COMMITTEE ON FINANCE
NEWS RELEASE

Max Baucus, Chairman
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Carried Interest, Part 1
Opening Statement of Senator Max Baucus (D-Mont.)

In his 1906 message to Congress, President Theodore Roosevelt said:

"The man of great wealth owes a peculiar obligation to the State, because he derives special advantages from the . . . existence of government. Not only should he recognize this obligation in the way . . . he earns and spends his money, but it should also be recognized by the way in which he pays for the protection the State gives him. . . . [H]e should assume his full and proper share of the burden of taxation . . . ."

One of the jobs of this Committee is to ensure that our tax system is fair. Today, we examine whether some people who are earning great wealth are also avoiding their full and proper share of the burden of taxation.

Some hedge fund managers and private equity managers are taking home more than $100 million a year in what is called "carried interest" income. And much of that income is being taxed at the long-term capital gains rate of 15 percent. They are not paying the higher rate for ordinary income.

Now, professional athletes, Silicon Valley executives, and lawyers on contingency fees will also often take home a great deal of income. God bless them! A lot of that income is also based on performance. But they tend to pay taxes at the ordinary income rate.

So the question arises: Is the income that these managers are earning properly capital gains income? Or are some people of great wealth merely taking advantage of the tax code to pay less than their full and proper share?

The amount of assets under management in venture capital, private equity, hedge funds, and real estate funds is growing rapidly. American hedge funds, for example, now manage nearly $2 trillion in assets. These kinds of alternate investments are often providing phenomenal returns for investors and managers alike.

Managers of these alternative investment vehicles generally conduct business in a series of entities that for tax purposes are treated as partnerships. And managers of these funds generally receive two types of income: management fees, and what is called "carried interest."

Our primary focus today is the carried interest. A carried interest is essentially an interest that the manager has in the profits of the investment partnership.

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The manager receives the interest when the fund is created. And the manger receives payment on that interest only after the initial investment is returned to the outside investors and the fund exceeds a certain level of profit.

The Internal Revenue Code provides that when a partnership sells stock that is held for more than a year, the partners who receive money from that sale treat the proceeds as long-term capital gains.

Now, there are many views of what these managers are doing to earn their income. One view is that the manager is a service provider. Under this view, they are taking advantage of the tax law to change ordinary income into capital gains.

Another view is that the managers truly own these funds. Under this view, the managers bring capital to the partnership in the form of their ideas. And the investors bring capital in the form of cash. The managers are allowing the investors to share in the managers' enterprise.

Alternatively, the managers bring capital to the partnership in the form of their intellectual property, goodwill, business contacts, and know-how. And once again, the investors bring capital in the form of cash. In either event, under these views, the argument is that capital gains treatment is appropriate.

And maybe the right answer is that there is a blend of services and capital income. The right answer may vary from one investment strategy to another. The purpose of these hearings is to explore the economics and understand the arguments.

No matter what we may ultimately decide to do, we will in no way wish to change the interests of the limited partners.

And another issue that we will want to address today is publicly-traded partnerships. Last month, Senator Grassley and I introduced a bill on this subject out of concern that several fund managers might seek to go public without paying corporate tax. The Tax Code generally requires a corporate level of tax on an entity that seeks to access public capital. There is also a good argument that the fund managers who are becoming publicly traded partnerships are stretching the law.

The United States economy is strong and dynamic. Our entrepreneurship creates new jobs. We do not want to stifle the mother of invention.

On the other hand, we wish to ensure fair treatment under the tax code. That fair treatment may make our economy more dynamic.

These are challenging issues. We want to ensure that our entrepreneurial system continues to function well. We want to ensure that people are free to continue to create great wealth. And at the same time, we want to ensure that people still contribute their full and proper share of the burden of taxation.

I look forward to a spirited discussion.

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