches a "bifurcation" example to illustrate her discussion of the proposed § 710. In Burke's example, the GP receives a 20% profits interest in a three-year fund with an initial capital pool of \$100 and an annual growth rate of 100%. The GP receives a carry of \$20 in year one (20% of the fund's \$100 profit), \$40 in year two (20% of the fund's \$200 profit), and \$80 in year three (20% of the fund's \$400 profit). Burke characterizes the GP's income of \$40 in year two as \$20 in ordinary income and \$20 in capital gain from the capital reinvested by the GP after year one (100% growth on \$20); Burke applies the same logic to the GP's income in year three. *See id.* This is incorrect. After year one, the \$200 fund pool is bifurcated into "LP capital" of \$180 and "GP capital" of \$20. The GP is entitled to 20% of the \$180 growth on LP capital in year two as service income, or \$36, and 20% of the growth on GP capital as investment income, or \$4. Put another way, after year one, the GP has a 10% capital share in the fund (\$20 of \$200). Correspondingly, of the GP's \$40 income in year two, 10% is attributable to gains on actual invested capital, or \$4. Under bifurcation, therefore, the GP's \$40 income in year two represents \$36 in ordinary income and \$4 in capital gain.

154. Note, *supra* note 8, at 1783 (citation omitted); *see also* Fleischer, *supra* note 8, at 55 (posing a similar hypothetical).

155. $A[1] = 0.2 \times 100,000,000((1 + 0.1)^1 - (1 + 0.1)^0) = 2,000,000$.

GP's investment income I , equals \$0.¹⁵⁷ Beginning in year two, the GP begins to earn investment income on actual capital invested after year one. For year two, the GP's aggregate income A , equals \$2,200,000,¹⁵⁸ the GP's service income S , equals \$2,160,000,¹⁵⁹ and the GP's investment income equals \$40,000.¹⁶⁰ The model repeats this formula for each of the seven years of the fund's life, and the resulting bifurcated payment streams are presented in Table 1:

TABLE 1
Mathematical Bifurcation in
The Carried Interest Problem's Hypothetical (Year by Year)

	Service Income ¹⁶¹ (Ordinary Income)	Investment Income ¹⁶² (Capital Gain)	Total Carry
Year 1	\$2,000,000	\$0	
Year 2	\$2,160,000	\$40,000	
Year 3	\$2,336,000	\$84,000	
Year 4	\$2,529,600	\$132,400	
Year 5	\$2,742,560	\$185,640	
Year 6	\$2,976,816	\$244,204	
Year 7	\$3,234,498	\$308,624	
Total Income	\$17,979,473	\$994,868	\$18,974,342

Under a regime that treats only that income derived from actual invested capital as capital gain, the GP's \$19,000,000 carried interest in *The Carried Interest Problem's* hypothetical would represent about \$18,000,000 in ordinary income and about \$1,000,000 in capital gain. Interestingly, even assuming the

$$156. S[1] = 0.2 \times 0.1 \times \left(100,000,000(1 + (0.1(1 - 0.2)))^0 + (\sum_{n=1}^0 A[n]) (0.1(1 - 0.2)) \right) = 2,000,000.$$

$$157. I[1] = 0.2 \times 0.1 \times (\sum_{n=1}^0 A[n]) = 0.$$

$$158. A[2] = 0.2 \times 100,000,000((1 + 0.1)^2 - (1 + 0.1)^1) = 2,200,000.$$

$$159. S[2] = 0.2 \times 0.1 \times \left(100,000,000(1 + (0.1(1 - 0.2)))^1 + (\sum_{n=1}^1 A[n]) (0.1(1 - 0.2)) \right) = 2,160,000.$$

$$160. I[2] = 0.2 \times 0.1 \times (\sum_{n=1}^1 A[n]) = 40,000.$$

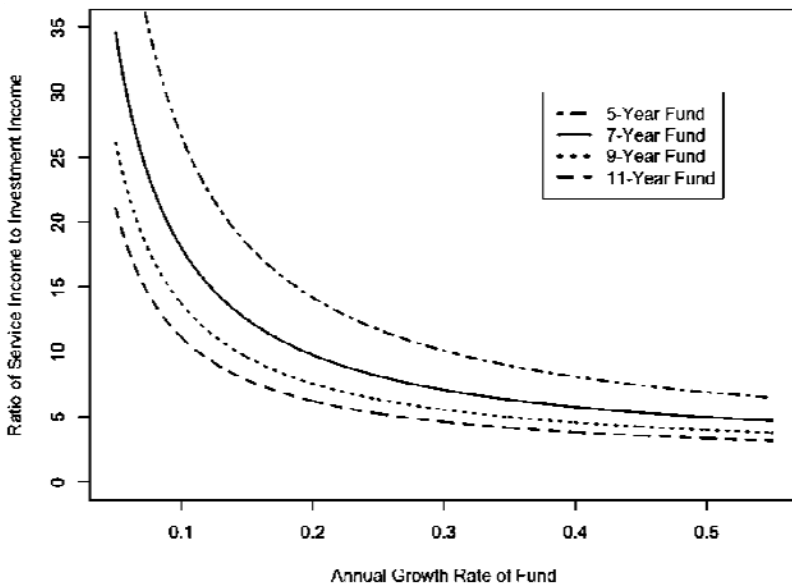
161. The values in this column reflect income to the GP attributable to services provided by the GP each year, on a year-by-year basis.

162. The values in this column reflect income to the GP attributable to gains from capital *actually invested* by the GP, accruing each year due to foregone (reinvested) midstream income from previous years, on a year-by-year basis.

most favorable growth pattern for the GP, mathematical bifurcation suggests a staggeringly high ratio of service income to investment income.

Figure 2 illustrates the ratio of service income to investment income in carried interests under mathematical bifurcation across varying fund durations and varying assumed annual growth rates. Generally, longer fund lives and higher assumed annual growth rates reduce the ratio of service income to investment income by allowing more time for the GP’s actual invested capital to appreciate, and at higher rates of appreciation. Nevertheless, even assuming unusually high growth rates in longer-term funds to demonstrate the best-case scenario from the GP’s perspective, the service component of a carried interest exceeds—by several multiples—the component from actual invested capital at all reasonable fund durations.¹⁶³

FIGURE 2
Mathematical Bifurcation Across Fund Duration and Growth Rate:
Ratio of Service Income to Investment Income Comprising 20% Carried
Interest in Self-Liquidating Funds Across Varying Annual Growth Rates



163. As Figure 2 indicates, even if an unusually long eleven-year fund were to grow at an impossibly high rate of 50% annually or higher, the ratio of service income to investment income would have a limit approaching about four or five to one.

C. *Mathematical Bifurcation Compared with Other Alternative Approaches and Applied to the Battle of Analogies*

In theory, mathematical bifurcation responds to every difficulty presented by the alternative proposals above. First, because it taxes the GP only upon the ultimate profits distribution, mathematical bifurcation solves the timing and valuation problems inherent in Fleischer's Cost-of-Capital Method and targeted by the modified Cost-of-Capital approach. Second, because the model draws upon actual fund performance from the ex post perspective, mathematical bifurcation does not suffer from the arbitrariness of imputed interest, which requires an approximate valuation of the GP's services to plug into the § 7872 calculus. Imputed interest may be a clever tool of fiction used to approximate service income—but mathematical bifurcation requires no such fiction. Finally, because the model deals with funds on a case-by-case basis rather than under preordained and forced disaggregation, mathematical bifurcation lacks the bluntness and rigidity of the 75/25 approach delineated in proposed § 710. With regard to the battle of analogies, mathematical bifurcation underscores that whether a carried interest more closely resembles sweat equity, an ISO, or an NQSO in economic form is less important than whether tax theory justifies a particular characterization of a carried interest's component parts.¹⁶⁴

Table 2 illustrates the disaggregation of the carried interest's components, as well as the present value of the carry to the GP at fund formation, in *The Carried Interest Problem*'s hypothetical under each of the alternative proposals discussed above in Part II:

164. For instance, sweat equity treatment employs a fixed service-income-to-investment-income ratio of zero to one; ISO and NQSO treatments employ varying ratios more similar to that called for under mathematical bifurcation.

TABLE 2
Disaggregation and Present Value Under Alternative Methods in
The Carried Interest Problem's Hypothetical

	Carried Interest	Service Component	Investment Component	Present Value of Carry ¹⁶⁵
Status Quo: All Capital Gains	\$18.97	\$0.00	\$18.97	\$8.86
Levin: All Ordinary Income	\$18.97	\$18.97	\$0.00	\$6.69
Proposed 710: 75/25 Compromise	\$18.97	\$14.23	\$4.74	\$7.23
Fleischer's Cost-of-Capital ¹⁶⁶	\$18.97	\$3.64	\$15.33	\$7.86
Modified Cost-of-Capital ¹⁶⁷	\$18.97	\$3.64	\$15.33	\$8.44
Mathematical Bifurcation	\$18.97	\$17.98	\$0.99	\$6.80

IV. PRACTICAL LIMITS OF REFORM

Admittedly, mathematical bifurcation responds to many of the difficulties presented in other alternative approaches only by suspending complicating factors that exist in reality. This likely renders mathematical bifurcation impossible in practice.¹⁶⁸ Recall, however, that this Note does not seek to provide a *practicable* alternative for taxing carried interests. Rather, it aims to offer a *theoretically* superior starting point for the carried interest debate, derived from the premise that income only from actual invested capital should receive preferential capital gains treatment.

165. To simplify for comparison, assume a flat tax rate of 39.6% on ordinary income and a 20% rate on long-term capital gains. See I.R.C. § 1 (2012). Further assume that a moderate 8% after-tax discount rate determines each regime's present value to the GP at fund formation. See Note, *supra* note 8, at 1783.

166. Assume an imputed interest rate of 2.60%. See Rev. Rul. 2013-11, 2013-20 I.R.B. 1059, 1060 tbl.1 (setting the applicable rate of interest on long-term loans prescribed by § 7872 for May 2013).

167. Assume an imputed interest rate of 2.60%. See *id.*

168. See Note, *supra* note 8, at 1791 ("With midstream distributions and other complications, backing out a single annual percentage could be prohibitively complicated.").

David Weisbach advocates maintenance of the status quo tax treatment of carried interests.¹⁶⁹ Under the “theory of line drawing,” Weisbach argues that any change in historical treatment would be at worst “easily avoidable” by sophisticated GP players, and at best “difficult and complex” to administer.¹⁷⁰ “Without examining the consequences [of reform],” he explains, “we cannot make good policy choices.”¹⁷¹

To the extent of his practicability argument, Weisbach is correct. This Note has suspended a number of complicating factors to arrive at mathematical bifurcation. In particular, the model ignores annual management fees, midstream payments, intrafund transfers, and other disruptive transfers that would render an ex post disaggregation of service income from investment income extremely difficult, if not impossible. A more complex mathematical model could certainly capture and account for these factors, but such a model would likely prove unfeasible from an administrative standpoint.

Regarding the application of line-drawing to the taxation of carried interests in general, however, Weisbach’s argument is unsatisfactory. Line-drawing appears to opt—somewhat tautologically—for the status quo, simply because changing the status quo requires changing the status quo. Other commentators describe line-drawing as “a jack-of-all-trades argument used in many tax debates” that “would apply to any change in the tax code.”¹⁷² Rather than engage the theoretical arguments for one approach over another, line-drawing avoids scholarly debate in favor of the easy way out.

Moreover, assuming—as Weisbach does—that a line must be drawn somewhere, mathematical bifurcation introduces a counterargument for opting to draw that line in favor of all-ordinary-income treatment instead of the status quo treatment. Line-drawing in favor of the status quo purports to head off administrative difficulty and tax avoidance. Practicably speaking, a carried interest comprises an amalgam of ordinary income and capital gain that is impossible to unravel. Even so, the model demonstrates that, in most cases, the investment component of a carried interest will be insignificant relative to the service component. Therefore, if administrative convenience is the chief aim of the line-drawing theory, perhaps line-drawing actually makes a stronger case for all-ordinary-income treatment, which accords with administrative ease, but offers the additional benefit of sounder theoretical footing.

169. See Weisbach, *supra* note 9, at 715.

170. *Id.* (italics omitted).

171. *Id.* at 718.

172. Note, *supra* note 8, at 1785.

CONCLUSION

The carried interest debate brings to mind the Heisenberg uncertainty principle: as we hold certain aspects of the problem constant through assumption, our observations and predictions become fundamentally imprecise because other aspects move and change.¹⁷³ To illustrate the explicit disaggregation of carried interest income, this Note assumes away many of the complexities inherent in private equity profits distribution fee arrangements. It likely does so to an extent that renders actual disaggregation impracticable. But sometimes we must pick our battles between theory and practice. This Note demonstrates that, if we assume income only from actual invested capital merits capital gains treatment, then the current tax treatment of carried interests is at odds with pure tax theory. Mathematical bifurcation answers the only relevant theoretical question with regard to capital gains treatment by showing that a carried interest is comprised of both income from services and income from invested capital—and that, in most cases, the investment component will be insignificant relative to the service component. The current debate over the taxation of carried interests, which sidesteps this theoretical question in favor of policy arguments about incentivizing entrepreneurial risk-taking and requiring “fair” financial contributions from fund managers to the public fisc, is largely conjectural. Mathematical bifurcation, while arguably unfeasible in practice, offers a valuable new theoretical starting point for the debate. From here, each side can specifically articulate, on policy grounds, why the tax treatment of carried interests should provide more or less incentive for entrepreneurial risk-taking and operational participation on the part of fund managers, or why it should require more or less financial contribution from fund managers, than is called for under a strict application of tax theory.

173. See *Uncertainty Principle*, *supra* note 12.

