This week, the Senate Finance Committee is scheduled to hold a second hearing on the tax treatment of “carried interest.” 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.

Current law allows these managers to pay tax on all or most of their carried interest income at the 15 percent capital gains rate, instead of at the individual income tax rate that would otherwise apply, typically 35 percent for these high-income individuals. Rather than being taxed as managers receiving compensation for services rendered, recipients of a carried interest are taxed as though they were investors who had supplied 20 percent of the financial capital of the fund.

In addition, a small group of private equity firms are beginning to take advantage of a provision of current law that makes it possible for them to avoid paying corporate income taxes, even after issuing public stock. Prior to the development of this new tax strategy, nearly all publicly-traded partnerships were subject to the corporate income tax.

Both of these issues are attracting congressional scrutiny. While part of the apparent impetus for the burst of congressional activity is the rapid growth of

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**KEY FINDINGS**

- The current tax treatment of “carried interest” allows private equity firm managers to pay tax on a large portion of their compensation at the 15 percent capital gains rate, rather than at the 35 percent top income tax rate that would otherwise apply.

- As financial industry billionaire Warren Buffett has noted, this means managers earning $500 million can easily end up paying a smaller share of their income in taxes than many middle-income Americans do.

- Further, by treating carried interest differently than other comparable forms of compensation, the tax break creates economic distortions. Rather than helping the economy, taxing carried interest at low rates likely makes the market for financial services somewhat less efficient than it otherwise would be.

- Some have claimed that eliminating the tax break for carried interest would greatly harm state employee pension plans and other investors. This argument does not withstand scrutiny and has been rejected by pension plans themselves.

- The carried interest controversy also illustrates how taxing capital gains at much lower rates than other income creates powerful incentives for tax schemes designed to reclassify regular income as capital gains.

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1 The author would like to thank Lily Batchelder, Matt Fiedler, Jason Furman, Robert Greenstein, James Horney, and Chad Stone for helpful comments and discussions.
the private equity industry and the highly publicized tax machinations of the Blackstone Group, there are at least three additional justifications for giving these issues serious attention.

- **Economic efficiency.** If carried interest is largely or entirely compensation for management services, as appears to be the case, then it is being taxed more lightly than almost all other forms of compensation for similar services.\(^2\) Generally speaking, a tax system is more efficient when it treats like activities alike: rather than having tax rates determine how people allocate their resources, it is better for the tax system to create a level playing field.\(^3\) Thus, Harvard economist Greg Mankiw, former Chair of the Council of Economic Advisers under President Bush, has written that from an economic perspective, carried interest should be taxed the same as other compensation for services.\(^4\) Similarly, Congressional Budget Office Director Peter Orszag testified to the Senate Finance Committee, “[The tax treatment of carried interest is] important [because]... anytime you have similar activities taxed in different ways, you create distortions... So an executive in a financial services firm or a manager of a public mutual fund... is taxed in a different way for those services than a general partner in a private equity or a hedge fund, and that should be of concern to tax policymakers because of the distortions it can create...\(^5\)

- **Revenue implications.** Given that private equity funds hold $1 trillion in assets, the revenue lost by taxing carried interest as capital gains could easily amount to several billion dollars a year.\(^6\) That amount is small relative to total federal revenues, but sizable relative to the cost of key initiatives many in Congress would like to fund, such as expansions in the State Children’s Health Insurance Program or increases in tax incentives for higher education or in the Earned Income Tax Credit.

- **Tax equity.** If a manager made $500 million from a carried interest (a high but far from unprecedented figure for managers of private equity funds), had no other income, and claimed no deductions or exemptions, his effective federal income and payroll tax rate this year would be 15 percent. By comparison, the effective tax rate (taking into account individual income

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\(^2\) University of Illinois Law Professor Victor Fleischer has described carried interest as “the single most tax-efficient form of compensation [i.e. the form of compensation that is taxed most lightly] that is available without limitation to highly-paid executives.” Victor Fleischer, “Two and Twenty: Taxing Partnership Profits in Private Equity Funds,” University of Colorado Law Legal Studies Research Paper No. 06-27, revised June 12, 2007, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=892440.

\(^3\) One important exception is when activities generate sizable social costs or benefits. For example, many economists think it would be efficient for the federal government to impose a tax on carbon emissions.


\(^6\) The $1 trillion figure is given in: 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. In addition, hedge funds hold another $1 trillion in assets, and hedge fund managers also typically receive a portion of their compensation in the form of carried interest. However, hedge funds frequently hold investments for periods of less than one year, a period too short to qualify for the reduced tax rate for long-term capital gains. Thus, a much smaller share of the income of hedge fund managers — as compared to the income of private equity fund managers — is currently taxed at the 15 percent long-term capital gains rate; a larger share is already taxed as ordinary income.
taxes and only the employee side of the payroll tax) for a single individual earning a $45,000 salary would be 20 percent. As billionaire financier Warren Buffett has stressed, there is something questionable about a tax provision that makes it possible for individuals with multi-million dollar incomes to pay tax at lower rates than their secretaries — particularly at a time when income concentration is rising rapidly, with financial industry compensation likely playing a meaningful role in this trend.8

After providing some background on the tax issues surrounding the private equity industry, this analysis focuses on the issue that has generated the most controversy — whether carried interest is compensation for services rendered. The analysis concludes that carried interest does indeed constitute compensation for work performed; it then examines efficiency arguments for changing the tax treatment of carried interest, as well as claims that doing so would harm the economy. Finally, the analysis discusses the ways in which this controversy illuminates the broader issue of capital gains taxation. (In addition, the box on page 10 briefly discusses specific proposals to change the tax treatment of carried interest.)

Background9

Although the carried interest controversy can seem quite complicated, it really requires an understanding of only a few central concepts and terms. (For definitions of key terms, see the box on page 4.)

The structure of private equity funds. The typical private equity fund is structured as a partnership (or as a limited liability company, the tax treatment of which is very similar). A private equity fund is typically managed by a private equity firm; this firm is the “general partner” in the partnership and determines the investment strategy of the fund. The fund’s financial capital comes from investors who are designated as the fund’s “limited partners.” These investors may be pension funds, insurance companies, endowments, or wealthy individuals.

If private equity funds were instead publicly-traded corporations, the general partners would be the corporations’ employees — for instance, its managers — and the limited partners would be the shareholders. The partnership structure is simply an alternative organizational form.

The compensation package of private equity fund managers. The general partner of a private equity fund is most often compensated in part by a fixed management fee and in part by a stake in the firm’s profits, known as a carried interest. The management fee is usually set equal to 1 or 2 percent of the assets the fund has under management; it does not depend on the performance of the fund’s

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investments. While management fees typically provide private equity fund managers with quite high incomes, they are not the source of the extraordinarily high incomes for which these funds' managers are known. Those extremely high incomes arise from the carried interest portion of the compensation package, which is typically set equal to 20 percent of firm profits.10

The tax treatment of carried interest. Managers who receive income from a carried interest are treated, for tax purposes, as if they had received a 20 percent profit share in the private equity fund as a result of contributing 20 percent of the fund’s financial capital.11 Partnerships are “pass-through entities” for tax purposes, which means their profits are “passed through” to shareholders, who pay tax on the income based on its character.12 Since private equity funds realize the vast majority of their profits in the form of long-term capital gains, this means these profits are passed through as

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10 Sometimes, the carried interest is subject to a “hurdle rate:” for instance, the fund may have to achieve an 8 percent rate of return before the general partner is entitled to receive its 20 percent share of the profits.

11 Often, the managers will contribute a small amount of financial capital to the fund, though considerably less than 20 percent of its total capital. Issues related to such contributions are discussed below.

12 Partnerships have the option of electing to be treated as corporations for tax purposes, but the carried interest issue only arises in the case of partnerships that are treated as pass-through entities.
capital gains, and the managers pay tax on them at the capital gains rate, rather than as compensation for services performed. For a manager earning $100 million from a carried interest, that tax benefit amounts to about $23 million ($20 million due to the difference between the 35 percent top income-tax rate and the 15 percent capital gains rate, and $2.9 million due to avoiding Medicare payroll taxes on the $100 million in income). In addition, managers are not required to pay any tax on the carried interest when they acquire it; no tax is due until the firm’s profits are realized. (This issue is discussed in the box on page 10.)

Private equity firms that go public. The general partners in private equity funds are themselves typically partnerships: private equity firms. Recently, some of these firms have chosen to sell shares of publicly-traded stock. In the past, when a partnership decided to become publicly traded, it would lose its “pass-through” status and become subject to the corporate income tax. Thus, if the private equity firms that have recently gone public were subject to the usual tax rules, they would begin to pay corporate income tax on their earnings and could distribute them to managers either by paying them a salary or by providing them with stock or stock options (these would be subject to the tax rules governing those forms of compensation, which are considerably less generous than those governing carried interest).

However, private equity firms have recently discovered that a provision of partnership tax law allows them to sell shares to the public without becoming subject to the corporate income tax if they adopt a particular structure, because they derive most of their income from capital gains, dividends, and interest.

Economic Analysis of the Carried Interest Controversy

An economic analysis of the treatment of carried interest hinges on whether carried interest is correctly characterized as capital gains income or as compensation for services. To the extent that it is correctly characterized as compensation, taxing it as the capital gains rate is inefficient (as well as inequitable). Although the economic effects of this inefficiency are undoubtedly small relative to the size of the U.S. economy as a whole, it would almost certainly help — rather than harm — the economy to eliminate this source of inefficiency.

Categorizing Carried Interest: Capital Gains or Compensation?

There are two key reasons to conclude that carried interest is appropriately categorized as compensation for services, not as capital gains.

First, private equity fund managers are not putting their own financial capital at risk. A basic standard for establishing whether income represents capital gains would seem to be whether the individual receiving the income had capital at stake. But as Bloomberg News columnist John Berry pointed out, “The general partner gets the 20 percent in return for management services, not because he put 20 percent of the money in the investment pot.”

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Managers do sometimes make a small contribution of capital to the fund. When this occurs, a small share of the carried interest could be considered a financial investment. But the small amount managers contribute is typically between 1 and 5 percent — not 20 percent — of the fund’s total capital, and the carried interest income attributable to it can be separated out and treated differently under the tax code. Notably, as discussed in the box on page 10, the House legislation that would tax carried interest as ordinary income would continue to treat as capital gains the portion of the income attributable to a capital investment. As the Financial Times recently commented in an editorial, “Managers may invest in their own private equity funds, in which case [the] tax advantages would rightly apply to that component of their income. But much the larger part of what they typically receive is exactly akin to a performance bonus, not a reward for capital put at risk, and to treat it otherwise for tax purposes is a gross distortion.”

Second, private equity managers are performing a service, for which the carried interest is clearly compensating them. Unlike limited partners, private equity fund managers are responsible for making investment decisions and managing investments. Managers often sit on the boards of the companies they invest in and frequently are involved in the day-to-day decisions of these companies, not unlike corporate CEOs.

At the Senate Finance Committee hearing on carried interest, the venture capital representative described her work this way: “What we do, Senator, is to help build a company — you know, we take a technologist, as an example, who knows a lot about how to build a chip but has never hired a salesperson, a marketing person — never even put together an HR person — and we will advise them on how to take that technology idea... be a catalyst to help pull that technology through the process to ultimately get it commercialized:” in essence, sustained, long-term consulting services. Strikingly, in a filing with the Securities and Exchange Commission (for purposes of the Investment Company Act of 1940), the Blackstone Group explained, “We also believe that the primary source of income from each of our businesses is properly characterized as income earned in exchange for the provision of services.”

Risk Isn’t Relevant

The main defense that has been offered for categorizing carried interest as capital gains is that, as former-Treasury Secretary and current private equity firm chairman John Snow argued, carried interest “carries a lot of risk.”

Yet as economist Greg Mankiw, former Chair of the Council of Economic Advisers under President Bush, commented, “Deferred compensation, even risky compensation, is still compensation, and it should be taxed as such.” Or, as he asked, “Suppose Harvard reduced my

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15 Transcript of Senate Finance Committee Hearing.


A Partial List of Risky Forms of Compensation Taxed at Ordinary Income-Tax Rates*

- Performance bonuses
- 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
- Most business income of an S corporation, partnership, limited liability company, or sole proprietorship

Opponents of changing the tax treatment of carried interest have sought to find competing examples: cases of risky labor income taxed at the capital gains rate. Some also have suggested that it is inappropriate to address the tax treatment of carried interest in the financial services industry without also addressing tax loopholes affecting other industries.

Asked about the carried interest controversy, former Treasury Secretary and Goldman Sachs Chairman Robert Rubin anticipated this response by industry lobbyists, and suggested it was beside the point. He stated:

“You can characterize it as a performance fee, you can characterize it as a carried interest, you can characterize it any way you want, but basically I think what they’re doing is getting paid a fee for running other people’s money and if that is essentially what’s happening, while you can certainly create all kinds of analogies that are complicated and if I were arguing against this I think I would try to develop a lot of complicated analogies and use that as my way of trying to prevent something from happening, I think at the core there is a very good argument to be made for treating this as ordinary income.” **

If the analogies are legitimate and other forms of labor income really are being taxed at the capital gains rate, perhaps the Finance and Ways and Means Committees should turn their attention to these other cases next year.


salary to zero, and for my teaching, it paid me a small share of the capital gain on the endowment. Would you then suggest that this compensation be taxed at the capital gains rate?"  18

Similarly, CBO Director Peter Orszag testified, “As an economic matter, the character of carried interest income should not depend on whether the compensation is performance-based. A wide range of performance-based compensation, including arrangements in which service providers accept the entirety of the risk of the success or failure of the enterprise, is effectively labor income and taxed as ordinary income for services. Contingent fees based on movie revenue for actors, for

example, are taxed as ordinary income, as are performance bonuses, most stock options, and restricted stock grants. So too are incentive fees paid to managers of other people’s investment assets, when those fees are documented as such… Instead, the key issue is whether the carried interest represents a fee for services provided or a return of partnership long-term capital gains allocated to one partner (the general partner) under conditions that are not qualitatively different from the returns allocated to the other partners (the limited partners).19

Not only does the tax code tax many forms of risky compensation at ordinary income tax rates (see the box on page 7), but exempting these forms of income from the regular income tax would make little economic sense. The progressive income tax itself defrays risk: it takes a larger share of the gains when things turn out well, a smaller share when things turn out poorly, and it allows a deduction for losses. But it is hard to justify taxing risky compensation at lower rates than other compensation. People embark upon risky pursuits because, while there is a risk of realizing very low income, the expected value of the return is sufficiently high relative to non-risky alternatives that the risk seems worth taking. Private equity fund managers are very well rewarded for the risk they take; they do not need an additional tax subsidy for it (any more than executives of publicly-traded companies need an extra tax subsidy for stock options or lawyers need an extra tax subsidy for contingency fees).

More Efficient to Tax Carried Interest at Ordinary Income Tax Rates

Generally speaking, for any given level of revenue collected, a tax system is more efficient when it is neutral between similar activities. Rather than having tax rates determine how people allocate resources, it is better for the tax system to create a level playing field. In fact, when economists talk about how taxes can harm the economy, they simply mean that a tax may lead people to allocate resources differently than they otherwise would: for instance, to work less, save less, or consume a different bundle of goods and services.

While some of the economic distortions associated with taxes are basically inevitable — virtually any tax system will tax work but not leisure, thus potentially leading people to work less — other distortions can be avoided if the tax system consistently taxes like activities alike. For example, as long as all forms of labor compensation are taxed alike, the tax system will not generally affect individuals’ decisions about what type of work to take on. This benefits the economy, since it means that individuals will choose what field to enter based on what generates the highest returns, rather than based on arbitrary tax distinctions.

When it comes to carried interest, this general point about tax neutrality has concrete implications. It means that taxing carried interest at lower rates than the compensation that these managers could earn in other, comparable pursuits could distort decisions along various dimensions:

• Employment decisions. A talented individual might take a job at the Blackstone Group,

19 Peter Orszag, “The Taxation of Carried Interest.” This analysis is not changed by the fact that, in some cases, carried interest is subject to a “hurdle rate:” a rate of profit the fund has to achieve before the managers start to receive their share of fund profits. While a hurdle rate makes the carried interest somewhat more risky, risky compensation is still compensation. As Orszag explained, “a hurdle rate would affect the precise examples and calculations but not the underlying substance of the issue.”
rather than Goldman Sachs, simply because of the tax benefit, even though he could have been more productive at Goldman Sachs.

- **Decisions about organizational form.** A group of individuals considering starting an investment services company might decide not to operate as a public corporation, even if that was the most appropriate governance device, simply because of the tax advantages of operating as a partnership.

- **Compensation decisions.** Managers and investors might change the structure of contracts to provide more compensation in the form of carried interest, even though a different compensation structure would create a better mix of incentives.

University of Illinois Law Professor Victor Fleischer finds evidence that this is occurring on a large scale among venture capital funds. He writes, “The peculiar tax treatment of a profits interest in a partnership [i.e. a carried interest] encourages parties to keep the status quo [with respect to the compensation structure],” even though that structure of compensation may result in “venture capitalists… engaging in riskier strategies than their investors would prefer, rushing products to market and pushing management to pursue IPO [initial public offering] exits…”

People often speak of equity and efficiency as competing goals in tax policy, which they sometimes are. In this particular case, however, tax equity and efficiency go hand in hand: efficiency would almost certainly be advanced by taxing carried interest like other, economically equivalent, forms of income.

**Objections to Taxing Carried Interest at Ordinary Income Tax Rates**

Proposals to change the tax treatment of carried interest have been met with the vague criticism that they would hurt the economy. As discussed above, it is more likely that the tax break itself harms the economy (though it should be noted that the negative economic effects of the tax break, as well as any economic effects from eliminating it, are almost certainly very small). Several more specific objections that have been raised to changing the treatment of carried interest are discussed below.

- **Objection 1: Changing the tax treatment of carried interest would seriously damage the industry, and especially venture capital firms.**

  It’s true that ceasing to subsidize private equity firms relative to other sectors of the financial services industry could conceivably lead some individuals to opt for another line of work or some businesses to opt for another organizational form. But, as discussed above, to the extent that the choices individuals and businesses currently make are motivated purely by the tax break, it would be better economically if they made different choices.

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20 More specifically, Fleischer argues that investors in venture capital funds would be better off if managers’ carried interest were more frequently subject to a “hurdle rate:” a rate of profit that had to be achieved before the managers’ would begin to receive the carried interest. Victor Fleischer, “The Missing Preferred Return,” UCLA Law and Economics Research Paper Series No. 05-8, February 22, 2005, [http://papers.ssrn.com/sol3/papers.cfm?abstract_id=671363](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=671363).
In any case, it seems highly unlikely that changes in the tax treatment of carried interest will have a significant effect on private equity firms. Put simply, as Law Professor Mark
Economic Advisors under President Bush, has pointed out that even under the Levin bill approach, “It is as if the manager put the initial value of the carried interest in a tax-deductible IRA, deferring tax on this compensation until the money is withdrawn at a later date. The proposed reform, therefore, does not seem excessive.”

On the one hand, this similarity between the Levin bill approach and a deductible IRA means that even enacting the Levin bill would not fully level the playing field between carried interest and other forms of labor compensation. On the other hand, the fact that the Levin bill preserves a sizable tax advantage for carried interest should alleviate the concerns of those who believe that maintaining some tax advantage for carried interest is important or that a modest portion of carried interest income is appropriately classified as a capital gain (or loss, depending on the fund’s performance).


** For a summary of options, see Victor Fleischer, “Two and Twenty: Taxing Partnership Profits in Private Equity Funds.”


******* For example, one view of carried interest is that it equivalent to a “nonrecourse,” interest-free loan from the limited partners of a private equity fund to the general partner. Typically, the tax code would tax the implicit, forgiven interest from such a loan (calculated based on the current rate on federal securities) each year as ordinary income, but then tax the gain (or loss) on the interest secured by the loan as capital. The Levin bill approach — deferring all tax until realization but then taxing all earnings at the ordinary income rate — could be viewed as a simpler, “rough justice” approach. Indeed, on average, it should be more favorable.

Gergen testified to the Senate Finance Committee, “[That] concern assumes that the people who are providing labor in venture capitals have just as good alternatives where they can make just as much. And so if you lower the yield to them by a fraction, they’re going to do something else. I’m dubious.”

Or as tax economist Leonard Burman noted, “These deals are immensely profitable, and would happen with or without a tax subsidy.” For example, the Blackstone Group’s Initial Public Offering was reportedly in high demand, despite the possibility of a tax increase.

In addition, the Economist pointed out, “Venture capitalism has done much better in America than Britain, although the incentive from carried interest is bigger in the latter. The industry’s success clearly depends on other things than tax.” The magazine’s editorial concluded, “To work its magic, private equity does not need an unfair tax break, designed for another age and another set of entrepreneurs.”

21 Transcript of Senate Finance Committee Hearing.


*Objection 2: Changing the tax treatment of carried interest would significantly hurt “ordinary investors,” like those enrolled in state employee pension plans.*

The argument underlying this objection is that if managers do not benefit from a tax preference for carried interest, they will insist on higher compensation, which will diminish returns to investors; therefore, we should preserve the tax preference. By that logic, the federal government should probably end taxation altogether for financial industry managers, on the theory that some part of the tax cut would trickle down to investors, including those enrolled in employee pension plans.

Even apart from the question of whether it is worth preserving an expensive tax break just because a fraction of its benefits reach people one may want to help, the evidence suggests that the fraction of this particular tax break’s benefits that reach investors, as opposed to the managers themselves, is quite small. Orszag testified, “The argument you’d have to make is that somehow the tax break to the general partner would be shared with the limited partners...” “I think it’s more likely that the general partner 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.”

Interestingly, according to an article in Bloomberg News, “the pension funds whose interests [the private equity firms] 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.”

*Objection 3: Changing the tax treatment of carried interest would lead American firms to move overseas.*

According to experts, this objection ignores the realities of the private equity industry and U.S. tax law. Fleischer observes, “Funds that target U.S. portfolio companies will rarely perform these services from abroad; indeed, funds shows a remarkable tendency to congregate regionally.”

Moreover, according to Orszag, U.S. tax law does not allow investment firms to escape tax simply by moving their headquarters overseas. Rather, U.S. law would make it difficult for these firms to avoid U.S. tax even if the managers were to move overseas, give up their U.S. citizenship, and take other extreme steps.

Those who expect financial firms to relocate abroad typically suggest that they would move to the United Kingdom. But as Finance Committee Chair Max Baucus noted at the

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25 Transcript of Senate Finance Committee Hearing.


27 Victor Fleischer, “Two and Twenty: Taxing Partnership Profits in Private Equity Funds.”

28 Transcript of Senate Finance Committee Hearing.
Committee hearing, the U.K. is also seriously considering eliminating tax benefits for carried interest.

This is not an exhaustive list of the arguments that have been made against taxing carried interest as ordinary income. Some have argued, for example, that closing the carried interest loophole is not feasible. While a complete rebuttal to that argument would require a detailed examination of partnership tax law, the plethora of proposals for dealing with the problem suggests that doing so certainly is possible. For a description of some of these proposals, see the box on page 10.

The Carried Interest Controversy: A Vivid Illustration of a Larger Issue

Supporters of reconsidering the treatment of carried interest include people who strongly support the lower tax rate for capital gains. Nevertheless, the carried interest controversy illustrates the problems that are endemic to the very large differential that now exists between the top tax rate on labor income and the 15 percent capital gains rate.

The capital gains differential provides powerful incentives for people to convert labor compensation into something that can be classified as a capital gain. As is well known, differential tax treatment of similar forms of income creates economic inefficiencies. In addition, efforts to convert compensation into something that can be classified as a capital gain typically involve large investments in tax planning, which siphon resources from more productive activities, adding to the inefficiency. As economist Leonard Burman explained in a recent column discussing the carried interest issue, “What the low rate on capital gains does is spur a huge amount of unproductive tax sheltering. Wealthy individuals invest enormous sums in schemes to convert ordinary income into capital gains... Capital is drawn away from productive investments, hurting the economy. Similarly, the highly talented people who dream up tax shelters could, in a better world, do productive work.”29 The private equity industry itself provides additional examples of tax schemes that result motivated by the rate differential. (See box on page 14.)

In addition, the tax planning opportunities created by the reduced capital gains rate can make unproductive investments worthwhile. Former Federal Reserve Vice-Chairman Alan Blinder writes, “When I discuss this issue with my Economics 101 students, I show them an example of a proposed investment that loses money before tax (and which, therefore, should be rejected) but which actually turns a profit after tax because of the preferentially low capital gains rate. (Accountants and tax lawyers live this example every day.) The government thus induces people to make bad investments...”30

Any economic benefits produced by low capital gains tax rates need to be weighed against the economic distortion that the capital gains differential can induce, as the carried interest controversy illustrates. This trade-off has led Burman to conclude: “[T]he tax break on capital gains does more harm than good.”31

31 Leonard E. Burman, “End the Break on Capital Gains,” Washington Post, July 30, 2007. For a brief discussion of claims made about the economic benefits of low capital gains rates, and why they are probably exaggerated, see Aviva
The low effective tax rates that private equity fund managers pay also illustrate another result of the low capital gains rate: it is one of the principal reasons many very high-income individuals pay little in federal income taxes. In fact, because many wealthy people receive large shares of their income in the form of capital gains, it would be virtually impossible to ensure that these individuals pay tax at rates as high as middle-income earners without changing the tax treatment of capital gains.

Conclusion: Both Opponents and Supporters of Low Capital Gains Rates Should Support Changing the Tax Treatment of Carried Interest

The preferential rate for capital gains deserves careful reexamination. But even if Congress is not willing to consider eliminating the rate differential, lawmakers should promptly address the treatment of carried interest. As the Economist has explained, “In theory, an efficient tax system would tax both income and capital gains at the same rate — and allow people to make their decisions on merit alone. But even if you think capital gains and income should be taxed differently, carried interest looks like income, not equity, and should be treated as such.”

More Examples of Capital Gains-Related Tax Schemes in the Private Equity Industry

The private equity industry also offers other examples of the mischief that can result from a large capital gains rate differential.

- Private equity firm managers have found ways to convert even their management fees into carried interest, allowing them to pay tax on them at the capital gains rate. In some cases, this conversion has occurred after a firm’s profits were already known: that is, once the value of the additional carried interest was certain.*

- In addition, according to a New York Times analysis, the Blackstone Group devised a way for its partners to effectively avoid tax on the bulk of the large profits they secured by selling shares of Blackstone to the public. In essence, the partners paid tax at the 15 percent capital gains rate on their profits from selling shares in the public offering, while receiving the benefit of a tax deduction attributable to what is known as “goodwill” (essentially, the value of the firm’s intangible assets) in an amount equal to their profits, and taking these deductions at the 35 percent corporate income tax rate.** Thus, rather than paying tax on their profits, it appears they may have ended up with a net tax subsidy that further increased their already extremely large profits (or at least with a very low tax rate).

* Peter Orszag, “The Tax Treatment of Carried Interest.”

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32 Economist, “Carried Away: Private Equity.”
The Financial Times similarly commented, “For another day are bigger questions of whether it ever makes sense to tax capital gains at a lower rate than ordinary income (the policy that gave rise to this problem in the first place), and in the American case, whether the tax system as a whole should be made more progressive. The case for reform on both points is strong, in fact. But the carried interest anomaly can be dealt with promptly, and should be.”\textsuperscript{33}

Senate Finance Committee Ranking Member Charles Grassley has offered an additional argument for giving the tax treatment of carried interest a hard look. He observed, “As a Republican who supports lower capital gains rates, I am concerned [that] to the extent we permit the dilution of the investment concept, we risk undermining the arguments we have made for the lower rates…”\textsuperscript{34} Grassley apparently is saying that the onus is on those who support low capital gains rates to protect the tax code against the most serious abuses to which those low rates can give rise. Prominent among those abuses is the taxation of various forms of compensation for services at the capital gains rate.

\textsuperscript{33} Financial Times, “The Fair Way to Tax Private Equity.”

\textsuperscript{34} Transcript of Senate Finance Committee Hearing.