Addressing Objections to H.R. 2834 – the Levin Carried Interest Bill[1]

Introduction

With congressional and media scrutiny surrounding the "carried interest" income tax loophole expected to intensify this fall, many advocates and aides have sought a set of responses to frequently raised objections to H.R. 2834, the bill introduced by Rep. Sander Levin to close this loophole.

The carried interest issue is essentially one of simple tax fairness, as the Levin bill (H.R. 2834), would eliminate an inefficient, inequitable, and unjustified tax preference for private equity and hedge fund managers. This preference allows these managers who are paid millions or even billions for their labor to pay a 15 percent capital gains tax rate on compensation for their service, rather than the ordinary income tax rate that applies to everyone else. This loophole sets up a perverse reality where millionaire fund managers are paying significantly lower federal tax rates than their receptionists. This loophole is unfair to those people, and to all Americans who pay regular income taxes, as it is costing the federal government billions of dollars a year.

This paper focuses on objections to the Levin bill raised during the last few months over the course of the debate on this issue. The issues involved are not nearly as complex as some industry lobbyists have claimed. This analysis seeks to demystify these objections and offer cogent responses to them.

Impact on Returns

Wouldn't closing the carried interest loophole weaken returns to pension funds and other investors?

Some argue requiring investment managers to pay their fair share in taxes would lower returns to pension funds and other investors because managers will charge higher fees or will not have as much incentive to work to generate high returns. According to Orin Kramer, Hedge-Fund Manager and Chairman of the New Jersey State Investment Council, "The argument that this is about the interests of retired public employees is ludicrous."[2]

Furthermore, Bloomberg News has reported the National Conference on Public Employee Retirement Systems, the largest trade association for public-sector pension funds, has taken the position that the Levin bill would not "undercut" investment returns.[3]

Investment managers cannot raise fees for current investors. These fees are set in contracts between the investor and the manager when the investor agrees to invest in a fund. They are settled and may not be changed. In addition, the fees charged by private equity, real estate, and hedge fund managers are already higher than fees charged by mutual funds. If managers could command higher fees than they charge now, they would already be doing so.

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[1] This analysis was developed by a working group of fiscal policy analysts. Assisting in this effort were: Prof. Lily Batchelder, NYU School of Law and the Tax Policy Center; Dana Chasin, OMB Watch; Jonathan C. Goldstein, Thacher Proffitt & Wood LLP; Heather Slavkin, AFL-CIO; and Steve Wamhoff, Citizens for Tax Justice. The working group also thanks Prof. Victor Fleischer, University of Illinois; Jason Furman, Brookings Institution; and Robert McIntyre, Citizens for Tax Justice.

[2] "Buyout Firms' Tax Rise Wouldn't Hurt Workers, Pension Funds Say," Bloomberg News. July 11, 2007; http://www.bloomberg.com/apps/news?pid=20601103&sid=aqyXkfhsNZmY&refer=us

[3] "Pension Funds Lift Opposition to Buyout-Firm Tax Rise Pension Funds Lift Opposition to Buyout-Firm Tax Rise," Bloomberg News. September 5, 2007; http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aFcONwb4.Ov8

Carried interest, performance bonuses, stock options, and restricted stock grants are all forms of compensation intended to create an alignment of interest among employees and outside investors. This legislation simply aligns the compensation for investment managers with those who receive other forms of performance-based compensation. The theory that without a tax preference for carried interest, managers would give up on the funds they manage ignores the realities of the industry. If a manager stops focusing on a fund and returns suffer, that manager is going to find it difficult to win investors' business in the future, regardless of how much taxes they pay on their income.

Capital Formation
Won't closing the loophole deter investments that generate real growth, innovation, long-term investments, and capital formation vital to the health of our national economy?

The implication of this argument is that, if the tax loophole was closed, talented individuals would leave the private equity industry or investors would stop contributing capital to these funds. Taxing carried interest as ordinary income would have virtually no impact on taxes paid by the investors who actually contribute the capital to these funds. Since, as discussed above, it would also likely have little or no impact on investor returns, it is unlikely there would be much change in investor behavior and therefore little impact on capital formation. Given the potential for huge gains, <u>it is a far-fetched notion that there would be a shortage of talented individuals eager to manage private equity funds – or that fund managers would suddenly leave the field – if their compensation were taxed like that of any other managers.</u>

Moreover, many other high-paid individuals (movie stars, baseball players, CEOs, investment bankers) are willing to work hard even though they pay regular income tax rates on their income. There is no reason this expensive tax subsidy should be extended to fund managers.

Sweat/Founders Equity
Shouldn't fund managers who contribute their time and energy to the fund be allowed to count their 'human capital' as 'sweat' or 'founders' equity, which should be taxed at the capital gains rate of 15 percent?

<u>No, and the question is mostly irrelevant. Fund managers are hired by the funds' investors to raise money and manage investments. They make little or no up-front contributions to the fund and merely design and implement investment strategy on behalf of their clients.</u>

Fund managers should be in the same position as investment bankers – workers whose compensation is taxed as ordinary income. They are unlike the funds' investors, or the grocery store owner, or the high-tech start-up founder, all of whom invest their own financial capital or tangible assets, and who actually own their companies. An investment fund manager does not. Peter Orszag, Director of the Congressional Budget Office, testified before Congress, specifically addressing the sweat equity argument. Orszag supported the important distinction between people who risk their own capital and those who contribute to economic activity without risking capital.[4]

The risk fund managers assume, if any, in managing other people's money is similar to a lawyer's who takes a case on a contingency basis – and contingency fees are taxed as ordinary income, not capital gains. The risk involved is actually the investors', who stand to lose their entire capital contributions should the investment go bad. Any sweat off managers' brows is the same as any

[4] Peter Orszag, The Taxation of Carried Interest; Statement before the Committee on Ways and Means. U.S. House of Representatives; September 6, 2007; http://www.cbo.gov/ftpdocs/85xx/doc8599/09-06-CarriedInterest_Testimony.pdf

workers' sweat – it does not confer any equity position and does not entitle their earnings to capital gains treatment. Similarly, painters or writers are taxed at ordinary income rates when they sell a painting or book, regardless of whatever risks or investment in time, labor, and assets they may have made to create their work. Of course, any portion of a profits interest attributable to financial capital invested by the fund manager would be taxed as capital gain and not ordinary income under the Levin bill.

International Competitiveness
Won't closing the loophole force fund managers to leave the U.S. for lower tax jurisdictions, in particular, the United Kingdom?

This type of tax avoidance would be very difficult in practice. While a foreign general partner may not be subject to the proposed tax bill, relocated U.S. managers will still be subject to this tax. U.S. managers would most likely have to take drastic steps, including renouncing their U.S. citizenship, to avoid taxation under this bill regardless of where they live.

Scope of the Bill's Impact
Which partnerships would be affected by the Levin bill? Would the bill unfairly treat different types of partnerships in different ways?

<u>The Levin bill would substantially reduce arbitrary and differential treatment under the tax code.</u> The bill seeks to end the current discriminatory tax treatment permitting hedge fund and private equity managers to pay a lower tax rate on the carried interest portion of their income than those working in other professions pay on their compensation. All partnerships managing investments in commodities, real estate, derivatives or securities in any type of business whatsoever would be covered under the Levin bill.

<u>Real Estate Sector</u>
The National Association of Realtors claims H.R. 2834 would adversely affect every real estate partnership – is this a valid statement?

<u>This is hyperbole. The legislation's only impact on the real estate industry would be to change the tax treatment of compensation paid to real estate investment managers – not individual homeowners, realtors, builders, or real estate investors.</u> While the fund managers would have to pay ordinary income tax rates for managing the partnership, returns on real estate investments would be unaffected.

Any investment manager who takes a share of an investment fund's profits as her compensation will be affected, regardless of the type of assets she manages. The test for the tax treatment of a payment under this bill is whether the income is compensation, not how much it is or whether it is for managing a specific type of asset or using a certain investment strategy. The bill rectifies a fundamental unfairness – compensation for services should be treated as ordinary income and taxed accordingly, regardless of its source.

The bill does includes an exception so it would not affect an entity's ability to qualify as a Real Estate Investment Trust (REIT), regardless of whether the REIT receives carried interest income flowing from another real estate partnership.

Market Conditions

Isn't this exactly the wrong time to close this loophole, when there is a massive credit squeeze in the housing market and stock prices are in a decline?

The current troubles of parts of the capital markets and housing industries, and whether they continue, have nothing to do with taxes. As explained above, the proposed legislation would not change the tax liability of any investor, nor is it likely to have any impact on returns, so there is no reason to believe it will have any impact on financial markets. If private equity fund managers lose money this year, they will owe nothing in taxes, regardless of whether the carried interest loophole is closed or not.

Revenue Estimates

Why bother if this tax change would not raise significant amounts of revenue? Or will it?

While the Joint Committee on Taxation has not yet released an official revenue estimate, most existing estimates suggest that the amount of revenue raised by the Levin bill is likely to be well in excess of $1 billion a year. Private equity funds hold more than $1 trillion dollars in assets, with hedge funds holding comparable amounts. Based on these figures and others, independent analysts have estimated that closing the carried interest loophole would raise between $1 billion[5] and $12 billion[6] annually.

Over time, the amount of revenue raised will depend on how investment funds respond to the change in law. Among other considerations, some have suggested that if the Levin bill were enacted, an investment fund could prevent carried interest from being taxed as compensation by characterizing it as an option. However, the value of an employee stock option is generally taxed as compensation under current law. Others have suggested that if the Levin bill were enacted, an investment fund could cancel out the higher tax rate on the manager's carried interest payments by taking deductions for compensation paid. Such deductions are valueless for those limited partners who are tax-exempt or subject to the alternative minimum tax, and existing tax rules limit the ability to shift deductions to taxable partners.

All of these alternative ways of using carried interest result in the fund manager being paid income for their services. These different approaches to evading income taxes illustrate how the current treatment – as probably the most tax-advantaged way of receiving large amounts of compensation – distorts compensation decisions and privileges fund managers above other managers, not to mention all other Americans.

Conclusion

Fundamental tax fairness is at the heart of the issues discussed above. The bottom line is millionaire fund managers should not be able to pay a lower tax rate on their income than the people who clean their offices and answer their phones. It really is as simple as that.

More Information

[5] Michael S. Knoll, University of Pennsylvania Law School; The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of Taxing Profit Interests as Ordinary Income, August 16, 2007; http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1007774

[6] Randall Dodd, Tax breaks for billionaires; Loophole for hedge fund managers costs billions in tax revenue, July 24, 2007; http://www.epi.org/content.cfm/pm120

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