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Statement of Sen. Chuck Grassley
Hearing, "Carried Interest, Part 1"
Wednesday, July 11, 2007

Thank you, Chairman Baucus, for calling this hearing. I'd like to address this hearing in two parts. The first part is what this hearing and the committee inquiry is about. The second part is what this hearing and committee inquiry is not about. So, let's first discuss what this hearing and the committee inquiry is about. The issue we are examining today arises from the intersection of partnership tax rules and the lower rates on capital gains. A carried interest is an interest in a partnership's profits that is received in exchange for performing services for the partnership, as opposed to contributing capital.

While this issue is not new to the tax law, it has received heightened attention from the proliferation of private equity and hedge funds structured as partnerships. The carried interest issue relates to the timing and character of income. In 2003, I fought long and hard, to get the lower capital gains rates into law. I continued the fight last year, over the fierce opposition of the Democratic Leadership, to get the lower rates extended through 2010, and I'll be at it again in the years leading up to 2011. In each battle, the opposition will call the lower rates tax cuts for the rich.

We justify the lower rate on capital gains as a remedy against the double taxation of investment income and the resulting benefits of economic growth. As a Republican who supports lower capital gains rates, I am concerned that to the extent we permit the dilution of the investment concept, we risk undermining the arguments we have made for the lower rates, and also making it more expensive to extend them. We can't allow the carried interest tail to wag the capital gains dog. The partnership tax rules came into the Code in 1954. Under these rules a partnership itself is not subject to tax, unlike a corporation. Instead, the income, and the character of that income flows through to its partners.

If a partnership realizes ordinary income, then the partners are taxed on that income at ordinary tax rates. But if the partnership realizes capital gains, then the partners are taxed at capital gains rates. This makes perfect sense when all the partners invest capital in the partnership and share in the profits according to their invested capital.

But the carried interest issue involves a partner receiving a share of partnership profits, not for invested capital, but for performing services or contributing intangible know-how. Even if current

law is relatively clear, I wouldn't call it a no-brainer that all of those profits should be taxed as a return on investment rather than a return on labor. Keeping taxes low on investment returns is sound tax policy. But we need to preserve the integrity of that policy in order to maintain it.

A separate issue, the publicly traded partnership issue, also involves tax code integrity. I joined Chairman Baucus as an original co-sponsor on a bill that would require private equity and hedge fund managers that go public to pay corporate taxes. Some have inaccurately described this bill as an attack on capital formation and as a tax increase on a single industry. But this issue is about closing a loophole, not raising taxes.

A hallmark of corporate status is access to public markets. Our bill prevents the long term erosion of the corporate tax base, which was Congress' initial concern in creating the current rule that publicly traded partnerships are taxed as corporations. Any type of business can operate in partnership form. However, if that business decides to go public, it will generally be taxed as a corporation and pay an entity level tax. Our bill merely clarifies that firms that manage private equity funds and hedge funds will be treated no differently than their competitors or any other active business that goes public.

I agree with those who say our corporate tax rate is too high. But that's a different debate, and we'll never get there if we stand by and watch a significant part of our economy escape the corporate tax system while still accessing public markets.

Now, Mr. Chairman I want to move to the second part of my statement and address what this hearing is not about. Contrary to the claims of some press reports, lobbyists, and politicians, our inquiry, and any proposal that it may produce, is not about raising taxes on capital income. It is not an attack on the investor class. It is about the definition of capital income versus labor income. Since 1922, our tax code has taxed long term capital gains at lower rates than ordinary income, except for a brief period following the tax reform act of 1986. I make this point to some Republicans and some Democrats who may have come down on this issue on opposite sides before they even know the facts.

Mr. Chairman, Steve Forbes, for instance, describes our publicly traded partnership loophole closing proposal as "putting special taxes on equity funds." He went on to say that "envy" was the basis of our publicly-traded-partnership proposal. Another commentator, a Heritage Foundation economist, said, "Senators Baucus and Grassley apparently think it is wrong that fund managers get a slice of the capital gains pie if investments rise in value, and they want to tax those gains as if they were income instead of increases in net worth."

I'd direct Mr. Forbes and other critics to cool it on the hysteria and get their facts straight. This is a bipartisan Finance Committee process that has not reached the conclusions they suggest. And while we're talking about charges of a fictitious tax increase, I'd like to remind folks on my side of the aisle that during my tenure as Chairman and Ranking Member, I never put forward a proposal for the purpose of raising revenue. If the proposal was good policy, then I recommended it to our committee, whether it raised or lost revenue. For those who want to recklessly charge our deliberate, transparent policy inquiry as a tax increase exercise, I'd ask them a question. Which Finance Committee Chairman in the last generation cut the American People's taxes more than I did?

For folks on the other side of the aisle, I'd say take a look at John Harwood's recent article in the Wall Street Journal. Mr. Harwood noted the shifting sands of the composition of the Democratic base. That is, roughly half of the voters with incomes above \$100,000 now vote Democratic. Mr. Harwood said, "These changes have altered the election-risk calculus that Democrats confront as they consider whether to raise taxes on hedge-fund managers or tax Fortress and the Blackstone Group as corporations. The Democratic benefactors on Wall Street may not vote their wallets – abortion rights and global warming move them more – but they aren't eager to become political punching bags, either."

So, this hearing and the committee's inquiry is not about a revenue grab from private equity firms or hedge funds. Folks on both sides ought to roll up their sleeves, move away from partisan talking points, and join Chairman Baucus and me in finding the facts.

Secondly, this hearing is not about well-settled tax policy principles regarding capital assets or the propriety of current law capital gains rates. Capital gains arise from the sale of a capital asset. We know what capital assets are – they are shares of stock, real estate, and other property held for investment. The Code's definition of a capital asset recognizes the distinction between investment income and labor income by disqualifying certain property held by those whose personal efforts created the property.

As I indicated above, the Congress has spoken on the 15 percent current law top rate on capital gains. I am a strong supporter of a permanent top rate of 15 percent. Our hearing today and the committee's larger inquiry is not about well-settled notions of capital assets and the current law rates.

Mr. Chairman, I'd encourage all members to keep their eye on the ball. It is appropriate – in fact, a responsibility -- for this Committee to thoroughly examine these carried interest issues and determine if the tax law is operating consistently with the sound policy on which it is based. Lower taxes on capital gains and corporations can help American businesses compete in the global economy. But to maintain and improve on these sound policies, we need to preserve their integrity. Knee-jerk opposition to our inquiry will only serve to bolster opponents of these policies.