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Opening Statement of Senator Chuck Grassley
Hearing, "Carried Interest, Part II"
Tuesday, July 31, 2007

Thank you, Chairman Baucus, for calling this second hearing on the tax treatment of carried interest. At the last hearing, we had a balanced approach. We have the same here. This hearing, and the committee's inquiry, is about the distinction between capital income and labor income. This issue arises frequently in partnerships, when a person receives a carried interest, or an interest in a partnership's profits, in exchange for performing services for the partnership, as opposed to contributing capital.

This hearing is not about well-settled principles regarding capital assets or the propriety of current capital gains rates. It is not an attack on the investor class or capital formation. We are not questioning the tax treatment of the return on any partner's invested capital. That return is, and should continue to be, taxed at preferential capital gains rates.

This hearing is also not about a revenue grab from Congress. It is not about whether alternative asset managers are good or bad for society. We're not here to have a hearing on each industry, measure its value to society, and assign a tax rate accordingly. This hearing is about our responsibility to ensure that the tax code is operating fairly and consistently with the intent behind enacted policies. If it is not, then there is an unintended subsidy being provided to some, while others pay for it with higher taxes.

There are a lot of sound, pro-growth tax policies that Congress needs to advance to keep our economy strong. The individual capital gain preference is an obvious one. Like I've done before, I'll be working to get that policy extended. Another policy is our corporate tax rate, which is the second highest among OECD countries. We're standing still while our trading partners are lowering corporate tax rates. Economists tell us to make our system more efficient by lowering rates and broadening the base by eliminating preferences for specific industries. Well, we're looking at a potential base broadener here. But if we can't even examine these kinds of issues in a deliberate, thoughtful way, then I'm afraid we'll never get in a position to talk about lowering rates.

Folks on both sides of the aisle ought to roll up their sleeves, move away from partisan talking points, and join Chairman Baucus and me in finding the facts. The carried interest issue is complicated, and some might say headache-inducing, but this committee is responsible for getting the policy right. So we need to take our aspirin and wade in. Mr. Chairman, you remember the T.V. series “Dragnet” and the characters, Sergeant Joe Friday and his partner Bill Gannon. Sergeant Joe Friday used to say, “just the facts, ma’am.” Like Joe Friday, we’re just trying to get the facts. We haven’t made up our minds yet. With that open mind, I look forward to today’s discussion.

I’d also like to submit for the record my response to some of the criticisms of our publicly traded partnership bill. The two arguments I respond to are (1) it singles out private equity and hedge fund management firms; and (2) it would result in unfair triple tax on private equity management firms that go public. I disagree with those arguments, but rather than take the time going through my detailed response here, I will just put it in the record.

Statement of Senator Chuck Grassley
Response to Criticisms of Publicly Traded Partnership Bill
Carried Interest, Part II
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Now, I’d like to respond to a couple of criticisms of our publicly traded partnership bill. Our bill would treat investment advisory and asset management firms that go public as corporations, just like virtually any other active business that decides to go public. The bill would do this by taking away the ability of these management firms to structure the form of their compensation as capital gains in order to shoe-horn their way into a passive-type income exception. Remember, it is firms that manage investment funds we are talking about here, not the funds themselves.

One criticism of the bill is that it unfairly singles out private equity and hedge fund managers. The critics argue that these fund management firms should be allowed to go public and retain their partnership status because other active businesses, like oil and gas pipelines, for example, are able to do so. This argument sounds good, but it goes too far. This argument would support allowing any active business to go public as a partnership and avoid paying a corporate level tax.

In 1987, Congress enacted a general rule: partnerships that go public will be treated as corporations. Like most general rules, however, there are exceptions. Congress allowed certain types of active businesses, like oil and gas pipelines, to keep their partnership status. The investment advisory and asset management business, however, was not among these businesses. In fact, there was actually one such partnership that the 1987 law did not permit to remain a partnership beyond a 10 year transition period. So Congress spoke to this issue in 1987, and concluded that investment advisory and asset management businesses that go public should be taxed as corporations under the general rule.

So, then, how is it that the recent private equity and hedge fund management firms that have gone public are able to say that they qualify for an exception? These firms claim that their income qualifies for another exception – the passive-type income exception – by structuring their fees as carried interests, so that the capital gain character of the income realized at the private fund level flows through to the publicly traded management firm.

These firms view themselves as engaged in the active investment advisory and asset management business, not as investment companies. The Securities and Exchange Commission ("SEC") agrees with this view. As we heard at our last hearing, the SEC looks to reality. And in the SEC's view, these firms are operating companies, not investment companies. They are not investing their own assets; they are investing on behalf of others. To those critics who claim our bill unfairly targets these firms, I ask what other types of active businesses have tried to claim an exception intended for passive income? You could argue that our bill doesn't single out these companies; they've singled out themselves.

Our bill takes these firms at their word that they are providing services rather than making passive investments, even though they structure their fees to achieve capital gain characterization. But if they want to go the passive investment route, perhaps we should consider subjecting these firms to the code's requirements for mutual funds or real estate investment trusts. There would be no corporate level tax if these firms met these requirements. That brings me to another criticism of our bill – that it would impose triple taxation on the private equity industry.

The argument goes like this: If you tax private equity management firms as corporations, then there will be three levels of tax. Once at the portfolio company level, again at the private equity firm level (but only on its share of capital gains from the carried interest), and a third time at the shareholder level, albeit at a reduced rate. The portfolio companies don't pay much corporate tax while they are owned by the funds these firms manage, in part due to the amount of leverage put into them. But if they did, any dividends would be eligible for the dividends received deduction. While the dividends received deduction addresses the double corporate tax problem for dividends, it is a fair criticism of our corporate tax system to say that there is no mitigation of double corporate tax for capital gains on stock sales. Of course, the validity of this argument in the private equity context depends on the carried interest being properly viewed as investment income, rather than service income, which is the topic of today's hearing.

But even if the private equity firm's carry is properly viewed as investment income, the triple tax argument also goes too far. This is no different from a publicly traded corporation selling stock in an unconsolidated subsidiary. There may be a sound policy argument here to reduce the potential for two levels of corporate tax as a general matter. But there is no sound policy reason to maintain a preference for financial buyers, like private equity firms, over strategic buyers, like corporations, who can each raise capital in public markets to make the acquisition. After all, Treasury just had a conference on business tax reform, and there was universal agreement that the code contains too many preferences that favor specific industries.