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COMPROMISE PROVISION TO NARROW "CARRIED INTEREST" TAX LOOPHOLE SHOULD NOT BE WEAKENED FURTHER

By Chuck Marr and Gillian Brunet

A provision in the jobs bill that the House passed on May 28 would partially close a tax loophole that allows investment fund managers to pay taxes on a large part of their income — their "carried interest" — at the 15 percent capital gains tax rate rather than at normal income tax rates of up to 35 percent. Unfortunately, the version of this provision that Senate Democratic leaders unveiled on June 8 is weaker than the House-passed version, and lobbying efforts continue for the Senate to weaken it further. The Senate should resist these efforts. In addition, the House-Senate negotiators who will iron out the final version of the jobs bill should move this provision back in the direction of the House-passed provision.

The House voted in December to *eliminate* the carried interest loophole, which would raise an estimated $25 billion in revenue over ten years to help pay for the extension of the research and experimentation tax credit and other tax provisions. Then, in response to lobbying by affected parties (private equity, venture capital, and real estate interests), key House and Senate members agreed on a compromise to let fund managers continue paying the capital gains rate on one-fourth (25 percent) of their carried interest. The House passed the compromise in its jobs bill on May 28.

The affected industry players have been lobbying heavily to weaken the compromise, arguing that their work should entitle them to pay lower tax rates than police officers, doctors, scientists, small business proprietors, and others on more than one-fourth of their income. Their arguments do not withstand scrutiny.

Put simply, the work that private equity fund managers do is work. The income they derive is ordinary income — it is compensation for the work that they do and the services they provide, *not* a return on capital they have invested. "Carried interest" is a somewhat complicated concept, as explained below, but it clearly constitutes income for services provided — and people compensated with carried interest should pay tax at ordinary income tax rates and not at the preferential capital gains tax rate.

Opponents of narrowing the loophole on carried interest have been pushing at least four different changes to significantly weaken the compromise that House and Senate members developed and that is reflected in the bill the House passed last month:

- Increasing the percentage of carried interest that would still be taxed at the capital gains rate (for more on this, see p. 6).

- Partially exempting carried interest that is derived from profits on assets held for a long period of time (for more on this, see p. 6).

- Exempting venture capital firms from *any* change in the tax treatment of carried interest (for more on this, see p. 6).

- Weakening or removing a "backstop" in the provision designed to ensure that fund managers can't maneuver around the provision, and continue to pay capital gains rates on all carried interest (for more on this, see p. 7).

The Senate has already given ground in two of these areas. On June 8, Senate Democratic leaders announced a revision to the House-passed provision that would: (a) allow investment fund managers to shelter 35 percent of their carried interest as capital gains income (up from the House bill's 25 percent), and (b) allow fund managers to shelter an even larger share — 45 percent — of carried interest earned on assets held at least seven years. As explained below, these changes are unwarranted, and the Senate should hold the line against additional changes that would further weaken the provision and lose more revenue.

Carried Interest and How to Tax It

As compensation, private equity fund managers typically receive a modest management fee plus 20 percent of the fund's profits above a threshold level. This right to 20 percent of the profits is known as "carried interest." Currently, the managers' carried interest is taxed as capital gains, meaning that it faces a top tax rate of only 15 percent, regardless of how affluent a fund manager is and what tax bracket he or she falls in.

The carried interest that these fund managers receive is compensation for work they perform in managing a fund's investments; it is not a return on capital of their own that they have invested. (Fund managers tend to contribute a modest amount of capital to the funds they manage, but any gains they receive on those investments are taxed at the capital gains rate and would continue to be taxed that way under the legislation.) Accordingly, compensation received as carried interest should be treated under the tax code the same as income that other Americans receive for the work they perform.

As the Blackstone Group, a major player in the private equity market, summed it up in a filing with the Securities and Exchange Commission: "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."[1] It is a basic tenet of tax policy that compensation for services rendered should be taxed as ordinary income, *not* as capital gains.

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[1] Cited in Citizens for Tax Justice, "Myths and Facts About Private Equity Fund Managers — and the Tax Loophole They Enjoy," July 2007, http://www.ctj.org/pdf/privateequity071907.pdf.

In addition, while tax policy decisions sometimes pose a choice between equity and economic efficiency, no such dilemma exists here — taxing carried interest as ordinary income would promote *both* equity *and* efficiency. Employees of investment banks provide essentially the same kind of services as private equity fund managers but face higher tax rates because their income is taxed as ordinary income, not as capital gains. It is not equitable for people who perform basically the same services and receive similar amount of income to face different tax rates. Nor is it efficient for the tax code to provide an incentive for a talented investment banker to jump to a private equity firm in order to take advantage of a tax loophole.

Recent House-Passed Provision Represents Compromise Approach

In December, the House approved legislation to extend various popular tax provisions that were slated to expire. To help offset the cost, this tax "extenders" legislation closed the carried interest loophole completely, treating carried interest as ordinary income and taxing it that way, raising $24.6 billion over ten years.

On May 28, the House passed a revised version of the extenders legislation, as part of its jobs bill, that included a compromise carried interest provision. In response to intensive lobbying from private equity firms, the new provision taxes *75 percent* of carried interest income as ordinary income. The remaining 25 percent would continue to be sheltered — i.e., to be taxed at the lower capital gains tax rate. Private equity professionals thus would still be taxed less than investment bankers, doctors, scientists, and business proprietors and executives, among others, although their tax advantage would be reduced.

The revised provision also is weaker than the earlier House provision in that its implementation would be delayed until 2011 and it would then be phased in. Affected individuals would be able to treat 50 percent of carried interest as capital gains in 2011 and 2012, before the provision took full effect in 2013.

The changes made to the original House provision reduced the savings the provision produces by about 30 percent, according to the Joint Tax Committee — from $25 billion over ten years to $18 billion.

Arguments Against Closing Carried Interest Loophole Lack Foundation

Private equity firms have advanced various arguments for continuing to tax carried interest as capital gains. These arguments do not withstand scrutiny.

- **Argument: fund managers should receive a reward for taking risks.** Some of the fund managers who would be affected, and their lobbyists, argue that their compensation deserves preferential tax treatment because it involves raising and managing funds for risky investments.

  The argument that the government should provide large tax incentives for firms to take on added risk rings hollow. As Peter Orszag testified in 2007, when he was director of the Congressional Budget Office, many types of professionals perform work that involves taking risks and receive compensation that depends on how the risk-taking venture turns out. Yet unlike fund managers, these other professionals pay tax at regular rates. Orszag testified:

> 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.

Harvard economist Greg Mankiw, who served as Chairman of President George W. Bush's Council of Economic Advisers, has made a similar point, noting that "Deferred compensation, even risky compensation, is still compensation, and it should be taxed as such." He adds:

> [Nobel prize-winning economist] Paul Krugman hit the nail on the head with this question: "why does Henry Kravis [co-founder of the private equity firm Kohlberg Kravis Roberts & Co.] pay a lower tax rate on his management fees than I pay on my book royalties?" The analogy is a good one. In both cases, a person (investment manager, author) is putting in effort today for a risky return at some point in the future. The tax treatment should be the same in the two cases.[2]

In short, the fact that the economy may benefit from the work of those who manage investment funds, including venture capital funds, should not entitle fund managers to lower tax rates than other workers who also contribute to the economy, such as police officers, heart surgeons, scientists, small business proprietors, and corporate CEOs.

- **Argument: this tax break is needed to attract the "best and brightest" to be fund managers.** This argument, advanced by some fund managers and lobbyists, fails on two grounds.

  First, given the enormous sums of money that many fund managers are paid, it is hard to believe these lucrative positions will not remain highly attractive if carried interest is taxed like other income.

  Second, if it is true that this tax break *does* attract a greater number of highly talented individuals to be hedge fund or equity fund managers, that is more likely to be a *negative* for the economy than a positive, because it means the tax break is enticing people to be fund managers rather than scientists, engineers, medical researchers, or people who work in other occupations that may provide greater economic benefits.

  As one venture capitalist (see box, next page) recently wrote: "If we force hedge funds and the like to compete for talent on a more level playing field, then maybe we'll see our best and brightest minds go to more productive activities than moving money around and taking a cut of the action."[3]

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[2] Greg Mankiw, "The Taxation of Carried Interest," Greg Mankiw's Blog: Random Observations for Students of Economics, July 19, 2007, http://gregmankiw.blogspot.com/2007/07/taxation-of-carried-interest.html.

[3] Fred Wilson, "Why Taxing Carried Interest As Ordinary Income Is Good Policy," AVC blog, May 29, 2010, http://www.avc.com/a_vc/2010/05/why-taxing-carried-interest-as-ordinary-income-is-good-policy.html.

Venture Capitalist: "It's time for asset managers to start paying their fair share of taxes."

Fred Wilson, a venture capitalist and principal of Union Square Ventures, wrote recently:

> [C]arried interest is a fee for managing other people's money. It is a fee based on performance, but it is a fee nonetheless. It is not fair or equitable to other recipients of fee income to give a special tax break to certain kinds of fees and not to others.
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> But even beyond the basic argument of equity and fairness, there are some other important factors to consider.
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> We have witnessed financial services (think asset management, hedge funds, buyout funds, private equity, and venture capital) grow as a percentage of GNP for the past thirty years. The best and brightest don't go into engineering, science, manufacturing, general management, or entrepreneurship, they go to Wall Street where they will get paid more. And on top of that, we have been giving these jobs a tax break. That seems like bad policy. If we force hedge funds and the like to compete for talent on a more level playing field, then maybe we'll see our best and brightest minds go to more productive activities than moving money around and taking a cut of the action.
>
> Changing the taxation of the managers will not reduce the amount of capital going to productive areas. The sources of the capital: wealthy families, endowments, pension funds, and the like, will still put the capital in the places where they will get the highest after tax return. And these sources of capital, if they are tax payers, will still get capital gains treatment on their investments in hedge funds, buyouts, and venture capital. And the fund managers will still have to compete with each other to get access to that capital and their incentives will still be to produce the highest returns they can produce, regardless of whether they are paying capital gains or ordinary income on their fees.
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> We may see the best managers investing more of their own capital and less of other people's money with these changes to the tax law. When I invest my own capital in a company (either directly or through my funds) and the investment generates a capital gain, I will still get to pay a lower tax rate. So at the margin, I might prefer to invest my own capital over someone else's with the new tax rules. I believe that is good policy. I have seen a correlation between a manager having significant "skin in the game" and long term performance. So if these tax changes produce more "skin in the game" that will be a good thing….
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> It's time for asset managers to start paying their fair share of taxes. We are among the most highly compensated people in the world. And we've been getting a huge tax break for years. It's not right and I am happy to see our government finally do something about it.

"Why Taxing Carried Interest As Ordinary Income Is Good Policy," AVC blog, May 29, 2010, http://www.avc.com/a_vc/2010/05/why-taxing-carried-interest-as-ordinary-income-is-good-policy.html.

- **Argument: Closing this tax break would harm middle-income Americans.** One opponent of the measure, Robert Johnson of RLJ Companies, has said: "Remember we manage money for union employees, for corporate employees, for teachers, firemen and the like and our job is to help these unions and pension funds protect their employees when they retire."

  This argument is devoid of merit. The tax rate that fund managers pay on their carried interest has no bearing on the returns that employee pension funds earn on money they invest in these funds. Economists generally agree that taxes imposed on labor are borne by labor. And the fund managers will still have the same incentive to manage pension fund investments well and secure high earnings on them — if they perform poorly in managing those investments, the pension funds will move their capital to other fund managers who perform better. The implication that union, corporate, or other employee pension funds will be hit is patently false.

Proposals to Weaken House-Passed Measure in Senate Are Not Justified

The following sections discuss the four main efforts to further weaken the House-passed compromise and explain why none of them represent sound policy:

Increasing the Share of Carried Interest That Would Still Be Taxed as Capital Gains

As noted, the bill the House passed in December would have taxed, as ordinary income, 100 percent of carried interest income from the provision of services. The subsequent House-passed compromise proposal would allow fund managers to have 25 percent of this labor income taxed at the preferential capital gains rate. This means that people working in these financial services sub-sectors would be taxed more lightly than other workers in the financial services industry as well as those in other industries — an unfair and economically inefficient policy.

Nevertheless, some senators have successfully pushed to increase the exemption from 25 percent of carried interest to 35 percent in the new Senate Democratic version of the proposal. This makes the provision more inequitable and inefficient. The House-passed compromise, which would still allow these taxpayers to shelter one-quarter of carried interest income at preferential rates, would be preferable.

Partially Exempting Long-Term Carried Interest

Carried interest enjoys an additional tax advantage beyond the lower tax rate. Typically, taxpayers pay taxes on compensation for services in the year that the services are provided; carried interest, in contrast, is not taxed until the profit is distributed.[4] This is known as deferral, and it allows the taxpayer to pay the tax in dollars whose value has been eroded by inflation. The initial House-Senate compromise proposal did not touch this tax timing advantage, so taxpayers would continue to receive a tax break that increases the longer their compensation is deferred.

Unfortunately, Senate leaders have added a further timing-related tax advantage, allowing 45 percent of carried interest that is realized on assets held for at least seven years to be taxed at the capital gains rate. This change is unnecessary, given the existing tax incentive to hold assets over the long term.

Exempting Managers of Venture Capital Funds

Venture capital funds — private equity funds that invest in start-up businesses — have been lobbying for an exemption from the provision, arguing that changing the tax treatment of their carried interest would hurt them and thus the economy. Such an exemption would be unwarranted.

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[4] Victor Fleischer, "Two-And-Twenty: Taxing Partnership Profits in Private Equity Funds," *New York University Law Review*, Volume 83, Number 1, April 2008, p. 11, http://www.law.nyu.edu/journals/lawreview/issues/vol832008/number1/index.htm.

Venture capital is indeed important to the U.S. economy; venture capital fund managers channel money from investors to entrepreneurs and provide valuable services to help entrepreneurs build successful businesses. Yet they should not be taxed less than other people who also do important work.

As Stanford Law Professor Joseph Bankman cogently explained to the Senate Finance Committee in July 2007:

> In order for the current low rate [on carried interest] to be efficient, it would have to be shown not just that fund managers will work less if the tax is increased, but that they are relatively *more* sensitive to tax than those in other occupations. As noted above, fund managers now pay tax at about half the maximum rate of doctors. This would be efficient (though still objectionable as unfair) only if it could be shown that doctors are relatively insensitive to tax, and so will continue to work notwithstanding the high rate, or that fund managers are extremely sensitive to tax, or that some combination of these two assumptions is true. Again, no one has presented any evidence that this is the case.

As noted above, it is hard to believe that the people working to help find and fund the next Apple or Google are motivated primarily by a tax shelter and would leave the industry rather than be taxed like other Americans.

Weakening "Backstop" Designed to Ensure Compliance

Some private equity firms are reportedly urging the Senate to remove a "backstop" in the current provision that is designed to prevent taxpayers from skirting changes in the tax treatment of carried interest. Here's why this backstop is necessary:

A carried interest generates tax liability for its owner in two instances: when the underlying asset (generally an investment partnership fund) realizes profit and when it is sold. If the bulk of carried interest were taxed as ordinary income, then managing partners who hold carried interests would have an incentive to sell their right to the carried interests just *before* the underlying assets were liquidated (or, alternatively, before they realized profits), in which case their profit from the sale of the right to the carried interest would be taxed as capital gains, not as ordinary income.[5] The purchaser would also pay taxes at capital gains rates when the (former) carried interest realized profits, because once it was sold, the carried interest would no longer actually constitute a carried interest; instead it would be taxed like any normal investor's interest in the fund.

As Victor Fleischer, a leading expert on this issue and a law professor at the University of Colorado, has explained: "When Stephen Schwarzman and Pete Peterson sell their chunks of Blackstone and get capital-gains treatment, really what they're doing is monetizing their future stream of carried interest."[6]

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[5] The managing partners could do this by selling either their shares in the management partnership that owns the carried interest or by selling the carried interest itself, depending on the structure of the investment company.

[6] Ryan J. Donmoyer, "White House's Orszag Says Higher Tax on Fund Managers to Pass Within Weeks," Bloomberg, May 13, 2010, http://preview.bloomberg.com/news/2010-05-13/tax-increase-waiver-for-venture-capital-firms-sought-by-senators-in-bill.html.

Both the House-passed provision and the new Senate version of the proposal contain a backstop that would prevent this from happening. Under them, the sale of a carried interest, or a share in a management entity that holds a carried interest, would be taxed primarily (65 percent in the Senate version) as ordinary income rather than as capital gains. Removing this backstop could lose substantial revenue that the provision would otherwise generate.

If Congress appears unlikely to remove the backstop, the private equity industry may argue that Congress should create a special exemption in the backstop for what is known as "goodwill valuation." This, too, would be unwise.

Goodwill valuation accounts for the difference between the sale price of a firm and the fair market value of the firm's assets. It generally corresponds to the firm's intangible assets, such as brand recognition or reputation, but can be manipulated for tax purposes. When a fund manager sells his or her share in a management entity that holds a carried interest — the profits from which would be taxed as ordinary income under the House-passed proposal — part of the sale price could reflect goodwill. And since both unrealized carried interests and goodwill are difficult to value, this introduces the possibility of gamesmanship if goodwill is not taxed the same as carried interest.

Currently, it does not matter for tax purposes what portion of a firm's sale price represents goodwill and what portion represents carried interest, since the same tax rates apply to the entire amount. But if Congress were to tax the bulk of carried interest as ordinary income while allowing goodwill to continue to be taxed at preferential capital gains rates, this would encourage firms to overstate the portion of a sale price that is goodwill and understate the portion that is carried interest.[7]

The House-passed compromise provision already affords one-quarter of all carried interest income the preferential capital gains rate. There is no justification for adding a special goodwill exemption on top of that.

Conclusion

While considerations of equity and economic efficiency would argue for taxing all carried interest as ordinary income, the House-Senate compromise that the House passed on May 28 represents a sensible step forward. Policymakers should aim to enact a provision that is as close as possible to this version.

In addition, the people who will be affected by the partial closure of this tax break are both affluent and highly sophisticated, and they can be expected to take what steps they can to minimize the provision's impact on them. Francois Hechinger of BDO Seidman, who advises venture capital firms, has observed that upon enactment, "the games will begin" because "That's when people will

[7] To benefit, a firm would have to hold its management company (which provides investment management services to funds) and its general partner vehicle (which holds carried interests in its funds) in one entity. Managers of such firms hold a partnership interest that includes both a stake in the management company and the carried interest. At present, relatively few firms are structured in this way, but the tax incentives provided by a goodwill exemption could encourage private equity funds to restructure in order to benefit from them.

try to figure out how to get around this."[8] Accordingly, the provision needs to be drafted as tightly as possible to accomplish its intended purpose.

[8] Andrew Ross Sorkin, "Bobbing as the Taxman Weaves," *New York Times,* May 17, 2010, http://www.nytimes.com/2010/05/18/business/18sorkin.html?scp=1&sq=hechinger&st=cse.