Private Investment Managers Should Pay Their Fair Share of Taxes

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Congress is beginning to pay attention to a glaring inequity in the tax code: multi-millionaire managers of private investment funds pay a *lower* tax rate on their compensation than ordinary working Americans. They do this by devising ways to make payment for their services look like capital gains, taking it in the form of a percentage of profits ("carried interest"). This enables them to pay tax at a maximum rate of only 15 percent on much of their compensation. As a result, a worker earning a little over $40,000 a year is in a higher tax bracket than billionaire hedge fund managers.

The same fiction – that "carried interest" is not compensation for services but a return on passive capital investment – allows private investment management firms that have gone public in multi-billion dollar deals to claim that, unlike most other publicly traded partnerships, they are exempt from the corporate income tax. Yet, at the same time, they are telling the Securities and Exchange Commission (SEC) that the income they receive *is* compensation for services and *not* income from investments so that they can avoid SEC regulation as "investment companies."

Failure to close these tax loopholes means that other Americans are left to pick up the tab. Middle-class taxpayers effectively subsidize a hefty share of the lavish compensation packages of investment managers. These special tax privileges cost the nation billions of dollars in revenue, at a time when millions of struggling families who lack health care, adequate nutrition, and good quality child care are told that the nation cannot afford to help them. And they widen the gap between the very rich and everyone else, which is already at historic levels.

Congress is considering legislation to close these tax loopholes and make the private investment industry pay its fair share. A bill introduced in the House on June 22, 2007, H.R. 2834, would require private investment managers to pay tax on the compensation they receive for providing investment management services at the same rate as other taxpayers pay on their compensation. H.R. 2834 also would require publicly traded partnerships that provide investment management services to pay tax the way corporations and most publicly traded partnerships do, as would S. 1624, a bill introduced in the Senate on June 14, 2007.

PRIVATE EQUITY 101

- Private investment funds – private equity, venture capital and hedge funds – are investment vehicles that raise capital from wealthy private individuals and institutions such as endowments and pension funds, rather than through issuing securities on the public markets. Private equity and hedge funds have grown dramatically in recent years and are currently estimated to control over $2 trillion in assets.[1]

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- Private investment funds are generally structured as partnerships. There are two types of partners: limited partners, who contribute the capital for the funds to invest, and general partners, who provide asset management services and investment advice to the funds.

  - The general partner is itself a partnership, a private investment management firm, made up of individuals who provide management services to the fund. For example, the Blackstone Group, which made its highly publicized Initial Public Offering in June 2007,[2] is the partnership that provides investment management services, not the private equity fund itself.[3]

- Private equity and hedge fund managers typically receive compensation for the management services they provide in two forms: a percentage of the annual assets under management and a percentage of the future profits of the fund: the "carried interest." A common fee arrangement is "two and twenty": two percent of the annual assets of the fund and twenty percent of the future profits of the fund.[4]

- Private equity and hedge fund managers are among the most highly paid workers on the planet. Three hedge fund managers earned over $1 billion each in 2006; the combined earnings of the top 25 hedge fund managers were $14 billion, enough to pay the salaries of New York City's 80,000 public school teachers for nearly three years.[5] The top 20 private-equity fund managers are estimated to have earned an average of $658 million each last year—a total of almost $13.2 billion.[6] Much of this compensation is income from carried interest, which is taxed at a maximum rate of 15 percent.

HOW PRIVATE INVESTMENT FUND MANAGERS ARRANGE TO PAY A LOWER TAX RATE ON THEIR COMPENSATION THAN OTHER AMERICAN WORKERS

- **The managers of private investment funds arrange their compensation so that much of it looks like capital gains, rather than payment for services.**

  - Private equity and hedge fund managers negotiate with the limited partners who provide the investment capital over how the general partners will be compensated for providing management services. The part of their fee that is based on a percentage of assets is taxed as compensation. But, by arranging to take a large portion of their compensation as a percentage of profits ("carried interest"), the managers can exploit partnership tax rules to make this part of their compensation look like capital gains.

  - When a private partnership earns income, the income is divided among the partners according to their shares in the partnership. The partners pay tax on the income they receive, based on the character of the income received by the partnership. If the partnership receives capital gains, the income is taxed as capital gains to each partner at a maximum rate of 15%. If the partnership earns ordinary income, it is taxed to each partner as ordinary income at a maximum rate of 35%.

Capital gains income is taxed at more favorable rates than income from work.

Capital gains income – the amount realized when an asset is sold for more than its purchase price – is subject to a maximum federal income tax rate of 15 percent. "Ordinary income," including compensation for work, is subject to a maximum federal income tax rate of 35 percent.

Hourly wages, salary, tips, overtime, commissions, performance bonuses, stock shares, stock options, and business income are all taxed as ordinary income at rates up to 35 percent.

Capital gains income is not subject to employment taxes. Compensation is subject to federal employment taxes for Social Security (12.4 percent on earnings up to $97,500 in 2007, including the employer and employee share) and Medicare (2.9 percent on all earnings, including the employer and employee share).

  - When a private investment fund sells off an asset, it realizes capital gains, and the income is divided among the partners. However, it is not only the limited partners who put up the investment capital – the usual test for capital gains treatment – who claim the lower capital gains rate. The managers who receive income from their carried interest also take advantage of the lower capital gains tax rate, even though the carried interest represents compensation for services, rather than a return on invested capital.
    - For example, if a fund makes a profit of $500 million from selling off a company, and the managers' carried interest is 20 percent, $400 million will go to the investors who put up the capital and $100 million will go to the managers. Treating the managers' payment as capital gains rather than compensation means that they pay at most $15 million in taxes instead of $35 million.

- **Average American workers pay higher tax rates on their compensation than private investment managers.**

  - The 15 percent tax rate that private equity and hedge fund managers pay on income from carried interests is the same federal income tax rate that a single person pays on earnings between $16,575 and $40,600. On her earnings between $40,600 and $85,850, her income tax rate is 25 percent – two-thirds *higher* than that of private equity and hedge fund managers. In addition, all of her income is subject to an additional 15.3 percent payroll tax, split equally between her and her employer.

Should Capital Gains Be Taxed at Lower Rates than Income from Work?

The more favorable treatment of capital gains income in the current tax code creates an incentive for wealthy taxpayers to devise ways to convert income from work into capital gains. But the tax code hasn't always had this differential. Under the 1986 Tax Reform Act, the same tax rates applied to income from capital gains and income from work. Beyond the current effort to ensure that all forms of compensation, including carried interest, are taxed at the same rate lies a broader question: should capital gains income be taxed at lower rates than income from work?

Leonard Burman, Director of the Tax Policy Center, recently summarized the arguments in favor of ending the tax break on capital gains:

"… [T]he tax break on capital gains does more harm than good. The overall level of saving responds little to tax rates. And enough investment is financed from sources unaffected by individual income taxes -- such as pension funds, insurance companies and foreigners -- that the direct taxation of capital gains of U.S. stakeholders doesn't matter much.

"… What the low tax 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, often making investments that would make no sense absent the tax savings. 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.

"… If Congress doesn't want to see this problem come back in another guise, it should close the giant capital gains loophole once and for all. That would make the tax system fairer and more efficient…"[6]

- **Private investment managers in firms that are going public are using other tax loopholes to cut their taxes even further**.
    - The Blackstone Group partners made billions when the firm went public, and will initially have to pay tax at the 15 percent capital gains rate. However, they are expected to get most of the taxes they pay back through another loophole.[8]
        - When the Blackstone Group went public in a deal that raised $4.75 billion, the partners transferred "good will" – an intangible asset such as a brand name – valued at $3.7 billion to a new, wholly owned subsidiary corporation. The corporation, unlike the original partners, is allowed to take a deduction for the depreciation of good will over time, generating a tax deduction at the 35 percent corporate rate. Yet, the partners will receive most of the benefits of the deduction, because the corporation agreed to pay the partners 85 percent of the tax savings the corporation realizes. Over 15 years, the tax savings to the partners from this maneuver are estimated at $751 million in today's

dollars, nearly $200 million more than the capital gains taxes they will pay on the $3.7 billion.[9]

THERE IS NO JUSTIFICATION FOR PROTECTING THE SPECIAL TAX PRIVILEGES OF PRIVATE INVESTMENT MANAGERS

- **The carried interest loophole means average Americans are subsidizing the lavish compensation of private investment managers.**
    - When private investment managers can arrange to pay tax on their compensation at a maximum rate of 15 instead of 35 percent, their after-tax earnings get a major boost.
        - For a hedge fund manager who earns $100 million from carried interest, the tax break amounts to a $20 million bonus, subsidized by other American taxpayers.
    - The carried interest loophole costs the nation billions of dollars a year in lost revenue,[10] at a time when millions of struggling families are told that the nation can't afford to help them access health care, adequate nutrition, good quality child care and other vital services.
- **Income from carried interest is not a return on invested capital.**
    - Private investment managers receive carried interest in exchange for the investment advice and asset management services they provide. Unlike investors in the fund, the managers do not risk any of their own investment capital in exchange for the carried interest, and will not suffer capital losses if the fund loses money.
    - Some managers have negotiated to transform the fees they are due as a percentage of fund assets into additional carried interest, in some cases even after realized profits were known. As CBO Director Peter R. Orszag testified: "That those components of compensation are substituted for each other suggests, at least in part, that both types of income represent compensation to the general partner."[11]
- **Other workers whose compensation depends on performance are taxed at rates up to 35 percent on those payments, not at capital gains rates.**
    - Many workers receive part of their compensation based on performance, such as sales commissions, shares of stock, and bonuses. These payments are taxed as ordinary income at rates up to 35 percent, not as capital gains.
    - Other workers invest years of "sweat equity" in a project and take the risk that their work won't pay off, such as authors writing books and lawyers working for contingency fees. Yet royalties and contingency fees are taxed as compensation, not capital gains.

- Other workers contribute ideas, creativity, and "intangibles" to their work. A Nobel Prize-winning professor who commands a higher salary because she brings prestige to the institution is taxed on her full salary at ordinary income rates.

- **The self-serving claims of private investment fund managers that eliminating their special tax treatment will hurt retirees or the economy don't hold up.**

  - Requiring private investment managers to pay tax on their compensation the way other working Americans do will not change the way investors in a fund who contribute capital will be taxed. Pension funds, educational endowments, and other tax-exempt entities that invest in private investment funds will continue to be tax exempt.

  - Even without special tax treatment, private investment managers whose compensation is tied to fund profits will have ample incentives to seek high returns for investors.

Private equity and hedge fund managers claim that their work contributes to the economy and creates jobs. Whether or not, on balance, these claims are true – and private equity and hedge fund buyouts can also eliminate jobs[12] -- it is certainly true that millions of other Americans work hard, take risks, contribute to the economy, create jobs and don't get the same tax break on their earnings.

PRIVATE INVESTMENT FIRMS THAT GO PUBLIC SHOULD BE TAXED AS CORPORATIONS

Just as individual private investment managers claim that their carried interest income represents capital gains rather than compensation, private investment management firms that are going public claim that they should be exempt from the corporate income tax because they get their income from passive investments, not from operating a business. But their own statements to the public and the Securities and Exchange Commission are to the contrary.

- **Publicly traded partnerships are generally taxed as corporations**.

  - Corporations and most publicly traded partnerships that have access to public capital markets are taxed as corporations at rates up to 35 percent. [13]
    - The rules on the tax treatment of publicly traded partnerships were enacted by Congress in 1987 to prevent erosion of the corporate tax base.[14]
    - There are a few exceptions to the general rule that publicly traded partnerships are taxed as corporations. Those exceptions apply to partnerships that receive at least 90% of their income from oil and gas, real estate, or passive investments.[15]

- **Publicly traded firms that provide investment advice and asset management services should not qualify for the tax exemption for passive investment partnerships.**

  - The private equity partnerships that have recently gone public, such as the Blackstone Group and Fortress Investment Group, are not offering the public the opportunity to buy shares in the investment *funds*, but in the firms that provide investment advice and asset management services to those funds.[16]

- Publicly traded private equity partnerships themselves state that their income comes from providing services, not from making investments.
  - For example, the Blackstone Group stated in its Initial Public Offering (IPO) documents, "[w]e believe that we are engaged primarily in the business of providing asset management and financial advisory services and not in the business of investing, reinvesting or trading in securities. 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."[17]

- Publicly traded investment management partnerships have secured an exemption from SEC regulation of investment companies on the ground that their income does not primarily come from making investments.
  - Under the Investment Company Act of 1940, publicly traded companies that are "investment companies" are subject to a different regulatory structure than are operating companies. "Investment companies" are defined as firms that are primarily engaged in the business of investing in securities, or that engage in the business of investing in securities and own investment securities, the value of which exceeds 40% of their total assets.[18]
  - Based on the filings by the Blackstone Group and the Fortress Investment Group, the SEC concluded that the firms exempt from regulation as investment companies because they "are engaged primarily in the business of managing money for others, and not in the business of investing for themselves. In each case, their income and revenues are primarily derived from their asset management business and not from their own investments…."[19]
  - The SEC specifically determined that the carried interests held by Blackstone and Fortress—the rights to receive a percentage of the profits of the underlying fund—were not "investment securities," but "part of the compensation for managing the underlying funds…."[20]

CONGRESS IS CONSIDERING PROPOSALS TO CLOSE THE LOOPHOLES FOR PRIVATE INVESTMENT MANAGERS AND FIRMS

- **H.R. 2834 would require private investment managers to pay taxes on their compensation at the same rate as other working Americans and require publicly traded investment partnerships to pay tax as corporations do.**

  - The bill would tax income from carried interest received by partners in an investment services partnership as ordinary income. It also would be subject to the self-employment tax. Gain on the sale of a carried interest would be taxed as ordinary income. However, income that is a return on capital the partners have actually invested would be taxed as capital gains.

- The bill would apply to the carried interest of partners in investment management firms whether or not they were publicly traded. It would apply to partners who provide financial advice and asset management services with respect to a range of assets, including securities, real estate, commodities, options, or derivatives, but not to Real Estate Investment Trusts.

- The bill would prevent publicly traded partnerships that receive more than ten percent of their gross income from carried interest from claiming the passive investment exemption from corporate tax, because the bill clearly defines income from carried interest as ordinary income.

- **S. 1624 would require publicly traded investment management partnerships to pay tax as corporations.**

  - The bill only applies to the tax treatment of investment management partnerships that elect to go public. Unlike H.R. 2834, it would not affect the tax treatment of income from carried interest received by partners in private investment management firms.

  - The bill makes clear that publicly traded partnerships providing investment advice or asset management services do not qualify for the passive investment exemption from corporate tax.

  - The bill would apply to taxable years of a partnership beginning on or after June 14, 2007. A transition rule would postpone the application of the bill for five years for partnerships that were publicly traded on or before June 14, 2007, or filed a registration statement with the SEC for an IPO before that date. Thus, the provisions of S. 1624 would not apply to Blackstone or Fortress until June 14, 2012. H.R. 2785 is similar to S. 1624, but does not include the five-year transition provision.

CONCLUSION

There is no justification for continuing to allow private investment managers to pay lower taxes on their compensation than ordinary working Americans, or for allowing private investment firms that go public to avoid paying taxes the way corporations and other publicly traded partnerships do. Closing these loopholes will not fix all the inequities in the tax code nor raise all the revenues needed to address unmet needs, but fairness demands that they be addressed, and quickly.

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[1] Peter R. Orszag, *The Taxation of Carried Interest*, before the Committee on Finance, United States Senate, July 11, 2007, available at http://finance.senate.gov/hearings/testimony/2007test/071107testpo.pdf.
[2] David Cho, *Buyout Bonanza*, Washington Post (June 12, 2007), available at http://www.washingtonpost.com/wp-dyn/content/article/2007/06/11/AR2007061100751.html.
[3] Testimony of Andrew J. Donohue, Director, Division of Investment Management, U.S. Securities and Exchange Commission, Concerning Initial Public Offerings of Investment Managers of Hedge and Private Equity Funds, Before the Committee on Finance, United States Senate, July 11, 2007 (Donohue Testimony), available at http://finance.senate.gov/hearings/testimony/2007test/071107testtd.pdf.

[4] Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, University of Colorado Legal Studies Research Paper Series (March 2007).
[5] Jenny Anderson and Julie Creswell, *Top Hedge Fund Managers Earn over $240 Million*, New York Times (April 24, 2007), available at http://www.nytimes.com/2007/04/24/business/24hedge.html?ei=5088&en=22f49c09d1ef88eb&ex=1335067200&pagewanted=print.
[6] Michael K. Ozanian and Peter J. Schwartz, *Wall Street's Highest Earners*, Forbes.com (May 21, 2007), available at http://www.forbes.com/free_forbes/2007/0521/102.html.
[7] Leonard Burman, *End the Break on Capital Gains*, Washington Post (July 30, 2007).
[8] David Cay Johnston, *Tax Loopholes Sweeten a Deal for Blackstone*, New York Times (July 13, 2007).
[9] *Ibid*.
[10] Randall Dodd, *Loophole for Hedge Fund Managers Costs Billions in Tax Revenue*, EPI Policy Memorandum #120 (July 2007), available at http://www.epi.org/content.cfm/pm120.
[11] Orszag testimony, *supra* note 1.
[12] Ianthe Jeanne Dugan, *How a Blackstone Deal Shook Up a Workforce*, Wall Street Journal (July 27, 2007); Service Employees International Union, Behind the Buyouts: Inside the World of Private Equity (April 2007), available at http://www.behindthebuyouts.org/introduction/.
[13] Joint Committee on Taxation, Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests, before the Senate Committee on Finance, July 11, 2007, JCX-41-07, p. 51, available at http://www.house.gov/jct/x-41-07.pdf.
[14] Id. at 24.
[15] Internal Revenue Code Sec. 7704(c).
[16] Donohue Testimony, *supra* note 3.
[17] The Blackstone Group, L.P. S-1, Registration Statement, p. 49, available at http://www.sec.gov/Archives/edgar/data/1393818/000104746907002068/a2176832zs-1.htm.
[18] Donohue Testimony, *supra* note 3.
[19] *Id.*
[20] *Id.*