2007

Taxation of Profit Interests and the Reverse Mancur Olson Phenomenon

Darryll K. Jones

THE TAXATION OF PROFIT INTERESTS AND THE REVERSE MANCUR OLSON PHENOMENON

DARRYLL K. JONES*

PROLOGUE

It is impolite, one supposes, to talk about politics in mixed company. For purposes of this Article, "mixed company" refers to the thoroughly heterogeneous groups interested in any particular item of tax legislation.[1]

---

* Professor of Law, Stetson University College of Law. LLM (Tax), University of Florida, 1994. This Article is based on a presentation given at the Capital University School of Law's Annual Business and Tax Annual CLE Program, November 9, 2007. It also arose from the author's experiences as a witness during House and Senate Hearings Congressional hearings conducted in summer and fall 2007 regarding the taxation of profit-interests. *Hearings on Carried Interest II Before the S. Comm. on Finance*, 110th Cong. (July 31, 2007) (statement of Darryll K. Jones), *available at* http://finance.senate.gov/hearings/testimony/2007test/073107testdj.pdf; *Hearing on Fair and Equitable Tax Policy For America's Working Families Before the H. Comm. on Ways and Means*, 110th Cong. (Sept. 6, 2007) (statement of Darryll K. Jones), *available at* http://waysandmeans.house.gov/hearings.asp?formmode=view&id=6431.

[1] On the other hand, a legal realist might suppose that one cannot possibly separate politics, broadly defined, from anything, especially the topic of tax reform:

> 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 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. Those who characterize those diverse changes to the Code that were enacted in 1986 as **tax** reform are implicitly adopting the false dichotomy that there are "good" changes (those designated as **tax** reform which pursue the public interest and somehow rise above **politics)** and "bad" changes (those which favor special

(*continued*)

Mixed company exists with any combination of democrats, republicans, special interest groups, legislators, lobbyists, judges, advocates, moralists, scholars, rich, poor, capitalists, laborers, and other persons, whether individually or collectively, and of any disparate description, quite frankly, whose economic or moral interests are in the least bit implicated by taxation. In mixed company, then, politics are never, or hardly ever to be explicitly acknowledged as the absolute trump card of any given tax statute or decision.[2] Violations of this implicit social rule usually result in personal offense, since mixed company necessarily implies mixed, if not diametrically opposed, viewpoints.

The preceding observation presented itself at the January 2008 Annual Meeting of the Association of American Law Schools, during which the intellectual father of the most attended to subchapter K[3] legislative reform

---

> interests and are the product of **politics**). This untenable classification permeates contemporary analysis of the **politics of tax** policy.
>
> The pretense underlying this conceptual framework ultimately denigrates the political process. It presupposes that the traditional congressional policymaking process is "corrupt" to the extent it is tainted by politicians and interest group **politics**, while genuine **tax** reform constitutes that rare triumph of reason and the pure science of **tax** policymaking. Such sentiments betray a utopian longing for the day when **tax** academics will leave the universities and think tanks and take over the reins of the Treasury Department, and perhaps the membership of the House Ways and Means and Senate Finance Committees as well. Presumably, when that happens, **tax** reform no longer will be a mere aberration or departure from **politics** as usual, as it was in 1986. Instead, rational policymaking finally would supplant **politics** as usual.

Sheldon Pollack, *Tax Reform: The 1980's in Perspective*, 46 TAX L. REV. 489, 491 (1991) (emphasis added). This Article concerns the effect of collective political action on the recent efforts to reform the taxation of profit interest. Throughout, I try to avoid subjective judgments regarding whether that effect is "good" or "bad."

[2] Sheldon Pollack is one of the few scholars who has written extensively regarding the direct influence of politics in the tax legislative process. *See id.*; Sheldon Pollack, *A New Dynamics of Tax Policy*, 12 AM. J. TAX POL'Y 61, 62 (1995) (concluding that the instability of the tax legislative process results from a number of "long term political trends").

[3] Laws relating to the taxation of partners and other owners electing to be treated as partners are contained in subchapter K of the Internal Revenue Code, comprising I.R.C. §§ 701–61.

proposal since 1954, Professor Victor Fleischer,[4] noted with palpable disgust and a gloomy visage that his thoroughly sensible efforts to reform the taxation of "profit interests" appeared doomed; not just politely declined with thanks, but repudiated in the most pejorative sense, as in the same sense as Senator Hillary Rodham Clinton's efforts to reform health care some fifteen years earlier.[5] In short, the problem with which Fleischer was concerned was that persons providing services to a partnership and receiving amounts indisputably and substantively representing compensation for services (a fact admitted even by the recipients) are, under current law, able to convert income from services into income from property and thereby gain access to preferential capital gains tax rates.[6] Fleischer's reform proposal essentially called for the reinstatement of long-held tax policy to correct a glaring but little publicized inequity.[7] Very highly paid service providers were taxed at 20% less than much lower paid service providers, for reasons having nothing to do with policy assertions made in support of capital gains taxation.[8] Fleischer's idea, originally

---

[4] *See* Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1 (2008) (regarding the need to reform partnership tax laws so that recipients of profit interest are prevented from converting ordinary income into capital gains). *See also* Note, *Taxing Private Equity Carried Interest Using Incentive Stock Option Analysis*, 121 HARV. L. REV. 846, 846 (2008) [hereinafter *Taxing Private Equity*] ("Rarely does an idea that germinates in a law review article catch the attention of Congress. Even more rarely does such an idea inspire policy statements by presidential candidates. Recently, however, an idea that originated in Professor Victor Fleischer's forthcoming article, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, has done both. The issue to which it relates is the taxation of the so-called 'carried interest' that private equity professionals earn from their funds' investments.")

[5] *See Health Care Reform—Dead for Now*, N.Y. TIMES, Sept. 24, 1993, at A24.

[6] *See generally* Howard E. Abrams, *Taxation of Carried Interests*, 116 TAX NOTES 183 (2007).

[7] Fleischer, *supra* note 4, at 3–7.

[8] The amounts earned by hedge and private equity fund managers are so large that they raise the danger that correct analysis of underlying tax issues might be skewed by envy:

> Given the fact that these funds are private, no comprehensive figures on managers' compensation are available, although a number of consultants and trade groups do publish estimates. According to *Alpha* magazine, the top 25 hedge fund managers earned $14 billion in 2006. Comparable annual lists are not published for private equity managers, probably because cash distributions occur less frequently than in hedge funds, and there is greater year-to-year variation. One estimate is that managers earned $45 billion over the past six years.

(*continued*)

hailed as necessary as a matter of fairness,[9] has since been effectively caricatured as yet another example of government's anti-capitalist confiscatory fiscal policy.[10] With that, the idea once talked about in circles whose inhabitants used words and phrases such as "reform," "horizontal equity" and "distributive justice" had been exiled to American tax reform's version of Siberia, perhaps to languish for a period of "re-education," perhaps to await a resurrection and vindication many years hence.[11] Regardless, it is useful towards a better understanding of the structure and purposes of our tax code to pause and consider the path to the *status quo ante* with respect to the taxation of partnership profit interests. If nothing else, reconsideration of the path to the present location rehabilitates and consoles, if such is necessary, the messenger—in this case, Professor Fleischer. More importantly, though, it forces upon us the intellectual honesty that ultimately allows for a higher regard of our tax topic. Perhaps, too, intellectual honesty will eventually lead to the reform that

---

MARK JICKLING & DONALD J. MARPLES, CONGRESSIONAL RESEARCH SERVICE REPORT, TAXATION OF HEDGE FUND AND PRIVATE EQUITY MANAGERS (July 5, 2007) 1, 4, http://opencrs.cdt.org/document/RS22689. Another commentator notes that in 2006, "the top hedge fund and private equity managers in America earned an average of $658 million each, which is 22,255 times the pay of the average U.S. Worker. And of course all of these earnings were taxed at just a 15 percent rate." *Hearing on Fair and Equitable Tax Policy for America's Working Families Before the H. Comm. on Ways and Means*, 110th Cong. (Sept. 6, 2007) (Statement of Leo Hindery, Jr., Managing Director, InterMedia Partners), *available at* http://waysandmeans.house.gov/hearings.asp?formmode=view&id=6436.

[9] *See* Alan S. Blinder, *The Under-Taxed Kings of Private Equity*, N.Y. TIMES, July 29, 2007, § Business, at 4 ("Why shouldn't they pay taxes like the rest of us?").

[10] One partisan argues, in the guise of academic research, that:

> Taxing carried interests as ordinary income rather than as capital gains would eliminate the "sweat equity" tax incentive to create small businesses. The likely result would be a reduction in entrepreneurial activities including those associated with the restructuring of inefficient corporations. In turn, this reduction could deter business investment and slow economic growth.

JOINT ECONOMIC COMMITTEE, RESEARCH REP. 110-14, CARRIED INTERESTS, TAXATION, AND ENTREPRENEURSHIP 3 (Oct. 22, 2007), *available at* http://www.house.gov/jec/ResearchReports/2007/rr110-14.pdf.

[11] President-elect Obama's tax plan promises to reform the taxation of profit interests. *See* Barack Obama's Comprehensive Tax Plan, *available at* 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") (last visited Oct. 24, 2008).

ought to have initially occurred but which now seems destined to die in exile or await resurrection only after many more years of injustice.

There is a wealth of scholarship, some predating and some provoked by Fleisher's original observations, concerning the taxation of amounts paid to fund managers.[12] The scholarship thoroughly and accurately describes the tedious details of profit interest taxation. Until now, academic discussion regarding profit interests has been characterized by an implicit surrealism that fails to account for the rent-seeking and rent-extraction in which all stakeholders, truth be told, engage.[13] The purpose of this Article is not to repeat the tedious details, though at times it will be necessary to do so. The Article attempts to identify the politics—the rent-seeking and rent extraction motivations—that have resulted in the continuation of the otherwise illogical approach to the taxation of profit interests. "Political science" is, after all, a recognized science precisely because there are socio-political cause and effect relationships that ought to be considered with respect to any area of law or government. Identification of cause predicts and explains effect; the present exercise will therefore contribute a sense, however unsatisfactory that sense may be, of rationality to our topic. Without an understanding of political realities, we would be left to conclude that the taxation of profit interests is an irrational aberration. Worse, we might question whether there is any rationality at all to the tax code. It is the latter possibility with which tax scholars ought to be most concerned, even if only for reasons of self-preservation. Scholars are very nearly uniform in the conclusion that the yield from service partners—the name given to those fortunate enough to be granted an interest in exchange for their labor—is incorrectly and unfairly taxed at rates lower than the compensation earned by other laborers.[14] Yet the law continues to ignore this consensus, suggesting that

---

[12] *See, e.g.*, Noël B. Cunningham & Mitchell L. Engler, *The Carried Interest Controversy: Let's Not Get Carried Away*, 61 TAX L. REV. 121 (2008); Chris William Sanchirico, *Taxing Carry: The Problematic Analogy to "Sweat Equity"*, 117 TAX NOTES 239 (2007); Abrams, *supra* note 6. For a much longer list of articles see *id.* at 239, n.1.

[13] For an in-depth discussion of rent-seeking and rent extraction, see FRED S. MCCHESNEY, MONEY FOR NOTHING: POLITICIANS, RENT EXTRACTION AND POLITICAL EXTORTION (1997).

[14] The best source from which to measure the nearly unanimous consensus amongst tax scholars is online. One widely read blog contained this recent post:

> While the political issue is very much up in the air in DC, even among some Democrats, it's safe to say that there is an academic consensus among tax profs on the issue: the status quo is problematic, and it

(*continued*)

scholars just don't know what they are talking about or are, as is often alleged are "out of touch" with the real world.[15] Thus, the taxation of profit interests in subchapter K serves to indict the entire tax code; unless rationally explained, what can only otherwise be labeled an unexplained aberration will serve as an accusation that the tax code, and indeed those who are its presumptively objective caretakers—tax scholars—are entirely lacking in rationality.

The Article proceeds from this point through four acts, each of which highlights, largely without subjective judgment whenever possible, the rent-seeking and rent extraction motivations animating the outcomes. Indeed, the Article agrees with the idea that rent seeking and rent extractions are rational behaviors and indeed may even have a legitimate place in tax law.[16] So, in Act I the Article describes the law as it came to be as a result of *Diamond v. Commissioner*,[17] a relatively small dollar amount case that challenged the unstated political compromise theretofore

---

> should be addressed . . . . We may not all agree on exactly what to do about the tax issue—(1) tax the grant of a profits interest at ordinary income rates, (2) tax the returns at ordinary income rates at the back end, or (3) a hybrid approach (like my Cost of Capital or loan approach), or (4) even repealing the capital gains preference altogether. Some of us would apply the changes to all partnerships, others would limit it to smaller partnerships. But as more tax academics weigh in, it's clear that there's a consensus that this is an issue worthy of legislative action. . . . [E]veryone agrees that there's a case for reform. And this isn't a bunch of lightweights; nor is it a group that generally believes in higher taxes, or more redistribution. We tend to believe in a broader base and lower rates, and that's one way of viewing carried interest reform. There are really few academic voices in dissent . . . .

TaxProf Blog, The Academic Consensus on Carried Interest (Aug. 1, 2007), http://taxprof.typepad.com/taxprof_blog/2007/08/the-academic-co.html (last visited Oct. 24, 2008).

[15] On October 3, 2007, the New York Times published an interview with Professor Fleischer in which Fleischer briefly explained his view of the problem with the taxation of profit interests and how the law should be changed to correct that problem. Andrew Ross Sorkin, *A Professor's Word on the Buyout Battle*, N.Y. TIMES, Oct. 3, 2007, *available at* http://dealbook.blogs.nytimes.com/2007/10/03/a-professors-word-on-the-buyout-battle/. An online reader, perhaps picking up on Fleischer's suggestion that someone would accuse him of not understanding the real world, argued in response that academicians were "totaly [sic] out of touch with reality." *Id.* (comment 4).

[16] *See infra* Act II.

[17] 492 F.2d 286 (7th Cir. 1974).

existing. *Diamond* and its aftermath provide the first evidence of successful rent-seeking behavior in the tax code with regard to the taxation of profit interests. The case expressed before-the-fact agreement with Fleischer's proposal.[18] Indeed, the legal outcome initially confirmed that rent-seeking would not prevail over sound tax policy.[19] Surprisingly, that is if one ignores rational rent-seeking behavior as a determinate of tax law, the government promptly gave away that confirmation. The give-away was so stark that the judiciary once rejected the government's concession.[20] When, in a case subsequent to *Diamond*, the IRS attempted to disavow its policy-justified victory, that court explicitly rejected the disavowal.[21] Even in that instance, though, the manner in which the court rejected the rent-seeking outcome made possible by the government's attempted disavowal left open the possibility that rent-seeking would eventually be rewarded.

In Act II, we see how the temporarily diminished hope that rent-seeking would determine the resolution of a substantive tax issue reemerged as the dominant motivator for the rule that prevails to this date. Rather than seek judicial or what might be referred to as public-law approval of the implicit agreement between rent-seekers and rent-providers, the government merely entered into a private agreement whereby sound or at least universally agreed upon tax policy was modified for political purposes. As Act II will show, the government issued two revenue procedures that essentially codified the rent-seeking agreement previously disallowed by the judiciary. Those revenue procedures describe, in broad detail, the method by which a small contingency of financially interested taxpayers, i.e., the partnership tax bar, were successful in elevating political demands over sound tax policy. The agreement was very nearly set in stone—via the issuance of still pending proposed regulations[22] that would have permanently codified its terms—when Professor Fleischer essentially unmasked what seemed like a legitimate policy compromise,[23] exposing the tax policy costs and financial

---

[18] *Id.* at 286–92.

[19] *Id.* at 292.

[20] Campbell v. Commissioner, 943 F.2d 815, 818–19 (8th Cir. 1991) (rejecting government's attempt to concede that the grant of a profit interest to a partner was not a taxable event).

[21] *Id.* at 820.

[22] Dep't of Treasury, Internal Revenue Service, *Partnership Equity for Services*, 70 Fed. Reg. 29675 (May 24, 2005).

[23] Professor Howard Abrams, one of the few scholars who support the *status quo ante*, argues that the current approach is in fact a reasonable method of achieving the proper

(*continued*)

windfalls associated with the rent seeking that actually animated the agreement. Indeed, there were at least arguable policy reasons that might have been asserted by objective, disinterested persons in support of the current arrangement. Those policy assertions, though, have since been disproven or overcome and are not even relied upon, in disguise of rent-seeking or rent extraction, by those who have successfully prevented substantive reform.

In Act III, the Article describes one legislative reform proposal to correct the taxation of profit interests, as well as the policy arguments offered in opposition to the proposal. Those arguments were useful only as tools to disguise the otherwise blatant demands for rent or rent extraction. That is, the forces that came together to defeat reform in the short term were initially depicted as holding opposing views, when in reality they worked together for their mutual benefit. One side preserved its government subsidy, while the other extracted rents in exchange for that preservation. The policy arguments offered in opposition to reform are superficially attractive, it should be admitted, but none of them withstand critical or even scant scrutiny. One can only conclude that even those who purportedly agreed with the need for reform did so only as part of a larger effort to extract rents from those who stood to lose from the enactment of that reform.

Act IV introduces a recently articulated theory known as the "reverse Mancur Olson phenomenon."[24] Mancur Olson posited collective political action as essentially a process whereby special interest groups identify threats to, or opportunities for government funded, "non-market" returns and then, in the form of lobbyists, prey upon legislators who must either continue or grant the subsidy, or risk losing financial support useful for remaining in or achieving higher office.[25] Under this widely respected theory, legislators are victim rather than perpetrator and eventually make tax determinations based on money and the desire to maintain incumbency.

Two recent scholars have challenged the conventional political theory, though, that special interest groups form exclusively in response to or in pursuit of government subsidies referred to in economic literature as

---

result. Abrams, *supra* note 6, at 188 ("[T]he current system of taxation, though based on administrative convenience, ultimately reaches what is close to a proper result. And it is hard, both practically and conceptually, to draft a broad rule that reaches a better one.").

[24] Edward J. McCaffery & Linda R. Cohen, *Shakedown at Gucci Gulch: The New Logic of Collective Action*, 84 N.C. L. REV. 1159, 1164 (2006).

[25] *Id.* at 1172–73, (citing MCCHESNEY, *supra* note 13, at 45).

"rent."[26] These scholars assert that savvy legislators themselves identify opportunities for rent extraction when they become cognizant of threats to existing rents or opportunities to create new rents.[27] The reverse Mancur Olsen theory asserts that legislators turn the tables on interest groups by using the threat of lost or denied rent to provoke the formation of special interest groups and then extract financial benefits from the groups in exchange for the continuation or grant of rents to the group.[28] It is sometimes thought that special interest groups, formed rather spontaneously in response to Fleischer's whistle-blowing activity, descended upon legislators and successfully blocked the legal reform that would have deprived them of the non-market returns offered by taxation of profit interests. In Act IV, the Article demonstrates how the reverse Mancur Olsen phenomenon worked to successfully thwart the substantive reform called for by Fleischer. As one scholar noted, the reforms were best characterized as a "no-brainer," meaning that having sufficiently identified the problem's cost, the effectuation of a solution was a simple matter of quick, easy, uncontroversial legislative action.[29] The best evidence of the reverse Mancur Olsen effect, though, came in the form of unexpected alliances between legislators who usually oppose what they view as untoward tax benefits for wealthy taxpayers (i.e., populist-sounding Democrats) and legislators who usually oppose redistributive policies embodied in progressive tax rates (i.e., free market sounding Republicans).[30] The reverse Mancur Olsen phenomenon occurred in almost precisely the manner described by the theory's proponents to effectively turn a "no-brainer" into a controversial measure destined for exile.

---

[26] McCaffery & Cohen, *supra* note 24. "Rent" refers to "non-market" economic returns that one economic actor pays to or extracts from another party. *Id.* at 1172.

[27] *Id.* at 1172–73.

[28] *Id.*

[29] Professor Mark Gergen has referred to the necessary fix as a "no-brainer" in informal settings. His more formal articulation states, "There is a fairly simple solution to the problem of the taxation of carried interests: amend Section 702(b) to treat a partner's distributive share as ordinary income when the partner receives the distributive share as compensation for services rendered by the partner to the partnership." *Hearing on Fair and Equitable Tax Policy for America's Working Families Before the H. Comm. on Ways and Means*, 110th Cong. (Sept. 6, 2007) (Statement of Mark P. Gergen, Professor of Law, The University of Texas School of Law, Austin, Texas), *available at* http://waysandmeans.house.gov/hearings.asp?formmode=view&id=6433.

[30] *See infra* Act IV.

The Epilogue suggests that even despite our penchant for rent-seeking or rent-extraction, tax policy may eventually prevail. To the faithful, rent-seeking and rent-extraction are annual, though temporary, phenomena that hardly ever outlast fundamental policy. Truth yet prevails. There is reason for hope if this be true. This might especially be the case with regard to the taxation of profit interests because the *status quo ante* with respect to the taxation of profit interests arguably threatens the rents provided to a larger group of rent seekers and rent extractors. So long as profit-interests are taxed at capital gains rates, there exist reasons to question whether capital gains rates, themselves, are ever truly justifiable as a policy grounds. The uneasy political compromise that animate preferential capital gains rates is undermined by the grant of such rates to service providers in receipt of profit interests. As pointed out by the proponents of the reverse Mancur Olson phenomenon, the existence of one rent may threaten the existence of another, thereby generating a contest between two groups of rent seekers or rent extractors. Only one can prevail. The epilogue predicts that the taxation of profit interests will eventually be reformed because those who benefit from the grant of rents via preferential capital gains will command more allegiance than those who support the preferential taxation of profit interests. There will be vindication for Professor Fleischer after all, though more for political than tax policy reasons.

ACT I: *DIAMOND V. COMMISSIONER*[31]

Diamond serves more to exemplify fundamental tax policy than it does the rent-seeking or rent-extraction that underlies present law. It may be, though, that rent seeking occurred at a less organized level prior to *Diamond*.[32] The literature suggests that the practicing bar intentionally eschewed careful tax analysis—which would have resulted in the recognition of ordinary income either upon grant of the profit interest or when amounts were paid with respect to the profit interest.[33] Instead, the

---

[31] 492 F.2d 286 (7th Cir. 1974).

[32] *See, e.g.*, Craig E. Cammock, Comment, *The Effect of Revenue Procedure 93-27 on Taxation of Partnership Profit Interests Received in Exchange for Services*, 30 WILLAMETTE L. REV. 791, 794 (1994) ("Prior to the decision in *Diamond v. Commissioner* . . . the Service and the tax bar reached a consensus that the receipt of a profits interest in exchange for services constituted a nontaxable event.").

[33] Carolyn S. Nachmias, *Using Profits to Compensate a Service Provider—Potential Partnership Characterization*, 21 FLA. ST. U. L. REV. 1125, 1138–44 (1994) (regarding the

(*continued*)

universal advice, given primarily to executives upon receipt of essentially incentive compensation for services, was that the compensation would and should be taxed only upon receipt of yields from the profit interest.[34] The presumptively ordinary rates that should have applied to those yields were apparently of no concern to the bar.[35] Indeed, the government never challenged this advice until Sol Diamond's rather conspicuous attempt to accelerate the conversion of his ordinary income into capital gains.

The taxpayer in *Diamond* forced explicit consideration of the tax outcome that prevails today. Sol Diamond epitomizes the meaning of "service partner." In *Diamond*, one partner contributed $78,000 to a partnership.[36] Sol Diamond, a mortgage broker, contributed no capital but agreed to arrange financing for the venture.[37] He was successful in arranging a loan for $1,100,000 and, as compensation, was granted a vested right to share in 60% of the future profits from the operation of the partnership.[38] Thus, in addition to exemplifying a classic "service partner," Diamond also demonstrated what is meant by the phrase "profit interest." His due consisted of an inchoate right to share in profits from capital owned by another partner.[39] In fundamental terms, Sol received immediate or future compensation for services,[40] depending on timing principals discussed in Act II. The Service did not argue for immediate income exclusion;[41] indeed, it might never have even reacted to the arrangement had not Diamond sought to sell his profit interest for $40,000 a mere few weeks later. Diamond effectuated the sale, reporting $40,000 short term capital gain[42] and thereby forced the issue that plagues the tax code today.

The fundamental tax policy objection in *Diamond* was that a laborer had performed services for a capitalist, generating income for that

---

consensus amongst commentators that receipt of profit interest was not a taxable event despite the lack of authority for that consensus).

[34] *Id.* at 1139 n.87.

[35] *Id.* at 1138 n.81 (citing Jules I. Whitman, *How a Partner Whose Primary Contribution Is Services May Achieve Capital Gain*, 22 N.Y.U. INST. OF FED. TAX'N 653, 663–64 (1964).

[36] *Diamond*, 492 F.2d at 287.

[37] *Id.* at 286.

[38] *Id.*

[39] *Id.* at 287.

[40] *See* Treas. Reg. 1.61-2(d) (2003) (regarding the receipt of compensation in a form other than cash); *see also Diamond*, 492 F.2d at 286–87.

[41] *Diamond*, 492 F.2d at 287, 290.

[42] *Id.* at 287.

capitalist presently or in the future.[43] Settled tax law, of course, determines that service compensation is to be taxed at ordinary rates and that compensation may occur as the result of the payment of cash, property, or even other services.[44] Economically, *Diamond* was no different from any other laborer and yet through use of a partnership he was able to convert ordinary income into capital gains. The result would have been consistent with tax policy if, indeed, *Diamond* actually occupied the status of those intended to be benefited by capital gains taxation.

The latter point requires brief considerations of the policy justifications underlying capital gains taxation. Tax rates have always been progressive, though the rate of progressivity has varied over the history of the tax code.[45] As taxpayers earn more, they are expected as a matter of distributive justice pay a higher percentage of their income as taxes.[46] The rates set on income from capital however cut against this pattern. Under current rates for example, income from labor is taxed at marginal rates as high as 35%,[47] while an identical amount of income from capital is normally taxed at rates as high as only 15%.[48] Some proponents consider this disparate treatment regressive and thus patently unfair.[49] Still, there are elegant policy theories in support of the disparate treatment and, if accepted, lead to the conclusion that social utility increases when tax on yields from capital are decreased even while tax on income from labor is not.

Thus, if Sol Diamond's partner—the partner who contributed capital—had sold a small interest in the partnership to a third party for $40,000, it would have been perfectly consistent with accepted tax policy for him to have reported the yield as capital gain, taxed at 15% by today's rates. Diamond's gain arose purely from his labor and thus should have been taxed as ordinary income, up to 35% by today's rates. The disparity seems all the more inequitable if we assume that Diamond's partner is much

---

[43] *Id.* at 288.

[44] *Id.* at 290 (noting that the Tax Commissioner asserted delinquencies when a partner tax payer had not reported the market value of a profit share in ordinary income).

[45] *See generally* Vada Waters Lindsey, *The Widening Gap Under the Internal Revenue Code: The Need for Renewed Progressivity*, 5 FLA. TAX REV. 1, 7–12 (2001).

[46] *Id.*

[47] I.R.C. § 1(a)–(e) (LexisNexis 2008).

[48] *Id.* § 1(h). While some capital gains are taxed at 25 or 28%, most are taxed at 15%. *See id.* § 1(h)(1)(C).

[49] Noël B. Cunningham & Deborah Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319, 321 (1993).

wealthier than Diamond. In the absence of sufficient justification, the tax law ought to eliminate the disparate treatment.

The three traditional reasons for the capital gains preference—reasons that are important to the tax treatment of profit interests—include the desire to avoid (1) tax on "phantom gain" or double taxation on the same income, (2) the "lock-in" effect, and (3) bunching.[50] These three outcomes, and their inapplicability to Sol Diamond, are best demonstrated by an example. Suppose Diamond's partner earned $100, after taxes, during a period when annual inflation was 10%. Assume further a constant tax rate of 15% for income less than $30.00 and 30% for income over $30.00. If Diamond's partner invest his $100 in the partnership and more than one year later sells the partnership interest for $110, he will be treated as though he has a $10 accession to wealth. His tax will be $1.50. As a result of inflation, however, Diamond has no more purchasing or consumption power on the date of the sale than he had on the date of the investment. His nominal gain is illusory, at best, and it will be as if Diamond were taxed a second time on the identical $100.[51] He would have been better off had he immediately consumed the $100 invested in the partnership.

The second reason for the capital gains preference—lock in—is closely related to the first and third justification. The taxation of mere inflationary gain discourages divestment when perhaps it would be economically rational and socially useful to divest.[52] Suppose, for example, that Diamond's partner invested in an oil and gas partnership but after five years realized that moving his investment to renewable energy sources would be preferable. Upon that realization, he might sell his investment and use the proceeds to invest in renewable energy sources. If he did so, however, he would face two negative consequences. First, he would have to pay taxes on the gain from his divestment. The desire to avoid taxes on divestment acts as a disincentive to divestment (and reinvestment) and thus creates the "lock-in" effect. Second, the sale of the asset after five years, "bunches" all of the appreciation as taxable gain into year six.[53] Thus, Diamond's partner would have $61.05 in nominal gain in year six that would be taxed at 30% since his annual income would exceed $30. His tax liability would be $18.31; had the appreciation been taxed as it accrued (at

---

[50] *Id.* at 319, 325, 328, 344.

[51] *Id.* at 337–40 (regarding the taxation of inflation).

[52] *Id.* at 344–49 (regarding the lock-in effect).

[53] *Id.* at 328–30 (regarding the bunching effect).

a rate of 10% per year), the aggregate tax liability over the same five year period would have been only $9.16. The bunching effect caused a nearly twofold increase in tax liability.

Lowering the rate of tax, as occurs via a capital gains preference, provides Diamond with "rough justice" because with any given asset it is nearly impossible to determine the portion of its appreciation attributable to inflation and the portion attributable to real increase in consumption power. Likewise, we cannot know for sure the precise impact of the lock-in or bunching effects. In any event, the theories are elegant enough to provide us with enough reason to conclude that the benefit of disparate treatment of yields from capital and yield from labor outweigh the apparent unfairness.

The same conclusion cannot be made with respect to the grant of capital gains preference to Sol Diamond. The first assumption upon which the capital gains preference rests is that the financial capital invested in the partnership was previously taxed at ordinary rates at least once prior to its investment. Sol Diamond's invested human rather financial capital; there was no previous instance of taxation at any rate because the tax code does not levy human capital itself. There is no phantom gain/double taxation problem with respect to yields from human capital. There is also neither a lock-in nor bunching effect because there has been no previous investment of previously taxed income. Thus, granting a tax preference to Sol Diamond would serve no useful purpose to justify the unfairness that would exist as between Sol Diamond and any other service provider.

The tax bar might have been perfectly content to take their winnings from pre-*Diamond* transactions had the Tax Court simply ruled that the grant of a profit interest was not an appropriate occasion to impose a tax, but any yields later realized from that grant should be taxed as ordinary income, at least to the extent of the value of the services giving rise to the profit interest. As explained above, the biggest danger to the tax code arising from Sol Diamond's strategy was the improper treatment of ordinary income as capital gains. Instead of focusing on the point at which conversion occurred—Diamond's sale of the profit interest—the Tax Court, no doubt in response to the government's apparently sensible logic, ruled that the grant of the profit interest was itself an event appropriate for taxation at ordinary rates.[54] This conclusion successfully thwarted the conversion of service income to capital income but at the same time it threatened to upset the *status quo ante*. Profit interests were relatively rare

[54] Diamond v. Commissioner, 492 F.2d 286, 286 (7th Cir. 1974).

devices used, specifically, to provide deferred compensation for highly paid executives.[55] *Diamond* threatened that strategy not because it incorrectly diagnosed the problem—conversion of ordinary income to capital gain—but because it incorrectly treated the problem. Conversion was, at that time, a fortuitous benefit with which the tax bar seemed unconcerned.[56] The significant, intended benefit was instead deferral of tax liability.[57] *Diamond's* treatment of the profit interest as a taxable event prevented conversion but also threatened the significant tax benefit most profit interest recipients sought.

ACT II: RENT SEEKING AND REVENUE PROCEDURES

The tax bar's universally negative reaction to *Diamond* was swift and unequivocal. It manifested itself in two ways. The first might legitimately be described as an unstated conspiracy to simply ignore *Diamond's* holding that the grant of a profit interest constituted a taxable event.[58] Instead, practitioners continued to advise taxpayers that there were no immediate tax consequences from the grant of a profit interest. The second involved the pursuit of an essentially *sub rosa* agreement with the government that would reinstate the non-taxability of profit interests in a more formal manner than a simple wink and a nod.[59] The bar was helped

---

[55] *See* Mark P. Gergen, *Reforming Subchapter K: Compensating Service Partners*, 48 TAX L. REV. 69, 84–88 (1992) (regarding the grant of a profit interest as deferred compensation); *see also* Cammock, *supra* note 32, at 791 ("Many high-bracket taxpayers have effectively deferred recognition of income by rendering services to a partnership in exchange for a nontaxable interest in future partnership profits.").

[56] *Diamond*, 492 F.2d. at 289–90.

[57] *Id.* at 290. Indeed, deferral is normally accompanied by a lower tax rate. This is because the deferred income can be paid to the recipient at a time of his or her selection, normally during a tax year when the recipient is in a lower tax bracket.

[58] Arnold W. Martens, *The* Mark IV Pictures *Decision Offers No Guidance for the Tax Advisor, Only More Confusion*, 38 S.D. L. REV. 641, 660 ("A series of cases and a general counsel memorandum gave support to the pre-*Diamond* belief that the issue with respect to services exchanged for a profits interest in a partnership could be ignored. Tax advisors based this belief on the theory that the profits interest had no current ascertainable value.").

[59] I refer to the government's resolution as a "sub rosa" agreement because it was implemented by way of revenue procedures. *See supra* notes 22 & 23 and accompanying text. Revenue Procedures are essentially means by which the Internal Revenue Services ("the Service") instructs taxpayers how they should report a tax position. Rev. Proc. 89-14, 1989-1 C.B. 814 ("A 'revenue procedure' is an official statement of a *procedure* published in the Bulletin that either affects the rights or duties of taxpayers or other members of the public under the Internal Revenue Code and related statutes, treaties, and regulations or,

(*continued*)

along in both pursuits by the government's almost immediate disavowal of its own victory in *Diamond*.[60] The Seventh Circuit Court of Appeals affirmed *Diamond* in 1974[61] and by the end of 1975 the Treasury Department had already suggested on two separate occasions that the holding be ignored.[62]

Actually, there were legitimate reasons why *Diamond* might have been overruled by statute or authorized regulations in a more considered and deliberate manner. The key fact upon which the tax bar relied prior to *Diamond* was the asserted inability to correctly value the profit interest.[63] Sol Diamond's sale of his profit interest less than three months after he received it contradicted the notion that the interest could not be objectively valued. The Tax Court simply assumed that the value of the profit interest on the date it was sold must have been equal to the value of that interest on the date Sol Diamond received it.[64] In pursuit of its decision to ignore *Diamond's* holding, the tax bar nevertheless argued that the facts of that case were *sui generis* and extraordinarily unlikely to reoccur.[65] The rather obvious fallacy in the assertion that profit interests are incapable of valuation is that the parties themselves have assigned a value via arms length negotiation. Laborers do not usually work for free, nor do capitalist expect free service. The parties themselves know the value of the profit interest because one has used it to obtain needed services and the other has accepted the interest in lieu of the cash value of her services. The

---

although not necessarily affecting the rights and duties of the public, should be a matter of public knowledge.") (emphasis added). Nevertheless, the revenue procedures had the effect of substantive authority because they essentially announced that the Service would not challenge taxpayers who took positions contrary to the holding in *Diamond.*

[60] I.R.S. Gen. Couns. Mem. 36,346 (July 23, 1975) (recommending for a third time that the government not follow the holding in *Diamond*).

[61] 492 F.2d 286 (7th Cir. 1974).

[62] I.R.S. Gen. Couns. Mem. 36,346 (July 23, 1975). *See also* Laura E. Cunningham, *Taxing Partnership Interests Exchanged for Services*, 47 TAX L. REV. 247, 250 (1991).

[63] *See, e.g.*, FEDERAL TAXATION COMMITTEE, CHICAGO BAR ASSOCIATION, REPORT OF SUGGESTIONS FOR ADMINISTRATIVELY ADDRESSING THE UNCERTAINTY CREATED BY THE TAX COURT DECISION IN WILLIAM G. CAMPBELL, 59 TCM 236 (1990) (Feb. 1991), *available via Lexis at* 91 TNT 58-35 (arguing that a rule requiring recognition of income upon grant of profit interest created severe valuation problems); SECTION ON TAXATION, LOS ANGELES COUNTY BAR ASSOCIATION, COMMENTS ON THE TAXATION OF THE RECEIPT OF A PROFITS PARTNERSHIP INTEREST FOR SERVICES (May 1991), *available via Lexis at* 91 TNT 130-26 (same).

[64] *Diamond*, 492 F.2d. at 288.

[65] Martens, *supra* note 58, at 659.

valuation problem is illusory, at best, and therefore should not as the basis for delaying taxation.[66]

Even assuming, as logic ultimately dictates, that a profit interest is capable of valuation, there is still one legitimate reason why the ability to value the interest does not require immediate taxation. It is generally assumed that valuation, *per se,* requires the imposition of tax liability.[67] Indeed, the receipt of something valuable, particularly that which is bargained for, ought normally to result in taxation. Value, though, is not invariably synonymous with income. Income is not an objective construct such that we can determine its occurrence from the ability to value something. "Income" as it is used in tax jurisprudence embodies the notion that it is presently appropriate to demand that the recipient pay a tax.[68] Hence, valuation is merely one aspect of the larger concept of "income." That concept includes administrative convenience, as in the case of withholding tax on appreciation until that appreciation is actually realized to avoid the administrative burden of determining the exact value of that appreciation.[69] It also takes into account liquidity, the desire to avoid forced divestment and, in fact, the right to plan transaction specifically to defer taxation.[70] All of these considerations recently determined, for example, that a baseball fan who suddenly found himself in possession of record-setting baseball indisputably worth $3 million dollars did not have income immediately.[71] Though that which the fan

---

[66] *Cf.* Treas. Reg. § 15A.453-1(d)(2)(iii) (2008) ("Only in those rare and extraordinary cases involving sales for a contingent payment obligation in which the fair market value of the obligation (determinable under the preceding sentences) cannot reasonably be ascertained will the taxpayer be entitled to assert that the transaction is 'open.'").

[67] 84 C.J.S. *Taxation According to Value* § 73 (2001).

[68] 2 STAND. FED. TAX. REP. ¶ 6001 (CCH 2008).

[69] *See* I.R.C. § 1001 (LexisNexis 2008); Cottage Savings Ass'n v. Comm'r, 499 U.S. 554, 559 (1991) ("As this Court has recognized, the concept of realization is 'founded on administrative convenience.' *Helvering v. Horst*, 311 U.S. 112, 116 (1940). Under an appreciation-based system of taxation, taxpayers and the Commissioner would have to undertake the 'cumbersome, abrasive, and unpredictable administrative task' of valuing assets on an annual basis to determine whether the assets had appreciated or depreciated in value.").

[70] KEVIN E. MURPHY, CONCEPTS IN FEDERAL TAXATION 29–30 (1996).

[71] *See* Lawrence Zelenak & Martin J. McMahon, Jr., *Taxing Baseballs and Other Found Property*, 84 TAX NOTES 1299, 1300–01 (1999) (regarding the IRS' decision not to impose a tax on the fan who caught Mark McGwire's record setting baseball).

obtained was capable of valuation, it need not have been taken into account until the property's easily determined value had been converted.

The same considerations better support postponing a tax levy upon the receipt of a profit interest than does the assertion that a profit interest is incapable of valuation. Clearly, the profit interest is capable of valuation, but requiring immediate payment of taxes would encourage premature divestment and infringe upon the taxpayer's delicate right to plan the occurrence of income to her own advantage. Valuation is simply not a sufficient reason to postpone taxation because there are very few things, if any, that cannot be valued to a reasonable degree of certainty.

It is probably because valuation is not an insurmountable problem in any event that the tax bar remained so concerned even as the government was willing to concede the bar's uncritical advice that the grant of a profit interest did not result in immediate taxation. Nearly twenty years after *Diamond*, the Eighth Circuit Court of Appeals, mistakenly conflating valuation and income, determined in *Campbell v. Commissioner*[72] that the grant of a profit interest capable of valuation was indeed a taxable event.[73] If that were true, the bar must have realized, nearly every grant of a profit interest would be a taxable event. It would be a mere matter of time before the valuation fallacy would be exposed.

The tax bar's repeated assertions that it lacked understandable authority regarding the taxation of profit interest most likely resulted instead from the realization that the precedents were all too clear. It was after *Campbell v. Commissioner* that the bar came to understand that the non-market returns (i.e., rent) were in serious jeopardy.[74] Read together, *Diamond* and *Campbell* represent the rather uncomplicated rule that the ability to value a profit interest means immediate taxation is appropriate and indeed required. The bar's assertions were profitable to the extent they persuaded the government to join in what seems like a feigned confusion regarding valuation capabilities. In Revenue Procedure 93-27,[75] the government restated the simple, though substantively incorrect proposition that the inability to value a profit interest requires that the grant of the profit interest results in immediate taxation. The concession to the bar, though, came in the procedure's extraordinarily narrow limits on the circumstances in which a profit interest would be deemed capable of

---

[72] 943 F.2d 815, 823 (8th Cir. 1991).

[73] *Id.* at 823.

[74] *See* Abrams, *supra* note 6, at 183 & n.2.

[75] Rev. Rul. 93-27, 1993-2 C.B. 343.

valuation. The procedure essentially limits valuation capability to profits interest that "relates to a substantially certain and predictable stream of income from partnership assets" or a profit interest that is disposed of within two years of receipt.[76] The latter instance presumably refers to a situation such as in *Diamond* where the taxpayer sold the profit interest soon enough after its receipt that the sale price could easily be used as a market valuation of the interest on the date it was granted. Ultimately, the tax bar obtained the return to pre-*Diamond* law it desperately sought.[77]

Significantly, Revenue Procedure 93-27 applies only when profit interests were granted to a person providing services "in a partner capacity or in anticipation of becoming a partner."[78] What it failed to address was the characterization of amounts later paid with respect to the profit interest. Under IRC 702(b), items taxable to the partners are characterized at the partnership level.[79] If the partnership realizes capital gain and allocates a portion to the service partner in accordance with her profit interest, what will have started as compensation, taxed as ordinary income, will be converted to capital gain. That possibility was never addressed in Revenue Procedure 93-27, but in Revenue Procedure 2001-43,[80] the government essentially mandated that outcome. Revenue Procedure 2001-43 requires, as a condition of maintaining the non-taxability of the profit interest, that the recipient be treated as a partner from the date of the grant.[81] Thus, amounts paid with respect to profit interest would be paid to a "partner" and thus characterized at the partnership level under IRC 702(b). Here, then, was an additional opportunity for rent-seeking behavior. Not only could a taxpayer structure her compensation so as to defer tax liability, and quite properly so, but she could also have that compensation taxed as though it represented earnings from property rather than services.

ACT III: THREATS TO FUND MANAGER RENTS

Administrative convenience is the overriding policy concern in Revenue Procedures 93-27 and 2001-43.[82] The tax code, Subchapter K

---

[76] *Id.* at 344. In addition, if the partnership in which a profit interest is granted is a publicly traded partnership, the grant of profit interest will result in immediate taxation. *Id.*

[77] Simon Friedman, *Partnership Capital Accounts and Their Discontents*, 2 N.Y.U. J.L. & BUS. 791, 799 (2005).

[78] Rev. Rul. 93-27, 1993-2 C.B. at 344.

[79] I.R.C. § 702(b) (LexisNexis 2008).

[80] Rev. Rul. 2001-43, 2001-2 C.B. 191.

[81] *Id.*

[82] *See* Abrams, *supra* note 6, at 186.

especially, often sacrifices tax accuracy for the sake of administrative convenience.[83] In some instances, the benefit of achieving the precisely correct outcome is viewed as not worth the corresponding administrative burden.[84] The lost revenue from intentional inaccuracy is thought to be less than the cost of getting to the most accurate outcome.[85] There would be very little burden, though, associated with requiring the parties to divulge the market value of services and then taxing that amount as ordinary income. As rational economic actors, the parties would have determined the value of the services provided in any event.

Thus, the two revenue procedures implicitly overstate the cost of tax accuracy. They assume administrative difficulty with respect to the valuation of profit interests and, as a result, tolerate an uncertain amount of revenue loss under the assumption that the revenue loss is never greater than the costs associated with a rule requiring valuation and immediate taxation. This section shows that while the costs associated with administrative burdens of accuracy were overstated, the lost revenue from intentional inaccuracy was greatly understated. Once those burdens and lost revenue were accurately measured, the Congress initiated corrective action that, in turn, led to the occurrence of the reverse Mancur Olson phenomenon, discussed in Act IV.

As noted earlier, the enduring assumption regarding profit interests is that the difficulty in valuing those interests justifies postponing taxation until profits are actually paid. In Act II, the Article discounted the valuation difficulty but nevertheless agreed for different reasons that taxation should be delayed until amounts are actually paid. The assumed cost of accurately taxing profit interests were thought to be higher than the revenue losses from intentional inaccuracy. In fact, the revenue procedures are based on the assumption that the revenue loss is usually nil. Both rulings treat the grant and receipt of a profit interest as a closed transaction

---

[83] *Cf.* Treas. Reg. 1.701-2(a)(3) (1995) ("[C]ertain provisions of subchapter K and the regulations thereunder were adopted to promote administrative convenience and other policy objectives, with the recognition that the application of those provisions to a transaction could, in some circumstances, produce tax results that do not properly reflect income.").

[84] *See, e.g.*, Friedman, *supra* note 77, at 799–801 (discussing 2005 changes to Treasury regulation sections 1.704-1(b) and 1.704-2 that highlights high burden of compliance against risk of incorrect outcomes).

[85] *Id.*

as of the date of the grant where the value of the compensation is zero.[86] Doing so means that future payments are taxed as though they are entirely unrelated to the services but instead derived from partnership's activities. Treating the grant and receipt of the profit interest as a closed transaction requires a determination that the amount of compensation paid to the service partner is zero—a conclusion that belies rationality since people do not bargain their labor away for nothing. If the compensation is zero then the expense incurred by the service recipient must also be zero; if it is assumed that all parties to the transaction are taxed at the same rate the revenue loss must also be zero because the trade or business expense deduction[87] for compensation must equal the amount included by the service provider as gross income. Thus, the government loses tax revenue when it allows a service provider to forego inclusion but essentially recoups that lost revenue by denying an equal deduction to the service recipients. Even if the government had accurately determined that valuation costs were insignificant it would still have reason to conclude that the valuation costs exceeded the loss revenue because the lost revenue would almost always be zero.

In early 2006, Professor Victor Fleischer wrote what might legitimately be characterized as the academic equivalent of a media expose.[88] Using typical contract terms found in hedge, private equity and venture capital fund governing documents, Fleischer showed how the nearly forty year old expedient compromise regarding the taxation of profit interests had come to exemplify an incredibly inefficient and inequitable "loophole" in the tax code.[89] His article initiated a long overdue

---

[86] Under the "liquidation method" the value of the compensation is equal to the value of the amount of assets the service partner would receive if the partnership liquidated immediately after grant of the profit interest. Since upon grant of the profit interest the service partner receives only the right to receive future unearned profits, the value of her liquidation rights on the date of the grant must be zero. *See* Cunningham, *supra* note 62, at 255.

[87] I.R.C. § 162 (LexisNexis 2008).

[88] *See* Fleischer, *supra* note 4. *See also Taxing Private Equity*, *supra* note 4, at 846 (noting the media and popular attention given to Fleischer's article); Thomas Brennan & Karl S. Okamoto, *Measuring The Tax Subsidy in Private Equity and Hedge Fund Compensation* (Drexel College of Law Research Paper No. 2008-W-01), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1082943.

[89] Fleischer, *supra* note 4, at 17–26.

discussion, provoked at least three Congressional hearings,[90] two legislative proposals,[91] and the publication of several more articles exploring the taxation of profit interests.[92] Fleischer's article and his call for reform generated more study and debate regarding the taxation of profit interests during the past two years then occurred during the previous forty years. Ultimately, though, it was tax politics rather than tax policy that determined the short term resolution of the conversion of ordinary income to capital gains through the use of subchapter K.

The intricate details of fund manager compensation are thoroughly explored in Flesicher's article and the many more that were published in response to his article.[93] The general details suffice for purposes of the present discussion. What hedge and private equity funds have in common are that they are usually organized as limited partnerships.[94] The limited partners obligate themselves to contribute investment capital, while the general partner agrees to provide investment management services.[95] Typically, the limited partners agree to compensate the general partner via the "two and twenty." "Two" refers to a fixed fee equal to two percent of the invested capital.[96] "Twenty" refers to a variable payment equal to twenty percent of the partnership gains derived from the investments selected and managed by the general partner.[97] As noted earlier, by having the compensation flow through the partnership, fund managers are able to convert compensation income, taxed at rates up to 35%, into capital gains

---

[90] Both the United States House of Representatives and the United States Senate held hearings during summer 2007 regarding the topic. *See Hearing on Fair and Equitable Tax Policy for America's Working Families Before the H. Comm. on Ways and Means*, 110th Cong. (Sept. 6, 2007), *available at* http://waysandmeans.house.gov/hearings.asp?formmode=detail&hearing=584; *Carried Interest, Part II: Hearing Before the United States Senate Comm. on Fin.*, 110th Cong. (July 31, 2007), *available at* http://finance.senate.gov/sitepages/hearing073107.htm; United States Senate, Committee on Finance, *Carried Interest, Part I: Hearing Before the United States Senate Comm. on Fin.*, 110th Cong. (July 11, 2007), *available at* http://finance.senate.gov/sitepages/hearing071107.htm.

[91] H.R. 2834, 110th Cong. (2007); S. 1624, 110th Cong. (2007). *See also Taxing Private Equity*, *supra* note 4, at 859.

[92] *E.g.*, *Taxing Private Equity*, *supra* note 4, at 846.

[93] *See* Fleischer, *supra* note 4; *see also supra* note 12.

[94] *See* Fleischer, *supra* note 4, at 8.

[95] *Id.*

[96] *Id.* at 3.

[97] *Id.*

taxed at rates up to 15%.[98] Fleischer argues, quite correctly, that none of the traditional reasons for granting the capital gains preference applies to fund manager compensation.[99] He considers five proposals for reform but ultimately settles upon changing the law so that yields from profit interest are simply taxed as ordinary income.[100]

The most significant point arising from Fleischer's work concerned the comparison between administrative burden and revenue loss. As noted above, the assumption underlying Revenue Procedures 93-27 and 2001-43 was that the substantive inaccuracy of treating yields from profit interest instead as yields from the partnership's invested capital cost the government very little, if anything.[101] The revenue lost by not requiring the inclusion of ordinary income upon grant of the deduction is perfectly offset, assuming service provider and service recipients are subject to the same tax rates on their ordinary income, by the increased revenue derived from denying the a trade or business expense deduction to the service recipients. Fleischer's research virtually shattered the comforting assumption that there were no net losses from the substantive inaccuracy. Most of the largest investors in pooled funds were indifferent, either because they were tax exempt, such as universities and pension funds, or could not have benefited from the denied tax deduction in any event.[102] Scholars who took these facts into consideration estimated the revenue loss from the substantive inaccuracy at amounts as high as $4.2 billion per year.[103]

In remarkably short order, both the U.S. House of Representatives and the Senate saw the introduction of bills that would reform the taxation of profit interests in the manner Fleischer proposed.[104] Initially, the bills were received as relatively uncontroversial measures that would restore

---

[98] *See supra* Act II.

[99] Fleischer, *supra* note 4.

[100] *Id.* at 47–54 (outlining proposals), 57–58 (discussing ordinary income method as preferred policy recommendation).

[101] *See supra* notes 75–81 and accompanying text.

[102] Fleischer, *supra* note 4, at 17–18.

[103] *See, e.g.*, Michael S. Knoll, *The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of Taxing Profits Interests as Ordinary Income*, *available at* http://lsr.nellco.org/upenn/wps/papers/172/ (last visited Oct. 24, 2008).

[104] H.R. 2834, 110th Cong. (2007); S. 1624, 110th Cong. (2007).

horizontal equity and intellectual integrity in the tax code.[105] There were complaints regarding added complexity and drafting suggestions, as with any legislation designed to implement a general policy determination, but there were no significant protests against the substantive idea of somehow requiring the application of ordinary rates to the yield from profit interests.[106] As it became apparent, though, that fund managers were really on the verge of losing a substantial tax subsidy, both legislators and lobbyists resolved their free-rider and organizational problems and mobilized themselves in an ultimately successful effort to defeat the proposal.[107] The result was the probably starkest, most fascinating example of the reverse Mancur Olson phenomenon since the articulation of that theory.

ACT IV: THE REVERSE MANCUR OLSON "SHAKEDOWN"

Conventional wisdom suggests that Congress' failure to correct the tax treatment of profit interests resulted from the inexorable pressure of primarily one small special interest group, namely, the group of investment fund managers.[108] This view would portray legislators as unwilling victims, along with the public, of purely self-interested but very well funded taxpayers who had no qualms about subordinating the tax code's logical integrity to their own greedy desires.[109] Conventional wisdom is comforting, in fact, because it restores some sense of "right" to those scholars who vainly and in quiet academic voice argued in support of reforms so clearly consistent with fundamental tax policy. The notion that scholars advocating reform are substantively wrong, particularly because they are out of touch with the "real world," is not only extraordinarily discomforting, it also calls into question one's very reason for existing. To conclude instead that politics and money corrupted and then thwarted reform, about which there is academic consensus, is an easier pill.

Two scholars, Professors Edward McCaffery and Linda Cohen, recently made significant contribution to conventional wisdom by coining and explaining the "reverse Mancur Olson phenomenon."[110] Mancur

---

[105] *See, e.g., Hearing on Fair and Equitable Tax Policy for America's Working Families Before the H. Comm. on Ways and Means*, Sept. 6, 2007, *available at* http://waysandmeans.house.gov/hearings.asp?formmode=view&id=7144.

[106] *See id.*

[107] *See infra* Act IV.

[108] McCaffery & Cohen, *supra* note 24, at 1161–62.

[109] *Id.* at 1165.

[110] *Id.* at 1164.

Olson's famous exposition on political science posits that small groups become cognizant of opportunities for "non-market returns," overcome their initial organizational and free-rider problems and, in the words of McCaffery and Cohen, "descend on Washington and other bastions of power, in the guise of corporate lobbyists" in successful pursuit of "rent[s]," the term used to describe those non-market returns.[111] The entirety of this process is referred to as "rent-seeking" and essentially portrays legislators—the gatekeepers of the governmental funds from which rent is available—as passive objects of prey.[112] McCaffery and Cohen, implicitly at least, think the notion of rent-seeking as the exclusive mode of collective political action is a bit naïve, or at least outdated.[113] They think instead that legislators are as much predator as prey. Rather than the passive objects of rent-seeking, legislators are more often perpetrators of rent-extraction.[114] In this view, legislators recognize an opportunity for reaping their own non-market returns in the form of campaign contributions, stimulate the formation of an interested special interest group, suggest the possibility of non-market losses via future legislation, and then "milk" the issue for as long as possible to extract rents from the interested taxpayers who stand to lose from any particular item of legislation. In short, McCaffery and Cohen portray legislators as extortionist.[115]

The reverse Mancur Olson phenomenon is most likely and most effective, according to McCaffery and Cohen, under three conditions. First, the group of interested taxpayers must be relatively small, wealthy and tightly knit.[116] Smaller, well-funded groups with fewer diverging issues make it easier to avoid collaboration and free-rider problems that would otherwise prevent the collective rent-seeking action or rent-extraction reaction.[117] Second, the issue from which the financial threat arises should be prolonged as long as possible so legislators can indefinitely "milk" it for campaign contributions.[118] Third, and perhaps most significant for the ideal occurrence of the reverse Mancur Olson

---

[111] *Id.* at 1161 (citing MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (1965)).

[112] *Id.* at 1163–64.

[113] *Id.* at 1164.

[114] *Id.*

[115] *Id.* at 1172–74.

[116] *Id.* at 1177.

[117] *Id.* at 1161.

[118] *Id.* at 1178.

phenomenon, is that there should be at least two diametrically opposed special interest groups.[119] The presence of at least two groups allows more legislators to participate in and benefit from rent extraction. It also serves as a reason for all legislators to cooperate in the indefinite prolonging, rather than resolution, of the issue raising financial threats.

Each of the three factors identified by McCaffery and Cohen exists with respect to the efforts to reform the taxation of profit interests. The most directly interested taxpayers consisted of a very small and wealthy group of investment fund managers. The taxation of profit interests has been an unresolved issue for nearly forty years; the issue will likely remain undecided for several more years at least.

Finally, there at least two groups of wealthy interested taxpayers with differing positions. Obviously, fund managers seek to maintain the *status quo ante* by which their compensation income may be taxed at capital gains rates. The opposing group most relevant to the occurrence of the reverse Mancur Olson phenomenon is not so readily identified. Those who simply object to unexplained preferences in the tax code initially come to mind. That population, however, is so large and diverse that it can hardly be referred to as a "special interest group." That population may ultimately impact the outcome but it is too broadly dispersed to overcome the coordination and free-rider problems that would make it an effective group of rent-seekers or an effective target for rent extraction. The group most likely to serve as "the opposition" and thereby lead to the optimal conditions for the reverse Mancur Olson phenomenon are taxable investors who themselves presently enjoy capital gains preferences. The justification for the capital gains preference is diluted to the extent the preference is extended to income having no logical connection to the traditional rationale for the preference, as is the case when fund manager returns are granted the preference. Thus, the extension of capital gains rates to fund managers generates threats to the gains derived by a separately defined group of taxpayers. The existence of a threatened group with opposing interests would logically lead to the more financially productive context for prolonged rent-extraction. Hence, we should logically assume that the current law with respect to the taxation of profit interest is the result of the reverse Mancur Olson phenomenon.

A fourth factor, one related more to the ability to predict the occurrence of the reverse Mancur Olson phenomenon, is the lack of any logically substantive reason not to impose certain costs on interested

---

[119] *Id.* at 1177–78.

taxpayers. McCaffery and Cohen do not explicitly include this factor as necessary or predictive of rent extraction but it is logically implicit from the examples they provide of previous rent extraction behaviors.[120] The absence of any reason not to impose the costs of profit interest reform is best exemplified in the profit interest context by the arguments actually and unabashedly set forth in response to Fleischer's article and subsequent legislative proposals. These arguments were essentially that if Congress actually reformed the law, fund managers would either restructure their compensation arrangements to nevertheless obtain the conversion which by that point would be clearly unintended, or would expatriate themselves from the United States in order to avoid the tax.[121] The incredible candor with which these arguments were made, and the fact that they had no substantive relationship to the underlying issue—the inequity of applying lower tax rates to some service providers—implicitly admitted that there were no legitimate substantive reasons for continuing the status quo. Clearly, rent extraction is rendered easier when the potential losers have no substantive argument upon which to rely.

There are many faces of the reverse Mancur Olson "shakedown" but the most accurate with regard to the efforts to reform the taxation of profit interest is that of Senator Charles Schumer.[122] Historically, Senator Schumer has argued against what he viewed as regressive tax policies.[123] The efforts to reform the taxation of profit interest, though, would impact an admittedly small group, but one largely populated in New York City, which is represented in Congress by Senator Schumer. Fund managers represent, within Senator Schumer's immediate proximity, a small, wealthy, group of taxpayers who stood to lose significant financial amounts if reform occurred.[124] McCaffery and Cohen emphasize that rent-extraction usually follows efforts by legislators to define and then informally organize the special interest groups from which rents can be extracted.[125] Soon after reformers introduced their bill in the House of

---

[120] *Id.* at 1175–76.

[121] *See* Fleischer, *supra* note 4, at 49–50, 57.

[122] For media reports regarding Senator Schumer and his opposition to efforts to reform the taxation of profit interests see Raymond Hernandez &Stephen Labaton, *In Opposing Tax Plan, Schumer Breaks With Party*, N.Y. TIMES, July 30, 2007, at A1; Jenny Anderson, *For Schumer, The Double-Edged Sword of Cozying Up to Hedge Funds*, N.Y. TIMES, June 22, 2007, at C6.

[123] Hernandez & Labaton, *supra* note 122.

[124] *Id.*

[125] McCaffery & Cohen, *supra* note 24, at 1176.

Representatives, Senator Schumer—ostensibly and ironically for reasons of "fairness"—sent signals that he was prepared to introduce a bill that would make it clear that the reform efforts would include other wealthy and well-defined groups.[126] As noted by one New York newspaper, Schumer's threat to introduce a bill that would explicitly extend reform to oil and gas partnerships seemed like a thinly veiled effort to enlist the opposition of a powerful interest group.[127] McCaffery and Cohen's reverse Mancur Olson phenomenon would more accurately determine that Schumer's threat was an effort to define and coordinate another special interest group from which to extract rents.[128] It would also prolong consideration of the efforts, just as McCaffery and Cohen predict in their initial exposition, thus extending the period over which rents could be collected.

Ultimately, efforts to reform the taxation of profit interests failed, despite having initially been welcomed as necessary and long overdue. The process by which those efforts went from being characterized as "no brainers" to efforts requiring indefinite and inconclusive consideration and reconsideration do not speak to the substantive merits as much as they speak to the influence of rent seeking and rent extraction on tax laws. Unlike McCaffery and Cohen, though, I am not so prepared to lament this reality. It is more productive for the moment that stakeholders simply recognize the reality so that they do not become dispirited in their higher efforts to at least identify the legitimate policy debates and conclusions that should inform tax laws. That an effort to find the optimal approaches to the distribution of tax burdens in society fails to produce concrete outcomes as a result of politics does not, in itself, prove that the effort was wrong or those expending the effort are "out of touch" with reality.

---

[126] *See* Geoff Earle, *Chuck Hedges His Bets*, N.Y. POST, Aug. 14, 2007, § News, at 3 ("Charles Schumer has begun drafting legislation that would close a loophole that allows wealthy hedge-fund managers to get big portions of their earnings taxed at less than half the rate paid by ordinary taxpayers. But his effort could actually frustrate efforts to end the tax break. In a move critics say is designed to sink the bill, Schumer wants to make the changes also apply to oil and gas firms—which would then deploy their lobbying clout to fight the bill.").

[127] *Id.*

[128] The *New York Times* reported that Senator Schumer raised more than $1 million dollars from private equity funds for the Democratic Senate Campaign Committee, of which Senator Schumer was chair in 2007. *See* Hernandez & Labaton, *supra* note 122.

EPILOGUE

As of the end of summer 2007, it became very apparent that efforts to reform the taxation of profit interests had died quietly, proving the triumph of politics over policy.[129] The reality need not be entirely disheartening. It is only our naïveté that makes us believe that tax law, unlike every other area of law, is or ought to be entirely immune from politics. Discarding naïveté does not also require that we abandon the search for "fundamental truths" in tax law, if indeed there be any. The prolonged discussion of the taxation of profit interests, for example, has been useful in the short term for the identification of the polar opposites along a spectrum of fairness. That one opposite prevailed over the other as result of rent-seeking and rent extraction does not render that outcome useless. Politics, after all, are ephemeral and fleeting; when political motivations subside or, more likely shift, underlying fundamentals will ultimately prevail if those fundamentals have been sufficiently defined.

---

[129] Jeffrey H. Birnbaum, *Buyout Firms to Avoid a Tax Hike; Reid Passes Word Senate Won't Act*, WASH. POST, Oct. 9, 2007, at A1 ("Senate Majority Leader Harry M. Reid (D-Nev.) has told private-equity firms in recent weeks that a tax-hike proposal they have spent millions of dollars to defeat will not get through the Senate this year, according to executives and lobbyists.").