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Before the Senate Finance Committee
Washington, DC
July 31, 2007

Mr. Chairman and members of the Committee, I am pleased to appear before you today on behalf of the Private Equity Council to present our views on the taxation of carried interest for partnerships, and I want to thank you and Ranking Member Grassley for the deliberative, thorough, and fair-minded process you and your staffs have undertaken to develop an understanding of this important issue. I am a partner and managing director of The Carlyle Group, one of the world's largest private equity investment firms, which originates and manages funds focused across four major investment areas: buyout; venture and growth capital; real estate; and leveraged finance. I also serve as the Chairman of the Board of the Private Equity Council, a relatively new organization comprising 11 of the leading private equity investment firms doing business in the United States. The PEC was formed to foster a better understanding about the positive contributions private equity investment firms make to the U.S. economy.[1]

Private Equity Investment

Before addressing the carried interest tax issue, I think it is important to describe private equity investment. Some have a perception that private equity investment is an esoteric form of "black box" finance practiced by a small cadre of sophisticated investors. The truth is that private equity investment is about numerous entrepreneurial firms, large and small, located in all parts of the United States, that are integral to capital formation and liquidity in this country. Some, like Carlyle, do multi-billion dollar transactions; others may do transactions of $5 million or less, locally or regionally. Private equity investment is also about benefits provided to tens of millions of Americans through enhanced investment returns delivered to pensions, endowments, foundations and other private equity investors. And private equity investment is about thousands of thriving companies contributing to the U.S. economy in many positive ways.

When you buy coffee in the morning at Dunkin' Donuts, see a movie produced by MGM Studios, or shop at Toys R Us, J. Crew, Petco, or Auto Zone, to name just a few, you are interacting with private equity companies. Private equity companies also own some of the office buildings in which we work, supply parts and equipment for the cars we drive and the airplanes we fly, and even deliver the power that lights our homes in some parts of the country.

At its core, private equity investment is simple: private equity firms – known as general partners (GPs) or "sponsors" -- establish a venture in partnership form (typically referred to as a "fund") in which they invest their own capital, and raise capital from third-party investors who become limited partners (LPs) in the fund. The general partners use the partnership's capital, along with funds borrowed from banks and other lenders, to buy or invest in companies that they believe could be significantly more successful with the right infusion of capital, talent and strategy.

As the GPs of their funds, private equity firms invest in companies with the intent of owning and operating them for several years or more. Private equity firms typically create value by improving the

[1] The members of the Private Equity Council are Apax, Apollo Advisors, Bain Capital, The Blackstone Group, The Carlyle Group, Kohlberg, Kravis & Roberts, Hellman & Friedman, T. H. Lee Company, Providence Equity, Silver Lake Partners, and TPG Capital.

operations, governance, capital structure, and strategic position of the companies in which they invest. The goals are to grow the companies, turn them around, and otherwise strengthen their performance.

Private equity has been extremely profitable for our LP investors, who receive most of the profits generated by PE funds. Over the 25 years from 1980 to 2005, the top-quartile private equity investment firms generated per annum returns to LP investors of 39.1 percent (*net* of all fees and expenses). By contrast, the S&P 500 returned 12.3 percent per annum over the same period. This suggests that $1,000 continuously invested in the top-quartile PE firms during this period would have created $3.8 million in value by 2005. The same amount invested in the public markets would have increased to $18,200. Private Equity Intelligence reports that between 1991-2006, private equity funds distributed $430 billion in profits to their LPs. Clearly, top PE funds have been exceptional investments over the past quarter century, a major reason we are able to continue to attract capital from LPs.

The largest category of investors benefitting from these exceptional returns have been public and private pension funds, leading public and private universities, and major foundations that underwrite worthy causes in communities across the country. The 20 largest public pension funds for which data is available[2] currently have some $111 billion invested in private equity on behalf of 10.5 million beneficiaries.

Private Equity Fund Structure

Most PE sponsors are themselves partnerships comprised of the founders and other individual owners of the private equity firm. The PE firms sponsor fund partnerships in which they serve as GPs. The sponsor typically charges an annual management fee to the fund partnership that ranges from one to two percent of the assets under management. The management fee finances the day-to-day operations of the PE firm, including employee salaries and office rent. While at one time a "standard" management fee might have been 2%, the typical management fee has been falling well below two percent recently, as fund sizes have grown and as raising capital for PE investment has become more competitive. In order to align the interests of the GP with their interests, LP investors generally want PE firms to be more dependent on generating returns from their ownership stakes in the funds than on collecting fees. In addition, the GP generally is required to invest its own capital in its PE funds, and, typically, the GP (often through contributions by its individual owners) will contribute 3-10% of the partnership's overall investment capital.

In addition to rights to the capital it invests, and a share of profits proportional to such capital, the GP's ownership stake in the fund also entitles the GP, under specified circumstances, to a portion (typically 20%) of the remaining profits. This contingent profits allocation is often referred to as a "carried interest." However, most PE funds are designed to ensure the limited partners' right to receive a return of their capital and a minimum level of profit <u>before</u> the GP receives any carried interest. Under a typical arrangement, when the PE fund sells assets at a profit, the LPs are entitled first to their capital back, plus an additional eight to nine percent per annum return on their capital (a so-called "hurdle" rate), as well as reimbursement for any fees paid to the GP. Only then, if any proceeds remain

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[2] California Public Employees Retirement System, the California State Teachers Retirement System, New York State Common Retirement Fund, Florida State Board of Administration, New York City Retirement System, Teacher Retirement System of Texas, New York City Teachers Retirement System, New York State Teachers Retirement System, State of Wisconsin Investment Board, New Jersey State Investment Council, Washington State Investment Board, Regents of the University of California, , Ohio Public Employees Retirement System, Oregon State Treasury, State Teachers Retirement System of Ohio, Oregon Public Employees Retirement Fund, Pennsylvania Public School Employees Retirement System, Michigan Department of Treasury, Virginia Retirement System, Minnesota State Board of Investment.

after the hurdle is cleared and fees are reimbursed, will the GP receive any proceeds from its carried interest.

The carried interest is also typically subject to a "clawback" provision that requires the PE firm (and, thus, the individual partners of that firm) to return distributions to the extent of any subsequent losses in other investments of the fund, so that the GP never ends up with more than its designated portion (e.g., 20 percent) of profits. If the fund generates losses on some investments, the GP shares in the downside because any profits from its carry on successful investments are offset by the deals gone sour. If enough deals in a fund do poorly, the GP could be left with no carry at all. Thus, the GP's retention of a carried interest in its funds effectively acts as both a risk-sharing mechanism and as an incentive: to find the right companies in which to invest, to use its entrepreneurial skills to improve those companies, and ultimately to deliver outstanding returns for LP investors.

Private Equity In Practice

PE investment transactions take many forms. They may involve the acquisition of a private company with the intent of providing its founders with the capital necessary to take its performance to the next level; they may involve the acquisition of a division of a large company, with the purpose of offering the newly independent business the management focus and resources needed to achieve a new mission; they may involve "privatizing" a public company in an effort to undertake improvements that would be difficult to achieve with the short-term earnings focus of the public markets.

But regardless of the type of company acquired, the central goals of private equity buyers are the same: they seek out companies with the potential for growth in value, and then they seek to strengthen, improve the performance and increase the value of the companies they own by putting in place the capital, talent and strategies necessary to achieve that growth. Any other approach would be counterproductive, because the entire business model rests on eventually selling those capital assets at a gain. That is why those who claim that private equity investment is all about "asset stripping" are missing the point: it is impossible to strengthen an underperforming business if you vaporize the assets and underlying enterprise value. Nor is private equity investing about "quick flips", into the public markets or otherwise. Bear in mind that even after a PE firm takes a portfolio company public, it usually maintains a very substantial equity stake in the company and continues to take an active role in improving the company's performance, often for many years. In other words, if it adopts a short-term mentality, a PE firm takes money out of its own pocket by undermining the value of its long-term ownership position. I have attached a few case studies as examples of how PE firms can strengthen the companies they own.

Academics and business leaders have recognized for years that the public markets can distort the incentives for companies to put in place sound long term business strategies. Because the managers of publicly-owned companies are forced to keep a close eye on quarterly earnings to maintain their stock price, they sometimes are hesitant to make the often substantial investments in new processes, personnel or equipment required to drive strong, long-term growth but which can depress earnings and lower share prices in the short term.

Private equity firms, on the other hand, can take a longer view. Without the pressures from public shareholders looking for short term gains, owners and managers can focus on what is required to improve the medium to long-term performance of the company. This structure also makes it far easier to align the interests of owners with those of managers who also have a direct stake in the ownership and success of the company.

That said, let me be clear that private equity firms are not disdainful of public ownership. We often help companies we own access the public markets, and we recognize that the public markets provide

certain advantages, such as capital access and liquidity. We do not hold out private equity ownership as a silver bullet nor is it right for every company. But we do believe that private equity provides a flexible form of ownership structure that, in appropriate circumstances, can create a successful operating environment for companies at different stages and in different conditions. By better aligning owner-manager interests and by instituting a nimbler operating style that fosters greater innovation and long-term investment, private equity owners are leaders in spurring improved productivity and competitiveness, and we have set a model increasingly embraced by public companies seeking to remain competitive in our global economy.

While data on private equity investment's impact on employment in the U.S. is anecdotal, research in Europe suggests that PE investments do indeed result in long term job growth. A study by the international management consulting firm A.T. Kearney found earlier this year that PE firms generate employment, on average, at a much faster pace than comparable, traditionally financed firms. Research by the British Private Equity and Venture Capital Association on both venture capital and private equity portfolio companies found that, during the last five years, businesses backed by private equity increased employment an average of nine percent per year compared to one to two percent for public companies. And earlier this year the Financial Times studied the 30 largest European private equity transactions in 2003-04 and reported that "overall, jobs were more likely to have been gained than lost as a result of private equity backed buys."

I will now turn to the carried interest issue.

Taxation of Carried Interest

There are many threads to the debate about the taxation of carried interest, and I don't want to oversimplify it. Attached to my testimony is a paper prepared by one of the country's leading tax professors, David Weisbach of the University of Chicago Law School. His paper addresses the many relevant policy and technical tax issues associated with this debate. In my testimony, I want to zero in on what appear to be the three principal arguments underlying proposals to raise taxes on the carried interests in private equity and other partnerships.

First, we hear that the taxation of carried interest allocations at capital gains rates represents some loophole allowing wealthy investors to pay taxes at lower rates than other similarly situated Americans. Second, we hear it argued that private equity general partners are not owners of a capital asset and thus should be taxed as executives earning pay for performance. Finally, we hear that taxing carried interest allocations at capital gains rates is not consistent with the principle that capital should be at risk as a predicate for capital gains treatment.

Let me first address the suggestion that private equity firm owners are exploiting a tax "loophole" to avoid higher taxes on their "compensation for services." This misleading sound bite ignores several fundamental facts. First, the profits realized by a private equity fund and allocated to the sponsor may include many elements: rent taxed as ordinary income; interest taxed as ordinary income; on occasion, short term capital gains taxed as ordinary income. Only the allocation of what is indisputably long-term capital gains—the profits from the appreciation in value of long-lived capital assets, such as the stock of a corporation—is taxed at capital gains rates. In addition, most private equity partners receive salary income, on which they of course pay taxes at ordinary income rates. One academic study (by Andrew Metrick and Ayako Yasuda of the University of Pennsylvania's Wharton School of Business) concluded that the average private equity firm obtains more of its receipts from fees than from capital gains allocations.

Most important (and too often ignored in this debate) is the fact that the carried interest is an *ownership interest,* held by the founders of a business enterprise and the partners they have enlisted to

help them build and grow that business enterprise. It is a form of ownership interest that has been used for many years in many contexts, and is commonplace in all forms of partnerships, including real estate, oil and gas, venture capital, small business ventures, and family business partnerships. The flexible partnership structure, in which capital, ideas and strategic management can be provided by different partners, who split profits according to agreement, has been critical to the legacy of entrepreneurship and "bootstrapping" that characterizes the success of American business. The tax treatment of this ownership structure is well settled by case law and administrative rulings of the IRS, and is anything but a "loophole."

The next argument is that taxing carried interest allocations at capital gains rates contravenes the principles underlying a differential rate for capital gains. Ranking Member Grassley has said that a capital asset is defined as "shares of stock, real estate, and other property held for investment." So where exactly does private equity ownership fit into this regime? I submit to you that it is unambiguous: we buy and own companies and there can be no doubt that the companies we own are capital assets held for investment. So the real question cannot be whether we own capital assets, or whether profits from the sale of those assets constitute capital gains, but whether our carried interest share of those capital gains should be recast as "pay for performance".

Again, this line of argument ignores the reality that a carried interest is, and has long been recognized as, an ownership interest. The relationship between partners with profits interests and those with the capital interests is that of co-venturers, not that of an employee and an employer. Neither party "receives" anything from the other, but rather the arrangement reflects their agreement as to their respective proprietary shares. In private equity funds, the GPs do not operate at the direction of the limited partners — the cornerstone of an employer-employee relationship. Quite the contrary, a PE fund is an enterprise established by the sponsor, which sets the investment strategy for the fund and makes the strategic decisions on which businesses to acquire, how to finance the acquisitions and how to run the businesses. The sponsor raises capital from the limited partners, who are offered in return a form of "financing partnership interest"—an ownership interest that typically entitles them to a return of their capital, the first allocation of profits from that capital until they have received a minimum return or "hurdle", and 80% of the profits from that capital once the "hurdle" has been satisfied. The PE sponsor retains an ownership interest that entitles it to a return of its invested capital, the profits attributable to that capital, and 20% of all other profits once the "hurdle" has been satisfied. In sum, we are co-owners with the limited partners in every sense of the word, not employees, and our respective ownership rights are defined at the inception of the venture.

The Weisbach paper I referred to earlier addresses this issue directly: "The analogy to an employee performing services is not appropriate. The tax law makes a fundamental distinction between an employee performing services and an entrepreneur creating or increasing the value of its business. There is little question that a sponsor of a private equity fund is more like an entrepreneur than an employee. The sponsor is the driving force, the individual with the ideas and the skill to make a project happen. The sponsor is the general partner of the fund with exclusive control over the fund's activity. As a general partner, the sponsor bears all of the fund's residual risk. Limited partnership interests are merely a financing method."

This brings us to the third issue: Some critics have said that PE firms should not be eligible for capital gains treatment because we do not have capital at risk. For starters, the assertion is factually inaccurate. The amount of capital contributed by PE firms to their funds, while perhaps a modest percentage of the total capital in the funds, can be quite substantial in absolute dollar amounts, and almost always represents a substantial portion of the net worth of the PE firm partners who ultimately contribute that capital. For example, at Carlyle, the individual partners of the firm have committed over $2 billion of capital to our partnerships, and these commitments are funded (in after tax dollars) out of the personal bank accounts of those partners. It is also important to note that, in addition to their significant investment in equity capital, PE firms contribute to their funds (and consequently put at risk) their

goodwill and other intangibles. Finally, the GP is the only partner with residual risk if the venture fails. If losses of the venture exceed invested capital, only the GP has liability for those losses.

It is true, as outlined earlier in my testimony, that if a partnership is sufficiently profitable, the percentage allocation of capital gains to the PE firm will be greater than its pro rata share of "cash capital at risk" in that partnership. However, capital gains treatment has *never* been tied to either the amount or proportion of capital at risk. It is tied to whether one has an ownership interest in a long-lived capital asset, which is sold at a gain. The proprietors of a small business may invest very little capital in the business, and may generate most of their ownership value through their personal efforts over many years; when they sell the business, their profit is nonetheless treated as capital gain. An entrepreneur receives capital gain treatment when he or she buys a condemned apartment building—possibly for $1 and a promise to renovate and pay real estate taxes--invests years of labor rehabilitating and leasing the building, and sells it at a profit. Nor is capital gains treatment dependent on the "proportionality" of invested capital. The founder of a technology company may put very little capital into the business and over the years raise billions of dollars in equity financing from third parties. Nonetheless, the founder will receive capital gains treatment on the sale of his or her 50% stock ownership, even if he or she has provided only 0.0005% of the capital.

In general, the tax code is ill equipped to qualitatively evaluate the level of "risk" associated with an investment or to distinguish between the worthiness of each investment eligible for capital gains treatment. Instead, the tax code adopts a straightforward principle; if you invest in or own a capital asset, hold it for more than a year, and sell it for more than you paid for it, you are taxed at long-term capital gains rates. The person who has generated gains buying and selling stocks on a laptop from his or her home is treated the same way as someone who invests $100 million to start a company or buy a mature company. We do not distinguish whether the proprietor has raised capital from borrowing on a nonrecourse basis, on a recourse basis, from investors, or from his or her savings. This capital gains treatment is available to every American. Indeed, fundamental fairness requires that the tax code not single out certain investors for less favorable treatment because they are, for example, private equity partners, or because they are successful.

Having said that the level of "risk" is not the touchstone for capital gains treatment, let me be clear that there is plenty of entrepreneurial risk associated with private equity firm ownership. It is true that we have recently been living through a period that has been conducive to private equity investment, and have witnessed an unprecedented private equity boom. But private equity is not a guaranteed money-making machine. In fact, the Congressional Budget Office discussion of this issue cited statistics from Private Equity Intelligence showing that 185 of the 391 U.S. buyout funds raised between 1991-2004 have not paid *any* carried interest to their general partners. Some of these funds may yet do so but some may never do so.

While much of the debate and media attention focuses on the largest and most successful firms, it is important for Congress to understand that the private equity universe includes hundreds of small PE firms and emerging minority-owned PE firms across the country. Each of these PE firms, large and small, face the real risk that after investing in and working with their portfolio companies for many years – and six years is the average holding period according to Thomson Financial – their proprietary interest in the venture may have no value and they may have nothing to show for their time and effort at the end of the day. I would not suggest to these business people that they have no risk. In fact, as I explained earlier, even if the PE fund is profitable, unless the fund produces a per annum return to the LPs in excess of the hurdle rate (e.g., 8-9% per annum, compounded) — on all investments over the lifetime of the fund (typically 10 years or more) -- the sponsor may be entitled to no carried interest, and any carried interest previously distributed on profitable investments will need to be returned.

Nor is the "risk" to PE firms limited to the capital it provides or the very real possibility that it will receive no return for the ideas, strategies, skills and efforts it contributes to the partnership. As the GP

of the partnership, the PE firm also assumes liabilities, both legal and de facto. There are many instances where GPs have not only received no carried interest but have gone out of pocket to ameliorate partnership losses. Whether or not they are legally obligated to do so, preserving the "franchise value" of their business often requires that they go the extra mile.

Finally, the notion that capital gains treatment should be available only "in proportion" to invested capital runs counter to the traditions of American business. The long-accepted tax treatment of carried interests is consistent with the principle that we reward those who take entrepreneurial risk to create and build long-lived assets, whether that risk involves investing capital or involves years of time, effort, and vision. Changing this treatment would discourage exactly the kind of risk-taking so central to innovation and economic progress, and it would enshrine into law a policy that says only those with money to risk should qualify for capital gains tax benefits.

It may be that the software programmer and the person who starts a small retail business are more sympathetic beneficiaries of capital gains treatment for carried interest than a partner in a large PE firm. But I remind you that each of the most successful PE firms started as a small business not that many years ago. And I submit to you that the entrepreneurial risk that PE firms take is every bit as worthy of this capital gains rate. Whether an investment creates and nurtures a business, as occurs with venture capital, or whether an investment strengthens a struggling business, allowing it to grow and become more competitive, the underlying principle is the same. Is creating the next Google more important to incentivize than an investment to strengthen iconic American brands such as Dunkin Donuts and Burger King, or to stimulate the growth in employment and expansion of a software company like Sungard, or to save from bankruptcy a company like Chrysler or Toys 'R Us? I believe all are important and I hope Congress will move with great caution before it changes the incentives that exist today for investors to nurture and grow such businesses.

Why Does It Matter?

Some acknowledge that the principles I have discussed are sound. But, they say, Congress needs sources of revenue and, in any event, there will be "no harm, no foul" – private equity partners may not want to pay higher taxes, but they can afford it and there will be no adverse economic or social consequences that flow from changing current law.

I submit that this perspective is a triumph of hope over reality. I am not here to tell you that the sky will fall and that private equity will shrivel up and die. Indeed, firms like mine, that have grown from start-ups to large enterprises as a result of success over many years, are the best equipped to "weather the storm." It is the smaller firms, and the next generation of firms, that will be at greatest risk. But across the sector, there will inevitably be consequences.

For to suggest that a 130% tax increase will have no effect on behavior is quite optimistic. Ask yourself if you would change your behavior faced with this sort of economic dislocation. So it is with private equity. It is a mistake to assume that nothing will change if Congress profoundly alters the basic business model on which our industry has been organized and operated with great success. For this reason, I urge you to proceed very carefully before risking an adverse impact on a form of ownership that has been a major and positive force in strengthening U.S. competitiveness, giving struggling or failing businesses a new lease on life, and pumping critically needed capital into the economy

Of course we will meet our responsibilities to our limited partners, even if the "rules of play" are changed in the middle of the game. And we will pay taxes on whatever basis is determined by Congress. But over time, investment structures will change; incentives for new fund formation (or formation of new PE firms) will be diminished; and there will inevitably be less activity in the sector, at least by U.S. firms with U.S. owners. There will be deals that won't get done, entrepreneurs that won't get funded, and turnarounds that won't be undertaken.

Moreover, while some have dismissed concerns that returns for LP investors will decline, this unfortunately is a possibility. True, the PE industry may develop new financing models that ensure the same level of return to PE firm partners and our LP investors (although, if we do, it is likely that these new structures would significantly reduce any anticipated tax revenue expected from this change). But it is also possible that PE firms will seek ways to offset at least a portion of the higher tax burden, and one likely result would be an eventual reduction in the returns of pension funds, endowments, foundations, and other investors who rely on these returns to carry out important social missions. This is exactly why Pensions and Investments Magazine, the leading trade journal for many such investors, recently said in an editorial that "pension funds, endowments, and foundations, even though they are tax-exempt institutions, might end up paying the increased taxes Congress is considering imposing on the general partners of hedge funds and private equity firms.…The result: lower returns for the pension funds, endowments, and foundations."

Another possible consequence is that U.S. firms will become less competitive with foreign PE firms, and even foreign governments with huge investment war chests. The Wall Street Journal noted last week that the world's capital is going global, reporting that Qatar, Singapore, China, Dubai and Abu Dhabi are among the sovereign governments searching for investment opportunities. They, and the major foreign PE firms with whom we compete, will not be as constrained by taxes, and may be in a more competitive position to acquire companies than U.S. PE firms with a higher "cost of capital."

The U.S. is the dominant capital market in the world, and this Committee has been very supportive of protecting that status. But tinkering with the tax status of U.S. private equity firms will make us less competitive. In recent weeks, the U.S. Treasury Department, the OECD, and KMPG have all reported that governments the world over are striving to make their tax systems more competitive to attract foreign capital and challenge U.S. dominance. The proposal to raise taxes on carried interest moves in exactly the opposite direction, potentially yielding preeminence in a sector that historically has been led by U.S. firms.

Finally, a possible consequence is that that U.S. private equity firms would move overseas. Some have also been dismissive of this possibility. But in his recent testimony before this Committee, Federal Reserve Board Chairman Ben Bernanke warned that tax increases on private equity could encourage firms to relocate to more hospitable markets. Candidly, I don't think a firm like ours would relocate its U.S. operations. But what Carlyle and our larger, well established colleagues do is only part of the analysis. The question is: will the U.S. be the home for the next generation of PE entrepreneurs, who will have discretion to start their businesses wherever the climate is most favorable? Or will the "center of gravity" migrate to Europe, Asia, the Middle East, or Eastern Europe, where firms will tend to seek first investment opportunities in their own regions. Will the U.S. see growth capital now invested to strengthen American companies shifting to help foreign firms better compete against U.S. businesses? And are the perceived benefits of this change in tax policy worth taking that risk?

Tax Treatment of Publicly-Traded Partnerships

I would like briefly to turn to S. 1624, sponsored by Chairman Baucus and Ranking Member Grassley, which would deny partnership treatment to certain publicly-traded partnerships that derive income (directly or indirectly) from services provided as an investment advisor or from asset management services provided by an investment advisor.

We oppose the bill on several grounds. It inappropriately singles out our industry for exclusion from the general rules for qualification as a PTP. In doing so, it will discourage private equity firms from going public in the U.S., impeding potential benefits both to such firms and the U.S. capital markets. Those PE firms which do go public will be subject to a "triple taxation" regime, with the same income potentially taxed at the portfolio company level, at the public entity level, and at the investor level.

And, despite all of this dislocation, the incremental tax revenue produced by the change is unlikely to be meaningful.

Virtually all private equity firms are organized as partnerships or other "flow through" entities today. Thus, going public as a PTP simply preserves the status quo for tax purposes. There is no abuse or tax evasion involved. In fact, public PE firms would generally conduct a portion of their operations through a corporation, thus subjecting to corporate taxation income which is not subject to such tax under private ownership.

Under the current law, there is a general standard for PTP qualification: 90% of income must be qualified income, such as dividends, interest and capital gains. The private equity industry is not seeking "special treatment" but simply the ability to use a structure that is made available to, and used by, other sectors, such as oil and gas. There is no justification for singling out PE firms for adverse treatment.

Indeed, exclusion of PE firms is particularly inappropriate given that their activities center around investments in corporations that are themselves taxable entities. Thus, income earned by these firms would be subjected to three levels of taxation: (i) the first level of corporate tax would be paid by the investment funds' portfolio companies on their operating income; (ii) the second level of corporate tax would be paid by the PE sponsor on its share of the gain from the sale of the portfolio companies or on distributions received from such companies; and (iii) the third level of tax would be paid by the public owners of the PE sponsor when they sell their shares. Because of the overall structure, the dividends-received-deductions would generally not be available to ameliorate the three levels of tax. Thus, the PTP bill appears to impose a penalty on publicly-traded PE firms that corporate enterprises in foreign jurisdictions do not bear, and which most other corporate enterprises in the U.S. do not bear (by virtue of consolidation or the dividends-received-deduction).

This penalty will constrain the ability of mature private equity firms to raise capital in the U.S. public markets that may be required to compete in an intense and increasingly global business. In turn, U.S. public market investors may be deprived of an opportunity to participate in the next phase of growth of this sector, and the competitiveness of the U.S. capital markets will suffer.

We understand that the bill was driven at least in part by a concern over erosion of the corporate tax base. However, as noted above, conversion by private equity firms to PTPs would simply preserve the status quo. Other financial firms organized as C corporations have not shown an inclination to organize as PTPs despite the opportunity to do so. Financial corporations contemplating a change to PTP status generally would face significant corporate taxes upon conversion, which will often be prohibitive.

Finally, the transition to public ownership may be important in succession planning and allowing a mature PE firm to survive beyond its founders. By discouraging and possibly precluding such steps, the bill imposes unfair limits on the ability of these firms to fully realize their potential.

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I appreciate the opportunity to present our views and look forward to working with Chairman Baucus, Ranking Member Grassley, and the rest of the Committee as you continue to explore these issues.