Editorials Supporting Closing Private Equity/Carried Interest Loophole as Matter of Fairness

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Washington Post Editorial

Private-Equity Tax Breaks, a Call to Be Up in Arms

Sunday, September 9, 2007; F03

Even by Washington standards, the private-equity industry certainly went over the top in conjuring up the economic woes that would befall the United States if their cherished tax breaks were taken away.

Pensioners would be destitute. Wall Street would pack up and move to Dubai. The hedge fund industry would disappear. Federal revenue would plummet. Entrepreneurial risk-taking would grind to a halt. And the urban underclass would slip even deeper into poverty.

And all that just because some of the richest people in the world would have to pay the same 35 percent tax rate on their income as dentists, lawyers and baseball players.

There is no mystery as to why the industry bothers to make these ridiculous and contradictory arguments -- billions of dollars in tax windfalls are at stake.

The only mystery is why Senate Democrats don't have the good sense to grab onto this as their centerpiece domestic issue as they head into the 2008 campaign. It's hard to think of an issue that better taps into the public anxiety about the markets and the economy, the anger about income inequality, or the disgust with a political system that bends to the will of powerful interests. And if Republicans go through with their threats of a filibuster and a presidential veto, Democrats ought to put aside all other business and call their bluff.

This is a make-or-break issue for Democrats. If they can't unite around this issue, then they aren't real Democrats and they don't deserve to govern.

Washington Post Editorial

Equity for Private Equity; Legislation to raise taxes on fund managers' income

13 July 2007; A16

INVESTMENT partnership funds can be enormously profitable, highly secretive and lightly regulated. People tend to get suspicious.

As a result, government bodies periodically try to tamper with private equity firms, hedge funds, venture capital firms and the like. This largely unregulated industry does a lot to stabilize America's financial system by fostering innovation and bringing inefficient or undervalued markets closer to equilibrium, and most of these attempts to regulate or reconfigure the industry would be bad for the U.S. economy. But this time around Congress has proposed legislation that makes sense.

A House bill would set a higher tax rate for "carried interest," the cut of profits typically awarded to fund managers at private equity firms and other investment partnerships. In these investment partnerships, a fund manager typically manages the investment made by himself and various limited partners, with the manager usually contributing about 1 percent of the investment. The fund manager then usually receives 2 percent of the assets he manages annually and 20 percent of the profits earned on the investment when it is sold. Even though this 20 percent cut makes up the bulk of the manager's compensation, and even though it is awarded for managing others' money, under current tax law this income is treated as capital gains rather than ordinary income. As a result, fund managers who make zillion-digit incomes from carried interest can be taxed at the same rate (15 percent) as a part-time janitor.

The House bill, sponsored by Sander M. Levin (D-Mich.), Ways and Means Committee Chairman Charles B. Rangel (D-N.Y.), Financial Services Committee Chairman Barney Frank (D-Mass.) and 13 other Democrats, would close this loophole for fund managers and treat their "carried interest" earnings as regular income taxable at the ordinary 35 percent top-income rate that high-earning employees in other industries must pay. The bill would not affect the other investors in these funds, nor would it affect the tax rate for profits that fund managers make on investments with their own money.

A Senate bill that also attempts to bring equity to the private equity industry would force investment partnerships that are publicly traded -- right now, only a handful -- to pay corporate income taxes. Support for the Senate bill has gained some momentum because of Blackstone Group's splashy initial public offering, one of the largest in history. The Senate's corporation-rather-than-manager-based solution seems less effective, however, because companies can easily move overseas (as many have already done), while individuals are less likely to do so. Investment partnerships can also simply choose not to go public.

Critics of the two bills argue that investment fund managers should be rewarded for taking high risks. But these fund managers, for the most part, are not risking their own money, and they're paid management fees during the duration of their partnerships, so they have steady incomes. Besides, plenty of risky industries don't enjoy comparable tax benefits. Income earned from managing an investment partnership fund should be treated just like the income earned for providing any other service.

New York Times Editorial

Raising Taxes on Private Equity

June 25, 2007

So much for the argument often made by managers of hedge funds and mavens of private equity that higher taxes would cripple their business.

The prospect of higher taxes did not dent, in the least, the initial public offering on Friday of the Blackstone Group, the giant private equity firm. The week before, a bill was introduced in the Senate to raise taxes on private equity firms that go public. On the day of the offering, a House bill was introduced that would raise their taxes, whether they're publicly traded or not.

And yet, Blackstone had a debut that was one of Wall Street's biggest, its thunder muted only by the announcement by its longtime rival, Kohlberg Kravis Roberts, that it, too, planned to go public.

The bills in Congress take aim at a provision of the tax law that has allowed private equity and hedge fund operators to pay a lower capital-gains tax rate of 15 percent, instead of the ordinary top income-tax rate of 35 percent, on the performance fees that make up the bulk of their huge paychecks.

With income inequality surging along with the need for tax revenue, the bills' supporters rightly conclude that it is untenable for the most highly paid Americans to enjoy tax rates that are lower than those of all but the lowest-income workers.

Fairness is not the only reason to change the rules. The private equity industry is on shaky ground when it claims that current practice is a correct application of the law.

Many of the firms' partners are not investing their own money in the various funds and ventures, and so have no direct risk of loss, the general test for claiming capital-gains treatment on one's earnings. Moreover, the tax rules in question were developed decades ago for enterprises that had passive investors to whom gains were passed along. Hedge fund managers and private equity partners are not passive. They're actively managing assets, and should be taxed accordingly as managers earning compensation.

The challenge now is to develop a single bill that can withstand the formidable lobbying efforts of the private equity industry to water it down.

To do so, the final bill should clearly apply to other firms where partners may also receive most of their pay as capital gains, such as oil and gas partnerships. It will also be necessary to narrow the bill, where appropriate. For instance, it could include a mechanism to allow some compensation to be taken in a form similar to incentive stock options.

Congress will achieve a significant victory, for fairness and for fiscal responsibility, if it ends the breaks that are skewing the tax code in favor of the most advantaged Americans.

USA TODAY Editorial

Wealth money managers make more, get taxed less

July 23, 2007 Monday; Pg. 10A

As many business executives, doctors, lawyers and other skilled professional know, the top income tax rate is 35%. The top rate on dividends and long-term capital gains is 15%.

Whether it makes sense to tax the output of expertise and hard work at more than twice the rate of investment returns is debatable. But, for better or worse, that's the way it is.

Except, that is, when it isn't. Owners of companies, ranging from small real estate partnerships to multibillion dollar hedge funds and private equity firms, have devised a way to erase this distinction. Their managers pay 15% on their income by dressing it up as investment returns -- even though they bear no investment risk or put none of their own money in play.

Nice work if you can get it. But in this case it constitutes a frontal assault on fairness. Why should such people pay only 15% when senior corporate executives pay 35% for making many of the same types of business decisions? More to the point, it's hard to see the logic (or the justice) in a school teacher or bus driver with taxable annual family income as low as $63,700 paying 25% when someone like Blackstone Group CEO Stephen Schwarzman can make nearly $700 million on the day his firm went public and pay at most 15%.

Congress is rightfully re-examining the issue. Reps. Sandy Levin, D-Mich., and Charles Rangel, D-N.Y., have a proposal. In the Senate, Max Baucus, D-Mont., and Chuck Grassley, R-Iowa, have a useful, if narrower, bill.

The practice they are seeking to ban or limit is a transparent ruse. Here's how it works using the example of a private equity firm: The partners raise capital from banks, pension funds and other large investors, which they use to buy companies and resell them. Their investors give them some direct compensation, which is taxable as income.

But most of the compensation comes in the form of an investment vehicle known as "carried interest," which gives them a right to a portion of the profits they generate (typically 20%). That portion of the profit is taxed 15%, just as if they supplied 20% of the capital at the outset.

It's a creative practice, but with a result that says the rich get to write their own rules. That's not a new problem in the American tax system, but it is nevertheless repulsive. Income is income, or so you'd think.

Supporters of this scam argue that these money managers actually are risking their own investments. It's just not money, in their case, but their "sweat equity," their time, their expertise. But the same could be said of the lawyer who takes a case on a contingency fee, the movie actor who negotiates a cut of the box office receipts, the financier who chooses to work for a firm known for paying enormous bonuses during good years. In most, if not all, of such cases, these people pay income taxes.

And so should partners in these exotic investment firms. More so because the tax they avoid paying is money that has to be made up by people of lesser means -- or borrowed from later generations by adding to the budget deficit.

These schemes add insult to injury at a time of increasing wealth concentration. It is time to end them.

Philadelphia Inquirer Editorial

Equity Managers' Loophole; Billion-dollar breaks

September 19, 2007 Wednesday; Pg. A16

For years, a relatively few players in the corporate takeover game have benefitted from a tax loophole that costs the federal government billions annually.

Now a push is under way in Congress to tax these wealthy managers of private equity funds at the same income-tax rates as everyone else. Congress should end this unfairness in the tax code.

Most workers pay income taxes on a graduated scale, with marginal tax rates running from a low of 10 percent, to a high of 35 percent for the wealthiest wage earners. But managers of private equity funds, who usually do extremely well for themselves, pay only a capital gains tax rate of 15 percent on most of their income. That's because the tax code considers their wages "carried interest," even though this compensation can run into hundreds of millions of dollars per individual. The preferential treatment can be worth millions of dollars to such a manager.

Rather than being taxed on compensation for services rendered, these managers are taxed as though they had invested a 20-percent stake in the fund. But, even though they sometimes gain equity stakes in the companies they buy and manage, they don't have capital at risk in the ventures. They're really being compensated for their expertise and effort.

This definitional fiddle creates a class of service provider that is taxed a preferential rate. Economist Greg Mankiw, former chair of the Council of Economic Advisers under President Bush, has said that carried interest should be taxed at the same rate as other compensation for such services. As it stands now, an executive in a financial-services firm is taxed differently from the manager of a private equity or a hedge fund.

There's no good reason why a person earning $200 million per year should pay a lower tax rate than a single worker earning $45,000 annually and paying 20 percent in taxes.

The loophole costs the Treasury several billions of dollars per year. The sum is small compared with the overall federal budget. But in a budget season in which Congress and the president are feuding over a difference of about $22 billion, such sums do matter.

Some argue that taxing these fund managers at a higher rate would harm ordinary investors, such as those enrolled in state employee pension plans, because the fund managers would demand higher compensation. But the evidence is slim. The liberal Center on Budget and Policy Priorities, a nonprofit think tank in Washington, said the impact on investors would be "quite small."

And this glaring inequity shouldn't be preserved on the presumption that a tiny fraction of it will trickle down to the folks already paying their fair share.

Washington Post Editorial

No Pay, No Patch

Thursday, November 8, 2007; A26

NEARLY EVERYONE wants to "patch" the alternative minimum tax. Not everyone wants to pay to do so. That is the challenge facing lawmakers as they race to install yet another temporary fix on the tattered federal tax system in time for the Internal Revenue Service to produce forms reflecting the change. How this job is accomplished will show whether congressional Democrats are willing to live up to the pay-as-you-go obligations they imposed on themselves when they retook control of Congress -- and whether Republicans can regain any credible claim to being committed to fiscal discipline.

The alternative minimum tax was created in 1969 to dun a tiny number of the super-rich who managed to avoid paying any income taxes. Because the tax isn't indexed for inflation and because the 2001 tax cut lowered regular tax rates, the AMT, without adjustments, will affect millions of taxpayers who everyone agrees were never its intended targets. But exempting those millions will cost a lot in forgone revenue, money that the Bush administration has built into its budget numbers. Because fixing the problem is expensive and complicated, lawmakers have chosen for years to slap a Band-Aid onto it -- and bill the cost to future generations. This year's model totals $50 billion, $76 billion when the cost of extending expiring tax provisions and other changes is included.

To its credit, the House Ways and Means Committee has produced an AMT patch whose costs are offset by other changes, including eliminating the carried-interest deduction that allows private equity and hedge fund managers to pay taxes at far lower rates than other wage-earners. This is far from a perfect solution: It would take 10 years of revenue to pay for the one-year patch.

It's preferable, though, to the approach of congressional Republicans and the Bush administration, which is to not offset the tax cut with new taxes or spending cuts. House Minority Leader John A. Boehner (R-Ohio) was illustrative of the irresponsibility. "Tax relief pays for itself by creating more American jobs for more taxpayers to strengthen our economy," he said in a statement. Perhaps Mr. Boehner believes that the Tax Fairy will simply leave $50 billion under the IRS's pillow; there is no economic basis for his statement that "tax relief pays for itself." Moreover, if Mr. Boehner doesn't like the way Democrats propose to finance the patch, what would he cut instead?

Republicans may not be the only obstacle to responsibility. Senate Democrats say they want to comply with the pay-go requirement, and there were hopeful signs last week from Majority Leader Harry M. Reid (D-Nev.). "I'm not in favor of waiving pay-go rules," he said. "I think we cannot waver on that." But Senate Finance Committee Chairman Max Baucus (D-Mont.) has been less definitive, saying only that he'd like to comply with pay-go to the extent possible; he has also not been eager to close the carried-interest loophole. Once the pay-go rule is ignored, though, lawmakers won't be able to discipline themselves in the future. This is a key test for the party that wants to wear the mantle of fiscal responsibility.

New York Times Editorial

Alternative Tax Showdown

November 8, 2007

The House and Senate are poised to vote on a vitally important tax bill that poses a test for each chamber of Congress. In the House, the vote on a short-term fix for the alternative minimum tax will test whether Democratic representatives have the courage of their convictions. In the Senate, the vote will test whether Democratic senators have any convictions at all, or just a belief in keeping the world safe for campaign contributors.

Under current tax law, 23 million taxpayers will owe the alternative tax for 2007, up from 4 million last year. The tax was originally intended to apply to multimillionaires. But most of this year’s alternative taxpayers make between $100,000 and $500,000 and about a third make less than $100,000. They all have good cause to feel rooked and to expect help from Congress.

The challenge is the “pay-as-you-go” budget rule adopted when Democrats took control of Congress this year. New tax relief must be paid for, either by raising taxes elsewhere or by cutting government benefits like Medicare or Social Security that cover everyone who is eligible. The one-year cost of shielding millions of Americans from a tax they should not have to pay is $51 billion.

The House tax committee met the challenge, drafting a bill that provides the needed tax relief and plugs the resulting budget gap, mainly by raising taxes on private equity partners and hedge fund managers. The bill is good policy. The tax relief assuages justifiably aggrieved taxpayers. Tax increases on private equity firms and hedge funds rectify outdated rules that have allowed the very wealthiest to enjoy tax rates lower than those paid by middle-income Americans and, in some cases, to defer taxes indefinitely.

But key Democratic senators, among them New York’s Charles Schumer, who is the main fund-raiser for Senate Democrats, are balking. They know they must provide alternative tax relief, but they don’t want to tax private equity and hedge funds to pay for it. Their defense of the industries’ morally indefensible tax breaks is tawdry. As The Washington Post reported yesterday, in the first nine months of 2007, as pressure built to dismantle the tax breaks, investment firms and hedge funds contributed $11.8 million to candidates, party committees and leadership political action committees. That’s more than was given in 2005 and 2006 combined. More than two-thirds of that money went to Democrats.

The Senate’s equivocating has rubbed off somewhat on the House. The bill is still expected to pass the House, as early as tomorrow, but some members have wondered aloud why they should support a tough measure if the Senate is determined to kill it.

The answer is that it is the right thing to do. The House bill holds true to the pay-as-you-go rule when doing so matters most, that is, when large sums and difficult trade-offs are at stake. It undoes a tax injustice. And maybe, just maybe, the money men in the Senate can be swayed by example.