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HIGHER TAXES ON CARRIED INTEREST WOULD BE BORNE BY INVESTMENT FUND MANAGERS

Pension Funds, Minority-Owned Businesses, and Low-Income Housing Development Would Be Largely Or Entirely Unaffected

By Aviva Aron-Dine

In the past few weeks, the Senate Finance and the House Ways and Means Committee have both held hearings investigating the tax treatment of carried interest, a form of compensation prevalent in the private equity industry. As part of their contractual arrangement with investors, the managers of a private equity fund typically receive a "carried interest" equal to 20 percent of fund profits: that is, they obtain the right to receive 20 percent of the profits ultimately earned by the fund, without contributing 20 percent of the fund's financial capital. Under current law, carried interest income is often taxed at the 15 percent capital gains rate, rather than at regular income tax rates. Many argue that this treatment is inappropriate, and that carried interest should be taxed as ordinary income, not as a return on investment.

Most tax policy experts agree that the tax treatment of carried interest should depend on whether it is more appropriately classified as capital gains income or as compensation for

KEY FINDINGS

Some of those seeking to preserve the tax break for managers of private equity funds (the "carried interest" tax break) have argued that, if this tax break were eliminated, pension funds and their investors — as well as minority-owned businesses and low-income communities — would be hurt. These arguments collapse under scrutiny.

- If taxes on carried interest are raised, most of the tax burden will fall on the managers fighting so hard to preserve the tax break. They are unlikely to be able to shift much of the cost to their investors, since investors are unlikely to keep investing in funds that substantially increase fees.

- Even if a change to the tax treatment of carried interest did affect investor returns, the impact on pension funds would be very small, since investment in private equity accounts for a small share of pension funds' total investment.

- The argument regarding minority-owned businesses and low-income housing is even more far fetched. Its advocates have offered no evidence that the private equity industry directs a large share of its resources toward these investments; in fact, in other contexts they themselves have stated that "less than 2 percent of all available private equity is invested in minority firms in a given year."

- Even if the tax break did offer some benefits to pension funds, minority-owned businesses, or low-income communities, this would not justify preserving it, as there are far less costly, better targeted options for helping these firms and areas.

services performed. Assuming that carried interest is compensating fund managers for the services they provide, it should be taxed at the same rates that apply to other forms of labor compensation.

Some defenders of the current treatment of carried interest have tried to argue that it is, in fact, not labor compensation. Others have conceded that it is compensation for services, but have argued that, even though other labor compensation (ranging from teachers' salaries to lawyer contingency fees to CEO bonuses) is taxed at ordinary income tax rates, applying these rates to private equity fund managers would damage the U.S. economy.[1]

Increasingly, however, opponents of changing the tax treatment of carried interest have turned to a different kind of argument. They have claimed that all is not as it seems. A tax increase on carried interest may appear to be a tax increase levied primarily on the extremely high-income individuals who manage multi-billion dollar private equity funds. But really, the burden of the tax (in economic terms, its "incidence") would be shifted to more sympathetic groups, such as employees whose pensions are invested in private equity funds. Recently, some private equity fund managers have even formed a coalition to argue that some of the incidence of the tax would be shifted to minority-owned businesses — in the form of reduced investment in these enterprises — or to low-income communities — in the form of reduced investment in low-income housing.[2]

This analysis examines these arguments. It finds:

- **The arguments are false.** If taxes on carried interest are raised, most of the tax burden will almost certainly fall on the fund managers who are currently battling so hard to avert the change. Any effect on investors would be very small; any effect on minority-owned businesses or low-income housing would be virtually imperceptible.

- **The arguments are largely irrelevant.** The tax treatment of carried interest should depend on the nature of carried interest income, not on whether a small share of the tax break is passed along to groups policymakers find sympathetic. As Stanford Law School Professor Joseph Bankman testified to the Senate Finance Committee, "If Congress wants to reduce the tax rate on investors, they don't have to adopt a Rube Goldberg scheme where we first reduce the tax rates on high paid professionals and then hope that some of the benefit goes to investors."[3]

Would Changing the Tax Treatment of Carried Interest Hurt Investors?

Some have argued 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 required to pay higher taxes, fund managers would increase either the annual fees they charge or the share of fund profits they demand.

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[1] These arguments are addressed in Aviva Aron-Dine, "An Analysis of the 'Carried Interest' Controversy," Center on Budget and Policy Priorities, revised August 1, 2007, http://www.cbpp.org/7-31-07tax.pdf. That analysis also provides some additional background on the carried interest issue and the private equity industry.

[2] Sarah Lueck, "Minority Group Fights Carry Tax Increase," *Wall Street Journal*, September 5, 2007.

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

It is certainly possible for the incidence of a tax to be shifted: for the burden of a tax to fall on someone other than the person who remits the tax to the government. The question is whether such a shift is likely to occur in this case. Several pieces of evidence suggest that at most a small portion of this tax change would be shifted.

- **Investors are unlikely to continue to invest in funds that substantially increase fees.** According to University of California Berkeley Economics Professor Alan Auerbach, the fees charged by private equity fund managers are high relative to those charged by the most closely comparable mutual funds.[4] 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. But that means that, if private equity fund managers were to further increase their fees, the difference in fees would exceed the difference in expected returns. This 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' business], they would already have done so without regard to their tax liability."[5] Managers are most likely already charging what the market will bear.

- **It is very unlikely that a modest reduction in the value of their compensation would lead private equity fund managers to leave the industry.** If a change in the tax treatment of carried interest led to a large reduction in the number of talented investment professionals seeking to manage private equity funds, it might be possible for the remaining managers to increase their fees. But, as the Joint Committee on Taxation has noted, private equity offers an exceptional opportunity for "individuals with skills in asset management but little capital of their own to achieve high income."[6] It is hard to imagine that taxing carried interest as ordinary income would lead investment professionals to disdain that opportunity.

  If investors are more responsive to an increase in fees than managers are to a reduction in their after-tax compensation, then most of the change in the tax treatment of carried interest will be borne by fund managers. As Congressional Budget Office Director Peter Orszag testified, "it's more likely that the general partner [the managers] is retaining more of the tax benefit in this case, in which case changing the treatment… to ordinary income would not really affect the limited partners and the underlying investors that much."[7]

- **In the past, tax changes have *not* led to changes in the compensation of private equity**

[4] 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.

[5] 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.

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

[7] Transcript of Senate Finance Committee Hearing, "Carried Interest:, Part I," July 11, 2007, obtained through Federal News Service.

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 fee levels based upon those changes in tax rates."[8] 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."[9]

In other words, even when capital gains tax rates changed, the standard compensation package for private equity fund managers remained the same: it appears to be largely or entirely independent of tax rates.

Furthermore, even if changing the tax treatment of carried interest *did* affect investor returns, the effect on pension funds — which seems to be policymakers' primary concern — 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 to the Finance Committee 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 return on these pension funds' assets, and quite possibly much less."[10] (Two basis points is two one-hundredths of one percentage point; annual returns could go, for instance, from 6.02 percent to 6 percent.)

Not surprisingly, some major pension funds have expressed skepticism about the claim that raising taxes on private equity fund managers would hurt them. According to Bloomberg News, "the pension funds whose interest [the private equity managers] claim to be defending aren't buying it."[11] 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 the tax change, suggesting that the managers believe they will indeed bear a substantial share of it themselves.)

If the Tax Break Did Benefit Pension Funds, Would That Justify It?

Suppose that taxing carried interest at the capital gains tax rate did increase pension fund returns. That still would not be a sound reason to preserve the tax break.

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

[9] Transcript of Senate Finance Committee Hearing, "Carried Interest, Part II."

[10] Alan J. Auerbach, "Carried Interest Taxation and Pensions: Testimony Before the Committee on Finance, U.S. Senate."

[11] Alison Fitzgerald, "Buyout Firms' Tax Rise Wouldn't Hurt Workers, Pension Funds Say," Bloomberg News, July 11, 2007. A more recent article noted, "Pension funds -- private equity's biggest investors -- have been largely silent on the issue, a sign that pension managers feel the tax rise would not hurt investment returns." Michael Flaherty, "Private Equity Having Tough Time Knocking Tax Rise," Reuters, September 17, 2007.

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

Suppose the carried interest tax break costs the federal government $6 billion per year.[13] And suppose again that, if the tax break were eliminated, half of the increased tax burden would be passed along to investors, meaning that investors receive half the benefits of the existing tax break. According to the Congressional Budget Office, pension funds were the source of about one-third of the capital invested in private equity funds in 2005.[14] Thus, even in this scenario, which assumes that a large share of the tax savings is passed on to investors, the federal government would be spending $6 billion per year in order to provide $1 billion per year to pension funds. Moreover, it would be aiding pension funds by means of a tax break that, because it treats the compensation of private equity fund managers differently than other, similar forms of compensation, almost cerrtainly makes the tax system less efficient (and less equitable).[15]

Also of note, it would be doing so in a manner that deprives the Medicare Trust Fund of needed revenue. Because carried interest is classified as capital gains instead of as labor compensation, *managers do not pay Medicare payroll taxes on it*. The National Women's Law Center has estimated that the loss to the Medicare Trust Fund from the carried interest tax break amounts to between $900 million and $1.8 billion per year.[16] Thus, even if one assumes that the tax break provides $1 billion to pension funds, one could think of this as a $1 billion transfer to pension funds from the Medicare Trust Fund. Stated another way, because of the carried interest tax break, policymakers eventually will have to cut Medicare benefits, cut payments to health care providers serving Medicare patients, or raise Medicare payroll taxes to a greater degree than would otherwise be necessary in order to restore long-term solvency to the Trust Fund. (The Medicare Trust Fund is short of resources and is projected to go insolvent in 2019.)

In sum, if Congress is, as it should be, concerned about the health of pension plans, a tax break for investment managers is not the way to address that concern.

Would Changing the Tax Treatment of Carried Interest Hurt Minority-Owned Businesses or Low-Income Communities?

The *Wall Street Journal* recently reported that the Private Equity Council of America is funding a coalition (the "Access to Capital Coalition") that argues that taxing carried interest as ordinary income would reduce investment in minority-owned businesses and low-income communities. (The group also appears to be arguing that the tax change would reduce the represenation of women and minorities in the private equity industry itself; this argument is addressed in the box on page 6.) To accept this argument, one would have believe *both* that the tax change would significantly reduce the

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[13] This figure is a hypothetical and was chosen to simplify the numerical example. However, it does fall within the range of estimates that have been published by analysts. No official revenue estimates for changing the tax treatment of carried interest are available.

[14] Peter Orszag, "The Taxation of Carried Interest," 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.

[15] See Aviva Aron-Dine, "An Analysis of the 'Carried Interest' Controversy."

[16] National Women's Law Center, "Private Investment Managers Dodge Billions in Medicare Taxes," September 2007, http://www.nwlc.org/pdf/DodgingMedicareTaxes.pdf. The tax break likely imposes negligible costs on the Social Security Trust Fund because earnings above $90,000 are not subject to Social Security payroll taxes.

Claims About the Importance of the Carried Interest Tax Break to Minority and Female Investment Fund Managers Are Difficult to Comprehend

Some statements by members of the Access to Capital Coalition suggest that the group's primary concern is not that raising taxes on private equity would reduce investment in minority-owned businesses and low-income communities but rather that it would reduce the representation of women and minorities in the private equity industry itself. For example, the organization's initial press release quotes the chairman of the National Association of Investment Companies as saying, "the present carried interest policy has been essential to attracting top talented minorities and women to the industry as independent firms and fund managers. Its elimination, consequently, would have the unfortunate effect of impeding this great progress."* This argument raises several basic questions that the coalition has yet to address. For instance:

- Why should the tax break for carried interest play a particular role in attracting women and minorities, as opposed to other individuals, to the private equity industry?
- If Congress is concerned about under-representation of women and minorities in that industry, why should it address that concern with a tax break for *all* private equity fund managers?
- Why should managers' compensation be subject to lower tax rates in this particular industry, when women and minorities take on managerial roles in many industries, and are under-represented in many industries?

Unless and until these questions are answered persuasively, it is difficult to make sense of the claim that, because some women and minorities are private equity fund mangers, all private equity fund managers should keep their tax break. This claim appears to be entirely devoid of merit.

* "National Coalition of Minority- and Women-Owned Businesses Formed to Oppose Tax Increase on Carried Interest," http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=ind_focus.story&STORY=/www/story/09-05-2007/0004656708&EDATE=WED+Sep+05+2007,+09:00+AM.

amount of investment funneled through private equity funds *and* that the redirection of some investment from these funds to other investment opportunities would hurt minority-owned enterprirse and low-income communities. Neither of these claims is credible.

- **Changing the tax treatment of carried interest is unlikely to signficantly reduce the amount of investment funneled through private equity funds.** As economist Leonard Burman, director of the Urban Institute-Brookings Institution Tax Policy Center, has noted, "These deals are immensely profitable, and would happen with or without a tax subsidy."[17] As discussed above, changing the tax treatment of carried interest is not likey to lead managers to leave the industry nor is it likely to lead to increased fees for investors; thus, it is hard to see how it would shrink the size of the private equity sector. Moreover, there is evidence that investment in private equity is not very responsive to tax rates. For example, the *Economist* magazine has pointed out, "Venture capitalism has done much better in America than Britain, although the incentive from carried interst is bigger in the latter. The industry's success clearly depends on other things than tax."[18]
- **Even if the tax changes did lead investors to redirect funds from private equity to other**

[17] Martin Vaughan, "Balance of Payments — A Rich Topic," *Congress Daily*, July 19, 2007.

[18] *Economist*, "Carried Away: Private Equity," June 9, 2007.

investment opportunities, the Access to Capital Coalition has offered no evidence that this would hurt minority-owned businesses or low-income communities. While the coalition has produced *examples* of private equity funds that invest in minority-owned businesses or low-income housing, it has made no effort to show that the industry as a whole directs a significant share of its resources toward these investment.

If anything, materials from the Coalition's own members suggest the opposite. In a 2004 briefing for the Congressional Black Caucus, the National Association of Investment Companies (an association whose members invest in minority-owned enterprises and that is one of the three founding member organizations of the Access to Capital Coalition) stated that, *"less than 2 percent of all available private equity is invested in minority firms in a given year"* (emphasis added).[19]

Similarly, while the industry has pointed to a few examples of funds that invest in low-income housing, *far more low-income housing development is funded by investment funds whose managers pay tax on their compensation at ordinary income tax rates.* Again, the Coalition has made no effort to show that, if some resources were redirected from the private equity industry to other investment opportunities, this would come at the expense of low-income housing.

- **There is no reason to think that the tax change would differentially affect those private equity funds that do invest in minority-owned enterprises or low-income housing.** Some comments by members of the Access to Capital Coalition suggest that its argument is that, even if the tax change does not injure the industry as a whole, it will reduce the industry's investment in minority enterprises. The implication seems to be that, without the tax subsidy, the return on these investments would be too low.

  This argument too is contradicted in Coalition members' other materials. For example, the National Association of Investment Companies asserts, "A recent study… found that NAIC member firms produced an internal rate of return of 23.9 percent… *The study noted that the results for NAIC member firms exceeded the results for the general private equity industry"* (emphasis added).[20] If the rate of return achieved by these funds is as high or higher than the return on other funds, then it is hard to understand why they would be differentially harmed by a change in the tax treatment of carried interest.

If the Tax Break Did Slightly Increase Investment in Minority-Owned Businesses or Low-Income Housing, Would That Justify It?

The claim that Congress should use a tax break for private equity fund managers to subsidize minority-owned businesses or low-income housing is even stranger than the argument that it should use such a tax break to subsidize pension plans. Consider the following. In 2006, the federal government:

[19] National Association of Investment Companies, "Understanding the Dilemma Facing America's Emerging Domestic Market: Industry Briefing for the Congressional Black Caucus Institute," August 14, 2004, http://www.naicvc.com/pdfs/edm-industrybriefing.pdf.

[20] National Association of Investment Companies, "Understanding the Dilemma Facing America's Emerging Domestic Market: Industry Briefing for the Congressional Black Caucus Institute."

- Spent $4.4 billion on the Low-Income Housing Tax Credit.
- Devoted $4.2 billion to the Community Development Block Grant.
- Spent $29 million on the Minority Business Development Agency.

By some estimates, the amount being spent on tax breaks for private equity fund managers *is larger* than the amounts being spent on any of these programs. And while some have questioned the effectiveness of the programs, each of them undoubtedly directs a much larger share of its resources to its intended target than preserving the tax break for carried interest would.

If the carried interest tax break did not already exist, no one would suggest creating it — as opposed to increasing funding for the Low-income Housing Tax Credit, the Community Development Block Grant, or the Minority Business Development Agency — in order to subsidize low-income housing or minority-owned enterprises. But if that argument sounds bizarre as a justification for a new tax break, then it is equally bizarre as a justification for continuing an old one.