

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

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## **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**

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Section II initiates an overdue critical examination of the historical *status quo ante*, 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 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 at least 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 nobody 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

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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., Oct. 21, 1968, at 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”).

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 preferred remained hidden in the dark.<sup>7</sup> Predictably and brazenly, those who all along had benefitted in comfortable

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

<sup>6</sup> “Irrational exuberance” is a phrase famously uttered by former Federal Reserve Chairman Alan Greenspan at a December 5, 1996 lecture sponsored by the American Enterprise Institute for Public Policy Research. <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 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. [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 <http://finance.senate.gov/hearings/testimony/2007test/073107testdj.pdf> (testimony at CARRIED INTEREST II); <http://waysandmeans.house.gov/hearings.asp?formmode=view&id=6431>

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

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(testimony at TAX POLICY FOR AMERICA'S WORKING FAMILIES). During the most recent presidential campaign, President Obama's tax plan included a provision to reform the 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"). Eventually, the President's proposed 2010 budget included a provision to tax payments received with respect to carried interests as ordinary income. OFF. 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 (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 obviously 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 ante*. Instead, I seek only to insist that proponents are not entirely

science. It is therefore legitimate to acknowledge self interest and politics<sup>10</sup> as much as logic and tax 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 ante* 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 present law tax

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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. 853 (2009). 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.

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

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>

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

<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. 93-27, 1993-2 C.B. 343, and Rev. Proc. 2001-43, 2001-2 C.B. 191.

<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 TAX'N, 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

Thus, when it became notoriously 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 are 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

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

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 ante*. The “blended labor/capital” argument<sup>19</sup> is an implicit 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

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<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 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. 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).

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> The label “partner” adds nothing to the intellectual challenge that the *status quo* proponents (“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

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<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” under state or federal law. See also Rev. Proc. 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).

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 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,

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<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.

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 ante* 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

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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 interest 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 ante* accept the legitimacy of horizontal equity. They then either attempt to prove that the *status quo ante* 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.





































































