RPC FISCAL FACTS

Taxing Carried Interest as Ordinary Income: A Bad Idea

The Senate may soon consider a proposal to tax what is known as a "carried interest" in an investment partnership at ordinary income tax rates, irrespective of the character of the income.[i] Although at first this may seem like an appealing source of revenue from hedge fund managers and other politically unsympathetic targets, the reasoning behind taxing carried interest at ordinary income tax rates does not hold up to scrutiny.

Background

- Managing partners of investment partnerships are generally also owners of the partnership through what's known as a "carried interest," which gives the managing partner a share of the fund's gains to help insure that his interests are aligned with the investors to achieve the highest long-term returns to the fund.[ii]
- Longstanding principles of partnership law and the tax code provide that any capital gain income earned by the partnership is treated like capital gains for tax purposes for all the partners, including the managing partner.[iii]
- <u>This is not a loophole exploited by investment funds</u>: the managing partner is an owner of the business and this tax treatment is standard for entrepreneurs who risk failure by investing with third party money.

Changing this treatment would affect far more than just the private equity industry.

- Most affected by this change would be real estate companies and venture capitalists with a longer investment horizon and who actively manage their investments and help ensure their long-run success.
- Hedge fund managers, who Democrats seem eager to target, would be among the least affected of all partnerships, as more than 80 percent of their securities are turned over within a year, subjecting those gains to ordinary income tax rates and not lower capital gains rates.[iv]
- Forty-eight percent of partnerships are in real estate and rental and leasing. These partnerships will be especially hard hit by any change to the tax structure since nearly 60 percent of their portfolio income is in long-term capital gains.[v]
- $1.1 trillion or one quarter of the investment capital provided to the U.S real estate sector in 2006 was equity capital, provided primarily by partnerships backed by private investors.[vi]
- The U.S. Conference of Mayors recently warned that raising this tax increase would "disproportionately impact the commercial and multi-family real estate industry."[vii]
- Pensions would also be harmed by this tax increase. Raising taxes on the managers of private equity partnerships will raise the costs for pension funds that invest with private equity. In 2006 the 20 largest pension funds invested in private equity represented 10.5 million retirees.[viii]
- Public and private pension funds have $437 billion invested in private equity partnerships worldwide.[ix]

Raising taxes on investment is bad for the economy

- Fifteen million Americans are currently unemployed. To return to five percent unemployment, 200,000 new jobs are needed each month for seven years.[x] Yet this tax increase would strike at the heart of a critical source of capital to small and growing businesses.
- Companies backed by private equity investors employ more than 6 million Americans.[xi] Firms that receive venture capital improve their chances of survival in their early years and speed their investment and growth.[xii]
- Critically, the first businesses that will lose access to equity capital are younger or marginal firms that may be on the brink of failure. To help small businesses, new government lending programs and credit subsidies are not necessary if private equity capital is available in private markets.
- As it is the after-tax rate of return that drives investment and savings decisions, raising taxes on these decisions can seriously distort where society invests and cause certain investments to not happen at all.[xiii] Decades of economic research show that saving and investment is the most critical component of long-term prosperity.[xiv] Raising taxes on the intermediaries who help channel these savings to productive activity is a way of discouraging long-term growth.

<u>Republicans have rejected this tax increase as a revenue raiser in the past, voting against it in the House and Senate</u>,[xv] and should not now accept a permanent change in tax policy to pay for temporary spending measures. Raising these taxes will result in less money for private investment, more money for government waste, and a permanent change to long established principles of law that will last well beyond the government's short-term need for revenue.

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[i] "Orszag says higher tax on fund managers to pass within weeks," Ryan J. Donmoyer, Bloomberg, May 13, 2010.
[ii] "Taxation of Carried Interests," Howard Abrams, Tax Notes, July 16, 2007.
[iii] "The Taxation of Carried Interests in Private Equity," David Weisbach, Virginia Law Review, May 2008.
[iv] Ed Easterling, "Hedge Funds: Myths and Facts," Crestmont Research, April 10, 2007, in Chamber Part II page 23.
[v] IRS Statistics of Income Division, Fall SOI Bulletin, 2009, Partnership Returns, 2007, Table 1.
[vi] Jonathan D. Miller, 2006, Emerging Trends in Real Estate, p. 21-24, found at U.S. Chamber of Commerce, "Analysis of the Impact of Increasing Carried Interest Tax Rates on the U.S. Economy, Part I," Sept. 2007 (hereafter "Chamber Part I").
[vii] "U.S. mayors caution against tax increase on carried interest," Jay Heflin, The Hill, May 17, 2010.
[viii] Chamber Part I, September 2007
[ix] Preqin Private Equity Intelligence, 2010 Update, on a global basis. Breakdown for U.S. not available.
[x] "Five myths about how to create jobs," James Manyika and Byron Auguste, The Washington Post, February 7, 2010.
[xi] Private Equity Council, May 4, 2010, at http://www.privateequitycouncil.org/press-releases/2010/05/04/private-equity-backed-companies-employ-more-than-6-million-americans-pec-report-finds/
[xii] Manju Puri and Rebecca Zarustskie, "Lifecycle dynamics of venture-capital-financed firms," on voxeu.org, Sept. 19, 2008.
[xiii] Lawrence H. Summers, "The After-Tax Rate of Return Affects Private Savings," AER, Vol 74, No.2, May 1984.
[xiv] Dale Jorgenson, "Productivity: Postwar U.S. Economic Growth," MIT Press, 1995.
[xv] See House Roll Call Vote 943, 111th Congress, 1st Session, Dec. 9, 2009, where all but two Republicans voted against the Tax Extenders Act of 2009, and U.S. Senate Roll Call Vote 414, 110th Congress, 1st Session, Dec. 6, 2007, where all 47 Republicans who were present voted against the Motion to Invoke Cloture on the Motion to Proceed to the Temporary Tax Relief Act of 2007.