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# **SOPHISTRY, SITUATIONAL ETHICS, AND THE TAXATION OF THE CARRIED INTEREST**

*Darryll K. Jones\**

## **I. INTRODUCTION**

This Article is, in essence, a strident expression of indignation about what a majority of tax scholars and, indeed, legislators consider a glaring yet persistent inequity in the tax code. In short, sometimes extraordinarily well-paid fund managers receive compensation taxed at capital gains rates. All other, usually very much lower-compensated, service providers are taxed at ordinary rates. The result is clearly regressive and yet, as of late, even some respected and knowledgeable scholars—though still in the minority—have unabashedly set forth sophisticated-sounding justifications. Objections based on unfairness, real, or even merely perceived, are difficult to express without a tone of indignation, particularly when the objecting party feels the inequity personally. Thus, the Article occasionally uses rhetoric that is specifically intended to indict as well as to disprove. One simply cannot argue in support of a patently offensive outcome without expecting a strident response, even if the responder strains to express that response with the same degree of dispassionate sophistry utilized by proponents of the inequity. Perhaps apologies in advance are in order. In any event, Section II provides a summary of the indignation and a roadmap to the rest of the Article.

## **II. A SUMMARY OF INDIGNENT OBJECTIONS**

Section II initiates an overdue critical examination of the historical *status quo*, as well as a preview of the assertions contained in Sections III through V. It should be noted, parenthetically, that similar critical examinations are occurring not only in the United States but in other

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countries as well. The Dutch,<sup>1</sup> German,<sup>2</sup> and U.K. governments,<sup>3</sup> for example, have recently undertaken a critical examination of how the “carried interest” is taxed, no doubt in part due to popular recognition of the inequity described in this Article. In particular, this Section notes that the initial decision to afford what can only be described as a tax advantage, relative to the taxes imposed on other service providers, was motivated by expediency. There is evidence, in fact, that fund managers were aware that their tax advantage might legitimately be viewed as unfair. Historically, fund managers’ strategy in response to questions regarding why their compensation is currently taxed at capital gains rates was to remain silent and hope no one noticed.<sup>4</sup> This strategy prevailed, when the pooled investment fund model was in its infancy. At the time there were no arguments offered in support of taxing what amounts to transfers for services as though they were in exchange for capital. There was only silence and unrequited interview requests.<sup>5</sup> The period of “irrational exuberance,”<sup>6</sup> however, has now exposed to light what fund managers had

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<sup>1</sup> See BORIS EMMERIG & RODERIK BOUWMAN, CHANGES IN DUTCH TAXATION OF CARRIED INTERESTS SCHEMES (July 29, 2008), <http://www.dlapiper.com/files/Publication/4a35b91f-c3eb-42d9-9813-2450625812d2/Presentation/PublicationAttachment/ac4369d3-a315-42e7-a39a-3192a8536300/Change%20in%20Dutch%20taxation%20of%20carried%20interest%20schemes.pdf> (regarding proposed legislation to tax carried interest payments at fifty-two percent).

<sup>2</sup> Uwe Baerenz, Amos Veith & Ronald Buge, *How Carried Interest Is Taxed in Germany*, 25 INT’L FIN. L. REV. 30 (Supp. 2006), available at <http://www.iflr.com/Article/1984651/How-carried-interest-is-taxed-in-Germany.html> (describing the German “Carried Interest Act” subjecting carried interest payments to ordinary taxation rather than capital gains taxation).

<sup>3</sup> See SELECT COMMITTEE ON TREASURY, TENTH REPORT, 2006-7, H.C.567-I, available at <http://www.publications.parliament.uk/pa/cm200607/cmselect/cmtreasy/567/56709.htm> (questioning whether U.K. capital gains taxation of carried interest result in inequity and distortion); see also Robert Peston, *Tax and Private Equity*, BBC NEWS: PESTON’S PICKS, June 15, 2007, [http://www.bbc.co.uk/blogs/thereporters/robertpeston/2007/06/tax\\_and\\_private\\_equity.html](http://www.bbc.co.uk/blogs/thereporters/robertpeston/2007/06/tax_and_private_equity.html) (describing “the irresistible pressure to reform this system [i.e. capital gains taxation of the carried interest] in some way . . .”).

<sup>4</sup> See Peter Landau, *The Hedge Funds: Wall Street’s New Way to Make Money*, N.Y. MAG., Oct. 21, 1968, at 20, 22 (discussing hedge fund managers’ efforts to avoid publicity for fear that the “the Internal Revenue Service could change the provision in the tax laws that makes a hedge fund manager’s 20 per cent [sic] fee taxable at capital gains rates.”).

<sup>5</sup> *Id.*

<sup>6</sup> “Irrational exuberance” is a phrase famously uttered by former Federal Reserve Chairman Alan Greenspan at a 1996 lecture sponsored by the American Enterprise Institute for Public Policy Research. Alan Greenspan, Fed. Reserve Chairman, The Challenge of Central Banking in a Democratic Society, Address at the Annual Dinner and Francis Boyer Lecture of the American Enterprise Institute for Public Policy Research (Dec. 5, 1996) available at <http://www.federalreserve.gov/boarddocs/speeches/1996/19961205.htm>. He used the phrase with respect to a discussion of the illogical increase in asset values, which explains in part the increased flow of capital towards hedge, venture, and private equity funds that are the subject of this Article. See, e.g., Victor Fleischer, *The Rational*

preferred remained hidden in the dark.<sup>7</sup> Predictably and brazenly, those

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*Exuberance of Structuring Venture Capital Start-Up*, 57 TAX L. REV. 137 (2003) (describing “irrational exuberance” as the sort of ‘we can’t lose ethos’ that caused an over investment in hedge funds); Sanford M. Jacoby, *Finance and Labor: Perspectives on Risk, Inequality, and Democracy*, 30 COMP. LAB. L. & POL’Y J. 17, 19–21 (2008) (describing the abundant capital investments in hedge funds and private equity funds as “another case of irrational exuberance”).

<sup>7</sup> The exacting scrutiny paid to hedge fund and private equity fund manager compensation is largely a function of the huge flows of capital into such funds, a percentage of which were paid out as compensation to those fund managers. In 2007, for example, “the fifty highest-paid hedge fund managers . . . earned a total of \$29 billion.” Jacoby, *supra* note 6, at 23. When Professor Victor Fleischer published his now famous article exposing the fact that many fund managers earned over \$100 million taxed at capital gains rates (generally fifteen percent), the scrutiny became more intense in the media, in Congress, and even as part of the 2008 Presidential campaign. See Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1 (2008). Although Professor Fleischer’s article appeared in the Spring 2008 issue of the New York University Law Review, it was first published online in March 2006 in draft form at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=892440](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=892440). Soon thereafter, media outlets around the world began scrutinizing the taxing of fund manager compensation. See, e.g., Alan S. Blinder, *The Under-Taxed Kings of Private-Equity*, N.Y. TIMES, July 29, 2007, Bus., at 4; *Taxing Private Equity*, N.Y. TIMES, Apr. 2, 2007, at A1:

The deeper question in all this is whether capital gains—which are currently taxed at less than half the top rate of ordinary income—should continue to be so lavishly advantaged. The answer there is no. Today’s preferential rate for capital gains is excessive, with no mechanism in the tax code to ensure that it is not overused. Excessively favoring one form of income over another encourages wasteful gamesmanship, creates inequity and crowds out other ways to foster risk-taking. Tackling the too-easy tax terms for private equity is a good way for Congress to begin addressing that bigger issue.

See also *A Private Equity Primer: Just Why is Their Tax So Low?*, THE DAILY TELEGRAPH (UK), June 21, 2007, at 4; John Beveridge, *Taxing Times Ahead for the Hedgers*, HERALD SUN (Austl.), June 21, 2007, at 69; Peter Lattman, *Academic Gets His Close-Up In Private Equity Tax Fracas*, WALL ST. J., June 20, 2007. Media reports, in turn, led to Congressional scrutiny. See *Carried Interest Part I: Hearing Before the S. Comm. on Fin.*, 110th Cong. (2007), available at <http://finance.senate.gov/sitepages/hearing071107.htm>; *Carried Interest Part II: Hearing Before the S. Comm. on Fin.*, 110th Cong. (2007), available at <http://finance.senate.gov/sitepages/hearing073107.htm> (hereinafter *Carried Interest II*); *Carried Interest Part III: Pension Issues: Hearing Before the S. Comm. on Fin.*, 110th Cong. (2007), available at <http://finance.senate.gov/sitepages/hearing090607.htm>; *Fair and Equitable Tax Policy for America’s Working Families: Hearing Before the H. Comm. on Ways and Means*, 110th Cong. (2007), available at <http://waysandmeans.house.gov/hearings.asp?formmode=detail&hearing=584> (hereinafter *Tax Policy for America’s Working Families*). I testified at *Carried Interest II* and *Tax Policy for America’s Working Families*. See *Carried Interest II*, *supra*, (statement of Darryll K. Jones) available at <http://finance.senate.gov/hearings/testimony/2007test/073107testdj.pdf>; *Tax Policy for America’s Working Families*, *supra*, (statement of Darryll K. Jones) available at <http://waysandmeans.house.gov/hearings.asp?formmode=view&id=6431>. During the most recent presidential campaign, President Obama’s tax plan included a provision to reform the

who all along had benefitted in comfortable obscurity from the capital gain characterization, and despite the open acknowledgment that carry payments are wealth transfers *in exchange for services*, now argue that carried interest payments are instead returns on capital and therefore have all along been properly taxed as capital gain.<sup>8</sup>

If nothing else, the unexpected outing suggests the heretofore unacknowledged presence and influence of situational tax ethics. One might expect that those who now so argue (usually in sophisticated or semi-sophisticated economic terms), deny awareness of the historical facts suggesting that they knew better all along, or indeed, that they are at all influenced by the prospect that their own financial situation might suffer. It is also admittedly against academic convention that purists, those who insist on ordinary income taxation of the carried interest, might harbor suspicions that academic discourse is skewed by personal bias or interest.<sup>9</sup> Taxation, though, is as much an art as it is a science. It is therefore legitimate to acknowledge self interest and politics<sup>10</sup> as much as logic and tax

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taxation of profit interests. See OBAMA'08, BARACK OBAMA'S COMPREHENSIVE TAX PLAN (2008), available at [http://www.barackobama.com/pdf/taxes/Factsheet\\_Tax\\_Plan\\_FINAL.pdf](http://www.barackobama.com/pdf/taxes/Factsheet_Tax_Plan_FINAL.pdf) (promising to "[c]los[e] other loopholes: including taxing [profit] interest as ordinary income" (emphasis in original)). Eventually, the President's proposed 2010 budget included a provision to tax payments received with respect to carried interests as ordinary income. OFFICE OF MGMT. AND BUDGET, A NEW ERA OF RESPONSIBILITY: RENEWING AMERICA'S PROMISE 122 (2009), available at [http://www.whitehouse.gov/omb/assets/fy2010\\_new\\_era/A\\_New\\_Era\\_of\\_Responsibility2.pdf](http://www.whitehouse.gov/omb/assets/fy2010_new_era/A_New_Era_of_Responsibility2.pdf).

<sup>8</sup> See, e.g., David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 VA. L. REV. 715 (2008). Professor Weisbach's article, which was also read into the record of *Carried Interest II*, was funded by the Private Equity Council. See *Carried Interest II*, *supra* note 7 (testimony of Bruce Rosenblum, Chairman of the Board, Private Equity Council), available at <http://finance.senate.gov/hearings/testimony/2007test/073107testbr.pdf>.

<sup>9</sup> Scholarly tax discourse only rarely acknowledges personal bias or interest as a determinate or influencing factor of tax rules; more often, tax scholars insist on the "logic" or "science" of their preferences. See, e.g., Marjorie E. Kornhauser, *The Rhetoric of the Anti-Progressive Income Tax Movement: A Typical Male Reaction*, 86 MICH. L. REV. 465 (1987) (arguing, in essence, that objections to progressive tax rates are influenced by a masculine world view); Beverly I. Moran & William Whitford, *A Black Critique of the Internal Revenue Code*, 1996 WIS. L. REV. 751 (1996) (setting forth many examples in the tax code, the articulation of which is influenced by those with the most to gain from the provisions based on race). Professor Weisbach's article, for example, insists that there is no theoretical basis for capital gain taxation and hence no logic against which capital gain taxation of carried interests conflicts. David A. Weisbach, *supra* note 8, at 742–43. It is not my purpose in this Article to indict the personal motives of those who argue for the *status quo*. Instead, I seek only to insist that proponents are not entirely disinterested in the outcome. Professor Weisbach's article is the easiest example because it was "funded" by private equity fund managers whose taxes would increase by a change in the law.

<sup>10</sup> Howard E. Abrams, *Taxation of Carried Interests: The Reform That Did Not Happen*, 40 LOY. U. CHI. L.J. 197, 227 (2009). A discussion on the influence of the political process on the efforts to reform the taxation of carried interests is presented in Darryll K. Jones, *The Taxation of Profit Interests and the Reverse Mancur Olson Phenomenon*, 36 CAP. U. L. REV.

fundamentals. That is why it should surprise no one that what is often labeled tax policy or logic is hardly either.

The overarching assertion made in this Article—that arguments in support of the *status quo* cannot be explained by logic, reason, or deduction—is intended to allow readers to draw the conclusion implicit in the Article’s title. Indeed, so much has been written on the topic that it is unnecessary to recount the events culminating in the present state of affairs to any great extent.<sup>11</sup> History, as noted above, is not entirely irrelevant. Thus, Section III will briefly outline the expedient decision regarding the

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853 (2009). Professor Abrams states:

There are, it seems, three possible explanations for the failure of carried interest reform to have succeeded. First, it could be that private equity outfoxed reform-minded academics. Professor Fleischer framed the carried interest issue largely in class-warfare terms, with private equity and hedge fund managers as the bad guys. Somehow, by the time legislative reform was proposed, the change captured real estate partnerships as well. But the arguments in favor of reform fit less comfortably on such a broad class of partners, many of whom are not wealthy and almost all of whom vote. Had the legislation targeted only private equity funds and hedge funds, it is hard to see how it could have failed.

A second explanation is that Congress did not want it to succeed in the first place. As Professor Fred McChesney first recognized more than twenty years ago, legislators who seek to maximize the value of their legislative activity for themselves can threaten insular groups with disadvantageous reform and then collect economic rents in exchange for not passing the legislation.

Abrams, *supra*, at 227.

<sup>11</sup> The seminal article on the taxation of carried interests (before the coining of the phrase “carried interest”) is: Mark P. Gergen, *Reforming Subchapter K: Compensating Service Partners*, 48 TAX L. REV. 69 (1992). Similar discussion on the issue prior to the outing of carried interests can be found in other sources. See Martin B. Cowan, *Receipt of an Interest in Partnership Profits in Consideration for Services: The Diamond Case*, 27 TAX L. REV. 161 (1972); Laura E. Cunningham, *Taxing Partnership Interests Exchanged for Services*, 47 TAX L. REV. 247, 252 (1992); Leo L. Schmolka, *Taxing Partnership Interests Exchanged for Services: Let Diamond/Campbell Quietly Die*, 47 TAX L. REV. 287 (1992). More recent scholarships provoked by Professor Fleischer’s article include: Howard E. Abrams, *Taxation of Carried Interests*, 116 TAX NOTES 183 (2007); Thomas J. Brennan & Karl S. Okamoto, *Measuring the Tax Subsidy in Private Equity and Hedge Fund Compensation*, 60 HASTINGS L.J. 27 (2008); 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 (2008); Sarah Pendergraft, *From Human Capital to Capital Gains: The Puzzle of Profits Interests*, 27 VA. TAX REV. 709 (2008); 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 (2008); Michael L. Schler, *Taxing Partnership Profits as Compensation Income*, 119 TAX NOTES 829 (2008); Weisbach, *supra* note 8; Note, *Taxing Private Equity Carried Interest Using an Incentive Stock Option Analogy*, 121 HARV. L. REV. 846 (2008).

present law tax consequences applicable to the grant of an equity interest for services.<sup>12</sup> The relevant part of the sequential history is contained in the very apparent and continuing consensus that a service partner's efforts to characterize compensation for services as capital gain was so presumptively illicit that scarcely a word was said in that partner's defense. After having confirmed the illicit nature of those efforts, the Internal Revenue Service (IRS) decided as a matter of prosecutorial discretion, not logic, reason, or deduction, that it was not cost efficient to enforce the conclusion.<sup>13</sup> The first purpose of tax law, of course, is to raise revenue for public goods and services.<sup>14</sup> Insisting on the purist approach, as this Article does, was considered inefficient because the revenues derived from taxing service providers upon the grant of an equity interest was estimated as insignificant at best.<sup>15</sup> Section III explains that scholars resurrected the issue when circumstances changed such that the revenue to be derived from a purist's approach was much more significant.<sup>16</sup> Thus, when it became notoriously

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<sup>12</sup> Formally, the history is embodied in *Campbell v. Comm'r*, 943 F.2d 815 (8th Cir. 1991); *Diamond v. Comm'r*, 492 F.2d 286 (7th Cir. 1974); Rev. Proc. 2001-43, 2001-2 C.B. 191; Rev. Proc. 93-27, 1993-2 C.B. 343.

<sup>13</sup> "Prosecutorial discretion" is used because the substantive decision to tax the yield from profit interests as whatever characterization prevailed at the partnership level was made by statements of procedure. See Rev. Proc. 2001-43, 2001-2 C.B. 191; Rev. Proc. 93-27, 1993-2 C.B. 343.

<sup>14</sup> See PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, FINAL REPORT xiii (Nov. 1, 2005), available at [http://www.taxreformpanel.gov/final-report/TaxReform\\_ExSumm.pdf](http://www.taxreformpanel.gov/final-report/TaxReform_ExSumm.pdf) ("We have lost sight of the fact that the fundamental purpose of our tax system is to raise revenues to fund government.").

<sup>15</sup> See Knoll, *supra* note 11, at 128-29:

If the tax rates, both for ordinary income and capital gain, are the same for the general partner and for all of the limited partners, then there is neither a net benefit nor a net loss from the current tax treatment of carried interests. In such circumstances, reforming the taxation of carried interests—by treating receipt as current ordinary income and payment as current ordinary deduction—will not increase net tax collections. The additional tax collected from the general partner will offset the reduced tax collections from limited partners.

<sup>16</sup> *Id.* at 161 (estimating an increase in revenues from the reformation of carried interest taxation at amounts ranging from two billion dollars to three billion dollars per year). The Joint Committee on Taxation estimated that the changed character of carried interest payments would yield \$25.624 billion over the period from 2008 to 2017. J. COMM. ON TAXATION, ESTIMATED REVENUE EFFECTS OF THE CHAIRMAN'S AMENDMENT IN THE NATURE OF A SUBSTITUTE TO H.R. 3996 (2007) (a bill to tax carried interest payments as ordinary income), available at <http://www.house.gov/jct/x-105-07.pdf>. The primary reason for the change from no net revenue to roughly two to three billion dollars per year is that many of the investors in pooled funds are tax exempt and thus would not claim a deduction to offset salary payments in any event. See *id.* at 129. The President's 2010 budget proposal asserts that the change would generate approximately twenty four billion dollars between the years

apparent that managers of private equity funds and hedge funds earned huge amounts while paying lower taxes than lower paid service providers, situational ethics argued instead in favor of taxing recipients logically and in the most apparently equitable fashion. Section IV acknowledges that though market conditions have once again dictated that the revenues derived from adherence to purity may be paltry as a relative matter at the moment,<sup>17</sup> there has always been intrinsic value in the purist approach. Inevitably, sophistry and situational ethics induce mischief because the former is eventually exposed as such, usually by a clever tax planner who exploits the sophistry for personal gain, while the latter requires very frequent adjustment as tax abuses derived from the deviation from logic or economics evolve. The fundamental thread that should answer tax questions without the need for convoluted statutory explanation becomes frayed each time sophistry and situational ethics are allowed to trump fundamental principles. Reliance on momentary expediency costs more than it saves; what is characterized as an expedient exception eventually becomes normative if only by repeated application. More importantly, sophistry and situational ethics serve as indictments beyond the limited context to which they seem momentarily pragmatic. If, for example, the grant of an equity interest is correctly taxed as capital gain, what then should be said about the historical justifications for taxing wealthier capitalists more favorably than poorer laborers? In other words, the application of capital gain rates to the carry inexorably suggests that there is no logical justification for the application of lower tax rates to the return on previously taxed invested capital.<sup>18</sup>

Section IV confronts two of the more inventive arguments in favor of the *status quo*. The “blended labor/capital” argument<sup>19</sup> is an implicit

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2010 and 2019. See OFFICE OF MGMT. AND BUDGET, *supra* note 7.

<sup>17</sup> See *Top Hedge Fund Manager Reaped \$3.7 Billion in 2007*, CHI. TRIB., Apr. 17, 2008, at C6:

Average compensation for the top 25 fund managers was \$892 million in 2007, up 68 percent from the previous year. The minimum compensation included in the ranking was \$210 million, Alpha said. Those salaries may be a high-water mark for the \$1.9 trillion industry, which had its worst start in nearly two decades this year. Hedge funds lost 2.8 percent in the first three months after gaining 10 percent in 2007, according to Chicago-based Hedge Fund Research Inc.

The President’s budget projects no revenue gain for the years 2009 and 2010. OFFICE OF MGMT. AND BUDGET, *supra* note 7.

<sup>18</sup> See *Taxing Private Equity*, *supra* note 11; see also Jones, *supra* note 10, at 878 (predicting that investors who enjoy capital gain treatment recognize that the taxation of carried interests as capital gain jeopardizes their own preferential treatment and will join those who oppose the *status quo* if only to maintain their own preference).

<sup>19</sup> This argument has most recently been set forth in Philip Postlewaite, *Fifteen and*



admission that the yield from human capital ought to be taxed at a certain rate, regardless of the means of payment or the legal status of the service provider. The only real objection relates to the alleged complexities that would arise if the grant of, or yield from, a carried interest was accurately taxed. The “entrepreneurial risk” argument is deficient for several reasons, including the initial fact that the fixed portion of fund manager compensation eliminates any risk of loss.<sup>20</sup> That argument too, though, is situational. Were it the only assertion, we would then conclude that eliminating the “two” from the “two and twenty” justifies differential taxation of fund managers. Hence, the more fundamental and logical response to the entrepreneurial risk argument is that the parties ought to be left to freely allocate the risks as they see fit and that preferential taxation is justifiable only to the extent the market does not adequately produce a needed commodity because the risk to labor or capital is too high.<sup>21</sup> If it were proven that fund managers are so risk averse that the market cannot account for that aversion, preferential tax treatment of those scarce labor suppliers would be justified. That case has not and likely cannot be made.

Throughout, the Article sets aside arguments based solely on semantics. Thus, that a service provider may very well be referred to as “partner” under state and even federal law is of no logical consequence to the determination of whether the service provider ought to be taxed more favorably than a service provider who is not so labeled by any definition.<sup>22</sup>

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*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. (forthcoming 2009), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1297301](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1297301). Professor Weisbach makes a similar contention. See Weisbach, *supra* note 8.

<sup>20</sup> Postlewaite, *supra* note 19. Hedge fund and private equity fund managers are typically compensated via a formula commonly referred to as “two and twenty.” Fleischer, *supra* note 7, at 9–11 (stating that the two percent fixed fee pays the fund manager’s salary).

<sup>21</sup> See Brennan & Okamoto, *supra* note 11 (applying subsidy theory to the taxation of the carried interest and concluding that the *status quo ante* unnecessarily subsidizes hedge and private equity fund managers).

<sup>22</sup> The Revised Uniform Partnership Act defines a partnership (necessarily composed of “partners”) as “an association of two or more persons to carry on as co-owners a business for profit.” UNIF. P’SHIP ACT § 101(6) (1997). For a far-reaching discussion of the label and consequences of the term “partner,” see Robert W. Hillman, *Law, Culture, and The Lore of Partnership: Of Entrepreneurs, Accountability, and the Evolving Status of Partners*, 40 WAKE FOREST L. REV. 793 (2005). In tax jurisprudence, one of the most important cases considering the meaning of partnership and partners is *Comm’r v. Culbertson*, 337 U.S. 733 (1949). In that case, the Court stated that the existence of a partnership depends on whether the parties “really and truly intended to join together for the purpose of carrying on business and sharing the profits or losses or both.” *Culbertson*, 337 U.S. at 741. Although recognized experts suggest that the enactment of I.R.C. § 704(e)(1) significantly broadens the definition of “partner” for tax purposes, the issue is of no consequence in this article. See William S. McKee, William F. Nelson & Robert L. Whitmire, *FEDERAL TAXATION OF PARTNERS AND PARTNERSHIPS*, ¶ 3.02[1]–3.02[5] (1997). I readily concede for purposes of this Article that the recipient of a profit interest may legitimately be labeled a “partner”

The label “partner” adds nothing to the intellectual challenge that the *status quo* proponent(s) necessarily face. Likewise, the fact that the detailed rules spawned by Internal Revenue Code (I.R.C.) § 704(b) preclude a nominal increase in a service partner’s capital account,<sup>23</sup> reflective of her contributed human capital, is just as irrelevant and inconsequential to the question of the proper rate of tax that should be applied to the service provider’s newly acquired wealth. Section IV pauses on this point to note that the administrative dictate that service partners receive no credit to their capital account in return for services—services that are to be compensated via a share of future profits—is not entirely a matter of expediency, sophistry, or even situational ethics. Here, there is at least a fundamental populist reason for an accounting conclusion reflecting that the service provider has not yet incurred a tax liability. Thus, the Article does not take issue with the fact that a service provider who agrees to postpone her ability to consume (i.e., eat or spend presently) has no present tax liability. The Article’s contention is that the value of an equity interest attributable to the expenditure of human capital ought to be taxed at a certain constant rate, whether that human capital is expended by an “employee” or a “partner.”

Section V, the conclusion, states the positive case by reiterating the initially unquestioned instinct that like taxpayers should be taxed alike. Thus, Section V reiterates a principle—horizontal equity—that has animated tax law since society first determined that every person who benefits from the provision of public goods and services ought to contribute to that provision and that a just society requires an equitable distribution of wealth.<sup>24</sup> To the extent society determines that forced extractions are the price of civilization, it must make those extractions in a just manner. To extract more or less from equally benefiting persons is to extract unjustly. Ironically, the simplicity of the argument emboldens proponents. Implicit in their responses is that those who insist upon a simple and unquestioned rule of horizontal equity do not understand the alleged complexities of the

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under state or federal law. *See also* Rev. Proc. 2001-43 2001-2 C.B. 191 (requiring that a recipient of a profit interest be treated as a “partner” for federal tax purposes as a condition for receiving the dispensation articulated in the revenue procedure).

<sup>23</sup> Treas. Reg. § 1.704-1(b)(2)(iv)(a) (2008) (stating that a partner’s capital account may be increased solely for contributions of cash, property, or allocated gains).

<sup>24</sup> *See, e.g.,* David Elkins, *Horizontal Equity as a Principal of Tax Theory*, 24 YALE L. & POL’Y REV. 43, 43–44 (2006):

The principle of horizontal equity demands that similarly situated individuals face similar tax burdens. It is universally accepted as one of the more significant criteria of a “good tax.” It is relied upon in discussions of the tax base, the tax unit, the reporting period, and more. Violation of horizontal equity, while not necessarily fatal, is nevertheless considered a serious flaw in any proposed tax arrangement.

world that somehow requires deviation from that golden rule. Section V neither summarizes nor restates the task undertaken in the preceding parts. It is, rather, a plea of sorts. It leaves to the reader the intellectual freedom to conscientiously evaluate the merits of taxing a service provider labeled as a “partner” preferentially vis-à-vis a service provider labeled an “employee.” The conclusion is intentionally lacking in sophisticated economic analysis, relying instead on a simple, straightforward assumption with which the reader either agrees or disagrees.

### III. AN EXPEDIENT STATUS QUO

The development of the law pertaining to the taxation of the carry is, in a word, a story of expediency. This is an instructive point because proponents explicitly or implicitly reject the notion that capital gains taxation of carried interest arose by mistake rather than by intelligent design.<sup>25</sup> To admit the former would place the intellectual burden where it ought to be. To assert the latter gives the *status quo* an initial sense of legitimacy—the assertion is essentially a rhetorical tool that responds to and serves to discount the value placed on visceral emotion that horizontal equity has a preeminent place in tax jurisprudence.<sup>26</sup> Thus, it is a disagreeable notion that taxing one service provided preferentially to another could be justifiable. Expediency in tax jurisprudence is not without value, but because it is situational, it cannot replace enduring values in a body of law that is itself ultimately an expression of social values rather than the objective conclusion of economic science.<sup>27</sup>

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<sup>25</sup> See, e.g., Postlewaite, *supra* note 19 (manuscript at 30):

A fundamental misconception about the current tax law is that the investment of human capital under the Code generates ordinary income. As illustrated, much of the return on compensatory transfers of equity interests in an enterprise is taxed preferentially. In fact, a profits interest in a partnership frequently generates ordinary income while an equity interests in a corporation, if profitable, invariably results in preferential capital gain. Thus, the assertion that the treatment of profits interest is inconsistent with other compensatory transfers of equity interests is mistaken.

<sup>26</sup> Even proponents of the *status quo* accept the legitimacy of horizontal equity. They then either attempt to prove that the *status quo* meets the horizontal equity criteria, see *id.*, or that the concept of horizontal equity is a “baseless concept” and therefore of no use. See Weisbach, *supra* note 8, at 740.

<sup>27</sup> Sheldon D. Pollack, *Tax Reform: The 1980's Perspective*, 46 TAX L. REV. 489, 491 (1991). The author states:

Many of the problems with most contemporary analysis of the federal income tax can be traced to this untenable assumption that those policies conveniently lumped together under the rubric of tax reform are something other than the expression of

Generically, the grant of a carried interest is the promise to pay an uncertain amount in exchange for services. Even proponents admit this much. The right is neither funded nor secured.<sup>28</sup> Hence, even after prevailing in *Diamond v. Commissioner*,<sup>29</sup> the government nevertheless determined for administrative reasons that receipt of a right to receive indefinite wealth in exchange for services should not cause an immediate tax liability.<sup>30</sup> It is a mistake, though, to characterize that decision as one

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a particular political perspective, one that has its own agenda, favoring certain interests over others, and with its own constituency that derives considerable political satisfaction and benefits from success in the political arena. Tax reformism is political by nature precisely because *any* change (whether designated as reform or otherwise) to existing political institutions and extant legal structures has distinct political implications. The adoption of any significant change to the tax law constitutes a political act. Indeed, the very decision to adopt an income tax is a political decision of the highest order.

*Id.*

<sup>28</sup> Cf. Treas. Reg. § 1.83-3(e) (as amended in 2005) (defining “property” to “include[] real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future.”).

<sup>29</sup> 492 F.2d 286 (7th Cir. 1974). The facts of *Diamond* are easily stated and understood:

Sol Diamond agreed to arrange a \$1.1 million loan for Phil Kargman’s purchase of a building. In exchange, Kargman agreed that Diamond would receive 60% of the profits from their joint operation of the building. The joint venture agreement stated that Kargman would provide all the cash needed beyond the loan amount for the purchase of the building, and that proceeds of any sale of the building would be distributed to Kargman to the extent of his cash contribution. Any sale proceeds beyond Kargman’s repayment right (i.e., any profit) would be divided equally. Kargman eventually contributed \$78,000 in addition to the loan proceeds to the joint venture.

DARRYLL K. JONES, *THE THEORY AND PRACTICE OF PARTNERSHIP TAXATION* 37 (2d ed. 2007). Mr. Diamond sold his profit interest less than one month later, recognizing \$40,000 in short term capital gain. The government argued, and the Seventh Circuit agreed, that Diamond realized \$40,000 upon grant of the profit interest, taxable as ordinary income. *Diamond*, 492 F.2d at 286. For a thorough discussion of the current doctrinal rules pertaining to the grant of a “profit interest” (i.e. a vested right to share in the future profits from business activity), see JONES, *supra*, at 36–44.

<sup>30</sup> See Rev. Proc. 93-27, 1993-2 C.B. 343 (stating that the government would not tax a recipient of a profit interest, except in very limited circumstances); see also Abrams, *supra* note 11, at 185 n.15 (stating that the current rules with regard to the taxation of carried interests are based on administrative convenience and describing a conversation with a former IRS Chief Counsel confirming that position). Another commentator flatly asserts that both the IRS and the tax bar made painstaking efforts to avoid the issue altogether:

The desire of the IRS and the courts to avoid addressing the *Diamond* issue has been revealed on many occasions. Primarily, three approaches have been employed to avoid dealing directly with *Diamond*: (1) framing the issue as whether

dictated entirely by expediency, even if the subsequent consequences resulting in the *status quo* were unanticipated. Instead, the grant of a profit interest makes it necessary to determine what, precisely, the law as an expression of popular will means by “income.” As a reductionist matter, it may be legitimately concluded that income is a function of the increased ability to eat or spend.<sup>31</sup> That is, income occurs concurrently with an increase in eating or spending power. Timing is necessarily implicit in what society means by income. The mere financial appreciation in stored property rights, though it may represent income in a strictly economic sense, is not income in the populist sense because the owner has not yet taken steps or been presented with circumstances that increase her ability to eat or spend.<sup>32</sup> Instead, the more often asserted convention with respect to a carried interest is that the taxpayer has income but the alleged inability to precisely value that income justifies a rule pretending otherwise.<sup>33</sup> This, however, is an unnecessarily sophisticated means to an end. The receipt of currency is conventionally thought to eliminate valuation difficulties. Yet

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the service provider is an employee versus a partner; (2) focusing on the absence of value of the profits interest; or (3) characterizing the service provider’s contribution as *property* within the meaning of section 721.

Carolyn S. Nachmias, *Using Profits to Compensate a Service Provider—Potential Partnership Characterization*, 21 FLA. ST. U.L. REV. 1125, 1145–46 (1994).

<sup>31</sup> *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955) (defining income as “undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion”). In my efforts to reduce the meaning of income to a purest form, I have often asserted that income occurs when someone’s real and present ability to “eat or spend” has increased. In less reductionist terms, my view of income is influenced by the liquidity of that which is received. Though the receipt may have ascertainable value, the failure of liquidity—that is, the ability to personally utilize the receipt or convert it to something that can be personally utilized—seems to me sufficient to preclude application of the label “income” and thus the present imposition of tax liability. See, e.g., Sergio Pareja, *Taxation Without Liquidation: Rethinking “Ability to Pay,”* 5 WIS. L. REV. 841 (2008). Arguably, liquidity in monetary terms is already an explicit condition precedent to the present application of the term “income” because *Glenshaw Glass* included the phrase “clearly realized, and over which the taxpayer ha[s] complete dominion.” 348 U.S. at 431. See Deborah H. Schenk, *A Positive Account of the Realization Rule*, 57 TAX L. REV. 355, 360–65 (2004) (discussing the role of liquidity on the decision to impose or postpone taxation). The notion is presented here only in topical form because the article is not about the alleged deferral arising from the decision not to tax the grant of a profit interest. I am not attempting a complete exposition of the deferral issue here.

<sup>32</sup> See *Eisner v. Macomber*, 252 U.S. 189 (1920).

<sup>33</sup> In *Campbell v. Comm’r*, the Eighth Circuit Court of Appeals held that the inability to determine a precise value on a profit interest prevented the present imposition of a tax liability. 943 F.2d 815, 823 (8th Cir. 1991). Read together, then, *Diamond* and *Campbell* stand for the proposition that a profit interest is taxable compensation for services only when the compensation is capable of easy valuation. The significant point of this synthesis, though, is the recognition that the recipient receives compensation for human labor.

valuation is, in every non-cash transaction, a subjective matter. If valuation difficulties were indeed sufficient to postpone tax liability the law should do so in a host of other situations as well. Valuation, in other words, is an overly broad justification for the decision to forego immediate taxation. With respect to carried interests, the law ought to instead acknowledge the populist notion that it is simply not right to exact a payment from a citizen whose own consumptive ability has not yet matured. Deferral, defined as the present receipt of income coupled with an illegitimately postponed obligation to contribute to the public fisc,<sup>34</sup> does not result from the untaxed receipt of a profit interest for services. Even though the grant is capable of quantification in monetary terms,<sup>35</sup> it is not income as that term is popularly understood.<sup>36</sup> The point is not irrelevant; the question becomes whether the passage of time ought to transform the circumstances under which the receipt was granted into circumstances that justify taxation at a lower rate. That is, whether the circumstances preventing the application of the label “income” changes by the passage of time such that the rate that would have applied earlier should not apply at the later time when the ability to eat or spend has in fact objectively increased.

Historically, the law answered the latter question in the affirmative,<sup>37</sup>

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<sup>34</sup> The textual definition of “deferral” is often implicit in any discussion of tax deferral. See, e.g., Stephen B. Land, *Defeating Deferral: A Proposal for Retrospective Taxation*, 52 TAX L. REV. 45 (1996); Christopher H. Hanna, *Demystifying Tax Deferral*, 52 SMU L. REV. 383 (1999). The Judiciary, too, uses the term “deferral” in the same pejorative sense used in the text. See, e.g., *Ashland Oil, Inc. v. Comm’r*, 95 T.C. 348, 354 (1990):

Prior to the Revenue Act of 1962, Pub. L. 87-834, 76 Stat. 960, a foreign corporation controlled by U.S. shareholders was ordinarily not subject to U.S. tax on foreign source income. The income became subject to U.S. tax only when it took the form of dividends distributed to the U.S. shareholders. President Kennedy, in 1961, characterized this tax deferral as undesirable and advocated its elimination in developed countries and in situations involving low-tax jurisdictions known as “tax havens.”

Sometimes, of course, tax deferral is used to provide incentive for certain types of spending, as is the case with retirement savings. See, e.g., I.R.C. § 401 (2006). When used with respect to the carried interest debate, though, the phrase is most often used pejoratively.

<sup>35</sup> Lee A. Sheppard, *Blackstone Proves Carried Interests Can Be Valued*, 115 TAX NOTES 1236 (2007).

<sup>36</sup> Imputed income is a more often stated example of wealth left untaxed largely because populist notions do not include such wealth as income. See generally Thomas Chancellor, *Imputed Income and the Ideal Income Tax*, 67 OR. L. REV. 561, 605–09 (1988).

<sup>37</sup> Rev. Proc. 2001-43, 2001-2 C.B. 191; Rev. Proc. 93-27, 1993-2 C.B. 343. Even after the court in *Diamond* ruled that the grant of profit interest was a taxable event, most partnership tax attorneys, with the IRS’s implicit (if not explicit) consent simply ignored the ruling and continued to advise clients that no taxes were due upon grant of the interest. Jones, *supra* note 10, at 867.

but not because circumstances—those existing at the time eating or spending ability objectively increased—changed in any substantive way. Rather, because by the time the eating or spending power objectively increased, the recipient's semantic status changed from that of service provider (i.e. "employee") to that of owner (i.e. "partner").<sup>38</sup> By the mere change in labels occasioned by the passage of time, the taxpayer manufactured the ability to receive a preference based on factors unrelated to whatever substantive justification exists for the preferential treatment.<sup>39</sup>

Two points should be made explicit with regard to the foregoing analysis. First, populism may sometimes be the expression of an incorrect notion. There are notorious historical examples to prove that point. Slavery and segregation, for example, were populist notions incorrect from inception; so too was national socialism. That populism may ultimately be admitted as incorrect does not mean that populism is never a legitimate underlying source of correctness or that it is never "fair" or "right."<sup>40</sup> Quite

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<sup>38</sup> In most cases, the character of a partner's income is determined by analyzing the relationship between the income and the partnership, rather than between the income and the individual partner. I.R.C. § 702(b) (2008) states:

The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (7) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

<sup>39</sup> If a service partner is compensated by receipt of a share of the fund's profits, the character of that compensation is determined by reference to characterization of that amount vis-à-vis the partnership. *Id.*

<sup>40</sup> Populism is often asserted as a counter-weight to those whose sophisticated rhetoric is presumed to elevate the substantive correctness of their arguments. Professor Weinstein, for example, states:

The combination of socialism, capitalism, and populism intersected to form the "three categories" that [Stanley P.] Caine concludes lay at the heart of progressivism: "more direct democratic control over government, new forms of taxation to eliminate privilege and assure more equitable distribution of society's benefits, and the strict control (if not public ownership) of monopolies." In other words, although the Progressive Era is identified as roughly the first two decades of the twentieth century, it must be understood as the continuation of political conflict that significantly predates reformist political activism.

Jack Russell Weinstein, *On The Meaning of the Term Progressive: A Philosophical Investigation*, 33 WM. MITCHELL L. REV. 1, 7-8 (2006) (quoting Stanley P. Caine, *The Origins of Progressivism*, in THE PROGRESSIVE ERA (Lewis L. Gould ed., 1974)) (citations omitted). I make no effort to obscure the fact that the assertions in this Article are indeed populist notions precisely because I do not concede the idea that herd mentality or majoritarian indignation underlying the initial response to the taxation of carried interests is

the contrary is true. The tax code, despite its relationship to the science of economics, is an expression of populist ideals.<sup>41</sup> It is the minority, not the majority, of populist notions that are incorrect; though when populism runs amuck the circumstances can be dire. Proponents may be tempted to discount the foregoing discussion of populism as unworthy of consideration merely because a super-majority of citizens adhere to the belief embodied therein. This, though, is an over-indictment since laws are inevitably expressions of populist notions however much they may be articulated in high minded terms or obscured by little understood lexicon. Populism, the collective judgment of a super-majority, is more often right than it is wrong. Hence, one cannot simply discount the idea that the grant of a promise to pay speculative amounts in the future—though capable of monetary valuation and subject to trade—is not the proper occasion to levy a tax. That the grant is not immediately subject to taxation does mean the conclusion to forego taxation constitutes “deferral.”

The second point to be made in this regard is that the accounting convention indicating that the grant recipient’s receipt is valueless is just that—a convention expediently used to signal the decision not to impose taxation; it cannot logically be a record that a service provider has worked for nothing.<sup>42</sup> In *Diamond*, for example, the taxpayer entered into a joint effort to make money with another taxpayer.<sup>43</sup> *Diamond* contributed services—sweat equity<sup>44</sup>—to the joint effort; his services were both valuable in monetary terms and subject to market demand. The other joint venturer’s contribution consisted of approximately \$78,000. An accounting depiction of the joint venture’s balance sheet would appear as follows:<sup>45</sup>

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necessarily misguided. Instead, I tend to agree with Professor Weinstein’s further point that, “[p]opulism is not an economic theory in the same category as socialism and capitalism. However, as each of these theories carry within them presumed and preferred political structures, as well as implications for political participation, it seems reasonable to understand populism as a counter-force to the other two.” *Id.* at 7 n.30.

<sup>41</sup> See Pollack, *supra* note 27, at 491.

<sup>42</sup> Even the proponents of the *status quo ante* agree with this assertion. See, e.g., Weisbach, *supra* note 8, at 734 (2008) (“If we really wanted to put a number on the value of a profits interest, however, we could do so, and zero is clearly not the right number.”); see also Postlewaite, *supra* note 19 (manuscript at 15) (“the current approach under the Code is to value the property interest upon its receipt by the service provider and treat only that amount as a return on human capital in the year of receipt.”). Professor Postlewaite later asserts that service partners currently include the value of their partnership interest in income presumably to be taxed at ordinary rates, without addressing the accounting fiction that causes the income to be valued at zero. “Upon receipt, [service partners] are taxed on the basis of their current liquidation value . . . .” *Id.* at 26.

<sup>43</sup> *Diamond*, 492 F.2d at 286–87.

<sup>44</sup> See Chris Sanchirico, *Taxing the Carry: The Problematic Analogy to Sweat Equity*, 117 TAX NOTES 239, 240 (2007).

<sup>45</sup> See Treas. Reg. § 1.704-1(b)(2)(iv)(b) (2008) (regarding the capital accounting rules pertaining to partnerships).



Assets			Liabilities and Partner's Capital		
Real	<u>AB</u>	<u>BK</u>	Liabilities: 1,100,000		
Property	1,178,000	1,178,000	Capital:	<u>AB</u>	<u>BK</u>
			Diamond	0	0
			Kargman	78,000	78,000

Although, as an accounting matter, Diamond received no quantified ownership for his services, (as a result his capital contribution to the joint venture is depicted as zero) his services were most assuredly not worthless as an economic matter.<sup>46</sup> To conclude otherwise would be senseless. People simply do not consider their labor valueless; they do not work for nothing. Thus, the transaction's accounting depiction is misleading as a substantive matter, though temporarily useful as a tool to implement the decision to postpone taxation of Diamond upon the grant of his profit interest. As discussed in greater detail below, proponents argue that Diamond is, in fact, being taxed according to normative standards. It just so happens, they argue, that his earned income is zero.<sup>47</sup> Any further accretions, according to the argument, are not derived from his services but from his "invested" capital. That his invested capital is zero is a nonsensical but expedient convention upon which the argument to tax further accretions as capital gain is necessary. As pointed out above, it makes populist sense to conclude that Diamond's tax obligation is zero at the time the profit interest is granted; it makes no sense, however, to conclude that when the yield from the services is finally realized, it is not actually a yield from services but instead a yield from invested capital.

Nevertheless, in two administrative pronouncements issued after *Diamond*, the IRS concluded that Diamond's yield would be treated as the yield from invested capital and thus potentially taxed as capital gain rather than ordinary income.<sup>48</sup> The IRS made this decision in response to practitioners' assertions that valuation issues made the problems attendant to the accurate taxation of recipients insurmountable and therefore

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<sup>46</sup> *Diamond*, 492 F.2d at 287.

<sup>47</sup> Postlewaite, *supra* note 19.

<sup>48</sup> In *Campbell*, the Court rejected the government's effort to disavow *Diamond's* holding that the receipt of a profit interest for services provided to a partnership resulted in compensation taxed at ordinary income rates. 943 F.2d at 818. Nevertheless, the court stated that the profit interest was so incapable of valuation that taxation should not occur upon its grant. Significantly, the court left intact the earlier holding that the income should, at some point in time, be taxed as compensation to which ordinary rates applied. The problem to which the court devoted its attention was timing, not characterization of income. Rev. Proc. 2001-43, 2001-2 C.B. 191 and Rev. Proc. 93-27, 1993-2 C.B. 343 require that when payments with respect to a profit interest is finally included in income, that it be so included under the rules applicable to partnership taxation.

contributed to an unacceptable level of uncertainty in the tax code.<sup>49</sup> The point is relevant here because it belies the argument that service partners are “taxed” just like any other service recipient and therefore the taxation of carried interest is not an anomaly but rather consistent with the taxation of all other service recipients. The ultimate proof, then, is that there is no logical support for the claim that the taxation of carried interests is normative, since no other service provider anywhere in the tax code is considered as having worked for nothing. Valuation difficulties are instead met with the assertion that almost nothing is incapable of valuation.<sup>50</sup> To the contrary, service providers are normally treated as having received something of value, and only the yield from that previously taxed reinvested amount is taxed at preferential capital gains rates.

Finally, two situational factors should be recalled in explanation of the decision not to tax the grant of a carried interest as ordinary income. The first concerns the assumption that no revenue would be lost from assuming that the profit interest had no value at the time of its grant because the amount of income would precisely equal the deduction granted to the beneficiary of the service provider’s efforts.<sup>51</sup> Hence, taxing the recipient would necessarily imply the grant of a deduction to the other partners, which deduction would precisely offset any revenue from income inclusion. The second situational factor concerns the assumption that subsequent amounts paid to the service provider as a result of partnership operations would normally result from ordinary business operations, thus producing gains taxed at ordinary income rates.<sup>52</sup> Substantive analysis aside, these assumptions support a pragmatic determination—i.e., the tax equivalent of the exercise of prosecutorial discretion—to treat the grant of a carried interest as a nontaxable event and subsequent yields to the service provider as “partner” as inevitably characterized by reference to the partnership’s normal business operations.<sup>53</sup>

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<sup>49</sup> See Jones, *supra* note 10, at 867–71 (describing practitioner response to *Diamond*).

<sup>50</sup> See Treas. Reg. § 15A.453-1(d)(2)(iii) (1994) (stating that it is “[o]nly the rare and extraordinary” case that property cannot be valued). Tax law has long since expressed strong skepticism for the proposition that even a variable right to receive wealth is incapable of valuation. See generally Jeffery L. Kwall, *Out with the Open Transaction Doctrine: A New Theory for Taxing Contingent Payment Sales*, 81 N.C. L. REV. 977 (2003).

<sup>51</sup> Compare I.R.C. § 61(a)(1)(2009) (regarding the inclusion of compensation in gross income) with I.R.C. § 162(a)(1)(2009) (regarding a deduction for compensation paid). See also Knoll, *supra* note 11.

<sup>52</sup> See Adam H. Rosenzweig, *Not All Carried Interests are Created Equal*, 29 NW. J. INT’L L. & BUS. 713, 717 (2009) (noting that “hedge funds rarely hold investments for more than a short period of time or with any significant exposure to long-term price fluctuations” and thus are more likely to produce short term capital gain taxed at ordinary rates).

<sup>53</sup> In other words, since in most cases the yield to the carried interest (at least with regard to hedge funds) will normally be taxed as ordinary income, the law should not be so concerned with the theoretical possibility that the application of I.R.C. § 702(b) (2009) to the

Significantly, the record of the decision contains none of the justifications belatedly put forth by proponents in support of capital gain treatment of the value of carried interests, whether at grant or when the grant results in actual payment.<sup>54</sup>

It is impossible that any such justifications could be made, a point offered here to prove the implication of this Article's title. Capital gains rates have always been justified as a consequence of objective economics.<sup>55</sup> A very simple example suffices. Suppose a service provider earns \$100 (net after tax) during a time when annual inflation is six percent. The \$100 is previously taxed (or exempted) and, of course, should not be taxed again to the same taxpayer. If the taxpayer buys property for \$100, and after one year sells the property for \$106, she will reap and pay tax on six dollars nominal gain. This is the case even though she is no richer than when she invested the \$100 in the property one year ago. She has a nominal gain under I.R.C. § 1001 but no economic gain; her ability to consume is no greater than it was one year ago. Her \$106 endowment one year later gives her no more purchasing power than she had one year earlier. Thus, taxing the six dollars nominal gain amounts to an additional tax on the same accession to wealth.<sup>56</sup> The upshot of this economic result is that the

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carry recipient will result in service compensation being taxed at capital gain rates. The author notes, of course, that private equity funds typically hold investments for longer periods of time and thus are more likely to generate capital gain. I discuss this observation in greater detail below.

<sup>54</sup> *Diamond*, 492 F.2d at 287.

<sup>55</sup> See Noel B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319 (1993) (providing a comprehensive discussion of the reasons for capital gain taxation). Proponents of the *status quo* assert that tax law has never sufficiently defined the theoretical underpinnings of capital gain taxation. See, e.g., Weisbach, *supra* note 8, at 742 ("Unfortunately, there is little if any conceptual clarity governing the distinction between capital gain and ordinary income."). If this assertion is true, then the taxation of carried interests differently from other income is ultimately arbitrary and thus the case for preference is even weaker. Though the justifications for capital gain taxation may prove weak, they have nevertheless been identified and generally agreed upon at least since 1957. See Walter J. Blum, *A Handy Summary of the Capital Gains Arguments*, 35 TAXES 247 (1957). It therefore seems surprising, at best, and disingenuous, at worst, to claim conceptual obscurity with respect to the asserted reasons for capital gain taxation. See also Rosenzweig, *supra* note 52, at 725 n.55 (citations omitted):

It is arguable whether the capital gains preference is the optimal way to fulfill this policy, or whether it does so at all. . . . It is clear, however, that these are the stated policies for the capital gain preference and that the rules crafted with respect to it have been justified in this manner, regardless of their efficacy.

<sup>56</sup> Cunningham & Schenk, *supra* note 55, at 337 ("One of the principal arguments used to support the preference is that capital gains are largely inflationary. To that extent, they do not represent economic income and should not be included in a base with Haig-Simons income as the norm."). Even if proponents do not accept the argument, there is at least

taxpayer who earns or is given \$100 is better off selfishly and immediately consuming it, instead of investing it long term, which would presumably generate greater societal benefit than immediate consumption.<sup>57</sup> She avoids double taxation by consuming the \$100 immediately. If she invests her \$100, notwithstanding the double taxation, she is better off not selling the investment one year later even if, from a societal standpoint, there are higher and better uses for her previously taxed capital. She might continue her original investment in the manufacture of manual typewriters, for example, when laptops are all the rage. This latter point is referred to as the “lock-in” effect.<sup>58</sup>

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enough historical evidence that tax scholars generally concede knowledge of the argument. See, e.g., *Gray v. Darlington*, 82 U.S. 63, 66 (1872):

The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. It constitutes and can be treated merely as increase of capital.

See also *Burnet v. Harmel*, 287 U.S. 103, 106 (1932) (“The capital gains preference was adopted to relieve the taxpayer from these excessive burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions.”).

<sup>57</sup> See *Cunningham & Schenk*, *supra* note 55, at 345–46:

Whether the lock-in effect attributable to the tax burden imposes a significant onus on the economy as a whole is less clear. Although an individual may benefit greatly by changing her portfolio, it is not clear that it matters much to society who owns IBM stock. Trading in marketable securities (a significant source of capital gains), for example, has only marginal effects on the economy as a whole and is not likely to increase the total amount of investment. While lock-in discourages some investors from selling stock and investing in venture capital, this is not a common case. If the real objection to lock-in is the difficulty in directing assets to venture capital, the preference should be redefined. Even if lock-in does not significantly burden the economy as a whole, it certainly burdens those holding appreciated assets and those not holding assets at all because they must pay higher taxes than they otherwise would have.

<sup>58</sup> *Id.* at 344. The author states:

The lock-in effect describes an investor’s reluctance to incur a tax on realization of gains; it is a direct consequence of prior decisions to impose a realization requirement and not to tax gains at death. An investor who is not taxed until realization and who can avoid tax altogether by holding an asset until death, tends not to change investments, even though he may believe that higher returns are available elsewhere.

*Id.*

Implicit, too, in the foregoing example is that there has been a beneficial “savings”<sup>59</sup>—referred to economically as “investment”—of previously taxed or exempted income.<sup>60</sup> To exonerate her from double taxation, the tax code imposes “rough justice”<sup>61</sup> by lowering the rate of tax on the nominal gain in an effort to alleviate double taxation. In contrast to the sophisticated analysis employed by proponents, the case against capital gain taxation of the carried interest is entirely simple. First, that which is invested to produce the gain from carried interest has not previously been taxed. The capital gain treatment of carried interest might be justified if that which service providers invested—their human endowment—had previously been taxed.<sup>62</sup> Assume, for example, that a fund manager’s expertise was worth \$100 in year one and she was taxed on that amount when the rate of inflation was six percent. If the same expertise yielded \$106 in compensation one year later and she was taxed on the six dollars nominal gain, we could easily conclude that she was being taxed in the absence of any increase in consumption power. Her \$106 endowment in year two could not have increased her consumption power from year one. Hence, the tax on the nominal gain would essentially be a tax on the present value of the amount on which she had previously been taxed. The foregoing analysis hinges, for its logical correctness, on the assumption that tax law imposes a levy on human endowment and then again on the conversion of that endowment into cash. If that were the case, the law would be justified in applying a lower rate on the conversion of human endowment into cash under the theory that the future cash value to which the endowment is converted is the inflationary equivalent to the present

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<sup>59</sup> *Id.* at 376–80 (evaluating the argument that a capital gains preference encourages savings and is therefore beneficial to society).

<sup>60</sup> Although Professor Rosenzweig does not sufficiently address the inflation justification for capital gains taxation, he does allow that the problem to which the capital gains preference is directed does not exist unless a taxpayer has made an investment of her own financial capital. Rosenzweig, *supra* note 52, at 725.

A fundamental aspect of the bunching and lock-in phenomenon is that they require an upfront investment in an asset and gain derived from that investment; in other words, the gain subject to bunching and lock-in is the return on the initial capital investment. In the case of carried interest in a private equity fund, however, there is nominally no upfront capital investment by the GP. Rather, the GP is effectively earning a return generated on the investment of capital contributed to the fund by the LPs.

*Id.*

<sup>61</sup> Cunningham & Schenk, *supra* note 55, at 338.

<sup>62</sup> For an in-depth discussion on the notion of taxing unexploited human ability (i.e. human endowment or human capital), see Lawrence Zelenack, *Taxing Endowment*, 55 DUKE L.J. 1145 (2006).

value of the previously taxed endowment. Logically, the owner of human endowment would derive greater utility using that endowment in a manner that does not produce a cash or cash equivalent conversion; the law would encourage leisure over work. The conversion would ultimately result in less utility to the owner because of the “double tax”; as a macro economic matter, society would be worse off as a result.

In the prototypical carried interest case, fund managers have never been taxed on anything prior to their investment of human capital in the fund. The tax on whatever yield arises is the first tax, since the law does not tax people on their mere potential to earn. Only if the law taxed people on earning potential, and then again upon the financial realization of that potential should we rightly be concerned about double taxation and the discouragement of converting human capital into cash. Moreover, the natural imperative to get a job precludes the lock-in phenomenon. Axiomatically, taxpayers would rather earn sustenance than forego even a single tax on the yield from their labor. Clearly, then, neither double taxation nor the lock-in effect justifies the application of capital gain tax rates to fund manager compensation.

The foregoing discussion of the classic reasons justifying lower rates on returns to capital than on returns to labor are implicitly based on what we mean by “income.” As noted earlier, income is a term that signals the increased ability to eat or spend and thus the increased ability to contribute to the public good. Proponents do not challenge these justifications. Instead, they rely on a less often stated justification for capital gain rates. Proponents assert that a service provider who agrees to be compensated not by a risk free cash or cash equivalent form of compensation, but by a risky form of compensation based on the venture’s probability of success is thereby deserving of lower taxation.<sup>63</sup>

Ultimately, we are obliged to assume that ordinary rates constitute the legitimate baseline of taxation. Here, again, the baseline is not a matter of objective science or deduction but merely an expression of popular will. Implicit in proponents’ arguments is that the extent to which a taxpayer risks transferring her services for no compensation—as is the case when a taxpayer agrees to be compensated only if the venture proves successful—she is entitled to a reward in the form of lower tax rates. This, of course, is an argument in subsidy.<sup>64</sup> That is, the venture to which the taxpayer places her compensation at risk is a public good that ought to be subsidized by the public fisc.

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<sup>63</sup> See Postlewaite, *supra* note 19 (arguing that since non-equity service provider compensation involves no risk, employees are different from fund manager service providers and thus not entitled to the capital gain preference).

<sup>64</sup> Brennan & Okamoto, *supra* note 11, at 31 (“A lower tax on one activity may fairly be described as a subsidy since the lower tax cost favors one activity over another.”).

The notion that normal or even enhanced risk-taking justifies the application of capital gains tax rates to fund managers is not entirely novel,<sup>65</sup> but nevertheless proves too much. Every entrepreneur is a risk-taker, but only entrepreneurial investors of previously taxed income are taxed at lower rates, and that is not because they are risk-takers, but for the reasons discussed above.<sup>66</sup> Suppose, for example, that a taxpayer buys 100 lemons to start a lemonade stand or simply to corner the market on lemons. She hopes to sell lemons or lemonade at a nice profit. The return on her strategy is, quite naturally, risky. The risk may be very high or very low, depending on market circumstances. There is no guarantee that she will sell one, ten, fifty, or one hundred lemons worth of lemonade. In any event, it is both unnecessary and unwise to provide a tax subsidy to her risk-taking merely because of the existence of risk. The market will reward or punish her risk-taking as the case may be. When the market punishes risk, it disciplines investors to the benefit of society. Softening that potential punishment via a tax break encourages irrational risk-taking and ought to be tolerated only when there is a demonstrable societal benefit that is not otherwise provided via market reward. Indeed, as fund manager compensation figures have historically shown, the market more than adequately spurs the risk-taking that fund managers indulge when they put their service compensation to the mercy of entrepreneurial risk.<sup>67</sup> The subsidy embodied in capital gains taxation is, in this instance, unnecessary and unjustified because neither the double tax nor lock-in potential is sufficiently present—the lemons being the stuff of inventory and therefore not likely to generate mere inflationary (or nominal) gain, or to cause capital to be diverted to unproductive use such as leisure or sloth. The more important point is that risk-taking has nothing to do with capital gains taxation. Every investment—whether of human or financial capital—involves risk. A theory that capital gains taxation is appropriate for risk-taking proves too much and is nothing more than a selective plea for lower

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<sup>65</sup> Cunningham & Schenk, *supra* note 55, at 340–44 (discussing the risk justification for capital gain treatment).

<sup>66</sup> *Id.* at 343. The authors state:

The definition of capital asset is not in any way targeted toward “risky” investments. There is no reason to think that financial investments in stocks and bonds are any riskier than a direct investment in a new business. Indeed, because an investor can diversify, existing financial instruments may be among the least risky investments available.

*Id.*

<sup>67</sup> See *supra* text accompanying note 7. Even if the market did not sufficiently compensate for perceived increased risk, a tax subsidy would remain unnecessary until such time as it were proven that the undersupplied goods or services were of such importance that government ought to subsidize them.

tax rates for certain activities, some or all of which might occur in the absence of the subsidy.<sup>68</sup>

The latter assertion perhaps overstates the case to the extent capital gains taxation can legitimately be viewed as a disguised subsidy (rather than as a remedy) to spur what should otherwise be “irrational” but nevertheless extremely beneficial societal behavior. Two examples suffice in this regard. The first pertains to the research and development tax credit.<sup>69</sup> We might conceptualize the research and development tax credit as an effectively lower tax rate applied to income directed towards a certain needed and socially beneficial activity that would insufficiently occur without a tax subsidy.<sup>70</sup> The effective rate on income used for research and development is zero because the financial cost (i.e. risk) of research and development is so high that rational people ought to spend their labor and money elsewhere. Rational behavior might result in an undersupply of a public good. Providing a lower tax rate via a credit encourages highly risky but nevertheless socially beneficial behavior not sufficiently provided by market incentives. Another example involves serving in combat. The tax rate on combat pay (zero percent) is lower than the tax rate on other services.<sup>71</sup> Engaging in combat is a risky, irrational behavior with such little hope of sufficient financial reward that we should expect it never to occur without something to offset the risk. Here, I am speaking only in the economic terms the proponents of capital gain taxation have used in the debate. Nevertheless, in an economic sense, there is insufficient hope of market reward to motivate those socially beneficial activities. It is only

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<sup>68</sup> See STAFF OF THE JOINT COMM. ON TAXATION, 110th CONG., PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS AND RELATED ISSUES PART I 56 (JCX-62-07) (2007):

The risk argument can be criticized, however, in that the capital gains rates apply to the disposition of capital assets, not to risk-taking in general that does not involve capital assets. Further, the capital gains tax rates apply to the disposition of capital assets that are not risky, or have little risk, such as the sale of U.S. Treasury debt with a yield close to the risk-free rate of return. Moreover, the capital gains tax rates do not apply to many types of income related to risk-taking. For example, capital gains rates do not apply to employee compensation that is performance-based, contingent on meeting sales targets or other performance measures. To the extent that the fund manager is risking his time and effort, but not his money, it is argued that the risk rationale for capital gains treatment does not apply.

<sup>69</sup> I.R.C. § 41 (2008). For a discussion of the use of the research credit and deduction to spur research and economic growth, see William Natbony, *The Tax Incentives for Research and Development: An Analysis and a Proposal*, 76 GEO. L.J. 347 (1987).

<sup>70</sup> Natbony, *supra* note 69, at 350.

<sup>71</sup> I.R.C. § 112 (2009) (providing for the exclusion from gross income the pay and compensation earned while serving in a combat zone).



when that conclusion can be made objectively—that the market insufficiently provides needed services—that deviations from normative taxation is justified. The assertion simply cannot be made with regard to services as a fund manager because the *hope* of financial reward (as opposed to the guarantee) is so high that the socially beneficial behavior will inevitably occur in sufficient quantities.

The foregoing analysis proves, without reliance on sophistry or situational ethics—such as might be appropriate if the market failed to provide sufficient reward to motivate needed services—that neither economic nor subsidy justifications support the application of capital gains taxation to the grant of a carried interest. Indeed, the proponents' arguments inadvertently lend credence to that conclusion and, since their expedient arguments are easily addressed they ultimately concede the issue. In Section IV, then, the Article addresses a representative sample of those arguments directly. A close analysis proves instead that proponents actually agree with the inapplicability of capital gain justifications to the carried interest. Nevertheless, proponents make arguments based either on semantics or more sophistry and expediency; they rely, for example, on the indisputable fact that a service partner is correctly treated as a partner under common law, that service partners might otherwise structure their transactions using certain legal fictions to achieve valuable conversion, or the administrative complexities attendant to the ordinary income treatment of carried interests would raise less revenue than simply indulging the incorrect application of fundamental tax theory to achieve the *status quo*. None of these arguments provide the sense of integrity that ought to characterize a body of law meant to apply equally to all persons subject to its provisions.

#### IV. THE SOPHISTRY OF RESISTANCE

The most telling aspect of the various arguments offered in support of the *status quo* is that they all implicitly admit that taxing fund managers for their services in a manner preferential to the compensation received by other service providers is contrary to horizontal equity. This Article selects three scholarly assertions as representative of the body of literature in support of the *status quo*. The first scholarly assertion is that the return from the carried interest is not a return to labor but instead a return to “blended” labor and capital.<sup>72</sup> The assertion is similar to that made by the third scholarly argument confronted here; that the carried interest results not from an expenditure of human capital but rather an investment of human capital.<sup>73</sup> This Article proves the first assertion false, at least insofar as the

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<sup>72</sup> See Postlewaite, *supra* note 19; Weisbach, *supra* note 8, at 755.

<sup>73</sup> See Postlewaite, *supra* note 19.

reasons for capital gain taxation are concerned. The third assertion is flawed because it conflates the initial grant of the carried interest, resulting from what the proponent refers to as an “expenditure,” with the yield from the carried interests. According to this argument the yield results from an “investment” rather than an “expenditure” of human capital, and therefore, is rightly taxed as capital gain.<sup>74</sup> To account for the lack of previous taxation, the proponent argues that the yield from the original expenditure, as opposed to the later investment, is indeed included in income and taxed at ordinary rates. According to the proponent, the amount is coincidentally valued at zero.<sup>75</sup> Whatever the ordinary rate may be, when it is applied to an amount quantified as zero, it fortuitously results in zero tax liability. With due respect to the proponent, this Article categorically labels that path sophistry because the original tax rate of zero is a mere accounting construct useful solely to signal the populist notion that the grant is not an appropriate moment of taxation.<sup>76</sup>

The second argument is equally flawed. It holds that since carried interest recipients could replicate the preferential outcome via a fictional “loan,” which would be respected as a matter of form, the law should indulge the *status quo* as well.<sup>77</sup> In other words, since recipients could effectively cheat to achieve conversion, they ought to be allowed to do so in the most direct and least expensive manner available. The factual predicate, one that this Article proves incorrect, is that the fictional loan necessary to achieve the outcome would precisely replicate the economic bargain between the fund managers and investors whose cooperation is needed for the conversion. Thus, both fund managers and investors would be indifferent as to which path to utilize, except for the additional transactional costs required by the use of the fictional loan. Each of these arguments sets aside the intrinsic moral value of integrity in the tax code. From a purist viewpoint—one which ultimately increases social utility to a greater extent than sophistry and situational ethics—reliance on these arguments is simply unacceptable.

#### A. The Disposition of Patently Incorrect Arguments

Before analyzing the proponents’ arguments, it is appropriate to briefly

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<sup>74</sup> Postlewaite, *supra* note 19 (manuscript at 9 n.19). Postlewaite states that “employee compensation [correctly taxed as ordinary income] can be viewed as the expenditure of human capital, while equity compensation involves the investment of human capital.” *Id.* It is unclear, and indeed inconsistent with present law, why the form of payment with respect to skill or labor should change the character of the income. Cf. Treas. Reg. § 1.61-2(d) (2003) (treating all compensation alike, whether paid in cash, property, or services).

<sup>75</sup> See Postlewaite, *supra* note 19.

<sup>76</sup> See *supra* notes 45–48 and accompanying text.

<sup>77</sup> See Noel B. Cunningham & Mitchell L. Engler, *The Carried Interest Controversy: Let’s Not Get Carried Away*, 61 TAX L. REV. 121 (2008).

address three other common consequentialist<sup>78</sup> objections, which relate to a fundamental notion that is sometimes intentionally disregarded in Subchapter K. First, Subchapter K intentionally requires that a partner's allocated share of income be characterized at the partnership level.<sup>79</sup> Thus, a taxpayer, who enters into a partnership that has held stock for more than one year is entitled to report long term capital gain from the sale of that stock even if the sale occurs one day after the partner's entry into the partnership.<sup>80</sup> It matters not that the partner held her proportionate share of the stock for merely one day. From this rule, proponents argue that the partner level characterization is a necessary consequence of the congressional intent animating partnership taxation. Simply put, proponents argue that partnership level characterization of income is inviolate. That is, the benefit of the rule is so great that it ought to be followed even in the rare circumstances where it causes a distortion of the partner's true circumstances. Once the label "partner" attaches, all further tax decisions are simply a matter of applying a straightforward rule. Unfortunately, the argument is belied by a very conspicuous provision in Subchapter K. I.R.C. § 724 represents a clear departure from partnership level characterizations. Other than the relatively simple record keeping required for compliance, the provision requires nothing else than that a partner who contributes ordinary gain or capital loss property be allocated ordinary gain or capital loss when the partnership sells or exchanges the property, notwithstanding that the property may qualify as capital gain or ordinary loss property, respectively, when owned by the partnership.<sup>81</sup> In

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<sup>78</sup> This term is used to refer to the notion necessarily implicit in proponents' advocacy for the *status quo*—that conversion is a rarely indulged distortion and in most instances the fund manager's compensation ends up being taxed as ordinary income anyway. Hence, the argument goes, insisting that the law comport with 'general tax principles' that tax compensation as ordinary income is unnecessary because the result will be identical to what it would be under the *status quo*. Consequentialism, in effect, argues that the *status quo ante* is justified because the correct results ultimately occur in most cases. See, e.g., Weisbach, *supra* note 8, at 733 ("Transactions [sic] fees received by the sponsor are taxed under general tax principles and are most likely taxed as ordinary compensation income. As noted, the fees represent around two-thirds of sponsor compensation. This means that roughly two-thirds of sponsor compensation is taxed as ordinary income."). More recent scholarship, though, suggests that even this consequentialist argument is false. See Gregg D. Polsky, *Private Equity Management Fee Conversions*, 122 TAX NOTES 743, 743 (2009) ("Private equity managers regularly attempt to convert their fixed annual 2 percent management fees into additional carried interest through so-called management fee conversions.").

<sup>79</sup> I.R.C. § 702(b) (2009). See also U.S. v. Basye, 410 U.S. 441 (1973).

<sup>80</sup> See also Treas. Reg. § 1.702-1(b) (2005).

<sup>81</sup> The I.R.C., obviously designed to prevent conversion of ordinary income into capital gains and capital losses into ordinary losses, provides, in part:

§ 724. Character of gain or loss on contributed unrealized receivables, inventory items, and capital loss property.

other words, the partnership level characterization of gain or loss is ignored, at little efficiency cost, in circumstances suggesting a rather obvious conversion attempt. That a service partner contributes services rather than property does not exacerbate whatever administrative difficulties have already been deemed insufficient to prevent the enactment and enforcement

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- (a) Contributions of unrealized receivables. In the case of any property which—  
(1) was contributed to the partnership by a partner, and  
(2) was an unrealized receivable in the hands of such partner immediately before such contribution,

any gain or loss recognized by the partnership on the disposition of such property shall be treated as ordinary income or ordinary loss, as the case may be.

- (b) Contributions of inventory items. In the case of any property which—  
(1) was contributed to the partnership by a partner, and  
(2) was an inventory item in the hands of such partner immediately before such contribution,

any gain or loss recognized by the partnership on the disposition of such property during the 5-year period beginning on the date of such contribution shall be treated as ordinary income or ordinary loss, as the case may be.

- (c) Contributions of capital loss property. In the case of any property which—  
(1) was contributed by a partner to the partnership, and  
(2) was a capital asset in the hands of such partner immediately before such contribution,

any loss recognized by the partnership on the disposition of such property during the 5-year period beginning on the date of such contribution shall be treated as a loss from the sale of a capital asset to the extent that, immediately before such contribution, the adjusted basis of such property in the hands of the partner exceeded the fair market value of such property.

I.R.C. § 724 (2009). The most relevant legislative history of I.R.C. § 724 articulates the following anti-conversion purpose:

The committee is concerned that, under certain circumstances, a taxpayer may alter the character of gain or loss merely by contributing property to a new or existing partnership. In particular, the conversion of capital to ordinary losses by contributing securities to a dealer partnership may allow a taxpayer to receive the benefits of capital gain taxation on appreciated securities while deducting ordinary losses on those which have declined in value. The committee believes that these potential abuses should be prevented by preserving the pre-contribution character of contributed (or substitute basis) property for an appropriate period. For similar reasons, the committee believes the existing rules preserving the character of certain property distributed by a partnership should apply to property the basis of which is determined by reference to the distributed property.

*Id.*

of I.R.C. § 724. As addressed in a bit more detail below, administrative burdens do not justify the clear horizontal inequity that would result in the absence of I.R.C. § 724.

The second “housekeeping” response relates to the status of the service provider as “partner” or “employee.” Some proponents argue that because common and tax law clearly allow a contributor of services to gain status as partner, the law necessarily, as a consequence of that label, presumes that any gains attributable to the taxpayer’s status as partner must be characterized at the partnership level in accordance with the authorities discussed immediately above.<sup>82</sup> This too is an argument adopted as a matter of expediency. Subchapter K has long since addressed the mischief that results when partners receive gain or profit while nominally occupying the status of partner but substantively performing as an employee or in some capacity other than a partner. I.R.C. § 707(a) and (c) clearly contemplate the possibility that a partner may simultaneously or alternatively perform services or provide property as partner, employee, or independent contractor. Though the factual inquiry may be detailed, and subject to obfuscations by the taxpayer and/or the partnership when it suits their purposes, Congress has not been deterred from determining that the inquiry ought rightly to be made.<sup>83</sup> In fact, substance has always been

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<sup>82</sup> See, e.g., Weisbach, *supra* note 8, at 729:

Once a partner receives a profits interest, he is a partner for purposes of the tax law and is taxed like any other partner. This means that he is taxed on his distributive share of partnership items. The timing, character, and other attributes of the income are determined at the partnership level and passed through to the individual partners under the normal partnership rules.

<sup>83</sup> Weisbach, *supra* note 8, at 731–34. Professor Weisbach argues, in effect, that I.R.C. § 707 was not really intended to deal with the problem of partnerships accelerating business expense deductions (i.e. indirect costs of capital expenditures) by disguising those payments as allocations. *Id.* On the other hand, Professor Polsky more accurately points out that I.R.C. § 707’s purpose is much broader and was also specifically intended to prevent the conversion allowed under the *status quo*:

Section 707(a)(2)(A) was principally directed at such a transmutation of a capital expenditure into (effectively) a current deduction. Nevertheless, the legislative history makes clear that Congress was also aware that artificial partnership transactions could be used to convert ordinary income to capital gains. It notes that “if a service-providing partner was allocated a portion of the partnership’s capital gains in lieu of a fee, then the effect of the allocation/distribution will be to convert ordinary income (compensation for services) into capital gains.”

Polsky, *supra* note 78, at 763 (citing STAFF OF JOINT COMM. ON TAXATION, H.R. 4170, 98TH CONG., Pub. L. No. 97-248, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 227–29 (Comm. Print 1984)).

preferred over form in tax law. Reliance on a taxpayer's nominal status as "partner" is therefore just as inconsequential with regard to the carried interest as a taxpayer's characterization of a sale of property under I.R.C. § 707(b) as a contribution followed by a distribution.

The final consequentialist argument to be disposed of is the alleged lack of value attendant to the grant of a carried interest. Economically, the grant of a carried interest represents a right to receive an undefined amount of wealth at some future point. To say that the right has no value is also to stipulate that the services used to acquire that right have no value. This is incorrect as a matter of rationality. Why would a person possessing skills subject to market demand, and without a specific intent to make a donation, transfer her services for nothing? The short answer is that she would not do so; she may, though, bargain for deferred compensation and in that case deferred taxation is appropriate. But there is nothing to support the fiction that she would labor for nothing. It should be noted, here, that value is not important as part of an argument to impose taxation on the recipient immediately upon grant of the carried interest. The Article has previously set forth the argument in support of the notion that valuation possibility is not the sole determinate of income. One may be in receipt of something valuable, yet not be subject to present taxation. Disputing the notion that a profit interest is incapable of valuation is instead important when determining the amount that ought to be attributed to services, and thus taxed at ordinary rates, and the amounts earned from the subsequent investment of the previously taxed amounts, and thus appropriately taxed at capital gains rates. Realism and common sense tell us that it is not that the parties cannot value the services traded in exchange for the future payment measured as a percentage of profit. It is simply that they refuse to publicly divulge that worth, each for different reasons perhaps. Surely, they know that worth, if only because a fund manager can determine the price her services would bring in a similar industry that disdained agency incentives. Likewise, the investors can obtain those services at a fixed price from other willing laborers. The notion that the market is so unpredictable that it cannot settle upon a reasonable valuation of common services is one for which the burden ought rightly be placed on those who would benefit from its acceptance.

#### B. The Disposition of Sophisticated Arguments

This Article separates the consequentialist arguments discussed and dismissed above from the consequentialist arguments discussed and dismissed below by labeling the former "expedient" and the latter "sophisticated." Both groups of assertions depend on their outcomes; the outcomes are thought tolerable, and therefore the arguments must be correct. What transforms the "sophisticated" arguments into sophistry is that they are flawed in a manner that is hardly obscure. Each argument is

plausible, in the sense that they would not likely draw sanction if presented to a court in support of the *status quo*. However, each argument admits that the objective *status quo* is incorrect<sup>84</sup> and relies on a very apparent factual or logical flaw for its success.<sup>85</sup> What initially seems attractive is ultimately exposed, ironically, as support for the initial populist, and even visceral, reaction that the preferential taxation of carried interests cannot be supported.

The first sophisticated argument is that payments made with respect to carried interests are improperly characterized as payments for services. Proponents obscure the problem presented by pointing to the common practice requiring fund managers to put some of their own capital—certainly less than the twenty percent of the total committed capital—into the pooled fund. Thus, even admitting that the profit interest is explicitly tied to services, proponents nevertheless argue that the service provider's very nominal "skin in the game" transforms the entirety of their compensation for services into yield from previously taxed income.<sup>86</sup> A

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<sup>84</sup> See Rosenzweig, *supra* note 52. Professor Rosenzweig argues, for example, that the taxation of yields to human capital ought to be taxed as ordinary income and that to the extent partnerships allocate only short term capital gain, taxable at ordinary rates, no reform is necessary. *Id.* I address the flaw in this argument below.

<sup>85</sup> Professor Postlewaite argues that payments made with respect to carried interests represent yields with respect to both "expended" and "invested" capital and since the initial expenditure of capital is taxed at ordinary rates, the treatment of carried interests is no more preferential than the tax treatment of any other service provider. See Postlewaite, *supra* note 19. I have previously addressed the legal fiction upon which the assertion rests. See *supra* notes 39–46 and accompanying text.

<sup>86</sup> The "Levin Proposal" introduced in the House of Representatives on June 22, 2007 would have taxed yields with respect to the grant of a carried interest as ordinary income. By its very terms, though, the provision would not have applied to amounts attributable to the partner's contribution of financial capital. See H.R. 2834, 110th Cong. (2007). The relevant portion of the bill stated:

Section 710 . . . .

(c) Investment Services Partnership Interest . . . .

(2) EXCEPTION FOR CERTAIN CAPITAL INTERESTS-

(A) IN GENERAL—If—

(i) a portion of an investment services partnership interest is acquired on account of a contribution of invested capital, and

(ii) the partnership makes a reasonable allocation of partnership items between the portion of the distributive share that is with respect to invested capital and the portion of such distributive share that is not with respect to invested capital,

then subsection (a) shall not apply to the portion of the distributive share that is with respect to invested capital. An allocation will not be treated as reasonable for purposes of this subparagraph if such allocation would result in the partnership

variant of this argument holds that capital gain taxation presently allows for preferential treatment of services because the yield to previously taxed income embodied in property can only be realized by the application of management services to that previously taxed capital. Under this argument, capital gain necessarily and intentionally taxes blended labor and capital in all cases; the taxation of carried interest is therefore consistent with present law and good economic theory. The factual flaw is that the yield to assets does not take into account the services performed in the holding, management, or sale of that asset.<sup>87</sup> A buyer of stock, for example, values the stock without regard to the intellectual capital expended in the decision to sell or hold.

Indeed, whatever appreciation may have occurred in the value of the stock by virtue of previous services will have already been taxed at ordinary rates.<sup>88</sup> Suppose the owner of a widget store buys, manages, and sells widgets for a period of three years. During such time, she will have earned income from the sale or management of her inventory—i.e., the sale of services or short term assets—which would be taxed at ordinary rates. As the store's volume increases over and above the amounts derived and taxed on an annual basis at ordinary rates, the goodwill value of the business would increase and the owner would decide to sell the business via a stock or asset sale. As the business represents previously taxed value embodied

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allocating a greater portion of income to invested capital than any other partner not providing services would have been allocated with respect to the same amount of invested capital.

*Id.*

<sup>87</sup> The tax code defines capital gain as gain derived from the sale or exchange of property. I.R.C. § 1221 (2009) (defining a capital asset as "property"); I.R.C. § 1222(1) and (3) (2009) (defining capital gain as that which derives from the sale or exchange of capital asset). If, indeed, the income from services should be characterized by reference to the property to which the services are directed (inventory or investment property, for example), then all service providers who hold, manage, maintain, or sell long term investments should be taxed at capital gain rates. It is hard not to consider this a nonsensical assertion.

<sup>88</sup> See Darian M. Ibrahim, *The Unique Benefits of Treating Personal Goodwill as Property in Corporate Acquisitions*, 30 DEL. J. CORP. L. 1, 7 (2005). The classic definition of goodwill presupposes that goodwill is an intangible asset created over a significant period of time in which ordinary income transactions occur:

The advantage or benefit, which is acquired by an establishment, beyond the mere value of the capital, stock, funds, or property employed therein, in consequence of the general public patronage and encouragement, which it receives from constant or habitual customers, on account of its local position, or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances, or necessities, or even from ancient partialities, or prejudices.

*Id.*



in property, it is appropriate to tax the owner only on the true profit made from the sale; it is economically inappropriate to tax the owner on the value of that which she already owns—a business whose value has been increased by the sale of services and inventory resulting in goodwill—and on which she has been previously taxed. Thus, the sale should produce a tax liability only to the extent the nominal amount exceeds the business' inflationary value. The key fact, though, is that the owner has already paid an ordinary tax on the services that contributed to the accretion in the businesses value.<sup>89</sup> The factual predicate does not apply when services are performed with respect to someone else's capital. While it can be proven that double taxation results with respect to the ongoing exploitation and later sale of one's own property, it cannot be said with respect to the management of someone else's property. If compensation for the services is made solely at the time the third party's property is sold, the management services would not yet be taxed and double taxation would not need to be alleviated. The inescapable conclusion is that the blended labor-capital argument does not apply unless a person owns both the labor and the capital being sold. Even then, the blended labor-capital argument relies on the fact that the value of the property sold has been increased by previously taxed yields from capital.

The second argument amounts to little more than an assertion that a service provider may achieve conversion through another, economically costlier analysis and therefore ought to be allowed the benefit of the less expensive and risky conversion strategy existing under the *status quo*. The gist of the argument is that the recipient of a carried interest payment occupies the economically equivalent status of a nonrecourse loan recipient who, having received the loan, invests the proceeds in long term assets.<sup>90</sup> Since the loan recipient would be entitled to capital gain treatment, so too should the fund manager, whose yield is essentially from borrowed capital. It is no doubt the case that a taxpayer may borrow and invest money to achieve capital gain taxation.<sup>91</sup> The rationale for this outcome is that the taxpayer is allowed to pay for the tax beneficial investment after the investment, when she repays the loan with previously taxed wealth earned from some other activity.<sup>92</sup> That is, the taxpayer will be obliged to earn

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<sup>89</sup> Cf. I.R.C. § 751(b) (2009) (requiring the seller of a partnership interest to pay tax at ordinary income rates on property that, had it been sold prior to the sale of the partnership interest, would have generated ordinary income).

<sup>90</sup> The most thorough discussion of this argument is described in Cunningham & Engler, *supra* note 77.

<sup>91</sup> *Id.* at 134 n.62.

<sup>92</sup> See *Comm'r v. Tufts*, 461 U.S. 300, 317 (O'Connor, J., concurring) (lamenting the treatment of purchases made with borrowed capital as an actual investment by the borrower, but noting that "we do not write on a [clean] slate" and therefore concluding that the longstanding result should be followed).

money with which to repay the loan and those earnings will be taxed at whatever rate otherwise applies to the earnings. Thus, the carry recipient who is treated as though she has invested her own capital via the loan analogy is placed on par with all other service providers. Even then, of course, the ordinary service provider—e.g. an employee rather than a partner—may be less well off because she must repay her loan from income taxed at ordinary rates. The fund manager may instead repay her loan from income taxed at capital gain rates. Here, the circularity of this option deprives the option of its comfort. Ultimately, the fund manager is granted access to investor status along with its attendant tax benefit without ever having to pay the toll that other investors must have paid at least once before. The fund manager's toll into the capital gains preference is paid from the very activity giving rise to capital gain. An employee's toll into the capital gains preference must be paid, at least once, from income taxed at ordinary rates. Assume, for example, two taxpayers each endowed with nothing but their natural abilities. Under a system that differentiates between ordinary and capital gain income, as does ours, neither one would be entitled to a preferential rate until such time as they expended their natural endowment, earned a certain yield from that expenditure and then instead of consuming that yield immediately, invested it long term. Only the yield from that initial investment of previously taxed income would be entitled to preferential tax treatment because it was made possible by the receipt of income taxed at the baseline level applicable to all human labor. As a matter of efficiency, setting equity aside for the moment, it is unwise to grant a service provider access to the preferential capital gain rates without first requiring that the provider expend her human capital. There is neither efficiency nor social utility to be gained by granting preferential rates to the lazy or fortuitous. All that is left, then, is inequity.

Applying this analysis to the present taxation of carried interests helps clarify the inequity. One service provider labors in a certain investment enterprise, the success of which is as much dependent on the laborer's loyalty and incentivized expertise as is the service provider who labors for a wealthier capitalist in a pooled fund. The owners of the business enterprise cannot or will not abide by the accounting slight of hand embodied in its laborer being treated as having borrowed and then invested some of their capital. Thus, the first laborer must earn, save, and then invest her after [ordinary] tax income before being granted capital gain preference with respect to any subsequent investment. The laborer who works for the wealthier capitalist is fortunate that the wealthier capitalist is willing and able to abide the accounting slight of hand suggesting that the laborer has actually invested her own capital. Under the implicit loan model, the second laborer's efforts are economically identical to the first and yet the second laborer is taxed preferentially to the first. The moral of the immediately foregoing discussion is that the first laborer ought to convince

the capitalist for whom she labors to indulge the accounting fiction embodied in the implicit loan analogy or, barring that, offer her labor to the second capitalist's benefit, perhaps driving down the price of labor in the second industry and driving up the price of labor in the first. In other words, the implicit loan is an unnecessary indulgence that has no boundaries. It is similar to the situational ethic resulting in the *status quo* and should predictably result in the same sort of mischief any deviation from an intellectually pure and honest approach occasions. Indeed, the loan analogy may be utilized with respect to most any laborer fortunate enough to gain the cooperation of the financial capital's true owner. Thus, what seems an expedient means of explaining away a glaring inequity in the tax code—that embodied in the *status quo*—will ultimately cause us to regret its adoption in some as of yet unknown fashion.

The third argument is that carried interests with respect to short term gains should remain taxed under the *status quo* because short term capital gains receive no preference.<sup>93</sup> The implication, of course, is that carried interests with respect to long term funds ought to be taxed differently than the *status quo*. That is, the use of carried interests with respect to short term fund should not cause any changes in the *status quo* because the recipient is taxed at the same rates as other service providers. The reasoning for this approach is derived from reverse engineering and ultimately relies on a “no harm, no foul” ethic. In those funds that implement a short term investment strategy, there is no conversion potential because the yields to that interest will qualify as short term capital gain, at best. The argument is that since the gain cannot qualify for long term capital gain treatment, the ultimate taxation of the yield is correct even if the path to that conclusion is incorrect. Notwithstanding the explicit admission that the recipient is made wealthier by the rendition of services, the proponent nevertheless considers it appropriate to allow the recipient to characterize her income as income from capital, albeit short term capital taxed at ordinary rates. The problem, of course, beyond the observation that it requires indulgence of a legal fiction (that the service provider has sold or exchanged a capital asset) is that the reasoning is offensive to the purist approach and thus more likely to spawn troublesome unintended consequences. One such unintended consequence is that short term capital gains increase the amount of capital losses deductible in any given year.<sup>94</sup> Thus, it is more beneficial to a service provider, particularly one who has unused capital losses, that her

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<sup>93</sup> See Rosenzweig, *supra* note 52.

<sup>94</sup> Capital losses are deductible only to the extent of capital gains, plus up to \$3000. I.R.C. § 1211(b) (2009). The limitation on capital losses is designed to prevent taxpayers from “cherry-picking”—realizing losses from investments to reduce taxes while deferring gains from investments. Michelle Arnopol Cecil, *Toward Adding Further Complexity to the Internal Revenue Code: A New Paradigm for the Deductibility of Capital Losses*, 1999 U. ILL. L. REV. 1083, 1109–11 (1999).

compensation be labeled short term capital gain rather than ordinary income. To the extent income may be labeled capital, either long or short, the taxpayer may accelerate losses that Congress believes ought instead to be matched with true yields from other investments. For example, a taxpayer whose short term gain is increased by \$100,000 because the \$100,000 yield on her carried interest is characterized as such, is allowed to increase the amount of her capital loss deduction by that amount. A fund manager whose \$100,000 yield is not so characterized does not suddenly generate an additional \$100,000 capital loss deduction eligibility. One can imagine that fund managers with significant short term capital gain would be motivated to characterize their carry payment as short term capital gain—perhaps even by changing the character of the portfolio's investments when economic considerations might dictate otherwise—solely to utilize short term capital losses realized from other sources. This unintended distortion could be avoided by adhering to the most accurate description of the carry payment, which is a payment made for services and thus ordinary income.

A more troublesome aspect of the “holding period” solution is that it leaves in place the *status quo* with respect to fund managers of long term assets. The implication is that fund managers of long term assets would be allowed to characterize the yields to their carried interest under the partnership flow-through rules and thus potentially as capital gain. That short term funds are deprived of long term capital gain treatment under the proposal because of a failure of holding period necessarily implies that managers of long term funds would be entitled to capital gain treatment. In other words, the short term holding period solution actually supports the *status quo*, even as the proponent admits that capital gain taxation is incorrect. The source of this mistake is the proponent's omission of inflation as a motivation for capital gain taxation. The proponent rightly notes the two other historical motivations—bunching and lock-in—for capital gain treatment but omits the problem of taxing inflationary rather than real gain. That problem arises exclusively when the value embodied in property has been previously taxed. If, upon the later sale, the asset produces a nominal amount realized not in excess of its past value, an additional tax amounts to a tax on the same amount previously taxed. The problem does not arise with respect to yields from services since no predecessor tax was ever imposed. Thus, the holding period solution is really nothing more than an insufficient justification for the *status quo*.

## V. CONCLUSION—A SHORT ESSAY IN LEGAL REALISM

This Article has largely been an exercise in “point-counterpoint.”

Proponents responded to the initial, popularly held indignation<sup>95</sup> with respect to the preferential taxation of carried interests payments first with silence<sup>96</sup> and then with justifications, all of which revolve around the implicit notion of the second best.<sup>97</sup> None of the responses withstand critical analysis though proponents can no doubt offer indefinite rejoinders to every counterpoint. What is most surprising is that proponents' arguments necessarily rely on the supposed vacuity of tax law. In other words, proponents assert that tax law is devoid of fundamental reason by which to determine the proper taxation of the carried interests or indeed any other economic activity.<sup>98</sup> The historical, often stated justifications for capital gains taxation are of little help because those justifications are suddenly without intellectual foundation and indeed are not even the subject of loose scholarly consensus.<sup>99</sup> If this is true, then what is the basis of capital gain taxation in any context? The proponents' logical conclusion must be that the imposition of capital gain tax rates on any particular economic activity, and not on others, is purely a matter of political will or complete happenstance.

A similar conclusion can be made with regard to the long held belief that horizontal equity ought to be the goal of our tax laws.<sup>100</sup> Horizontal equity—basic fairness—is the ethic that is so obviously violated by the taxation of the carried interest vis-à-vis the taxation of other yields to services. Indeed, it is so simple a proposition that very few taxpayers

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<sup>95</sup> See, e.g., Alan S. Blinder, *The Under-Taxed Kings of Private-Equity*, N.Y. TIMES, July 29, 2007, at 4.

<sup>96</sup> See Landau, *supra* note 4.

<sup>97</sup> That is, even proponents admit that taxing carried interest payments under capital gains rates is inconsistent with normative principles. See, e.g., Weisbach, *supra* note 8. As noted in Sections III and IV, proponents nevertheless insist on the *status quo* because of alleged efficiency or complexity concerns.

<sup>98</sup> See *id.* at 742–43. The most striking example of this is Professor Weisbach's assertion that capital gain taxation is without fundamental basis and therefore any assertion that carried interest payments do not fit the justifications for capital gain taxation are inconsequential. See *id.*

<sup>99</sup> *Id.* at 742 (asserting that “there is little if any conceptual clarity governing the distinction between capital gains and ordinary income”).

<sup>100</sup> David Elkins, *Horizontal Equity as a Principle of Tax Theory*, 24 YALE L. & POL'Y REV. 43, 43–44 (2006). He describes horizontal equity as:

The principle of horizontal equity demands that similarly situated individuals face similar tax burdens. It is universally accepted as one of the more significant criteria of a “good tax.” It is relied upon in discussions of the tax base, the tax unit, the reporting period, and more. Violation of horizontal equity, while not necessarily fatal, is nevertheless considered a serious flaw in any proposed tax arrangement.

*Id.*

require detailed explanation of its meaning. If nothing else, horizontal equity means that we should determine the extent to which two taxpayers are similarly or dissimilarly well off and then tax them accordingly.<sup>101</sup> Faced with this simple truism, proponents instead argue that horizontal equity has no theoretical basis and therefore cannot be relied upon to bring us to the correct result.<sup>102</sup> The argument is, of course, a means to discount populism as a legitimate basis of taxation. Though horizontal equity has undeniable intuitive and populist appeal, proponents nevertheless reject it because horizontal equity cannot be expressed in the sophisticated terms proponents rely upon to obscure the precise inequity they seek to discount. Most axiomatic truisms are incapable of sophistication.

It is, of course, only naïveté to think that taxation is purely the product of dispassionate scholarly analysis applied in antiseptic legislative halls.<sup>103</sup> Hence, the only valid objection opponents (like me) to capital gain taxation of carried interests ought to legitimately raise is that proponents insist on cloaking the *status quo* with an aura of objective correctness or fairness. We cannot argue that the political force resulting in the *status quo* is an illegitimate basis because the tax code is ultimately an expression of political will, whatever its sophisticated merits may be. Still, it would be preferable that the *status quo* be described for what it is—a concession made to well organized and well funded political will. Political will, after all, is the regimented expression of populism and, for the same reasons populism cannot be discounted as illegitimate because it lacks sophistry, neither can political will. Admitting this, though, would allow us to avoid transparent efforts to torture the attractive logic that still animates the tax code in the majority of circumstances even if political will is the force that ultimately translates populism into statutes and regulations.

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<sup>101</sup> One might imagine that proponents can always find technical differences between taxpayers, as no two people are exactly alike. Requiring instead that “exact taxpayers be treated exactly alike” would, of course, disingenuously gut the ethic. *See id.* at 44 (“It is important to emphasize that horizontal equity is concerned with individuals who are ‘similarly situated,’ not with those who are ‘identically situated.’”).

<sup>102</sup> After first asserting that horizontal equity supports the *status quo* because fund managers are just as similar to those who use borrowed money to produce capital gains. Weisbach, *supra* note 8, at 718. Weisbach then asserts that horizontal arguments are “conceptually baseless.” *Id.* at 740.

<sup>103</sup> I have noted elsewhere in my conclusion that the efforts to reform the taxation of profit interests will ultimately succeed or fail in response to political rather than economic science. Jones, *supra* note 10, at 881.

