PRIVATE EQUITY GROWTH CAPITAL COUNCIL

SUBMITTED ELECTRONICALLY

April 15, 2015

The Honorable Orrin Hatch
Chairman
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Ron Wyden
Ranking Member
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Chuck Grassley
Co-Chairman
Individual Income Tax Working Group
Committee on Finance
United States Senate
135 Hart Senate Office Building Washington, DC 20510

The Honorable Debbie Stabenow
Co-Chairman
Individual Income Tax Working Group
Committee on Finance
United States Senate
731 Hart Senate Office Building
Washington, DC 20510

The Honorable Michael Enzi
Co-Chairman
Individual Income Tax Working Group
Committee on Finance
United States Senate
379A Russell Senate Office Building
Washington, DC 20510

RE: Carried Interest is Appropriately Taxed as Capital Gains Income and Should Remain So in Tax Reform.

Dear Chairman Hatch, Ranking Member Wyden, Senator Grassley, Senator Stabenow and Senator Enzi:

This letter is submitted by the Private Equity Growth Capital Council ("**PEGCC**" or "**we**", as applicable) in response to the Finance Committee's invitation to provide comments on various aspects of tax policy as the Committee and its Working Groups weigh options for comprehensive tax reform. The PEGCC is an advocacy, communications and research organization established to develop, analyze and distribute information about the private equity and growth capital investment industry and its contributions to the national and global economy. Established in 2007, and formerly known as the Private Equity Council, the PEGCC is based in

Washington, D.C. The PEGCC's members are the world's leading private equity and growth capital firms united by their commitment to growing and strengthening the businesses in which they invest.

Introduction

The PEGCC supports reforming the nation's tax code, where appropriate, to encourage greater entrepreneurship, investment, capital formation, job creation and economic growth. Precisely because of this position, as described in more detail below, we oppose increasing taxes on carried interest or enterprise value.

A carried interest tax increase would nearly double taxes on businesses that facilitate investment and job growth in the United States. While some supporters of the tax increase claim it is only a tax on hedge fund managers, the proposed tax increase is squarely aimed at real estate, private equity, venture capital, and other businesses that make long-term investments that stimulate economic growth, innovation, and job creation. According to the IRS, there are more than 3.4 million partnerships and more than 25 million partners.[1] Many of these taxpayers could be negatively affected by this tax increase. Moreover, at the end of 2012, carried interest income received as long-term capital gains, as well as all other long-term capital gains, experienced a 58.7% tax increase as part of the fiscal cliff compromise.

We encourage Senators to avoid unfairly targeting carried interest and enterprise value for additional tax increases in the context of comprehensive tax reform. Tax rates on carried interest should remain fully aligned with the tax rates on all other similarly situated capital gains.

Many countries with which the United States competes tax carried interest as capital gains and often at lower rates than the United States. The proposed carried interest tax increase would put the U.S. at a competitive disadvantage and would draw capital from our shores to more friendly foreign markets. Thereby, this tax increase would aid job creation overseas.

The carried interest tax increase also contains an enterprise value tax, which would deny long-term capital gains treatment on the value of an investment partnership business built over many years if the business is eventually sold in whole or in part. In short, under this proposal, investment partnerships would be the only form of business in America subject to this discriminatory treatment. While some proponents of the carried interest tax increase proposal have recognized that the enterprise value tax is problematic, none of the proposed fixes to date have adequately eliminated the enterprise value tax increase.

The current tax treatment of carried interest and enterprise value is not a "loophole", a "subsidy", or a temporary tax expenditure. The carried interest tax increase would upend more than 100 years of partnership tax law characterizing carried interest and enterprise value as capital gains. Tax loopholes, subsidies, and expenditures distort or deviate from normal tax rules and principles. By contrast, carried interest earned in the ordinary course of selling a capital

[1] *See* Ron DeCarlo and Nina Shumofsky, *Partnership Returns, 2012*, Figure B, *at* http://www.irs.gov/pub/irs-soi/soi-a-pa-id1504.pdf

asset held for more than one year for a profit is, and as a policy matter should be, taxed as long-term capital gains.

The key criterion for capital gains treatment is whether the taxpayer has made an entrepreneurial investment – of capital or labor or both – in a long-lived capital asset, the return for which depends entirely on the growth in the value of the asset.

Historical Background - Since Its Inception, the Tax Code Has Always Appropriately Treated Carried Interest as Capital Gains Income

Since the creation of the Internal Revenue Code in 1913, the basic tenet of partnership taxation is that a partner generally cannot receive compensation from a partnership. Instead partners receive an allocation (or "distributive share") of income jointly derived from pooled capital *and* labor. A profits interest or carried interest is simply an allocation of income recognized by the partnership. The income to the partner takes the form of the income (e.g., ordinary income or capital gains) coming into the partnership and flows through to the partner.[2]

The Internal Revenue Code of 1954 provided two limited exceptions to the general rule that a partner cannot receive compensation from a partnership (see sections 707(a) and 707(c)). These limited exceptions, which still exist today, do not address carried interest.

In fact, nothing has changed over 100 years that should cause a profits interest, or carried interest, to be treated as compensation.

Private Equity Background

To place this important policy discussion in context, we would like to provide a brief description of the structure and operations of private equity firms and private equity funds:

Private Equity Firms

Private equity firms sponsor, manage and advise private equity funds (which are described below). Private equity firms, or the owners of private equity firms, typically own and control their funds' general partners (or, in the case of a fund that has a non-partnership structure, the equivalent controlling entity), which make investment decisions for the fund. Private equity firms most frequently are privately owned and controlled by their senior investment professionals.

There are more than 3,300 private equity firms in the U.S. In 2013 alone, private equity firms invested $443 billion in more than 2,360 U.S. based companies. There are more than 24,280 companies in the United States that are backed by private equity investment. Private equity-backed U.S. companies employ approximately 14 million people worldwide.

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2 *See, e.g., United States v. Coulby*, 251 F. 188 (N.D. OH)(1918).

Private Equity Funds

Private equity funds are partnerships formed to acquire large (often controlling) stakes in growing, undervalued or underperforming businesses. Private equity funds seek to structure the management and operations of the acquired businesses to grow and strengthen the businesses over the long-term. Many years later, private equity funds realize the increased value they have created by disposing of their interests in the acquired businesses. Outside investors, including pension funds, endowments, and corporate and individual investors (the "limited partners") generally contribute 90 to 97% of the equity capital used to acquire the businesses. The sponsor of the funds (the "general partner") provides the remaining 3 to 10% of fund capital. Investors generally cannot freely dispose of their interests in the funds. Their interests are liquidated as the fund disposes of the underlying investments, a process which generally takes 10 to 12 years from the fund's inception.

Carried Interest in the Private Equity Context

The general partner typically has an equity interest in the future profits of the fund, in addition to a capital interest for its cash contributions. This equity interest, which is known as the "carried interest," typically represents 20% of the net income and gains of the fund, after satisfying the "hurdle rate" of return (described below). The carried interest has no liquidation value when the fund is formed, and represents an interest only in the future appreciation of the fund.

Under a typical structure, when a private equity fund liquidates an investment, the fund is required to distribute the proceeds. The investors are first entitled to receive a return of their invested capital, plus a hurdle rate of return (often 8 or 9%). If any proceeds remain, they are typically split so that the general partner receives 20% of overall fund profits, and the investors receive 80%. The general partner's carried interest is subject to a clawback provision that requires it to return any such distributions to the extent of any subsequent losses in other investments of the fund that lower the returns of the fund below the hurdle rate. The private equity firms that sponsor private equity funds typically also receive a separate annual management fee from the investment partnerships that they manage. The fee is typically 2% or less of the capital that investors have committed to the fund or that has been invested and is under management. This fee is not based on the performance of the fund, and accordingly is taxed on a current basis as ordinary income.

The carried interest provides the general partner with upside potential similar to the potential afforded to the limited partners. If the fund does well, the general partner shares in the gains. If the fund does poorly, the general partner may receive nothing.

Carried interest is found throughout industries and market segments in which one party has the entrepreneurial vision and expertise and other parties invest cash capital. For example, real estate developers often have carried interest when they develop office buildings or other properties. Infrastructure developers who build ports, bridges, stadiums, and power plants often have carried interest. Oil and gas developers who drill for new sources of minerals often have carried interest as part of their arrangements with their investors. Venture capital, a subset of

private equity, has carried interest as a result of investments in start-up businesses. As it has become more common for more start-up ventures and small firms to select a partnership tax structure, carried interest also has become more common for owner-managers across the full spectrum of small operating businesses.

Tax Treatment of Carried Interest under Present Law

Under current law, investments made by private equity funds in capital assets (e.g., businesses) and the gains and losses realized by the funds on disposition of those assets are appropriately treated as capital gains and losses. The general partner's carried interest in a private equity fund is taxed on a "pass-through" basis, like any other equity interest in any other partnership. For tax purposes, the fund's income, gains, losses, and deductions flow through to the partners in the fund, including the general partner, with the same timing and character as recognized by the fund. Thus, to the extent that the fund's returns include ordinary income or loss, the carried interest is taxed as such. Similarly, to the extent that the fund's returns are long-term capital gains or losses, a share of those items is allocated to the general partner in connection with its carried interest.

Analysis

The present-law tax treatment of carried interest is founded on two sound and settled tax policies. The first is that capital gains are designed to reward entrepreneurial risk-taking. The second is that partnership profits should be taxed on a pass-through basis. Disturbing either of these long-standing and established tax principles would have ramifications well beyond private equity funds, adversely affecting the treatment of start-up ventures, small businesses, interests in real estate and natural resources, and other enterprises that involve carried interest or are dependent upon the personal efforts of the owners.

Proper Treatment as Capital Asset

The justification for a reduced tax rate for long-term capital gains is founded on the concept of entrepreneurial investment. Capital gains treatment is intended to encourage the type of risk-taking investment that is indispensable to the creation of durable value in the national economy, by rewarding those who invest in capital assets and realize capital gains. The requisite entrepreneurial investments are not limited to capital investments; they also extend to investments of labor. Our tax system has long recognized that a taxpayer may be entitled to capital gains treatment with respect to the sale or exchange of property where the gains are attributable in whole or in part to the taxpayer's own personal efforts. The key criterion for capital gains treatment is not whether the gains are attributable to capital or to labor. Rather, the key criterion is whether the taxpayer has made an entrepreneurial investment – of capital or labor or both – in a long-lived capital asset, the return for which depends entirely on the value of the asset.

For example, if the owners of a small operating business build its value through their own efforts, their interest in the equity of the business is treated as a capital asset, and their gains on

sale are treated as capital gains. This is true even where they have made the vast majority of their investment – perhaps all of their investment – through their labor, rather than cash capital.

The same principles apply in the pooled investment context, where the partners join together to invest capital and labor. The value of a real estate fund's assets is enhanced by the skill of its developer-general partner in identifying attractive buildings, engaging experienced management services, and positioning the real estate for optimal returns on sale. The value of a natural resource partnership's portfolio is enhanced by the skill of its developer-general partner in seeking out overlooked mineral deposits, engaging experienced mine operators, and structuring appropriate liquidity events. Likewise, the value of a private equity fund's investments is enhanced by the skill of its sponsor-general partner in identifying undervalued companies, arranging financing, developing and implementing management and operating strategies, and selling at attractive valuations. In each case, the funds are entitled to capital gains treatment on disposition of their assets, in recognition of the entrepreneurial risk they have taken by investing the capital and labor of their partners.

Consistent with Underlying Premise of Partnership Taxation

The core notion of partnership taxation is that partners receive a "distributive share" of income jointly derived from pooled labor and capital. The tax system has long recognized that parties in a venture may organize as a partnership, and arrange their equity interests to allocate the income, gains, losses, and deductions of the partnership among themselves as they see fit, so long as those allocations reflect the economics of the venture. By adopting a flexible system of pass-through taxation for partnerships, the tax law respects the parties' contractual arrangements, and enables joint ventures with complex equity structures to be conducted on a predictable tax basis. As a matter of long-standing tax principle, if the parties genuinely agree to share the profits of a venture in a particular way (whether those profits are operating income, dividends, capital gains, or interest), that agreement will be respected for tax purposes.

In private equity partnerships, the general partner's carried interest economically represents a share of the gains and losses of the fund. Unlike fixed compensation (which is properly taxed as ordinary income), the general partner receives income under a carried interest only if the fund actually has net gains over its entire term. Moreover, the character of the gains realized under a carried interest is the same as the character of the gains realized by the partnership and reflects the nature of the assets held by the partnership. Thus, if the gains realized by the partnership are ordinary, amounts received by the general partner under a carried interest will be ordinary income. In fact, most of the income from carried interest in a hedge fund is taxed at ordinary income rates, because the gains typically are short-term capital gains (i.e., from assets held for less than a year). If the gains are from long-term capital assets, amounts received by the general partner will be taxed at capital gains rates. The tax treatment of income received under a carried interest on a pass-through basis based on the amount and character of a partnership's gains and losses properly reflects the underlying premise of partnership taxation.

Enterprise Value

Any individual, partnership or corporation in the U.S. that creates a business and develops a sustainable customer list and an identifiable brand will have created goodwill or enterprise value. When that person sells the business, any gain attributable to the enterprise value of the business is taxable at capital gains rates. If the business is operated as a partnership or a corporation, gain from the sale of the partnership interest or the stock will also be taxed at capital gains rates to the extent attributable to goodwill value.

Like other ventures, investment firms grow and develop enterprise value or goodwill by investing and reinvesting profits in infrastructure and people. If a firm has significant enterprise value, it is because it has assembled an experienced workforce to manage its fund investments; built a track record of success on behalf of investors; developed a loyal client base; and, as a result, garnered an outstanding reputation in the industry, such that the firm's name is well-recognized and has value by itself.

The carried interest tax increase would also penalize the founders and owners of certain investment services businesses by causing them to be the only taxpayers in the U.S. who are required to pay tax at ordinary income rates on gain from the sale of enterprise value. There is absolutely no policy reason to treat enterprise value created by investment partnerships differently from enterprise value created by businesses in other industries. Like carried interest, enterprise value should remain taxed as capital gains income.

Current Tax Treatment of Carried Interest and Enterprise Value Should Continue

In summation, we urge the Finance Committee to maintain the current and long-standing tax treatment of carried interest and enterprise value. As noted above, at the end of 2012, carried interest income received as long-term capital gains, as well as all other long-term capital gains, experienced a 58.7% tax increase as part of the fiscal cliff compromise. We encourage Senators to avoid unfairly targeting carried interest and enterprise value for additional tax increases in the context of comprehensive tax reform. Tax rates on carried interest should remain fully aligned with the tax rates on all other similarly situated capital gains.

In order to assist the Committee and the Working Group in its review of this set of issues, we also encourage the Members and the staff to view our whiteboard video on carried interest, which is available via the following link: http://www.privateequityatwork.com/get-the-facts/industry-topics/

The PEGCC appreciates the Committee's consideration of this letter and is available to discuss any questions that the Committee may have.

Respectfully submitted,



Steve Judge
President and CEO
Private Equity Growth Capital Council