COMMITTEE ON FINANCE
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Max Baucus, Chairman
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Hearing Statement of Senator Max Baucus (D-Mont.)
Regarding Carried Interest Part III: Pension Issues

Thomas Carlyle said: "No man sees far; the most see no farther than their noses."

This Committee has a responsibility to see as far as we can — far beyond our noses. Before we choose a path, we do well to look down that path. We must understand how our decisions will affect taxpayers and the economy, months and years down the road.

That is why we hold hearings.

In July, we held two hearings on carried interest. Today's hearing follows up on our hearing July 31. At that hearing, one of the witnesses argued that increased tax liability for private equity managers would be paid by pensioners. Today, we will look into that claim.

We have held these hearings on carried interest to consider whether the current tax treatment of carried interest is fair. Is carried interest compensation for services? If so, then fairness would point to application of ordinary income tax rates. If carried interest is not compensation for services, then capital gains treatment is appropriate.

Today's hearing is not about whether or not carried interest is compensation for services. Today, I would ask all of you to set aside this important debate, and ask "what if"? If carried interest were taxed at the ordinary income rate, how would that affect pension funds?

We need to address two basic questions:

First, to what extent would an increase in tax liability for fund managers be passed through to investors?

Second, to what extent would this pass-through affect retirees and pension plans?

As to the first question: How much would an increase in tax liability be passed through to investors? The effect, if any, would depend in large part on how dependent pension funds are on private equity investments. In fact, most pension funds have a modest level of investment in private equity and hedge funds.

A survey of large pension plans by the newspaper Pensions and Investments showed that 36 percent of those pension plans had hedge fund investments. That means 64 percent of those large pension plans had no hedge fund investments.

The folks at Money Market Directories estimated that as of July 2006, American pension plans held $350 billion in alternative investments, including private equity and hedge funds. That is a lot of money.

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But in July 2006, American defined benefit pension plans had more than $5 trillion in assets. So they held less than 7 percent of their pension assets in alternative investments. Two surveys of American public pension funds found an even lower percentage — about 4.5% of assets — held in alternative investments.

On the other hand, in 2006, about 10 percent of hedge fund capital came from U.S. pension plans. This data says to me that hedge funds and private equity funds may need pension funds more than pension funds need private equity or hedge funds. And that means that hedge funds and private equity funds may not have the economic power simply to pass along increased costs to pension funds.

All that is not to say, however, that these alternative investments cannot play an important role in pension security.

Turning to the second question: Assuming there is a pass through cost, how would it affect retirees and pension plans?

Most pension funds that invest in private equity are defined benefit plans. Defined benefit plans promise their retirees a fixed benefit. And the sponsors of defined benefit plans have to make sure that they have enough money to pay that benefit. Thus additional fees passed through to private pension funds would generally flow through to the sponsors of defined benefit plans — the employers, not the retirees. It is employers that have the obligation to pay these benefits.

The situation for public pension funds is somewhat different. Public employees generally pay part of the cost of retirement benefits. And increased costs could be born in part by employees.

For public plans, the employer is really the taxpayers. Taxpayers support the public retirement system. So taxpayers would bear most of any additional cost that gets passed through. Some public plans pay additional benefits if investment earnings exceed specified levels. So a reduction in return could affect retirees.

I am very pleased that we have some experts here today that can help us to understand the role of private equity and hedge fund investments in financing pension plans. And they can help us to see how a change in taxation of these arrangements might affect pension plans.

This is an important and fascinating topic. I look forward to seeing what we can learn from today's panel. And together, I hope that we can help the debate to see well down the road.

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