
TAXING PARTNERSHIP PROFITS INTERESTS: THE CARRIED INTEREST PROBLEM

Profits interests in investment partnerships, colloquially referred to in the investment world as “carried interests,” “carry,” or “promoted interests,” are the focus of an intense tax debate that has recently been tabled, but not resolved, by the two-year tax compromise passed at the eleventh hour of the 111th Congress.¹ The most recent legislative attempt to address the carried interest issue through proposed section 710² may have failed,³ but the underlying problem is unlikely to be vanquished so easily.⁴ The ushering in of a new wave of federal legislators may grant Congress the ability not only to address the array of technical problems in proposed section 710,⁵ but also to improve the overall conceptual design of the proposed reforms.

Carried interests are often given to the general partners (GPs) of investment partnerships in exchange for their management of portfolio assets. Such carried interests entitle GPs to a share of the partnership profits, typically 20%.⁶ Traditionally, income from a carried interest is taxed under the established partnership tax principle that partners are taxed based on the character of their share of partnership income (either ordinary income or capital gains), rather than based on the character of the partner allocated such income (either active general part-

¹ See Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3296 (to be codified in scattered sections of 26 U.S.C.) (lacking any resolution to the carried interest question).

² References to “proposed section 710” correspond to the most recent version of the federal tax cut proposals proffered by Senate Finance Committee Chairman Max Baucus in September of 2010. See Job Creation and Tax Cuts Act of 2010, S. 3793, 111th Cong. § 402, sec. 710. Representative Sander Levin first introduced proposed section 710 in 2007 as H.R. 2834, 110th Cong. (2007), see Carol Kulish Harvey et al., *I Spy an ISPI: Expansive Breadth of Carried Interest Proposals*, 128 TAX NOTES 526, 528 & n.7 (2010), and later helped draft the better-known American Jobs and Closing Tax Loopholes Act of 2010, H.R. 4213, 111th Cong., see Harvey et al., *supra*, at 528 n.13. Many articles cited in this Note refer to the 2007 version of proposed section 710, which is substantially similar to the 2010 version.

³ Proposed section 710 was eventually omitted from the final enacted version of H.R. 4213, then on its seventh name, the Unemployment Compensation Extension Act of 2010, in July 2010. See Pub. L. No. 111-205, 124 Stat. 2236 (to be codified at 26 U.S.C. §§ 1, 3304). Proposed section 710 was also absent from the two-year tax compromise passed in December 2010. See 124 Stat. at 3296–3325.

⁴ The Obama Administration’s 2012 budget still includes a line item for “Tax carried (profits) interests as ordinary income.” OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, FISCAL YEAR 2012 BUDGET OF THE U.S. GOVERNMENT 186 (2011) [hereinafter 2012 U.S. BUDGET], available at <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/budget.pdf>.

⁵ See Mark P. Gergen, *A Pragmatic Case for Taxing an Equity Fund Manager’s Profit Share as Compensation*, TAXES, Mar. 2009, at 139, 149.

⁶ Samuel D. Brunson, *Taxing Investment Fund Managers Using a Simplified Mark-to-Market Approach*, 45 WAKE FOREST L. REV. 79, 80 (2010).

ner or passive limited partner).⁷ This fundamental partnership principle of pass-through taxation appears to yield an inequitable result: private equity GPs are taxed at long-term capital gains rates as low as 15% on partnership profits allocated to a carried interest, while the same amount of compensation structured as a salary would be taxed at ordinary income rates as high as 35%.⁸

Since a 2008 article by Professor Victor Fleischer questioned the current taxation of private equity carried interest,⁹ the issue has been unusually visible — at least for a tax issue — in the public press.¹⁰ As Fleischer presciently noted: “While the high pay of fund managers is well known, the tax gamesmanship is not.”¹¹ Though there is debate over whether taxing some investment managers at preferential capital gains rates is “gamesmanship” or valid recognition of the speculative nature of carried interests,¹² extensive media coverage nevertheless led to a series¹³ of failed legislative attempts between 2007 and 2010¹⁴ to close the carried interest tax “loophole” with proposed Internal Revenue Code section 710.

In relevant part, proposed section 710 would tax a fixed percentage of any partnership distribution to “service partners” of some partner-

⁷ See I.R.C. § 702(b) (2006); David A. Weisbach, Essay, *The Taxation of Carried Interests in Private Equity*, 94 VA. L. REV. 715, 719 (2008) (“[A] longstanding, central premise of partnership taxation holds that partners should be taxed as though they engaged in the partnership activity directly.”).

⁸ See John C. Coates IV, *Reforming the Taxation and Regulation of Mutual Funds: A Comparative Legal and Economic Analysis*, 1 J. LEGAL ANALYSIS 591, 606 (2009). The GP’s share is taxed at capital gains rates only if the income realized by the partnership is long-term capital gain, but private equity funds deal primarily with long-term investments.

⁹ See generally Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1 (2008).

¹⁰ For evidence, see, for example, 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, 117 & nn.1–2 (2008); and Marguerite Racher Snyder, Note, *Recasting Carried Interest: An Examination of Recent Tax Reform Proposals*, 84 IND. L.J. 1449, 1449–50 (2009). Warren Buffet observed that GPs pay lower taxes “than our receptionists . . . or our cleaning ladies.” Brunson, *supra* note 6, at 81 (2010) (quoting Andrew Ross Sorkin, *Putting a Bull’s-Eye on a Tax Loophole*, N.Y. TIMES, Mar. 10, 2009, at B1) (internal quotation marks omitted).

¹¹ Fleischer, *supra* note 9, at 5.

¹² See, e.g., Snyder, *supra* note 10, at 1462–65.

¹³ Increased taxes on carried interest are popular with sponsoring members of Congress because the estimated revenue increases could be used to offset unrelated spending increases. See Harvey et al., *supra* note 2, at 529. While the Obama Administration’s budget estimates the five-year revenue impact at about \$10 billion, Professor Michael Knoll calculates a seven-year impact of roughly \$3 billion. Compare 2012 U.S. BUDGET, *supra* note 4, at 186, with Knoll, *supra* note 10, at 140.

¹⁴ For a more detailed history, see Howard E. Abrams, *Taxation of Carried Interests: The Reform that Did Not Happen*, 40 LOY. U. CHI. L.J. 197, 211–12 (2009); Karen C. Burke, *The Sound and Fury of Carried Interest Reform*, 1 COLUM. J. TAX L. 1, 2 n.1 (2010); Alan D. Viard, *The Taxation of Carried Interest: Understanding the Issues*, 61 NAT’L TAX J. 445, 448–49 (2008).

ships¹⁵ at ordinary income rates, regardless of whether the original character of the income might have led to capital gains treatment.¹⁶ However, 25% of partnership assets are exempted from such recharacterization, so proposed section 710 represents a 75/25 compromise: 75% of the profits allocated to a GP based on a profits interest are recharacterized as ordinary income and 25% maintain their pass-through capital gains character.¹⁷ Even this partial recharacterization of pass-through income allocated to GPs flies in the face of the general principles of partnership law that all partners are treated equally and that income “passes through” the partnership conduit without interference or modification. Proposed section 710’s blunt solution to such a complicated problem triggered an outpouring of criticism.¹⁸ As technical criticisms are covered extensively elsewhere,¹⁹ this Note will focus on which method of taxation should be at the core of further carried interest reform attempts.

This Note argues that carried interest tax reform proposals must focus on disaggregating the GP’s remuneration into *both* a service-income component and an investment-income component. Carried interest cannot be characterized as *exclusively* service income or *exclusively* investment income. To ensure consistency with tax principles, amounts paid to the GP for management services should be taxed as

¹⁵ Proposed section 710 targets only “investment services partnership interest[s]” (or ISPIs), where a partner provides “a substantial quantity” of investment advice, asset management, or financing arrangement with regard to “specified assets,” including securities, investment real estate, commodities, and derivatives. Job Creation and Tax Cuts Act of 2010, S. 3793, 111th Cong. § 402, sec. 710(c)(1)–(2). For criticism of the breadth of this limitation of proposed section 710, see *infra* note 19.

¹⁶ See sec. 710(a)(1)(A) (“[A]ny net income with respect to such interest for any partnership taxable year shall be treated as ordinary income . . .”).

¹⁷ See *id.* sec. 710(g)(1), (g)(7)(A).

¹⁸ See, e.g., Abrams, *supra* note 14, at 227 (asserting that proposed section 710 is “a bad idea badly executed”); Burke, *supra* note 14, at 19, 43 (calling the proposal “theoretically flawed,” *id.* at 19, and noting that “Congress has barely begun to consider the myriad challenges of integrating § 710 with the already excessively intricate provisions of partnership tax,” *id.* at 43); Michael L. Schler, *Taxing Partnership Profits Interests as Compensation Income*, 119 TAX NOTES 829, 837–38 (2008); Memorandum from Stanley L. Blend, Former Chair of the Tax Section of the Am. Bar Ass’n, to Members of Congress (Nov. 13, 2007), available at <http://www.abanet.org/tax/pubpolicy/2007/071113commentshr2834.pdf>; Memorandum from David S. Miller, Former Chair of the Tax Section of the N.Y. State Bar Ass’n, to Members of Congress and Exec. Branch Officials (Sept. 24, 2008), available at <http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1166Letter.pdf>.

¹⁹ Many commentators criticize the complications proposed section 710 would produce in relation to the rest of the tax code. See, e.g., Howard E. Abrams, *A Close Look at the Carried Interest Legislation*, 117 TAX NOTES 961, 962 (2007); Schler, *supra* note 18, at 832–33. Others focus on proposed section 710’s targeted attack on *investment* partnerships. See, e.g., Howard E. Abrams, *The Carried Interest Catastrophe*, 128 TAX NOTES 523, 523–25 (2010); Abrams, *supra* note 14, at 223–27; Harvey et al., *supra* note 2, at 526; Amy S. Elliott, *Dormant Carried Interest Provision Could Have Broad Reach, Practitioners Warn*, TAX NOTES TODAY, July 30, 2010.

ordinary income, while income attributable to the GP's investment risk should result in only capital gains taxation. The reform regime that best fits the bill is a slightly modified version of Fleischer's Cost-of-Capital approach, which allows the GP to defer taxation until the occurrence of partnership-level realization events.

Part I briefly introduces the mechanics of partnership profits interests and their current taxation. Part II argues that proper disaggregation of the GP's compensation into a service-income component and an investment-income component should be at the forefront of any discussion on carried interest reform. Keeping the goal of disaggregation in mind, Part III canvasses the landscape of alternative proposals for taxing carried interest. In its conclusion, this Note suggests that a novel modified Cost-of-Capital approach best balances the strengths and weaknesses of the outstanding reform proposals.

I. THE MECHANICS OF PARTNERSHIP PROFITS INTERESTS

Carried interest is often presented as a private equity problem, but the debate implicates any investment partnership with long-term capital gains allocated to a profits interest. The term "private equity" refers to multi-million-dollar blocks of "private" capital from a limited number of wealthy investors or institutions, as opposed to the "public" money from unlimited numbers of investors holding exchange-traded, SEC-regulated securities.²⁰ Investors in private equity funds contractually limit their ability to withdraw their capital in order to allow the fund to invest in illiquid and long-lived assets.²¹ Thus, private equity is merely a loose term for a quickly growing investment sector²² that often holds assets for long periods and almost always uses the partnership organizational structure.²³ To review the taxation of carried interests properly, the discussion must be broadened to cover all investment partnerships that hold assets for long periods of time, whether strictly classified as private equity or not.

At the formation of any investment partnership, the general partner (who manages the partnership and its assets) and the limited partners (LPs) (who provide the partnership's capital) each receives interests in

²⁰ Most partnerships issue "interests" under Regulation D exceptions to 1933 Act registration requirements but face restrictions on the number, sophistication, and type of investors in the fund. See 17 C.F.R. §§ 230.501–.502 (2011); DAVID M. TOLL, PRIVATE EQUITY PRIMER vii (2005).

²¹ See Knoll, *supra* note 10, at 122 (clarifying that investment usually comes in the form of commitments to provide capital when opportunities are found (not in the form of immediate, up-front capital) and discussing the illiquidity of private equity funds).

²² For more details about private equity subcategories, see TOLL, *supra* note 20, at ii–vi.

²³ See PRIVATE EQUITY COUNCIL, PUBLIC VALUE: A PRIMER ON PRIVATE EQUITY 9 (2007), available at http://www.privateequitycouncil.org/wordpress/wp-content/uploads/pec_primer_layout_final.pdf.

the future profits of the partnership as determined in the limited partnership agreement (LPA).²⁴ The GP is often called the “service partner” because he²⁵ brings little to the table besides his management expertise and labor,²⁶ and the LPs are often called the “capital partners” because they contribute capital to the partnership and then have almost no involvement in its operation until they receive their money back. The IRS classifies partnership interests as either (1) capital interests, which were acquired by a capital contribution to the partnership and thus have an immediate liquidation value,²⁷ or (2) profits interests, which are rights to receive future profits that are not supported by a capital contribution.²⁸ In the private equity context, investment managers typically offer their services in exchange for 2% of the annual value of the partnership assets as an annual management fee (to keep the lights on)²⁹ and 20% of the eventual profits (to compensate them for their investment acumen).³⁰ This setup is the “two and twenty” pay structure after which Fleischer’s seminal article is named.³¹ The GP’s 2% management fee is taxed to the GP as ordinary income,³² limited by whatever offsetting ordinary business expenses the GP can deduct.³³ In contrast, the 20% share in the investment profits is currently taxed based on the amount of partnership profits allocated to the holder of the interest, not on the receipt of the interest itself.³⁴

A 20% profits interest, when granted to a GP at the formation of the partnership, is unambiguously an item of value that should be taxed as income under basic tax principles.³⁵ Indeed, if the GP were

²⁴ For more detail on private equity fund arrangement, see Adam H. Rosenzweig, *Not All Carried Interests Are Created Equal*, 29 NW. J. INT’L L. & BUS. 713, 716–20 (2009).

²⁵ Although the GP may sometimes be an entity rather than an individual, thinking of the GP as a single person clarifies the discussion.

²⁶ The GP often contributes a small amount of capital to the partnership as well. See Fleischer, *supra* note 9, at 8 (noting that LPs prefer the GP to have some “skin in the game” for incentive purposes (internal quotation marks omitted)). In fact, the GP was once required to contribute at least 1% of the starting capital to an investment partnership. See TOLL, *supra* note 20, at ix.

²⁷ See Rev. Proc. 93-27, 1993-2 C.B. 343 (“A capital interest is an interest that would give the holder a share of the proceeds if the partnership’s assets were sold . . . and then the proceeds were distributed in a complete liquidation of the partnership.”).

²⁸ See *id.* (“A profits interest is a partnership interest other than a capital interest.”).

²⁹ See Fleischer, *supra* note 9, at 23.

³⁰ See *id.* at 3.

³¹ See *id.* at 1.

³² *Id.* at 9–10.

³³ The GP could also be compensated with a salary, which would result in ordinary income taxation and a deduction at the partnership level for “ordinary and necessary” business expenses. Howard E. Abrams, *Taxation of Carried Interests*, 116 TAX NOTES 183, 184 (2007).

³⁴ See Fleischer, *supra* note 9, at 10–11.

³⁵ See I.R.C. § 61 (2006) (“[G]ross income means all income from whatever source derived”); Rosenzweig, *supra* note 24, at 722 (explaining that deeming a profits interest to have no value at issuance “is clearly a legal fiction; the carried interest must have some economic value to the GP since the GP accepted it in the first place and could earn substantial amounts in the future”).

to receive a 20% capital interest, he would simply be taxed on the readily ascertainable liquidation value of that capital interest under § 83 of the Internal Revenue Code.³⁶ However, unlike that of a capital interest, the liquidation value of a profits interest is zero. A profits interest's value is entirely speculative, based on later partnership profits that cannot be quantified at the partnership's formation.³⁷ Taxing the GP on the value of a profits interest at receipt is the most conceptually sound regime, but the impossibility of accurate initial valuation makes taxation at receipt practically unworkable.³⁸

In fact, even after the pivotal *Diamond v. Commissioner*³⁹ decision holding that the receipt of a profits interest is a taxable event,⁴⁰ the IRS promptly bowed to the administrative difficulty of valuing a profits interest ex ante and created the Revenue Procedure 93-27 safe harbor to prevent the receipt of a profits interest from qualifying as a taxable event.⁴¹ Even after the 93-27 safe harbor implicitly endorsed the idea that profits interests may be incalculable at receipt, much ink has been spilled in the debate over whether a profits interest can be valued fairly enough to allow the receipt of such an interest to be a meaningful tax event under § 83.⁴² However, other than the occasional claim

³⁶ Section 83 dictates that property received in exchange for services be taxed at ordinary income rates when fully vested (in other words, transferable or not at risk of forfeiture). See I.R.C. § 83(a); see also Treas. Reg. § 1.721-1(b)(1) (as amended in 1996).

³⁷ LPs often negotiate complicated and asymmetrical profit allocations to satisfy their cash flow and investment needs — making the valuation of a profits interest even more difficult.

³⁸ See Abrams, *supra* note 33, at 186.

³⁹ 492 F.2d 286 (7th Cir. 1974).

⁴⁰ *Id.* at 291. The court held that the granting of a 60% profits interest must be included in the taxpayer's gross income. The profits interest in an office building was unusually easy to price at receipt because the building was promptly sold soon after acquisition. See *id.* at 287-91.

⁴¹ There is a safe harbor from taxation on the grant of partnership interests that have zero current liquidation value (profits interests) and that are, inter alia, not related "to a substantially certain and predictable stream of income from partnership assets" or are not disposed of within two years of receipt. Rev. Proc. 93-27, 1993-2 C.B. 343. However, the safe harbor may not explicitly cover managers with both capital interests and profits interests. See Burke, *supra* note 14, at 10, 25 (claiming that the safe harbor "was arguably never intended to sanction the type of capital-gain conversion that prompted reformers' ire," *id.* at 25).

⁴² Section 83 allows for elective recognition of the fair market value at receipt, so a GP could elect to recognize a liquidation value of zero as the fair market value. See Andrew W. Needham, *A Guide to Tax Planning for Private Equity Funds and Portfolio Investments (Part 1)*, 95 TAX NOTES 1215, 1222 (2002). However, assigning a value of zero to a profits interest is quite different from being unable to value that profits interest. This distinction has been alluded to and criticized by many commentators. See Abrams, *supra* note 14, at 207 ("Taxpayers have argued for low, or even zero, initial values with surprising success."); Burke, *supra* note 14, at 10 (noting that "based on the confused state of current law" the government may not be willing "to challenge even patently erroneous valuations" (citing *Campbell v. Comm'r*, 943 F.2d 815 (8th Cir. 1991))). *But cf.* TAX SECTION, N.Y. STATE BAR ASS'N, REPORT ON PROPOSED CARRIED INTEREST AND FEE DEFERRAL LEGISLATION 27 n.72 (2008), available at <http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1166Report.pdf> ("Congress should limit the invested capital credit . . . to the lesser of the amount paid for the acquired interest or its liquidation value.").

that improvements in financial modeling or market valuation may allow the value of a profits interest to be estimated at receipt,⁴³ there is almost no support for forced ex ante valuation and taxation, regardless of how theoretically sound such a solution would be.⁴⁴ Instead, what remains is a second-best regime.

Such profit allocations, whether to capital interests or profits interests, are tracked in the partnership's capital accounts.⁴⁵ The capital account ledgers track how much of the partnership's current value "belongs" to each partner. Depending on whether objective valuations exist for partnership assets, some capital accounts may contain wildly speculative valuations, while others may contain known quantities. Hedge funds often estimate the value of assets annually (mark-to-market), while private equity partnerships do not readjust capital accounts or allocate the GP's carry until eventual realization events.⁴⁶

Partnership taxation centers on realization events at the partnership level, after which the partnership itself is merely a conduit for tax purposes.⁴⁷ GPs benefit from this conduit treatment, called "pass-through taxation," in two ways: First, partners are taxed on their share of partnership income only when a partnership-level realization event occurs, regardless of how long it takes for such an event to transpire or how many years go by before realized funds are distributed.⁴⁸ Due to the time value of money, the GP benefits from this deferral of taxation.⁴⁹ Second, realized partnership-level income retains its character (as ordinary income or capital gains) as it passes through the partnership to be listed on the tax returns of individual partners. If a partnership realizes capital gains, the gains are taxed as individual-level capital gains to the owners of both capital interests

⁴³ See Knoll, *supra* note 10, at 132–36 (using Black-Scholes option valuation, but simply assuming a value for the key input, volatility); Lee A. Sheppard, *Blackstone Proves Carried Interests Can Be Valued*, TAX NOTES TODAY, June 22, 2007.

⁴⁴ See, e.g., Abrams, *supra* note 14, at 211; Burke, *supra* note 14, at 27–30; Laura E. Cunningham, *Taxing Partnership Interests Exchanged for Services*, 47 TAX L. REV. 247, 256–61, 269 (1992) (claiming that taxing profits interests is "administratively infeasible," *id.* at 269); Fleischer, *supra* note 9, at 52 (arguing that the forced-valuation method would squeeze the "round peg of partnership equity into the square hole of § 83"); Schler, *supra* note 18, at 836–37; Viard, *supra* note 14, at 456 (labeling the taxation of carried interests upon receipt as "unsound" practice); Weisbach, *supra* note 7, at 733–35.

⁴⁵ See Treas. Reg. § 1.7041-(b)(2)(iv) (as amended in 2008) (discussing capital account requirements); Abrams, *supra* note 14, at 200–05 (giving an introduction to capital accounts).

⁴⁶ See Brunson, *supra* note 6, at 109 ("[P]rivate equity fund managers are not allocated their carried interest until the fund sells an investment and receives the money.")

⁴⁷ See I.R.C. § 701 (2006); JOINT COMM. ON TAXATION, PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS 20 (2007), available at <http://www.jct.gov/publications.html?func=startdown&id=1423> (giving an introduction to partnership taxation and the pass-through concept).

⁴⁸ See Abrams, *supra* note 14, at 203; Fleischer, *supra* note 9, at 12.

⁴⁹ See Fleischer, *supra* note 9, at 11–13.

and profits interests alike — in effect, the GP is treated identically to the LPs.

And therein lies the rub — the GP is treated like a partner, rather than like an employee. The GP benefits from both deferral of taxation until realization and pass-through character, but the pass-through character has been the primary focus of reform efforts (and rightly so). If the partnership realizes capital gains, the GP will receive capital gains remuneration in exchange for, at least in part, providing his *service* as a manager. Were the GP treated like an employee and paid with a cash salary rather than a profits interest, the GP would be taxed on his salary at ordinary income rates and would also be responsible for paying Medicare and Social Security taxes.⁵⁰ There is a stark discrepancy between taxing the GP at 35% (as an employee) and taxing the GP at only 15% (as a partner). Of course, merely comparing the two tax rates ignores the increased risk of a profits interest compared to the relative safety of taking a salary. In some sense, the “true culprit” behind the carried interest problem is the preferential long-term capital gains rate. Without such a preferential rate, there would be no difference between taxing the GP as a partner and taxing the GP as an employee, preempting the entire debate.⁵¹ Many have questioned the rationale behind a differential capital gains rate, but the preference is so well established as to be taken for granted here.⁵²

II. DISAGGREGATING SERVICE INCOME AND INVESTMENT INCOME

Much of the debate over the taxation of carried interests centers on the tension between two equally valid analogies often employed to explain what carried interests are “really like”: either an entrepreneur’s sweat equity or an investment advisor’s contingent bonus. The tax code has long included an implicit entrepreneurial subsidy for capital investment in the form of a lower capital gains tax rate.⁵³ Thanks to pass-through taxation, the GP’s profits characterized as capital gains at the partnership level are currently taxed as capital gains to the GP as an individual. On one hand, such capital gains treatment is justi-

⁵⁰ The GP’s compensation would no longer be entitled to the exclusion of capital gains from self-employment taxes, including Medicare taxes. See Chris William Sanchirico, *The Tax Advantage to Paying Private Equity Fund Managers with Profit Shares: What Is It? Why Is It Bad?*, 75 U. CHI. L. REV. 1071, 1110–12 (2008); Viard, *supra* note 14, at 458.

⁵¹ Philip F. Postlewaite, *The Taxation of Compensatory Profits Interests: The Blind Men and the Elephant*, 29 NW. J. INT’L L. & BUS. 763, 777 (2009).

⁵² See Noël B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319, 344–75 (1993).

⁵³ See Abrams, *supra* note 14, at 219–22 (“[T]he capital gain preference reduces the tax rate on returns to entrepreneurial risk to encourage risk taking.” *Id.* at 219). Compare I.R.C. § 1(h)(1)(C) (2006), with *id.* § 1(a)–(d).

fied because partnership success is largely based on the skill and hard work of the GP. The GP's carried interest has value only if the venture is sufficiently profitable⁵⁴ — thus, the GP's profits interest looks like founder's stock, or sweat equity.⁵⁵ On the other hand, the GP's profits interest looks like contingent bonus compensation paid based on value he created for his employer — thus, the GP should not escape ordinary income taxation due merely to his employer's ability to pay with a profits interest.⁵⁶

Key to solving the carried interest taxation dilemma is the understanding that both all-or-nothing analogies are only partly correct — there is no basis for choosing just one of the two extremes.⁵⁷ Those that advocate taxing the GP at ordinary income rates focus on the GP's provision of service to the partnership,⁵⁸ while those that defend the GP's access to pass-through capital gains treatment focus on the GP's exposure to investment risk.⁵⁹ Advocates for both positions are somewhat successful in their attempt to define GP compensation. However, as Professor Philip Postlewaite observed, such advocates are like blind men who each touch a different part of an elephant and “exclaim[] that the elephant is really something other than what it is.”⁶⁰

A better approach to comparing carried interest tax alternatives is to evaluate how well each alternative disaggregates the GP's income into a service component and an investment component.⁶¹ After disaggregation, each component fits squarely within existing tax prin-

⁵⁴ The GP may face more risk than the LPs because he must clear a hurdle rate before seeing any partnership profit at all. See JOHN RUTLEDGE, ANALYSIS OF THE IMPACT OF INCREASING CARRIED INTEREST TAX RATES ON THE U.S. ECONOMY: PART II 19 (2007), available at <http://www.uschamber.com/reports/analysis-impact-increasing-carried-interest-tax-rates-us-economy-o>.

⁵⁵ See Fleischer, *supra* note 9, at 44; Chris William Sanchirico, *Taxing Carry: The Problematic Analogy to “Sweat Equity,”* 117 TAX NOTES 239, 243 (2007) (explaining and rejecting the sweat equity analogy); Weisbach, *supra* note 7, at 730.

⁵⁶ Fleischer, *supra* note 9, at 50 (“Because of the quirk of the industry they work in, private equity fund managers pay tax at a lower rate . . . [T]here is no reason to believe that such activity needs a subsidy.”).

⁵⁷ Cf. Weisbach, *supra* note 7, at 741.

⁵⁸ See, e.g., Fleischer, *supra* note 9, at 51; Gergen, *supra* note 5, at 139.

⁵⁹ See, e.g., Abrams, *supra* note 33, at 188 (claiming that the “current law seems to reflect a fair set of compromises” and “ultimately reaches what is close to a proper result”); 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, 861–62 (2009); Postlewaite, *supra* note 51, at 765 n.7 (referring to himself, Abrams, and Weisbach as the “Gang of Three”); David A. Weisbach, *Professor Says Carried Interest Legislation Is Misguided*, 116 TAX NOTES 505, 508 (2007).

⁶⁰ Postlewaite, *supra* note 51, at 763.

⁶¹ See Burke, *supra* note 14, at 18 (introducing disaggregation and explaining that “a single profits stream would be divided annually into separate components consisting of labor return and investment return on reinvested implicit salary,” *id.* at 33). For definitions of service and investment in this context, see Weisbach, *supra* note 7, at 738–39.

principles (and the above analogies). The service component should be taxed at ordinary income rates as compensation for labor, while the investment component should be taxed at capital gains rates as return on “at-risk” capital.⁶² An approach that disaggregates the GP’s income results in more accurate taxation because it takes a lowest common denominator approach, where the correct tax principle is applied to each component. More importantly for political compromise, disaggregation allows the policy arguments for embracing either extreme to exist together, side-by-side. Adopting either extreme, to the exclusion of the other, leaves opposing arguments outstanding.

The current tax regime, viewed from a disaggregation perspective, essentially “rounds down” the service component of the GP’s income to zero and assumes that the entire remainder is properly classified as investment income.⁶³ When the current regime is expressed as such, the popular outrage at the current tax regime’s “loophole” is understandable. It is obvious that at least *some* service income must be a part of the GP’s compensation.⁶⁴ Likewise, a tax regime premised on the opposite principle — “rounding up” the service component of the GP’s income to 100% — would be problematic for the same reasons. Denying the GP capital gains treatment ignores the inherent risk associated with the GP’s carried interest⁶⁵ — the GP will make nothing from his profit interest if the partnership fails to reach a certain level of profitability.

The problem then lies in fairly and accurately disaggregating the two components of the GP’s income; indeed, perfect disaggregation may well be impossible.⁶⁶ However, addressing the carried interest problem from a disaggregation perspective provides a more constructive formulation of the dilemma than does an argument by analogy.⁶⁷ Even a mildly flawed attempt at disaggregation is better than getting bogged down in a fight over whether the GP is like an entrepreneur or an investment advisor. This Note proceeds to evaluate reform regimes

⁶² The myriad arguments for a regime that adopts either position are covered exhaustively elsewhere; this Note seeks to show that a combined approach is better than either alone. For arguments that carry should be taxed as ordinary income, see Fleischer, *supra* note 9, at 25–26; Gergen, *supra* note 5, at 139–41; and Snyder, *supra* note 10, at 1463. In contrast, for arguments in favor of taxing carry as capital gains, see Abrams, *supra* note 14, at 215–21.

⁶³ See Fleischer, *supra* note 9, at 41.

⁶⁴ See Abrams, *supra* note 33, at 187.

⁶⁵ To some extent, any solution to the carried interest problem should respect the decision to subsidize “entrepreneurial risk-taking” with a capital gains rate. See Abrams, *supra* note 14, at 219–20.

⁶⁶ See, e.g., Abrams, *supra* note 33, at 188 (“[T]here is no easy way to value the labor component of a carried interest.”); Burke, *supra* note 14, at 43 (suggesting that disaggregation may present a “fundamentally insoluble problem”); Weisbach, *supra* note 7, at 756 (“There is no way to draft laws or regulations that identify any potential service component to the capital allocation.”).

⁶⁷ Professor Adam Rosenzweig has suggested a holding period solution that is not discussed here. See Rosenzweig, *supra* note 24, at 735–46.

based on their ability to recognize that both service and investment components exist together in carried interest compensation.

III. TAXATION ALTERNATIVES

In surveying the many proposals to tax partnership profits interests, as this Part seeks to do, it is helpful to utilize a simple self-liquidating partnership example. The following illustration is borrowed from Fleischer, who employed a similar example in his comparison of reform alternatives⁶⁸: 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,⁶⁹ 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. Assume that ordinary income is taxed at a flat rate of 35% and long-term gains at a rate of 15%. Further assume that an 8% after-tax discount rate determines each regime's present value to LPs, the GP, and the IRS, shown in Table 1.

TABLE 1. PRESENT VALUES OF REFORM REGIME PROPOSALS
(MILLIONS)

	LP	GP	IRS
A. Unworkable Baseline: Valuation at Receipt	\$40.4	\$6.5	\$8.3
B. Status Quo: Pass-Through Capital Gains	\$37.5	\$9.4	\$8.3
C. Ordinary Income: Complete Recharacterization	\$39.7	\$7.2	\$8.3
D. Proposed Section 710: 75/25 Compromise ⁷⁰	\$37.5	\$7.7	\$9.9
E. Bifurcation: 20%, Annual Mark-to-Market ⁷¹	\$35.3	\$9.5	\$6.7
F. Cost-of-Capital: Annual Interest on Imputed Loan	\$37.5	\$8.4	\$9.2
G. Modified Cost-of-Capital: Including Deferral	\$37.5	\$8.7	\$8.9

Using this Note's framework, each regime discussed below can be seen as a different approach to disaggregating the GP's income into a service component and an investment component. After reviewing all

⁶⁸ Fleischer, *supra* note 9, at 55–57 (giving examples for some of the systems discussed here).

⁶⁹ A "hurdle rate" is a minimum rate that the partnership must return to LPs over the lifetime of the fund before the GP can participate in the upside.

⁷⁰ The LPs are denied a deduction under proposed section 710. See Bradley T. Borden, *Profits-Only Partnership Interests*, 74 BROOK. L. REV. 1283, 1313 (2009); Schler, *supra* note 18, at 838–39.

⁷¹ Note that the GP makes \$23.5 million if 20% is allocated annually and allowed to grow.

of the relevant regimes, this Note suggests that the best alternative is the cumulative Cost-of-Capital approach, which uses interest on a hypothetical loan as a proxy for the GP's service component.

A. The Unworkable Baseline: Valuation at Receipt

As mentioned above, the most conceptually sound regime would be to tax the value of the profits interest as ordinary income when it is first granted to the GP. This regime would treat profits interests given as compensation identically to capital interests given as compensation. Unfortunately, valuation of a profits interest is too difficult for such a "forced valuation at receipt" system to be workable in practice.⁷² Nonetheless, forced valuation is noteworthy as a baseline. In the above example, with perfect information that the GP's profits interest will eventually be worth \$19 million, the profits interest can actually be valued at receipt at \$11 million. Thus, the GP's present value, after being taxed at ordinary income rates in year one but receiving capital gains treatment on \$8 million of the \$19 million payout in year seven, is \$6.5 million.

B. The Status Quo: Pure Pass-Through Treatment

The current tax regime taxes all partners with distributional shares, capital and profits interests alike, equally. When partnership assets are sold, the GP includes his fraction of any proceeds on his individual tax return, just like the LPs. The character of the income realized in the partnership passes through to the GP, so the GP could be taxed entirely at capital gains rates if the partnership assets so dictate. In the above example, the GP's profits interest entitles him to a \$19 million share of the partnership's realized profits at liquidation. Under current tax law, the capital gains character passes through the partnership and, because the GP's basis in the profits interest is definitionally zero, the GP is taxed at long-term capital gains rates on the entire \$19 million share. The present value of the GP's \$16.1 million after-tax profit, at the formation of the partnership, is \$9.4 million.

Commentators criticize the status quo, in large part, for fairness reasons. The GP, who primarily contributed labor in exchange for the profits interest, can escape at a tax rate lower than the rate paid on any salary greater than \$40,000.⁷³ While not all GPs are billionaire private equity moguls — family business partnerships and real estate investment partnerships use carried interest as well — taxing all income allocated to a profits interest as investment income is a large

⁷² See *supra* pp. 1777–78 (discussing the valuation problems arising from taxation at receipt).

⁷³ At \$40,000, the average single-filer income tax rate exceeds 15%. See I.R.C. § 1(c) (2006).

“giveaway” to any GP whose income is so favored.⁷⁴ In other words, the status quo suffers from a complete lack of disaggregation: all income allocated to the carried interest is assumed to be investment income.

Responses to this fundamental criticism vary in sophistication. The most unsatisfactory response, which is a jack-of-all-trades argument used in many tax debates, is that sophisticated practitioners would find a way around any alteration to the tax regime.⁷⁵ Without evidence of a specific workaround, however, such a broad argument would apply to any change in the tax code. Similarly unsatisfying is the suggestion that an altered tax regime would encourage private equity funds to move offshore: this claim ignores the fact that most partnerships invest domestically, so moving offshore would subject them to complicated foreign investor taxation and, perhaps, even higher overall taxation.⁷⁶

A more valid response to the fairness criticism, while highly self-aggrandizing,⁷⁷ is that a lower tax rate on investment activities incentivizes managers to enter this productive line of work, which spurs economic growth.⁷⁸ This response not only takes private equity’s positive externalities as given without much evidence, but it is also empirically dubious as a balancing matter. While it is certainly correct that there will be some reduction in private equity activity if private equity partnerships are taxed at a higher rate, there is no evidence that the foregone deals would benefit society more than altered taxation.⁷⁹ Moreover, Fleischer argues *against* the status quo on similar incentive grounds, claiming that the status quo distorts the market by encouraging venture capital investments at the expense of other socially desirable forms of investment in innovation.⁸⁰

In defense of the status quo, GPs of investment partnerships do have the kind of “at-risk” capital (their entire compensation) that justifies *at least some* capital gains rate treatment. Moreover, a significant benefit of the status quo is its ease of administration and smooth integration with the existing partnership tax regime. Ironically, the oft-

⁷⁴ Knoll, *supra* note 10, at 125; *see also* Fleischer, *supra* note 9, at 49 (claiming the status quo is a private equity “tax subsidy”).

⁷⁵ *See* RUTLEDGE, *supra* note 54, at 52.

⁷⁶ *See id.* at 13–14; *see also* Brunson, *supra* note 6, at 119–21; Rosenzweig, *supra* note 24, at 747–48.

⁷⁷ *See* Shrilaxmi S. Satyanarayana, Note, *Tax Equality: Eliminating the Low Effective Marginal Tax Rates for Private Equity Professionals*, 82 ST. JOHN’S L. REV. 1589, 1606 (2008) (relating the industry viewpoint that the status quo is “imperative for nurturing innovation and preserving the United States’ economic leadership”).

⁷⁸ For reasons why private equity plays such a significant role in the U.S. economy, *see* RUTLEDGE, *supra* note 54, at 33–36.

⁷⁹ *See* Satyanarayana, *supra* note 77, at 1592–93.

⁸⁰ Fleischer, *supra* note 9, at 24–26.

criticized “inequities” result only from consistent treatment of the GP and LPs. Any attempt at reform that recharacterizes partnership income as ordinary income could easily lead to unforeseen consequences within the already complicated partnership tax law, as is seen in the tangled provisions of proposed section 710.⁸¹ Such complications will certainly lead to a variety of greater administrative costs, while the current system, and its weaknesses, are a “known quantity.”⁸² Although changes to the status quo are often forecasted to increase tax revenues,⁸³ greater complexity could easily lead to even greater need for future reform if unforeseen partnership tax complications lead to further GP “loopholes.”⁸⁴

C. Ordinary Income: Complete Recharacterization

Professor Mark Gergen first suggested taxing the proceeds of all compensatory distributional shares as salary payments at ordinary income rates.⁸⁵ Gergen’s proposal was originally part of a larger scheme to limit the ability of partnerships to pay out profits in any fashion except pro rata by capital investment — essentially simplifying partnership payout provisions to make all taxation more transparent.⁸⁶ While this core idea has been adopted and adapted many times, all such derivatives center on entirely recharacterizing the GP’s share of partnership profits as ordinary income, regardless of that income’s original pass-through character. Recharacterization would burden the GP with self-employment taxes (Social Security and Medicare); however, it would also entitle the partnership to an accompanying deduction for salary expense, which would reduce the tax burden of any LP who pays taxes proportionately.⁸⁷

⁸¹ See Burke, *supra* note 14, at 43–44.

⁸² Fleischer, *supra* note 9, at 49.

⁸³ In part, proposed section 710’s forecasted revenue increase results from its denial of a salary deduction to offset the GP’s recharacterized compensation. See Burke, *supra* note 14, at 21. Total tax revenues would remain unchanged if a matching salary deduction was allowed and all LPs were in the same tax bracket as the GP. *Id.* at 4–5. In fact, however, most private equity LPs are non-taxable entities (such as pension funds and endowments) that could not make use of a deduction, so some revenue increase is certain to occur if GPs are taxed at a higher rate, even if the LPs are allowed a matching deduction. See Fleischer, *supra* note 9, at 17–18; Sanchirico, *supra* note 55, at 243–44. For more on GP/LP joint tax minimization, see Burke, *supra* note 14, at 7–18.

⁸⁴ Weisbach, *supra* note 7, at 755–63.

⁸⁵ See generally Mark P. Gergen, *Reforming Subchapter K: Compensating Service Partners*, 48 TAX L. REV. 69 (1992).

⁸⁶ See *id.* at 69, 105.

⁸⁷ See Knoll, *supra* note 10, at 129 (noting that “there would be no net change in tax collections from treating carried interests as current ordinary income [if one] assumes that the limited partners would pay tax at the same rate as the general partner”). Note that a substantial proportion of private equity LPs are nonprofits. *Id.*; see also *supra* note 83.

In the above example, the partnership's liquidating distribution to the GP of \$19 million would be recharacterized as ordinary income, and its capital gains character at the partnership level would be disregarded in order to recognize its use as compensation in exchange for the performance of services. Taxed at ordinary income rates on the entire \$19 million, the present value of the after-tax payments to the GP would be \$7.2 million. The present value of the GP's tax liability to the IRS would correspondingly increase to \$3.9 million. However, the LPs would receive a salary expense deduction of \$19 million, allowing them (assuming that the LPs are in the same tax bracket and have unrelated income) to reduce their tax burdens by the same \$3.9 million that the GP's tax burden increases. Thus, except to the extent that LPs cannot use their deduction, Gergen's proposal does not increase tax revenues; it just shifts value from the GP to the LP (unless the parties contract around such a shift).⁸⁸

There are many supporters, both principled and reactionary, of a method that treats allocations of income to a profits interest as ordinary income,⁸⁹ in part because such a method would bluntly end any capital gains treatment for the GP. While the solution lacks nuance, recharacterization is attractive because it appears administratively simple and revenue-increasing.⁹⁰ There are caveats to these seeming advantages, however. If the LPs are allowed salary deductions, which would be consistent with existing tax principles, then recharacterization does not actually increase revenue; it merely shifts wealth from the GP to the LPs by increasing the GP's tax and granting the LPs a matching deduction.⁹¹ Moreover, GPs could work around ordinary income taxation by merely increasing their percentage profits interest from 20% to whatever percentage ensures that the after-tax division between GPs and LPs has not changed.⁹² Fleischer notes that a loan-based system, like the Cost-of-Capital approach described below, is a workaround that could prevent recharacterization.⁹³ It is also worth noting that recharacterization would decrease the incentive for future GPs to manage investment funds if their after-tax compensation is re-

⁸⁸ See Knoll, *supra* note 10, at 129 (describing the neutral revenue impact if increased taxation on GPs is paired with a deduction for LPs at the same tax rate). See generally Sanchirico, *supra* note 50, at 1079, 1105.

⁸⁹ See, e.g., Fleischer, *supra* note 9, at 57-58; Satyanarayana, *supra* note 77, at 1617; Heidi Glenn, *Former Treasury Secretaries Weigh in on Tax Reform, "Carried Interest,"* TAX NOTES TODAY, June 12, 2007 (relating the comments of Lawrence Summers and Robert Rubin).

⁹⁰ See Fleischer, *supra* note 9, at 51.

⁹¹ See Abrams, *supra* note 33, at 188.

⁹² See Knoll, *supra* note 10, at 129 ("A shift of the tax burden away from limited partners and towards the general partner will likely lead the limited partners to grant the general partner a larger carried interest in order to compensate for the shift in the tax burden.").

⁹³ See *infra* pp. 1792-95; see also Fleischer, *supra* note 9, at 52-54.

duced. So, to whatever limited extent such funds are socially beneficial, increased taxation may be inefficient.⁹⁴

Complete recharacterization does respect the GP's ability to defer taxation until partnership-level realization events, focusing on the character of the GP's compensation rather than its timing.⁹⁵ However, while the approach recognizes the benefits of granting the GP a tax deferral, any use of recharacterization is still fundamentally at odds with the partnership tax regime's pass-through treatment of partner income allocations.⁹⁶ The recharacterization approach also ignores the fact that some portion of the GP's carried interest is "at-risk" capital. Making the same mistake as the status quo approach, but in the opposite direction, complete recharacterization lacks any hint of disaggregation, completely ignoring the existence of an investment component.

D. Proposed Section 710: Fixed 75/25 Ratio

Resembling Gergen's ordinary income regime, the most recent version of proposed section 710⁹⁷ also subjects "income with respect to" a GP's profits interest to recharacterization as ordinary income.⁹⁸ However, section 710's recharacterization applies only to 75% of such income. The remaining income is characterized as it was at the partnership level,⁹⁹ resulting in what is essentially a 75/25 compromise. Proposed section 710 also denies a deduction to the partnership for the salary expense, which drastically increases the revenue potential of proposed section 710 (in fact, one could easily conclude that the denial of a deduction is entirely for revenue purposes¹⁰⁰). The other intricacies of the proposed section's application have been exhaustively covered elsewhere.¹⁰¹

In the above example, the \$19 million in proceeds from the GP's distributive share would be disaggregated under a fixed 75/25 split. Approximately \$14.2 million of the GP's proceeds would lose the character passed through from the partnership level and be considered ordinary income, while \$4.8 million would retain the character obtained in the partnership level and be taxed at capital gains rates. The present value of the after-tax payments to the GP would be \$7.7 million. As a result of the denied salary expense deduction, tax revenue would be higher than it would be under any of the other proposals.

⁹⁴ See Fleischer, *supra* note 9, at 47–49 (discussing the entrepreneurship subsidy).

⁹⁵ See *id.* at 51.

⁹⁶ See Borden, *supra* note 70, at 1303–14.

⁹⁷ See sources cited *supra* note 14 (discussing proposed section 710's history).

⁹⁸ Job Creation and Tax Cuts Act of 2010, S. 3793, 111th Cong. § 402, sec. 710(a)(1)(A).

⁹⁹ See *id.* sec. 710(g)(7)(A)–(B) (covering applicable percentages).

¹⁰⁰ See, e.g., Burke, *supra* note 14, at 21; Snyder, *supra* note 10, at 1451 n.12.

¹⁰¹ See, e.g., sources cited *supra* note 19.

It is worth noting that proposed section 710's core 75/25 concept could be seen as crude, fixed-ratio disaggregation. Unlike the status quo, which assumes that 100% of the GP's payments are the result of investment, or Gergen's ordinary income solution, which assumes that 100% of the GP's payments are the result of service, proposed section 710 recognizes the dual nature of the GP's compensation. More reasoned attempts at disaggregation are described below, but the advantages of proposed section 710 should not be lost amidst the technical criticisms of its proposed implementation.

E. Bifurcation: Estimate Service Component with Capital Accounts

The bifurcation approach explicitly disaggregates the GP's compensation into an annual service component, based on new compensation in a given year, and an investment component, consisting of the returns on previous years' compensation implicitly reinvested in the partnership.¹⁰² The service and investment components are teased apart using the partnership's capital accounts, already maintained for other purposes.¹⁰³ These accounts are designed and intended to track partner profit allocations accurately for even the most complicated partnership agreements.¹⁰⁴ Each year's service income is treated as reinvested capital interest on which the GP earns investment income thereafter. Such bifurcation through the use of capital accounts recognizes that the GP is providing labor on behalf of another by taxing every dollar allocated to the GP's profits interest as service income. However, bifurcation also recognizes the GP's investment risk by allowing previously earned service income to be reinvested and later taxed at the lower capital gains rates.

At first glance, the bifurcation approach, which explicitly embraces disaggregation, appears to be a made-to-order solution to the carried interest problem. However, the approach relies on having accurate partnership asset valuations each year that can be used to reallocate partners' capital accounts.¹⁰⁵ There are two practical problems with

¹⁰² Bifurcation appears to have a complicated history, as many academics have discussed the concept in different forms. Professor Samuel Brunson's article is one of the most recent pieces on the topic, proposing a "simplified mark-to-market" approach. See Brunson, *supra* note 6, at 105–07. However, Professor Karen Burke also helped to popularize the term "bifurcation." See Karen C. Burke, *Fuzzy Math and Carried Interests: Making Two and Twenty Equal 710*, 127 TAX NOTES 885, 890 (2010). Burke soundly criticizes bifurcation, comparing it to what she calls a "cash salary reinvestment" plan. See Burke, *supra* note 14, at 33–41. Burke cites to Gergen, who has written several works about the capital account "revolution," see *id.* at 42 n.156, but it appears William S. McKee, a former member of the Office of the Tax Legislative Counsel at the U.S. Treasury, initiated the earliest discussions of the idea, see Mark P. Gergen, *The End of the Revolution in Partnership Tax?*, 56 SMU L. REV. 343, 346–47 (2003).

¹⁰³ See Treas. Reg. § 1.7041-(b)(2)(iv) (as amended in 2008).

¹⁰⁴ See Needham, *supra* note 42, at 1220–21 (discussing the purpose of capital accounts).

¹⁰⁵ See Burke, *supra* note 102, at 889.

an annual mark-to-market requirement that make bifurcation, as theoretically sound as it is, infeasible as a business matter. First, investment partnerships' mark-to-market practices vary tremendously depending on whether objective valuations exist for each partnership's assets. While hedge funds can, and often do, value their assets annually with some precision, private equity and real estate partnerships hold illiquid assets that cannot in practice be valued accurately until realization.¹⁰⁶ Implementing the bifurcation approach would require forced annual valuations that do not accord with the widespread industry belief that valuation of assets in illiquid partnerships would be unreliable at best and wildly speculative at worst. In fact, it has been suggested that capital accounts are "wholly inadequate" to police "understatement of compensatory return" and "self-serving misvaluations."¹⁰⁷ That being said, fears of GP capital account manipulation are likely overblown because misvaluations, either intentional or accidental, are restrained by objective liquidating sale values of partnership assets.¹⁰⁸ But regardless of the degree of abuse that would result, mandating annual mark-to-market for every investment partnership would result in a prohibitive increase in partnership administration and government enforcement costs.¹⁰⁹

Second, and more importantly, the bifurcation approach would require fundamentally altering the standard "two and twenty" pay structure used by the majority of private equity partnerships. Currently, private equity GPs are allocated their 20% of profits only when partnership realization events allow objective valuation; the profits are *not* allocated annually based on mark-to-market values.¹¹⁰ The above example illustrates the dilemma: The GP's 20% carry, determined at year seven after the liquidating realization event, should be \$19 million; however, were the GP's 20% carry set aside annually in the capital ac-

¹⁰⁶ See Brunson, *supra* note 6, at 109.

¹⁰⁷ Burke, *supra* note 14, at 33-34.

¹⁰⁸ Because the GP cannot change the actual value of the partnership through capital account manipulations, overvaluation of the GP's capital account must be corrected by eventual undervaluation, and vice versa. Under the bifurcation approach, every dollar needs to be "earned" as ordinary income before it can be reinvested at capital gains rates. The GP generally prefers consistent returns over returns with high variability, because extreme periods of partnership asset overvaluation that are followed by periods of corrective undervaluation will increase the service component of the GP's share of profits relative to the investment component. Using the above example to illustrate, the partnership assets must eventually be valued at \$195 million in the liquidating sale, so any misvaluations must converge on that value. A smooth investment return of 10% over the life of a seven-year partnership results in a 74/26 ratio of service to investment income; however, concentrating all the growth in one year would result in a year of 80% growth and six years of 1% growth (to ensure that the ending partnership value is only \$195 million), but such a pattern would lead to a 94/6 ratio, which is less optimal for the GP.

¹⁰⁹ See Burke, *supra* note 14, at 42.

¹¹⁰ See Brunson, *supra* note 6, at 109.

counts and allowed to accrue capital gains, the GP's total compensation would be worth \$24 million in year seven.¹¹¹ The present value to the GP of this greatly increased payout is \$9.5 million. To make an analogy to interest rate calculation, this difference in outcome is similar to the difference between compounding interest annually or daily — a more frequent compounding period increases the end payout. As such, the bifurcation approach untenably alters the GP's compensation.

As a mathematical matter, it is possible to take a known amount of carry (in the above example, \$19 million, or 20% *cumulative* return) and work backwards to determine the annual percentage required to produce that outcome (in the above example, 16% *annual* return). Such an approach has yet to be seriously considered even though it brings all the benefits of pure disaggregation, including a strong theoretical foundation and seamless integration with existing partnership tax law. Further exploration in this area may lead to a solid potential reform alternative; however, it is difficult to evaluate the efficacy of such an alternative without more details on implementation. With midstream distributions and other complications, backing out a single annual percentage could be prohibitively complicated. Moreover, a backward-looking bifurcation approach suffers from hindsight limitations, and thus loses some theoretical credibility. Essentially, a backward-looking bifurcation approach is nothing more than a justification for a list of tax rates based on a partnership's cumulative profitability.

In a limited fashion, the concept of bifurcation may implicitly reside in proposed section 710's earned income exception.¹¹² Professor Karen Burke has noted that some of the GP's previously earned income could retain pass-through characterization as a "qualified capital interest."¹¹³ However, any attempt to use the vaguely worded earned income exception to allow the GP to reinvest amounts already taxed as ordinary income would be subject to later government challenge.¹¹⁴ Moreover, many LPAs further limit the usefulness of any bifurcation approach by restricting reinvestment of realized midstream profits.

In the end, the bifurcation approach, 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.

¹¹¹ The difference is the accumulated growth on the GP's annual reinvestment of carry. For example, the GP's service payment from year one grew at 10% for six years.

¹¹² See Job Creation and Tax Cuts Act of 2010, S. 3793, 111th Cong. § 402, sec. 710(d)(1).

¹¹³ See Burke, *supra* note 14, at 34–35.

¹¹⁴ See Burke, *supra* note 102, at 891 (claiming that a broad earned income exception could "invite valuation abuses that the capital account system is not designed to police").

F. *Cost-of-Capital: Estimate Service Component with Interest Rates*

The Cost-of-Capital alternative is based on the economic equivalence between a 20% profits interest and a 20% capital interest purchased with an interest-free loan.¹¹⁵ Imagine that a GP were to purchase a 20% capital interest in the partnership using an interest-free, nonrecourse loan from an LP.¹¹⁶ A later pro rata partnership distribution would entitle that GP, who is now functionally a capital partner, to 20% of the partnership profits — just as though that GP held a profits interest. Likewise, partnership losses would fall entirely on the LP's shoulders because the loan is nonrecourse to the GP's personal assets — just as though the GP held a profits interest. The interest-free loan creates a *synthetic* profits interest, which acts like a profits interest but would be formalistically classified as a capital interest. Under § 7872 of the Internal Revenue Code,¹¹⁷ the GP would have ordinary income in the amount of the annual interest payments “forgiven” by the LPs.¹¹⁸ Employing this forgiven-interest logic, Fleischer suggests that profits interests be taxed on their “cost of capital.” Thus, profits interests would be taxed *as if* they were capital interests supported by loans from the LPs where annual interest payments were forgiven.¹¹⁹

In the above example, the GP would be taxed annually on the forgiven interest associated with an imputed loan of 20% of the partnership's capital, which Fleischer calls the “cost-of-capital charge.”¹²⁰ The applicable rate of interest on long-term loans prescribed by § 7872 is currently 4%, so the GP with a 20% profits interest in a \$100 million partnership would be taxed annually at ordinary income rates on the \$800,000 cost-of-capital charge on the imputed \$20 million loan. When the GP eventually receives his \$19 million liquidating distribu-

¹¹⁵ Fleischer coined the term “Cost-of-Capital” and created the conceptual formulation described in this section, *see* Fleischer, *supra* note 9, at 39, but Professors Leo Schmolka and Laura Cunningham discussed the idea in earlier articles, *see* Leo L. Schmolka, Commentary, *Taxing Partnership Interests Exchanged for Services: Let Diamond/Campbell Quietly Die*, 47 TAX L. REV. 287, 302 (1991) (citing Cunningham, *supra* note 44, at 259, 262). A similar system, using a stock option analogy, was considered in a 2008 student note. *See* Note, *Taxing Private Equity Carried Interest Using an Incentive Stock Option Analogy*, 121 HARV. L. REV. 846, 858 (2008) (“[GPs] would be treated as having received a nonrecourse loan from the partnership that is forgiven — and therefore recaptured as ordinary income — to the extent that they receive distributions of profits.” (footnotes omitted)).

¹¹⁶ As Fleischer notes, “[a] nonrecourse loan is one where the creditor's recovery, in case of default, is limited to the collateral that secures the loan.” Fleischer, *supra* note 9, at 40 n.163.

¹¹⁷ I.R.C. § 7872 (2006).

¹¹⁸ *See* Schmolka, *supra* note 115, at 302–08 (suggesting that § 7872 for “compensation-related loans” should dictate rather than § 83).

¹¹⁹ *See* Noël B. Cunningham & Mitchell L. Engler, *The Carried Interest Controversy: Let's Not Get Carried Away*, 61 TAX L. REV. 121, 126–27 (2008); Fleischer, *supra* note 9, at 41–43.

¹²⁰ Fleischer, *supra* note 9, at 53.

tion, he would already have a \$5.6 million basis in his profits interest and would only be taxed on capital gains of \$13.4 million. The present value to the GP is \$8.4 million.

The Cost-of-Capital approach is an appealing alternative to taxing profits interests. By borrowing from § 7872, it simply applies an accepted method of taxation to two economically identical transactions (profits interests and capital interests supported by nonrecourse loans). The Cost-of-Capital approach is a source of revenue for the government because the salary expense deduction does not apply.¹²¹ A synthetic profits interest is the most likely workaround to avoid other taxes on a true profits interest, but adopting the Cost-of-Capital approach even preempts that workaround.¹²² Fleischer explained that any regime that allows LPs to make loans to the GP essentially establishes an *elective* Cost-of-Capital regime.¹²³ Proposed section 710 explicitly taxes LP loans to prevent such an “election.”¹²⁴

Most importantly, the Cost-of-Capital approach explicitly attempts to disaggregate the GP’s income by equating the value of the GP’s service with a “known quantity”: the amount of interest on a loan.¹²⁵ Fleischer explains: “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.”¹²⁶ By using a 20% loan as a proxy for the service required to earn a 20% profits interest, the Cost-of-Capital approach has a stronger theoretical justification than the status quo or recharacterization approach but avoids the host of annual asset valuation problems that weaken the bifurcation approach. The Cost-of-Capital approach disconnects the GP’s compensation from any unknown variables, making it a technically robust system.¹²⁷

One difficulty with implementing a loan-based system is determining a “fair” interest rate to use as a proxy for the GP’s labor. The

¹²¹ Forgiven interest payments are unlikely to be considered “ordinary and necessary” salary expenses for the partnership. See I.R.C. §§ 162, 707(a)(1); Abrams, *supra* note 14, at 223. But see Cunningham & Engler, *supra* note 119, at 130–31 (discussing the possibility that the GP could deduct interest payments as § 163(d) investment interest).

¹²² See Fleischer, *supra* note 9, at 57.

¹²³ Fleischer describes the “Talent-Revealing Election,” a hybrid regime wherein GPs can choose either a Gergen-like 100% ordinary income default rule or elect a Cost-of-Capital approach. *Id.* at 54–55. Because the election would make all extraordinary profits eligible for capital gains, “the election would be attractive to managers who expect to achieve high investment returns and unattractive to managers who are not so sure.” *Id.* at 54.

¹²⁴ See Job Creation and Tax Cuts Act of 2010, S. 3793, 111th Cong. § 402, sec. 710(d)(8).

¹²⁵ See Fleischer, *supra* note 9, at 41 (explaining that Cost-of-Capital implicitly allows “disaggregating the relative value of the returns on human capital”).

¹²⁶ *Id.*

¹²⁷ See *id.* at 53 (explaining that a GP’s annual income would be equal to the “market rate of interest times the percentage profits interest times the amount of capital under management”).

§ 7872 rate used in the preceding example above is clearly below-market for the level of risk of most investment partnerships and could be viewed as a giveaway to the GP.¹²⁸ 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.¹²⁹ Thus, charging the GP perfect-information market rates on the imputed LP loan would wipe out any later profit the GP expected to realize.¹³⁰ 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. Thus, any Cost-of-Capital system, either Fleischer’s or the one advocated by this Note, faces the challenge of finding a fair interest rate somewhere in the middle that captures the GP’s service efforts.

Despite its obvious strengths, the Cost-of-Capital approach has not been a serious contender for enactment, perhaps because it “over-fixes” the carried interest problem. Fleischer designed the Cost-of-Capital regime to address *both* of the benefits that the GP receives from partnership tax treatment: pass-through characterization of income and deferral of taxation until partnership-level realization events. Addressing both character and timing requires both disaggregation *and* forced annual taxation. Disaggregation addresses the valid concern that GPs may be paid with capital gains on service income that should be taxed at ordinary income rates. However, forced annual taxation seeks to prevent GPs from deferring taxation until gains are realized, which may actually be a strength — not a weakness — of the status quo. Deferral removes any doubt that taxable value has been allocated to the GP’s profits interest, while annual taxation may result in the GP being taxed even while the partnership is losing money. In the above example, the GP would pay annual tax bills of \$300,000, regardless of the profitability of the partnership and, by implication, regardless of the later value of the GP’s profits interest.

With regard to consistency with existing partnership tax principles, the Cost-of-Capital approach is something of a mixed bag. By taxing an imputed loan rather than recharacterizing the GP’s income, it is broadly consistent with existing partnership tax principles of pass-through characterization of income and equal treatment of partners.¹³¹

¹²⁸ See *id.* at 53 & n.208.

¹²⁹ See Schler, *supra* note 18, at 835–36.

¹³⁰ See Knoll, *supra* note 10, at 150–51 (“In order to provide the limited partners with a market return on the loan . . . the general partner/borrower must pay any and all profits on its 20 percent interest to the limited partners/lenders.” *Id.* at 151.)

¹³¹ Consistency with existing partnership tax principles is necessary, in part, to reduce complications and prevent additional room for workarounds. See *supra* note 19 (citing scholars who discuss proposed section 710’s complications and inconsistencies with existing law).

However, by taxing the GP annually, it introduces an element of accrual logic into partnership taxation without great support.¹³² As Fleischer acknowledges, this additional accrual-type taxation leads to increased complications and administrative costs.¹³³

G. Cumulative Cost-of-Capital Approach: Deferral Until Realization

This Note proposes a modified version of Fleischer's Cost-of-Capital regime, in which annual interest payments may be deferred until partnership realization events. Moreover, the GP would pay cost-of-capital charges only up to the amount of partnership profits he is allocated through his profits interest. This proposal maintains the great strength of Fleischer's Cost-of-Capital approach: that the forgone interest on an imputed loan from the LPs to the GP is a proxy for the service component of the GP's income. However, by allowing deferral of taxation until realization, the GP's tax bill is better connected to his partnership's individual profitability and circumstances. Moreover, by not taxing the GP annually, this modified approach avoids accrual-type logic embedded in Fleischer's proposal, which would complicate the existing partnership tax regime and create a liquidity problem for GPs.

In the preceding example, the GP is allowed to defer any taxation until the final liquidating realization event. At liquidation, the GP would have cumulative cost-of-capital charges of \$5.6 million, resulting from seven years' accumulation of annual charges of \$800,000 (from § 7872's 4% interest applied to a profits interest of 20% on capital of \$100 million). Since the GP's profit allocation of \$19 million exceeds the \$5.6 million cumulative cost-of-capital charges, the GP would be taxed at ordinary income rates on the \$5.6 million in deferred income while the remaining \$13.4 million would be taxed at capital gains rates. The present value to the GP is \$8.7 million, larger than the original Cost-of-Capital amount by the time value of money inherent in deferral.

Like Fleischer's Cost-of-Capital approach, this modified formulation embraces a disaggregation principle by separating out a service income component to be taxed at ordinary income rates. However, allowing deferral of taxation until realization creates a tighter connection between the GP's tax burden and the partnership's profitability — when the partnership is not profitable, the GP will not get allocated profits, and thus the GP will not be taxed. It is important that the

¹³² See Fleischer, *supra* note 9, at 53 ("This approach results in a modified form of accrual taxation.")

¹³³ *Id.* at 54 ("[The Cost-of-Capital method] is . . . complex. It might be difficult for taxpayers and the IRS to administer.")

proxy for the GP's service be tied to profitability because profitability is the best measure of the GP's efforts.

Moreover, allowing deferral until realization provides for more seamless integration into existing partnership tax principles. The Cost-of-Capital approach would deviate from the current realization-based partnership tax system by adding annual accrual-based events. Waiting until partnership realization events to tax the GP would prevent this disjointed outcome. Similarly, the modified Cost-of-Capital approach is more administrable than the original Cost-of-Capital approach because it makes use of existing partnership tax procedures and avoids accrual-related complications.

Admittedly, allowing the GP to take advantage of deferral until realization events does reduce the revenue potential of the modified Cost-of-Capital regime. The government loses the benefit of smooth, periodic payments; however, that downside likely does not outweigh what otherwise represents a more feasible compromise solution to the carried interest problem.

CONCLUSION

In the time for reflection on the carried interest question made possible by the recently passed two-year tax compromise, Congress could replace the entire framework underlying the current reform proposal with a more rational regime that would better integrate with the existing partnership taxation scheme. Unfortunately, the most obvious choice of taxation regime — taxing the profits interest at the time of its grant — is not an option because initial valuation is impractical. Left to taxing allocations to the profits interest rather than the profits interest itself, the regime that most cleanly disaggregates the GP's compensation — capital accounts bifurcation — is also not an option because it does not fit the current private equity pay scheme.

A cumulative Cost-of-Capital regime, like the original Cost-of-Capital regime, uses the notional "forgiven interest" on an imputed loan from the LPs to the GP as a proxy for the service component of the GP's compensation. However, a cumulative Cost-of-Capital approach improves on the original Cost-of-Capital regime by deferring the GP's annual cost-of-capital payments until partnership realization events. Taken as a whole, the cumulative Cost-of-Capital approach fits better with disaggregation logic, is more theoretically justified, has lower administration costs, is a more feasible political compromise, and is less of a departure from the existing partnership taxation scheme than other reform proposals.