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MYTHS AND REALITIES ABOUT CHANGING THE TAX TREATMENT OF PRIVATE EQUITY FUND MANAGERS

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Economists across the political system generally concur that eliminating the tax break for "carried interest" income, a form of compensation received by private equity fund managers, would improve the equity and efficiency of the tax system.[1] The tax code is more efficient when it creates a level playing field. The fact that carried interest income is taxed at the *capital gains rate* while compensation for similar services is taxed at *ordinary income tax rates* skews economic decisions and creates inefficiency.[2]

The tax break for carried interest also allows private equity fund managers with multi-million dollar incomes to pay tax at lower marginal rates than most middle-income Americans. Legislation adopted by the House Ways and Means Committee last week — and likely to be considered by the full House this week or next — would end this tax break, treat carried interest as ordinary income, and use the savings to help pay for Alternative Minimum Tax relief, which would reduce the tax bills of 23 million U.S. households.

The most commonly-heard objections to taxing carried interest as ordinary income do not take issue with the basic conclusion that doing so would be sound tax policy. Instead, they arise from various myths about whom such a policy change would affect. As discussed below, changing the tax treatment of carried interest would not damage the U.S. economy, would not devastate the real estate industry, and would not lower returns to investors. Its major effect would be to raise significant revenue by taxing a very small group of very highly-compensated individuals at the same tax rates other high-income Americans already pay.

Myth 1: Taxing carried interest as ordinary income would hurt the U.S. economy by discouraging entrepreneurship and harming small businesses.

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[1] For example, Harvard economist Greg Mankiw, former Chair of the Council of Economic Advisors under President George W. Bush, has written that, from an economic perspective, carried interest should be taxed the same as other compensation for services. http://gregmankiw.blogspot.com/2007/07/taxation-of-carried-interest.html.

[2] A "carried interest" is a right to receive a specified share (often 20 percent) of the profits ultimately earned by an investment fund *without* contributing a corresponding share of the fund's financial capital. It is part of the standard compensation package for managers of private equity funds. The issues discussed here are addressed in more detail in: Aviva Aron-Dine, "An Analysis of the 'Carried Interest' Controversy," Center on Budget and Policy Priorities, July 31, 2007, http://www.cbpp.org/7-31-07tax.htm.

Reality: The Ways and Means Committee measure applies only to carried interest income earned by individuals who provide investment management services. It does not affect small business proprietors. When the director of the Joint Committee on Taxation was asked about the provision's impact on "mom and pop" operations, he jokingly replied, "mom and pop private equity firms?"

The Ways and Means Committee measure would only affect individuals who provide investment management services and who are paid in the form of carried interest. The revenue raised by the measure would come overwhelmingly from extremely high-income people whose occupation is to manage *other people's* money; it would have *no effect on individuals starting up small businesses* (other than people setting up investment management firms).

It is extremely unlikely that the private equity fund managers affected by the provision would withdraw from their highly lucrative businesses if the carried interest tax break were eliminated, and they were taxed at the same rates as other very high-income Americans. As the Joint Committee on Taxation has noted, private equity offers an unusual opportunity for "individuals with skills in asset management but little capital of their own to achieve high income."[3] Similarly, Urban-Brookings Tax Policy Center Director Leonard Burman has noted, "These deals are immensely profitable, and would happen with or without a tax subsidy."[4]

The myth that changing the treatment of carried interest would hurt the economy trades on another myth, namely that most entrepreneurs or managers involved in risky occupations rely on the capital gains tax break, and that without that tax break, risky or entrepreneurial pursuits would not flourish. This is false. Income is supposed to be eligible for capital gains treatment *only* if the investor has his or her *own financial capital* at stake: that is, if the individual could lose his or her own money. Other risky or entrepreneurial income that represents compensation for labor services (rather than a return on capital that has been invested) — such as performance bonuses, lawyers' contingency fees, and most business income of an S corporation or partnership — is taxed as

A Partial List of Risky and Entrepreneurial Income Taxed at Ordinary Income-Tax Rates*

- Most business income of an S corporation, partnership, limited liability company, or sole proprietorship
- Performance bonuses (including those paid to private equity fund managers' counterparts at Goldman Sachs)
- Lawyer contingency fees
- Incentive fees paid to managers of investment assets
- Contingent fees based on movie revenue for actors
- Royalties
- Most stock options
- Restricted stock grants

* List drawn largely from Peter Orszag, Testimony Before the Committee on Finance of the U.S. Senate, July 11, 2007, http://cbo.gov/ftpdocs/83xx/doc8306/07-11-CarriedInterest_Testimony.pdf.

[3] Joint Committee on Taxation, "Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interest and Related Issues, Part I," JCX-62-07, September 4, 2007, http://www.house.gov/jct/x-62-07.pdf.

ordinary income (see box on page 2). There is no reason to think that economic health requires special tax treatment for managers of private equity funds.

Myth 2: Taxing carried interest as ordinary income would damage the real estate industry at a time when the housing market is already weak.

Reality: The Ways and Means Committee would do *nothing* to change the tax treatment of people who invest in real estate. And if anything, eliminating the tax break for carried interest would level the playing field between the large majority of realtors who do *not* benefit from the tax break and the few who do.

If policymakers are primarily concerned about discouraging residential investment, they should have no concerns about the carried interest measure. That measure would *not* take away the benefits of the capital gains rate from *anyone* who invests his or her own financial capital in housing or other real estate. It would only affect individuals who manage *other people's* investments in real estate.

Furthermore, changing the treatment of carried interest would affect only the very small share of real estate industry earnings that are eligible for the carried interest tax break. Most of the industry's business receipts are already treated as corporate income under the corporate income tax or as ordinary income under the regular income tax.[5] The rest of the real estate industry might actually *benefit* from the elimination of a tax break that advantages a few partnerships using an exotic compensation structure over everyone else in the business.

Myth 3: Taxing carried interest as ordinary income would hurt ordinary Americans by reducing returns to pension funds.

Reality: The tax change would have little or no impact on pension funds.

The carried interest provision in the Ways and Means Committee's tax package would not change the after-tax return to capital investments. It would only affect the tax treatment of compensation received by fund managers who have *not* invested their own capital.[6] Some lobbyists have argued, however, that if carried interest were taxed at ordinary income tax rates, fund managers would be able to pass all or part of the tax increase along to investors. The claim is that, if fund managers are required to pay higher taxes, they will increase either the annual fees they charge or the share of fund profits they demand. The evidence shows this argument to be highly dubious.

- **In the past, tax changes have *not* led to changes in the compensation of private equity fund managers.** Russell Read, Chief Investment Officer of the California Public Employees' Retirement System, testified that he had closely examined the issue, and "it is absolutely true that we believe that there has been no discernable change in the past on our negotiations and

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[4] Martin Vaughan, "Balance of Payments — A Rich Topic," *Congress Daily*, July 19, 2007.
[5] IRS data show that in 2002, the latest year for which complete data are available, only about 4 percent of the income earned in the real estate industry was in the form of long-term capital gains earned by partnerships and distributed to the partners. Since this is the only income that could *possibly* have benefited from the carried interest tax break, 4 percent is the highest possible share of the industry's income that could have been affected by changing the tax treatment of carried interest in that year. The actual share is probably lower.
[6] In some cases, private equity fund managers do invest some of their own capital in the funds they manage. Under the Ways and Means Committee bill, returns to that investment would *remain eligible for capital gains treatment*.

fee levels based upon those changes in tax rates."[7] Similarly, William Stanfill, a venture capital fund manager, told the Senate Finance Committee, "I have been in the business for 25 years, and the base compensation structure of Two and Twenty [management fees equal to 2 percent of the assets of the fund and carried interest equal to 20 percent of its profits] has survived all the tax changes over that period of time."[8] In other words, even when capital gains tax rates rose or fall, the standard compensation package for private equity fund managers *remained the same*. It appears to be largely or entirely independent of tax rates.

- **Managers probably cannot increase their fees and keep their investors.** According to noted University of California economist Alan Auerbach, the fees charged by private equity fund managers are high relative to those charged by the most closely comparable mutual funds.[9] Presumably, the difference between the fees charged by private equity fund managers and the fees charged by mutual funds approximately equals the difference between the returns (before fees) that investors expect private equity funds to achieve and the returns they expect from mutual funds. This means that if private equity fund managers were to further increase their fees, the difference in fees would *exceed* the difference in expected returns. That should lead investors to take their business elsewhere. Put another way, as a Joint Committee on Taxation analysis suggested, "if fund managers could demand a larger share of the yield of the investment fund [without losing investors] *they would already have done so without regard to their tax liability* (emphasis added)." [10] Managers are most likely already charging what the market will bear.

Even if changing the tax treatment of carried interest *did* affect investor returns, the effect on pension funds would be very small. While pension funds account for a reasonably large share of total investment *in* private equity funds, investment in private equity funds accounts for a very small share of total investment *by* pension funds. Thus, Professor Auerbach testified that even if half the tax increase were passed along to investors — and, for the reasons discussed above, this is an implausibly high share — this "would imply a reduction of at most around two basis points in the annual returns on these pension funds' assets, and quite possibly much less."[11] Two basis points is two one-hundredths of one percentage point (e.g. the difference between 6.0 and 6.02 percent).

Perhaps the strongest evidence that changing the carried interest provision would have little impact on pension funds is the views of the pension funds themselves. According to Bloomberg News, "the pension funds whose interest [the private equity managers] claim to be defending aren't buying it." One public employee pension fund chairman stated succinctly, "The argument that this is about the interest of retired public employees is ludicrous."[12] In contrast, private equity fund managers have been lobbying hard against this tax change. This is further evidence that the managers believe they will indeed bear most or all of it themselves.

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[7] Transcript of Senate Finance Committee Hearing, "Carried Interest, Part III: Pension Issues," September 6, 2007, obtained through Federal News Service.

[8] Transcript of Senate Finance Committee Hearing, "Carried Interest, Part II," July 31, 2007, obtained through Federal News Service.

[9] Alan J. Auerbach, "Carried Interest Taxation and Pensions: Testimony Before the Committee on Finance, U.S. Senate," September 6, 2007, http://finance.senate.gov/hearings/testimony/2007test/090607testaa.pdf.

[10] Joint Committee on Taxation, "Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interest and Related Issues, Part I."

[11] Alan J. Auerbach, "Carried Interest Taxation and Pensions."

[12] Alison Fitzgerald, "Buyout Firms' Tax Rise Wouldn't Hurt Workers, Pension Funds Say," Bloomberg News, July 11, 2007.