Senate Committee on Finance Hearing

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"Carried Interest Part II"

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Chairman Baucus, Senator Grassley and Members of the Committee, thank you for inviting me here today to testify on the tax treatment of carried interest. The views expressed here are my own and do not necessarily reflect the views of Stanford University.

I support changing the present treatment of carried interest. Reforms along the lines proposed by H.R. 2834, or by Professor Gergen in the July 11 hearing on this same topic, will increase economic welfare and make the tax law more equitable. Presently, our best and brightest young people choose among various occupations. They can become doctors, nurses, educators, or scientists. Those with an interest in business might become executives, farmers, stockbrokers, lawyers, consultants or investment bankers. All of these occupations, and countless other occupations, are taxed at a maximum rate of 35%. Alternatively, they can become fund managers, venture capitalists, or others who receive profits interests in partnerships that recognize long-term capital gain, and pay tax at a maximum rate of 15% on much of their income. To simplify exposition, I will generally refer to persons in this latter category simply as fund managers. I will drop this simplifying assumption where differences among profits recipients are relevant.

A basic and common-sense rule of tax policy is that we ought to have the same rate of tax apply across different occupations or investments. The relative profitability of different professions, or investments, ought to be dictated by the market, not the tax law. The subsidy given to fund managers distorts career choice, and in so doing reduces economic welfare. It is also unfair: why should fund managers get a lower tax rate than executives or scientists?

A number of arguments have been made in defense of current law. As discussed below, most of those arguments are without merit.

1. The low rate is justified by the important work fund managers do.

Some have argued that the low rate is supported by the importance of the fund manager's work. In the July 11 hearing, for example, Ms. Mitchell described some of the central intermediation and advisory functions she and others in her fund serve. Fund managers do perform important services. However, those who engage in other occupations also perform important services. The lower rate of tax on fund managers

would be justified by the importance of the work they do only if it could be shown that they perform more valuable work, relative to pay, than, say, surgeons, chief executive officers, or schoolteachers. No one has suggested this to be the case.

2. The low rate is efficient.

Some have argued that the low rate of tax on fund managers (whether or not justified by the importance of their work) is efficient. This argument assumes that fund managers would not work as much if they were taxed at the same rate as everyone else. At the July 11 hearing, an exchange between the Chair and Peter Orszag indicated that both were (in my mind properly) skeptical as to the scope of the decline in work effort that raising the tax rate would produce.

In fact, as a matter of economic logic, the low tax rate for fund managers will be inefficient even if it can be shown that fund managers would reduce work effort if the rate were raised. In order for the current low rate to be efficient, it would have to be shown not just that fund managers will work less if the tax is increased, but that they are relatively *more* sensitive to tax than those in other occupations. As noted above, fund managers now pay tax at about half the maximum rate of doctors. This would be efficient (though still objectionable as unfair) only if it could be shown that doctors are relatively insensitive to tax, and so will continue to work notwithstanding the high rate, or that fund managers are extremely sensitive to tax, or that some combination of these two assumptions is true. Again, no one has presented any evidence that this is the case.

If high rates on labor income are a problem, Congress should respond by lowering rates across the board. It could use some or all of the revenue from eliminating the low rate on fund managers to fund a reduction in the now-equal rates applicable to all employees.

3. The low rate on fund managers benefits key industries.

The low tax on fund managers is often defended not as a subsidy to fund managers, but as a benefit to the industries -- such as technology and financial services -- in which fund managers play important roles. One problem with this argument is that low rates on fund managers are an inefficient way to subsidize these or any other industries. If, for example, Congress wishes to subsidize the technology sector, reducing taxes on investments in that sector will be more efficient than maintaining a low tax rate on persons who spend some of their time performing advisory and financial intermediation functions for some companies in the sector. (In fact, Congress already subsidizes this sector through the research and development deduction and credit.)

A more fundamental problem with this argument is that while the financial services and technology sectors are important, other sectors of the economy are important as well. No one has suggested any reason to believe that the financial services sector is more important than, say, the manufacturing sector. Absent such evidence, wise tax

policy is to levy the same rates on all sectors. Subsidization of industry distorts the flow of investments, just as subsidization of occupation distorts career choice.

If high taxes on business income is a problem, Congress should respond by lowering taxes across the board.

4. The low tax rate on fund managers is consistent with the treatment accorded to inventors and entrepreneurs.

Everyone who testified in favor of capital gain treatment of carry at the July 11 hearing compared fund managers to entrepreneurs. One problem with this argument is that fund managers do not perform the same functions or face the same obstacles as entrepreneurs. An entrepreneur may work for years with little or no pay, betting her entire economic future on the success of her idea, invention or efforts. Fund managers perform intermediation and advisory services. They receive generous management fees and benefit from the performance of a portfolio of companies, the success of each of which is dependent on the inspiration and efforts of the entrepreneur.

One measure of how closely connected carry is to the provision of services is that some amounts taxed as carry are actually management fees that fund managers have simply elected to convert into carry. It is also worth noting that in statements to investors and to the Securities and Exchange Commission, some publicly traded fund management firms have described their business as the active provision of services.

(At a later point in this testimony, I discuss the proper treatment of profit participants in smaller partnerships, who in many cases do resemble entrepreneurs)

A more fundamental problem with this argument is that the entrepreneurs with whom the fund managers wish to be compared comprise a minute slice of American workers and a small slice even of those individuals who go into business-related careers. Only a handful of students at Stanford Law and Business Schools, for example, fall into the category of serial entrepreneurs, starting and selling one company after another. For both efficiency and fairness purposes, it seems more sensible to compare fund managers to the far greater portion of their cohort who are taxed at ordinary income rates.

5. Eliminating the capital gain treatment of carry represents a tax increase on investment.

In recent years, an increasing number of academics, liberal and conservative, have come to believe that low tax on investment income increases welfare. The efficiency rational for reducing taxes on investment is that high taxes lead individuals to spend rather than save, or engage in expensive and otherwise worthless planning to avoid paying the tax. When that occurs, welfare is reduced and the government gets no tax. In some cases, high taxes on investment income can also reduce labor effort. At the July 11 hearing, a number of Members who share the belief in low taxes on investment expressed

reservations about changing the tax treatment of carry. Their concern is that eliminating the capital gain preference is effectively a tax increase on investment.

In fact, the capital gain preference here is being used to reduce taxes not on investment, but on the labor income of some of the most highly paid citizens in the nation. The primary efficiency rationale for low taxes on investment income -- that it encourages savings over consumption -- does not apply. In this case, the capital gain preference does simply serve as a reduction of tax on the wealthy. Extending the capital gain preference to this group discredits the respectable general case for low taxes on investment income. My position here, I believe, reflects some of the concerns that Senator Grassley expressed in the July 11 hearing.

It is sometimes argued that the tax benefit to fund managers is justified because it indirectly benefits investors. The theory is that the tax benefit will increase the number of fund mangers and reduce the price paid for fund management services. The same argument would support reducing taxes on clerical staff who work in the financial sector. It would also support exempting from tax altogether the income of lawyers who help structure investments, or offer tax advice to investors. Stated in this fashion, the problem with the argument becomes obvious. Reducing the taxes on persons who are hired by investors is an inefficient and expensive way of reducing taxes on investment. It is also completely unnecessary. If Congress wishes to reduce the tax rate on investment it can do so directly, by reducing the capital gain rate, or increasing depreciation or other investment incentives.

6. The actual return to fund managers represents a mix of ordinary income and capital gain.

I have described the carry fund that managers receive as labor income and I support a rule that would tax the carry as ordinary income in the year received. That analysis and proposal is consistent with how the tax system does and should treat incentive compensation in other areas. For example, assume a company agrees to pay an employee 100x if and when he completes a given task. If the employee completes the task and is paid in year 5, he is and should be taxed at ordinary income rates in that year.

In his July 11 testimony, Peter Orszag characterized the carry as a mix of capital gain and ordinary income. Mr. Orszag's view can be illustrated by assuming a fund manager provides services for 5 years and receives carry at the end of the 5th year, when the fund investments are sold. Mr. Orszag would view the receipt of a profits interest in year one in return for services in that year as ordinary income. He would presumably view the fund manager as recognizing still more ordinary income in years 2 though 5, as, in return for his services, he is retained by the limited partners and his profits interest effectively vests. The difference between the ordinary income recognized in years 1 through 5 and the actual amount received on sale in year 5 is treated as capital gain.

Victor Fleischer, using a slightly different framework, reaches a result similar to Mr. Orszag.

The analysis of Orszag and Fleischer suggests we should treat part of the fund managers' income as capital gain. In that respect it would be more taxpayer-favorable than the proposal I support. However, it would also accelerate tax liability and in that sense be less favorable to the taxpayer. It would also raise the possibility the fund manager would be left with a combination of ordinary income and unusable capital loss, and in that sense, too, it would be less taxpayer-favorable. I believe that under reasonable assumptions as to the value of the profits interests (using a method similar to Black-Scholes) the net present value of the expected tax produced under Mr. Orszag's approach would not differ greatly from the results produced under the rule that Professor Gergen and I favor. The results under Mr. Fleischer's analysis would be even closer to the rule Professor Gergen and I favor. Almost all commentators believe that the "ordinary income at the time of receipt" approach is more easily administered than a rule that attempts to value profits interests in the year received.

In sum, while one could reasonably debate whether Peter Orszag, Victor Fleischer or I set forth the best framework with which to view the carry, the difference in expected tax owed under these frameworks may not be great.

7. Changing the treatment of carry imposes transaction costs on the government and taxpayers.

A number of commentators have argued that taxing as ordinary income the profits distributed to fund managers requires a number of other changes in the tax law, and that these changes will at least temporarily increase legal and accounting expenses associated with some partnerships. I think this is likely to be true. Large partnerships will have access to advisors who are trained to handle this complexity and will find any extra cost small relative to profits. For smaller partnerships, learning to live with the new rules may be more difficult. There are over a million real estate partnerships, for example. Many of these partnerships are located in smaller communities and involve only a few partners.

There is another problem with changing the treatment of carry for smaller partnerships: The recipients of profits interests in those partnerships tend to more closely resemble entrepreneurs than do the fund managers of larger partnerships. In the July 11 hearing, Assistant Secretary Eric Solomon brought up the example of a business owner who uses the partnership form to obtain funding to open a clothing store; countless other examples can be built on similar facts. The special treatment of profits of entrepreneurs is dependent upon the extent of capital gain preference and (to an academic) has not been adequately explained or explored. However, given the existence of that preference and the large disparity between capital gain and ordinary income, it seems good policy to exclude these partnerships from the ambit of any new rule.

Where to draw the line is an empirical question I have not examined. In today's market, though, it is possible for a partnership to commit substantial funds and still be small enough for profits participants to resemble entrepreneurs and to be disproportionately burdened by the complexity of coping with new rules. To take but one

example, an individual developer may stake his or her financial future on a single $15 million building project. The project might be carried out in partnership form, with a few limited partners supplying capital and the developer taking a profits interest. I would guess that any scoring of this proposal would show that most of the revenue from any change in law would come from the largest partnerships, as measured by assets. The Committee might limit the proposal to those partnerships.

Some might argue that a bill that covers only the larger partnerships is itself objectionable on fairness grounds. I think that argument is incorrect. It is sensible, here and elsewhere, to take the costs of legal complexity into account when deciding the scope of any rule. Moreover, as noted above, smaller partnerships tend to differ from the largest partnerships in qualitatively significant ways. It is foolish to expect that this Committee will be able to draft a rule that gets this or any other issue exactly right for all taxpayers. That simply cannot be done. The Committee should instead make sure that any rule it passes improves the overall efficiency and equity of the tax system, and that, when the question is close, it errs on the side of the taxpayers whose burden would be raised. The proposal being considered, if limited to larger partnerships, meets that requirement.

One final issue deserves mention. The proposal I favor would tax as ordinary income allocations of income to certain profit participants, even if the income allocated would otherwise be taxable as capital gain. Some partnerships might wish to respond to the new rules by restructuring their economic affairs so as to award fund managers with incentive compensation measured in the same manner as the current carry. Under existing law, this would also be treated as ordinary income to fund managers. However, this approach would generate an ordinary deduction to the partnership. This would be advantageous to many smaller partnerships, which have taxable limited partners who could use that deduction. Nothing in the proposal I favor would preclude such an arrangement.