S. HRG. 110–943

CARRIED INTEREST

HEARINGS

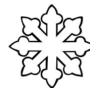
BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

JULY 11, JULY 31, AND SEPTEMBER 6, 2007



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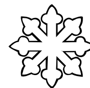

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CARRIED INTEREST, PART I

WEDNESDAY, JULY 11, 2007

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:04 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Bingaman, Kerry, Wyden, Schumer, Salazar, Grassley, Hatch, Lott, Snowe, Kyl, Bunning, Crapo, Roberts, and Ensign.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order.

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. He 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. 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 alternative 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. 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. The manager receives the interest when the fund is created, and the manager 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 receive money from that sale and 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 manager's enterprise. Alternatively, the managers bring capital to the partnership in the form of their intellectual property, goodwill business contacts, and know-how. 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. Maybe the right answer is that there is a blend of services in capital income. The right answer may vary from one investment strategy to another: venture capital, hedge funds, private equity, real estate.

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 tax status of the limited partners.

Another issue that we'll want to address today is publicly traded partnerships. Last month, Senator Grassley and I introduced a bill on this subject out of the concern that several fund managers might 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. It is 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. 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, I think, a very spirited discussion, not only today, but certainly over the next weeks and months.*

I now turn to Senator Grassley.

OPENING STATEMENT OF HON. CHUCK GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. Mr. Chairman, my statement is based a little bit upon a frustration I have with the obfuscation, the muddying of the waters, and the propaganda that is always a part of this town, so I hope you will forgive me.

I thank you very much for calling this hearing. I would like to address this hearing in two parts: the first part is what this hearing and the committee inquiry are about today; the second part is what this hearing and committee inquiry are not about.

So let us, first, discuss what the hearing and committee meeting are about. The issue that we're 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 that 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 the 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 will 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 rates on capital gains as a remedy against 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 investment concepts, we risk undermining the argument we have made for lower rates, and also making it more expensive to extend them. We cannot allow the carried interest tail to wag the capital gains dog.

The partnership tax rules came into being in the code of 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 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, really, perfect sense when all the partners invest capital in the partnership and share in the profits according to the invested capital.

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*For additional information on this subject, *see also,* "Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests," Joint Committee on Taxation staff report, July 10, 2007 (JCX–41–07), *http://www.jct.gov/publications.html?func=startdown&id=1423.*

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, I believe—and a lot of people believe—very sound tax policy. But we need to, at the same time, preserve the integrity of that policy in order to maintain that policy.

A separate issue, the publicly traded partnership issue, also involves tax code integrity. I joined Chairman Baucus as an original co-sponsor of 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 some have even said it is a tax increase on a single industry. But this issue is about closing loopholes, 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's initial concern in creating the current rule that publicly traded partnerships are taxed as corporations.

Any type of business can operate in any partnership form that they choose. However, if that business decides to go public, it will generally be taxed as a corporation and pay an entity-level tax.

Now, our bill merely clarifies that firms who 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 rates are too high, but that is a different debate. We will 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 on 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 our proposal that it may produce are not about raising taxes on capital income. It is not an attack on the investor class. It is about the definition—simple 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 because some Republicans and some Democrats have come down on this issue on opposite sides before they even know the facts.

Mr. Chairman, Steve Forbes, for instance, described our publicly traded partnership loophole-closing proposal as "putting special taxes on equity funds." He went on to say that "envy" was a 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 these gains as if they were income instead of increases in net worth."

I would direct Mr. Forbes and other critics to cool it, particularly on the hysteria that is out there, and get the facts straight. This

is a bipartisan, Finance Committee process that has not reached conclusion, hence, that is what this hearing is all about.

And while we are talking about charges of fictitious tax increases, I would like to remind folks on my side of the aisle—and not just the nine that are here, but the other 40 altogether—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 that our deliberate, transparent policy inquiry that is going on now is a tax increase exercise, I would ask them this simple 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, and maybe all 51 Democrats, I would like to have them 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, and he pointed to the fact that roughly half of the voters with incomes over $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 Investment or the Blackstone Groups 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 this committee's inquiry are 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. That is what this hearing and the next hearing that we will have are all about.

Second, this hearing is not about well-settled tax policy principles regarding capital gains or the propriety of current capital gains rates. Capital gains arise from the sale of capital assets. 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 on the one hand and labor income on the other hand 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 the permanent top rate of 15 percent. Our hearing today, and the committee's larger inquiry, is not about well-settled notions of capital gains and current tax rates.

Mr. Chairman, I would encourage all members to keep an eye on the ball. It is appropriate for this committee—in fact, the responsibility of this committee—to thoroughly examine all of these tax issues, particularly those that are new, particularly those that have maybe been on the books for 50 years, to find out whether they are working the way they ought to work.

And so it is appropriate to examine the carried interest issue 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 these sound policies, we need to preserve the integrity of our tax laws. Knee-jerk opposition to our inquiry will only serve to bolster opponents of these policies.

I also have the privilege, Mr. Chairman, of welcoming a new Republican to this committee. Mr. Ensign, thank you very much for wanting to serve. I know you will serve well. You work hard on all the committees on which you serve. Welcome.

The CHAIRMAN. Thank you very much, Senator.

I also, on behalf of the committee, welcome our newest member, John Ensign from Nevada. John, for those of you who may not know, first came to Congress in 1995. He was appointed to the House Ways and Means Committee as a freshman Congressman.

Senator Ensign is the fifth Senator from Nevada to serve on the committee. Many members will remember that his predecessor on the committee was Dick Bryan, the last Senator from Nevada to sit on the committee, and some Senators—not many—will also recall Senator Paul Laxalt from Nevada, who served on the committee in the 95th Congress. Senator Ensign will become the 344th Senator to sit on the committee. Welcome.

Now to our panel. We will start with Eric Solomon, Assistant Secretary for Tax Policy at the Treasury Department; then Peter Orszag, the Director of the Congressional Budget Office.

I might say, Mr. Orszag had a very busy week with this committee, working on trying to help get the scoring on the State Children's Health Insurance Program. He will be appearing before this committee in just a day or two—I think it is tomorrow—on the authorization of the Airport and Airway Trust Fund. And here he is today. Thank you for all your work.

Next, Mr. Andrew Donohue, the Director of the Division of Investment Management, Securities and Exchange Commission. Thank you very much, Mr. Donohue, for taking the time to help us out here. Kate Mitchell, next, the managing director of Scale Venture Partners, a venture capital firm in California. Thank you for coming. Finally, Professor Mark Gergen. Professor Gergen joins us from the University of Texas Law School. Professor Gergen teaches and writes on the taxation of partnerships and carried interest.

Thank you all very much. We'll start with you, Mr. Solomon.

STATEMENT OF HON. ERIC SOLOMON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. SOLOMON. Mr. Chairman, Ranking Member Grassley, and distinguished members of the Finance Committee, thank you for the opportunity to testify regarding the Federal income tax treatment of carried interests.

Carried interests have received increased public attention recently. However, carried interests are not a new phenomenon. They have been used successfully for many decades by small and large partnerships, across many industries, to pool the capital of investors with the ideas and skills of other entrepreneurs in joint profit-making enterprises.

The U.S. economy is, by any measure, among the strongest and most resilient in the world, and partnerships play an important role in that success. While there are many ways for U.S. business activities to be organized for tax purposes, a partnership in many instances allows the parties the greatest flexibility to match the form of business with their economic deal and joint undertaking. The partners decide what each will contribute in capital, ideas, and skills, and how they will share in profits and losses.

The tax rules applicable to partnerships permit taxpayers to conduct joint business or investment activities through a flexible economic arrangement without incurring an entity-level tax. Partnership income is not taxed at the partnership level, but flows through to the partners and is taxed to them based on its underlying character as either ordinary income or capital gain. In contrast to this pass-through treatment for partnerships, income earned by a corporation is subject to two layers of Federal income tax, once at the corporate level and again at the shareholder level as dividends are paid.

Accordingly, partnerships for both business and tax reasons are an attractive business model that encourages entrepreneurs to combine capital, ideas, and skills and build businesses, both small and large, across all industries. In 2006, over 2.8 million businesses filed a partnership tax return.

A carried interest, the topic for today, is another way to describe a profits interests in a partnership. Profits interests are used by partnerships of all sizes in a wide variety of businesses.

Upon receipt of a profits interest, the recipient becomes a partner in the partnership and pays tax in the same manner as other partners on his distributive share of the partnership's taxable income. The character of the income included in the partner's distributive share is the same as the character of the income recognized by the partnership. If the partnership earns ordinary income, then each partner's distributive share includes a portion of that income. If the partnership recognizes capital gain, then each partner's distributive share includes a portion of that capital gain. For example, if the partnership sells stock of a corporation that it has held for more than a year, the partner's share of the long-term capital gain will be taxed at the 15-percent Federal long-term capital gain rate. It is important to emphasize that a partner receives a benefit from owning a profits interest only if the partnership is successful.

The following example illustrates the application of these tax rules. An entrepreneur and an investor form a partnership to acquire a corner lot and build a clothing store. The investor has the money to back the venture and contributes $1 million. The entrepreneur has the idea for the store, knowledge of the retail business, and managerial experience. In exchange for a 20-percent profits interest, the entrepreneur contributes his skills and know-how. The entrepreneur and investor are fortunate. They are fortunate in that, by their combination of capital and efforts, the clothing store is successful. At the end of 5 years, the partnership sells the business for $1.6 million, reflecting an increase in the going concern value and goodwill of the business.

Under the tax rules, the entrepreneur has $120,000 of long-term capital gain, 20 percent of the profits. The investor has $480,000 of long-term capital gain, reflecting their business arrangement.

Under current IRS guidance, the entrepreneur does not have compensation income at the time of receipt of the 20-percent profits interest. He is treated as a partner from the date he receives the interest and is subject to tax at capital gains rates on his portion of the gain from the sale of the business. To the extent the partnership generates ordinary income from operations prior to the sale of the business, the entrepreneur is subject to tax at ordinary income tax rates on his distributive share of the operating ordinary income.

The central theme is that an entrepreneur who contributes skill and knowledge to the success of the enterprise and receives a profits interest will succeed only if the enterprise succeeds. The entrepreneur has acquired a profits interest in the enterprise, betting that his upside will provide an ample economic reward. The incentives provided by this structure align the goals of the investors and the entrepreneur.

The current tax treatment of profits interests provides certainty for taxpayers in planning their transactions and, at the same time, is administrable for the IRS. The current tax treatment also encourages the pooling of capital, ideas, and skills in a manner that promotes entrepreneurship and risk-taking.

The CHAIRMAN. Mr. Solomon, I neglected to remind everybody to keep their remarks to 5 minutes.

Mr. SOLOMON. Yes. I am on the last paragraph.

The CHAIRMAN. All right. Fine. Thank you very much. [Laughter.] Based on deep experience before this committee, thank you very much. [Laughter.]

Mr. SOLOMON. Yes.

Partnerships of every size and in every industry have established and operated their businesses in reliance on the existing tax rules. While it is important to review our tax laws and policies, we must be cautious about making significant changes to partnership tax rules that have worked successfully to promote and support entrepreneurship for many decades.

Thank you for the opportunity to testify before the committee today. I would be pleased to answer your questions.

The CHAIRMAN. Thank you, Mr. Solomon, very much.

[The prepared statement of Mr. Solomon appears in the appendix.]

The CHAIRMAN. And obviously all your statements will be totally included in the record.

Mr. Orszag?

STATEMENT OF PETER ORSZAG, DIRECTOR, CONGRESSIONAL BUDGET OFFICE, WASHINGTON, DC

Mr. ORSZAG. Chairman Baucus, Senator Grassley, members of the committee, thank you for inviting me to testify this morning on the taxation of carried interest.

A growing amount of financial intermediation is occurring through private equity and hedge funds, which are typically organized as partnerships or limited liability companies and now have

$2 trillion or more under management. In 2006, private equity funds raised $240 billion in capital, roughly 10 times the annual capital they raised in the early 1990s.

These organizational forums are growing rapidly for many reasons, including their tax advantages relative to traditional financial services corporations. In particular, as has already been noted, such partnerships do not pay a separate corporate income tax. Instead, they pass all income and losses through to the partners. The manner in which that income is then taxed to the partners is the central focus of my testimony.

The partnerships have two types of partners: first, limited partners who contributed capital, and, second, general partners who manage the partnership, determine investment strategy, and sometimes make modest capital contributions of their own.

The general partners receive two types of compensation: a management fee tied to some percentage of assets under management, and a carried interest tied to some percentage of profits generated by those assets.

So, for example, if a fund had a billion dollars in assets under management and the typical 2-percent management fee, those fees would amount to $20 million a year and that amount would not depend on the return on the $1 billion in assets.

The $20 million management fee is taxed as ordinary income to the general partner, since it reflects compensation for services provided. If the fund also generated $150 million in realized profits, the general partner enjoying a 20-percent carried interest would receive another $30 million, that is, 20 percent of the $150 million in profit.

In practice, at least within private equity funds, this carried interest often applies only after a hurdle rate is achieved, and then applies to the excess profits above that. The presence of such a hurdle rate would change the numbers, but not the underlying issues involved.

Taxation on the carried interest is deferred until the profits are realized on the fund's underlying assets and are then taxed to the general partner at the capital gains tax rate to the extent that the underlying realized profits reflect capital gains. So, at a capital gains tax rate of 15 percent, the $30 million in carried interest I mentioned would generate a tax liability of $4.5 million.

Now, here is the issue. From an economic perspective, a general partner in a private equity or hedge fund undertakes a fundamentally different role than that of the limited partners, because the general partner is responsible for managing the fund's assets on a day-to-day basis. The carried interest, furthermore, is disproportionate to the general partner's own financial assets invested in the fund, if any.

Most economists, therefore, view at least part—and perhaps all—of the carried interest as performance-based compensation for management services provided by the general partner rather than a return on financial capital invested by that partner. That perspective would suggest taxation of at least some component of the carried interest as ordinary income rather than capital gains.

Almost all other performance-based compensation is effectively taxed as labor income and treated as such in the tax code. Contin-

gent fees, for example, on movie revenue for actors are taxed as ordinary income, as are performance bonuses, most stock options, and restricted stock grants. So, too, are incentive fees paid to managers of other people's investment assets where those fees are documented as such rather than reflecting a carried interest in a formal partnership.

Although there does not appear to be any solid analytical basis for viewing carried interest solely as a return on financial capital for the general partner, there is an analytical debate about whether it should be viewed purely as compensation for management services or as a mixture of compensation for management services and capital returns.

My written testimony discusses one of the analytical perspectives for carried interest that would view it as partly compensation for a return on capital and partly compensation for labor services provided.

Given the widespread analytical view that at least part of carried interest represents compensation for services provided, a variety of proposals have been put forward to alter its tax treatment, and my written testimony discusses the relative advantages and disadvantages of those various different proposals.

Finally, it is worth emphasizing that much of the complexity associated with the taxation of carried interest arises because of the differential between the ordinary income tax rate and the capital gains tax rate. The characterization of the income would not matter to a first approximation if those two rates were the same.

From this perspective, further widening of the differential between those two forms of income would create even stronger incentives to shift income into the tax-preferred capital form and would exacerbate concerns such as the ones surrounding the taxation of carried interest.

I would just finally note that, as Mr. Grassley pointed out, given that differential, it is particularly important to classify income properly between ordinary income and capital income. Again, I think I have provided the analytical view for it being not entirely capital income.

Thank you.

The CHAIRMAN. Thank you, Mr. Orszag, very much.

[The prepared statement of Mr. Orszag appears in the appendix.]

The CHAIRMAN. Mr. Donohue?

STATEMENT OF ANDREW DONOHUE, DIRECTOR, DIVISION OF INVESTMENT MANAGEMENT, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, DC

Mr. DONOHUE. Chairman Baucus, Senator Grassley, and members of the committee, I am pleased to be here today to discuss the Securities and Exchange Commission's perspective with respect to the initial public offerings of investment advisory firms that, among other things, manage hedge and private equity funds.

As the head of the Commission's Division of Investment Management, I have responsibilities for overseeing and regulating nearly 1,000 investment company complexes with over $11 trillion in assets, and more than 10,000 investment advisors that manage more than $37 trillion in assets.

A number of issues have been raised about the recent IPOs of Fortress Investment Group and Blackstone Group. I am pleased to be able to offer the committee my knowledge and expertise, especially as it relates to questions of whether Fortress and Blackstone are investment companies and, thus, subject to the substantive provisions of the Investment Company Act of 1940.

Congress enacted the Investment Company Act to provide a separate and different regulatory structure for investment companies as compared to industrial or operating companies.

Among Congress's stated goals was to minimize the risk that an investment company might be managing in the interest of its managers or certain shareholders rather than to the benefit of all shareholders. The Investment Company Act provides important protections to the investment company investors.

I have great respect for the Investment Company Act and the role it has had in affording America's investors an opportunity to invest in our Nation's securities markets through a vehicle subject to meaningful oversight and protection. As a result, I believe the investment company status to be a critical determination.

The staff reviewed the Fortress and Blackstone registration statements in the normal course and consistent with past practices and Commission precedent. Applying tests established by Congress in the Investment Company Act, the staff concluded that Fortress and Blackstone do not appear to be investment companies.

First, under the orthodox investment company test, Fortress and Blackstone are primarily engaged, and hold themselves out as being primarily engaged, in the business of managing money for others, not themselves. Their assets, sources of income, officer/employee activities, historical development, and public statements are consistent with those of an operating company, not an investment company.

Second, in applying the inadvertent investment company test, Fortress and Blackstone do not appear to have 40 percent of their assets in investment securities. In addition to other assets, the primary assets of Fortress and Blackstone are their general partnership interests in the underlying funds they manage.

These general partnership interests raised two questions relevant to the investment company status determinations: first, are they securities or investment securities? Second, what is their value?

Under existing law, general partnership interests are not securities if the profits relating to those interests generally come from the efforts of general partners as opposed to the efforts of others.

In the case of Fortress and Blackstone, the issuers maintain control over the day-to-day management of the underlying funds, with senior employees exercising such management through wholly-owned subsidiaries.

The profits to the general partnership interests result from the efforts of the general partner managers, not others, thus, the general partnership interests would not constitute securities or investment securities.

With respect to valuation, the Investment Company Act requires an issuer to assign a fair value to general partnership interests like those at issue in the Fortress and Blackstone filings.

In determining fair value, the right to carried interest in underlying funds may be considered because such rights are inexorably linked to the general partnership interests. Applying these principles, neither Fortress nor Blackstone appear to hold investment securities with a value exceeding 40 percent of their total assets.

Put another way, in the context of both Fortress and Blackstone, the value of assets that are not investment securities, such as the general partnership interests, including the right to receive carried interest, is more than 60 percent of their total assets. This asset composition is indicative of an operating company business rather than an investment company business.

While conducting an investment company status analysis, the staff considers the status of a relevant entity prior to the offering, as well as after giving effect to the offering, and they also monitor the investment company status of certain companies on an ongoing basis.

In some cases, the staff may disagree with a company's investment company status analysis and request that it either register as an investment company or restructure its business or securities holdings so as to no longer be an investment company. The Commission will bring an enforcement action against a company in appropriate circumstances.

While the staff did not object to the investment company status conclusions in the Fortress and Blackstone registration statements, as noted in the required legends on all public offerings the Commission does not approve or disapprove of the securities offering, nor does it pass upon the adequacy or accuracy of the disclosures. Fortress and Blackstone remain liable for the statements contained in their registration.

Finally, it is important to consider that the public investors in Fortress and Blackstone are buying an interest in an ongoing business that, among other things, manages some underlying funds.

While the value of their investments in Fortress and Blackstone may be related to how well Fortress and Blackstone do at managing those underlying funds, as well as how well Fortress and Blackstone are operating their businesses, investors are not acquiring a share in the underlying fund.

Thank you for the opportunity to appear before the committee, and I would be happy to answer any questions you may have.

The CHAIRMAN. Thank you, Mr. Donohue, very much.

[The prepared statement of Mr. Donohue appears in the appendix.]

The CHAIRMAN. Ms. Mitchell?

STATEMENT OF KATE D. MITCHELL, MANAGING DIRECTOR, SCALE VENTURE PARTNERS, FOSTER CITY, CA

Ms. MITCHELL. Chairman Baucus, Ranking Member Grassley, members of the committee, thank you for having me here today. It is my privilege to share the role that venture capital plays in building new companies and to discuss the economics of carried interest within a venture capital partnership.

For 40 years, the venture community has been a catalyst for innovation. We use risk capital to build companies and create jobs.

To date, Congress has demonstrated a strong understanding of the importance of U.S. entrepreneurship.

We are asking you to continue to support this sector of the economy and recognize carried interest from these long-term venture capital investments as it has been viewed historically: as a capital gain.

Venture capitalists look for innovative ideas with the potential for growth. In 2006, venture-backed companies represented 17.6 percent of U.S. GDP and 10.3 million jobs. Our sector has created 9.1 percent of all U.S. private sector employment, yet only invested 0.2 percent of GDP. We are small, but we have a large impact on the U.S. economy.

We are pioneers of the biotechnology, semiconductor, and Internet industries, and are now focusing on alternative energies. Venture capital is also a national phenomenon, backing small businesses in all 50 States. My firm has recently invested in Utah, Arizona, Georgia, Florida, as well as along the entire West Coast from Seattle to San Diego.

Venture capital is about creating new companies. We do not rely on leverage or financial engineering, nor do we buy and sell publicly traded securities or companies. Venture capital helped launched Google, Microsoft, Genentech, Starbucks, and eBay. While these companies are household names today, they were launched as ideas put forth by entrepreneurs who had not grown a small business before.

As venture investors, our job is to identify and nurture these promising companies. We sometimes found them ourselves. VCs are active, providing weekly—sometimes daily—guidance to management on everything from prototypes to key hires, from corporate governance to intellectual property rights.

Venture capitalists make intangible contributions to our companies by leveraging our business experience and our personal networks to introduce those companies to key customers and business partners.

The reputation and goodwill that comes with this association is the key that opens doors which would otherwise remain closed to a start-up. This is why entrepreneurs actively seek out venture investors as partners.

We invest in companies for 5 to 10 years—often longer, rarely less—with the goal of going public or being acquired, generating a long-term capital gain.

But many VC-backed companies fail. On average, 40 percent of all venture investments lose money. Another 40 percent generate a modest profit, and only 20 percent achieve meaningful gains. We dig many dry wells, the cost of which is balanced by gains earned from our best investments. This balance is critical to support our entire portfolio of hopeful start-ups.

A venture capital firm receives two types of income: a 2-percent annual management fee and a 20-percent share of the VC's funds' cumulative net profits, what we are referring to here as the carried interest.

The management fee is guaranteed; the carried interest is entirely contingent upon a profitable fund. The 2-percent management fee is taxed as ordinary income and pays for our business op-

erations, office space, salaries, including all administrative personnel.

As partners, the GP and their limited partners come together to agree to the 20 percent carried interest and how it will be paid. Our fund must earn profit on our entire portfolio to return all invested capital, plus all management fees, before we receive any profit share.

Because the net profits of a fund are only knowable near the end of a fund's 10-year term, distributions of carried interest to the GP often only begin in the 7th year of a fund, if at all.

Consistent with current partnership tax laws, the VC fund structure encourages the pooling of labor and capital by allowing partners to divide the profits from the fund in whatever manner they determine best rewards the long-term entrepreneurial risk taken by each partner.

We believe it is appropriate to reward investors of sweat equity with the same long-term capital gain tax benefits that investors of financial equity receive. Sweat equity is the result of VC's contribution of time, skills and counsel, as well as the intangible contributions such as customer contacts, business know-how, and reputation. It is as valuable to the success of the business as contributions of financial capital. Both should be subject to the same tax treatment.

Carried interest is like the stock received by the founder of a start-up company, because we both receive equity interest in our businesses that are disproportionate to the financial capital invested in those businesses.

Each of us invests time, energy, know-how, and money in the hopes of building value. As a result, we all should, and currently do, receive capital gain tax treatment when the value is realized.

In the last several years we have begun to see the U.S. venture model exported to developing countries who have witnessed how venture capital has benefitted the U.S. economy. They are becoming aggressive in attracting those talents to their shores. The game is ours to lose.

We believe Congress has understood the value of venture capital by enacting and maintaining tax policies that promote our activities. We hope you will continue supporting this legacy of innovation. Thank you very much.

The CHAIRMAN. Thank you, Ms. Mitchell.

[The prepared statement of Ms. Mitchell appears in the appendix.]

The CHAIRMAN. Mr. Gergen?

STATEMENT OF MARK P. GERGEN, FOUNDREN FOUNDATION CENTENNIAL CHAIR FOR FACULTY EXCELLENCE, THE UNIVERSITY OF TEXAS SCHOOL OF LAW, AUSTIN, TX

Mr. GERGEN. Chairman Baucus, Senator Grassley, members of the committee, thank you for giving me a few minutes of your time.

I have written and taught on this subject for over 20 years. As Senator Grassley says, this is not a new issue. It is not targeted at a particular industry or group of people.

Just to clarify, right now a carried interest holder gets two tax benefits: they get deferral and they get conversion. On conversion,

they do not just get ordinary income into capital gains, which is more than halving the tax rate. They also avoid the Medicare tax, which is 2.9 percent. If they die with unrealized income, it is not taxed as income in respect to the decedent, so they avoid tax under the income tax entirely. They get additional benefits that are available because generally returns from capital are very easy to shield from tax. The capital gains rate is only one of the smallest preferences we have for returns from capital.

The inequity in this is evident. I'm not going to speak to the policy issues; I will leave that to the accountants. There is a very simple solution within current law and within the texture of subchapter K. That is to amend section 702(b) to provide that whatever the character of partnership income may be at the partnership level, a distributive share is ordinary income when it is compensation for services.

We can identify when it is compensation for services because it is such when it exceeds a partner's pro rata share of partnership capital. In my testimony I provide some additional technical changes that would have to be made to implement that.

Now, there are two aspects of this that I want to talk about in my remaining minutes. One is, it does not impose tax on receipt of the carried interest. That is, we are not taxing a profits interest when you get it, we are actually taxing it when you earn the profits.

I think that is the better solution because, first, usually the right to these profits is subject to forfeiture under section 83 and, therefore, whether you pay tax on receipt is elective. You have to make the election to be taxed.

Second, it is very, very hard to value these interests. Information is asymmetric. The taxpayer knows more than the government, and the government has limited enforcement resources. This is an invitation for strategic behavior if we try to tax on interest on receipt. But if we are not going to tax on interest on receipt, then what we ought to do is treat profits as compensation when they actually earn them.

The second point I wanted to talk about before I conclude is how we handle the problem of founder's capital, and I really think it is a non-problem. To the extent the founders contribute capital to a venture, returns on that capital will not be taxed as ordinary income, they will be taxed as capital gain.

Let me give you a simple example. A and B start a company. They each invest $1,000. At the end of 2 years, they have an asset that is worth $2 million. Now, if that is land they invested in, that is going to be capital gain to them. If that is a book that they created, that is going to be ordinary income to them because that is a self-created asset, as Senator Grassley was talking about.

At that point, C comes along and says, I will invest $8 million because I would like to make this even more valuable. From that point on, if A and B get a 10-percent return that is not going to be characterized as compensation, that is going to be a return on their capital in the partnership and will be taxed accordingly.

If they get more than a 10-percent return, I would submit that is because they are rendering services to the partnership and that should be taxed as compensation. This is unlike somebody who

starts their own business and builds it up because A and B are making money by mixing their labor with somebody else's capital. That is why it merits a different solution and why a different solution is available to us.

Now, as I conclude, let me just say that this allows us to fix a technical problem with tax law right now. That is the discrepancy between subchapter K's capital account system and section 83. I talk about that in my testimony. It is a technical problem it would be good to fix.

The second thing is, it deals with another potentially troublesome transaction, so let me conclude with a case I heard about in the 1980s, which tells us there is nothing new under the sun. What I heard about was a film deal, where you had an actor who was going to take a profits interest in the partnership. The partnership then went out and bought an asset—I cannot remember whether it was a house or jet—that they used in the making of the film.

When it was done, they booked up his profits interest before the royalties were earned so he did not have any ordinary income, and then they distributed out the house or jet, whatever it was, in liquidation of his partnership interest. He got that tax-free because that was a property distribution from a partnership. That ought to be taxable as ordinary income. In any context other than subchapter K, it would be taxable as ordinary income. I have been saying for 20 years we ought to fix this. Please do it.

The CHAIRMAN. Thank you, Professor.

[The prepared statement of Mr. Gergen appears in the appendix.]

The CHAIRMAN. I would like to begin with Mr. Orszag, and say I would like Mr. Gergen, Ms. Mitchell and others to respond. The basic question is, why is this an important issue? That is, what the proper tax treatment is of services provided on the one hand and capital contribution and partnership on the other?

That is, should the services provided, basically 702(b), be profits that get a capital gains treatment even though the managing partner has not contributed very much in terms of capital assets but is providing the intellectual capital, if you will?

So the question is, why is this issue important? Why should the Congress be involved in all of this? It has become a big issue. It is a big question. General partners are making a lot of money and they are not paying ordinary income on interest that they are receiving. Why is this important? Why are we getting into all of this right now? I will start with you, Mr. Orszag.

Mr. ORSZAG. Well, I think you have touched upon some of the factors. Clearly the reason—or one of the reasons—it appears to be receiving attention now is the growth that I mentioned in the amount of income and money that is flowing through these particular partnerships. But I think that really gets to the real issue of why it is important.

That is, any time that you have similar activities taxed in different ways, you create distortions. You create incentives for activity to flow into the lower taxed activity.

So an executive at a financial services firm or a manager of a public mutual fund is taxed in a different way for those services than a general partner in a private equity or hedge fund, and that should be of concern to tax policy makers because of the distortions

that it can create. And also potentially because of fairness issues across different kinds of managers.

Another reason, obviously, is that all of this activity does have some revenue effect. I should emphasize quickly that the Joint Committee on Taxation is responsible for evaluating the revenue effects of different proposals, but there clearly is the potential for a revenue effect from tax treatment changes of carried interest.

The CHAIRMAN. Professor Gergen, why is this important?

Mr. GERGEN. Two reasons. One is, it is an opportunity for fundamental tax reform. It is not often that Congress goes back and looks at subchapter K. Subchapter K has some flaws in it. This is one. It is a chance to fix it. It has been around for years.

But the second is, fundamental in our tax system is the effort to try to impose tax on returns to labor at ordinary rates, and we do a pretty good job at that. Not a great job at that, but a pretty good job of that. And any time we open a hole in that bucket, it is very troubling for efficiency reasons because of distortion, but also because of equity reasons.

This is a hole in the bucket. We are taking some returns to labor and taxing them at the capital gains rate and giving service providers preferences we give to returns on invested wealth.

The CHAIRMAN. Just to make things clear, no one is suggesting that anyone is violating the law, just that current law enables this result.

Mr. GERGEN. Right. Treasury could not fix this problem under current law. It goes further than that.

The CHAIRMAN. Correct.

Mr. GERGEN. They could not do this by regulation.

The CHAIRMAN. All right.

Ms. Mitchell?

Ms. MITCHELL. All right. What we think is that the application of the law is fulfilling its original intent, meaning new jobs, growth, exports are occurring because of the development of these new companies. To shift the structure of the law, at least from the venture perspective, means it will be much more difficult and there will be much less incentive to spend the time and the money.

Our current fund that was funded in 2004 is an example. We took savings from my job many years before joining Scale Venture, invested those savings in the business, spending a lot of time. From that fund which we initially put money and time in, in 2004, I will expect to get returns, from a carried interest standpoint, in 2011 or later. To reduce that incentive, to work with entrepreneurs and to invest capital——

The CHAIRMAN. I am sorry. My time is about expired, and I appreciate that point.

Another basic question is, how much less creative energy are entrepreneurs going to dedicate, whether it is VC, whether it is hedge funds, whether it is private equity, or whatnot, if the income they get can be treated as for the services—not for the capital contribution, but for the services—and is compensated generally at ordinary income rates as opposed to capital gains rates? How much less effort and creativity are entrepreneurs going to devote?

Ms. MITCHELL. Well, Chairman Baucus, my perspective on that would be, we would be more interested in staying in safer jobs

where you get better current income rather than speculating for the future. That would be a logical conclusion because that would be a safer alternative and a safer way to spend time, to stay with the existing company and not build a new one.

The CHAIRMAN. I would like Mr. Orszag and Mr. Gergen, very briefly, maybe 15, 30 seconds, to respond.

Mr. ORSZAG. There are a whole variety of other settings in which performance-based compensation is taxed as ordinary income, such as non-qualified stock options, fees for movie actors, et cetera, et cetera, et cetera, and that seems to elicit significant effort and labor supply.

I think it is also important to realize that the discussion is not about the tax treatment of the limited partners who are contributing the capital to the funds here. I think that is a very important point to keep in mind.

The CHAIRMAN. All right. My time is expired. We will get back to you, Professor. Thank you.

Senator Grassley?

Senator GRASSLEY. Thank you, Mr. Chairman.

Mr. Solomon, based on Secretary Paulson's recent public comments, has Treasury reached a conclusion that we should not change the status quo with respect to the taxation of carried interest and publicly traded partnerships?

What effort went into that analysis or what efforts are planned, and what types of potential unintended consequences, tax policy, and tax administration concerns should we take into account as we examine these issues?

Mr. SOLOMON. Thank you, Senator Grassley. There are two issues here. One issue is carried interest. The second issue is with respect to the treatment of publicly traded partnerships. Those are two separate, but related, issues.

First, let me address carried interest. The main theme, as I discussed in my testimony, is that we should be cautious about making significant, potentially unsettling changes to the tax law in an area where it has worked well to promote and support entrepreneurship and risk-taking for many decades.

So with respect to carried interest, it is important to note that carried interest has been successful for partnerships of all sizes, small and large, and for partnerships in many industries, such as real estate, for many years.

With respect to the second matter that you raised, which is publicly traded partnerships, it is a separate issue, but related. It raises very difficult issues about the interaction between our corporate system of taxation, which is a two-tier level of taxation, and our partnership system of taxation, in which there is only a single level of tax.

Senator GRASSLEY. You answered the last questions. What about Secretary Paulson and his recent comments? Has he reached a conclusion as to whether or not we should change the law yet?

Mr. SOLOMON. With respect to the carried interest?

Senator GRASSLEY. Yes.

Mr. SOLOMON. With respect to carried interest, we have concerns and cautions about making significant and potentially unsettling changes to the treatment of carried interest.

Senator GRASSLEY. Ms. Mitchell, how would you describe what you do in exchange for the carried interest, and why should all of the associated income be treated as return on investment rather than compensation?

Ms. MITCHELL. What we do, Senator, is we help a company—we will take a technologist, as an example, who knows a lot about how to build a chip, but has never hired a salesperson, a marketing person, never put together an HR plan, and we will advise him on how to take that technology idea—in the case of life sciences it might be something funded by the NIH—and be a catalyst to help pull that technology through the process to ultimately get it commercialized. We sometimes even step in when there is not capital to pay for professionals and actually help them on a day-to-day basis with aspects of that.

For that, our goal is to make money at the end. Not only is that speculative, whether or not we do—and it happens over a long period of time—I could actually even lose money. I could have early gains in my fund and have that followed by later losses, and pay taxes on that. So, it is not simply an up side for me, there is actually a down side on the carried interest alone.

Our objective is to try to get these engineers out of CISCO, these safe jobs, and move them into the garage to create the next CISCO. That is what we are trying to do.

Senator GRASSLEY. All right.

Now, if a partnership earns ordinary income—anything you want to say, but I will just say making and selling pies instead of capital gains from selling stock in companies—should the profits attributable to the carried interest still be considered a return on investment?

Ms. MITCHELL. Yes, if that happens within the course of the year per the partnership tax laws. If I have a company that I sell within a year, and the fund was profitable within a year, I would pay ordinary income. So, we intend to comply with the tax laws.

But anything that speculates to build a new business, which is what our venture is about and what our limited partners expect of us, should be considered capital gains. It is long-term. We have to earn it on a whole pool of investments, not just company by company.

Senator GRASSLEY. Do others have views on this issue I discussed with Ms. Mitchell that you would like to throw in?

[No response.]

Senator GRASSLEY. I guess you do not. I think, Mr. Chairman, I will let you go on to the next.

The CHAIRMAN. Thank you.

Senator Kerry, you are next. And just for information, Senators, the early bird list is: Senator Kerry, Senator Crapo, Senator Wyden, Senator Bunning, Senator Salazar, Senator Bingaman, Senator Kyl, and Senator Ensign.

Senator KERRY. Thank you. Thank you, Mr. Chairman and Ranking Member, for holding this hearing, which is an important one.

I think we have to be really careful how we are going to change what I think has some downstream impact, and I am trying to fig-

ure out whether it is quite as simple and clear as Professor Gergen is suggesting.

Massachusetts, particularly, I think is number two in the Nation for cumulative venture capital investment from 1971 to 2006, and we have created almost three-quarters of a million jobs. You can find a lot of parallels between REITs, real estate investments, certain kinds of structures that people invest and put their sweat equity into and wind up with capital gains at the end of that. I think we have to be thoughtful about where this separation is.

In a sense, all capital gain is performance-based, is it not, Professor Gergen?

Mr. GERGEN. No. Some is labor, some is capital. In fact, what we will end up doing, if you were to move to a system such as I propose, is venture capitalists could turn their carried interest into non-recourse loans from the people who are providing the capital.

Then they would have ordinary income equal to the very low rate of interest imputed on a non-recourse loan, which ends up being a fraction, probably, of the value of their compensation. Or, and this would have been my answer to your question, they can actually value their capital they are contributing because they really are contributing know-how.

Once you do that, you end up segmenting and probably low-balling, under-estimating the returns to compensation, but you are at least characterizing some of it as a return on labor.

Senator KERRY. But what happens if you are a major real estate developer and you say, all right, I am going to take a portion of this in ownership and people invest their capital, and you go out and you make the decision as to where to build, what to build with, hire those to do the work; at the end you would be paid, conceivably, a fee for what you have done. But if you have an equity interest, you are also going to get the capital gain, are you not, and that is going to be treated as such?

Mr. GERGEN. I would treat it as ordinary income unless——

Senator KERRY. But it is not currently treated as ordinary income.

Mr. GERGEN. Right. Right. I think that is wrong, because you have people who are real estate developers who are turning the returns from their——

Senator KERRY. What happens if it fails, on the down side? I mean, they are taking a risk in creating an asset which is appreciating according to its success. Is there not a parallel if you are, for instance, a fund manager of one kind or another and you sit on the board, as most of them do, or many of them do, and you make board decisions and you have a contingency equity position, is it possible that the contingency equity position which depends on the outcome and success of the venture, that that would be treated as the creation of an asset, which is, in effect, a capital gain, is it not?

Mr. GERGEN. If it is a return to labor, it ought to be taxed as compensation.

Senator KERRY. But there is always a mix of labor. That is the difficulty here.

Mr. GERGEN. You talk about the possibility of a loss. People are in a tax advantaged position with a loss because they are investing pre-tax income, meaning that if it grows in value they are not

going to be taxed until the profits are realized. If they go down in value, they do not have a capital loss.

Senator KERRY. When Bill Gates starts Microsoft and he puts Microsoft together, his basis in that stock would be treated as ordinary income, but I do not know what the basis would have been at the beginning. But once it appreciates and he sells the stock, that is going to be treated as capital gain as a result of his intellectual capacity, his intellectual input, his decision making, and so forth. It is treated as capital gain.

It seems to me you would fundamentally flip the capital market on its ear if you sort of blur the lines—or maybe it is clarify the lines, maybe that is what we have to do—between what is legitimate performance-based and what is legitimate asset appreciation and payoff for that risk taking, so to speak.

Mr. GERGEN. If you do it through a corporation, you are right. Bill Gates did it through a corporation. But then we pose a separate tax at the corporate level.

Senator KERRY. So that would be your distinction.

Mr. GERGEN. With the particular example of Microsoft, that is the distinction.

Senator KERRY. Well, then is the real question here——

Mr. GERGEN. The partnership, if you come to my example, once they have created this idea, if somebody else is going to come in and invest additional capital, they now have a capital interest. They have now invested capital. Only that slice that they created, like a painting, is going to be treated as ordinary income. The rest is capital gains.

Senator KERRY. Well, my time is up. But maybe there is some clarification that is necessary. Maybe the larger question is not whether you want to alter this fundamental notion of what is the legitimate appreciation in the asset that you have created—and the legitimate question may be whether or not those folks are paying a sufficient level of taxation. That may be the more fundamental question.

The CHAIRMAN. Thank you.

Senator Crapo?

Senator CRAPO. Thank you very much, Mr. Chairman. I appreciate your holding this hearing because I do believe we need to get to the details of what kind of impact this type of proposal would have if we were to make these changes in our tax law.

I, for one, have very strong concerns about the alternatives that are proposed to our current system of taxing partnerships, not only because they would raise the complexity, but also because they would run the risk of stifling innovation and risk taking, and in many cases, both. I appreciate the fact that the chairman intends to hold another hearing, as I understand it, on this issue.

I am also very pleased by the fact that Secretary of Treasury Paulson will hold a one-day conference on Thursday, July 26 in Washington, DC to examine ways in which our current business tax system affects economic growth and U.S. global competitiveness.

The concern I have is that, at a time when many of us are trying to raise concern about the competitiveness of the United States and global capital markets, the last thing I think we want to do is to

create a disincentive in our own tax law that would encourage business away from the United States and to other capital markets. That is really the concern that I have and what I would like to use my few minutes on in terms of asking questions.

But in terms of this notion that labor should be taxed as ordinary income, and I guess asset contributions should be taxed as capital, maybe, Mr. Solomon, I think any of you could answer this, but let us just take a typical partnership situation where three individuals decide they want to refurbish a building and then try to sell it at a profit, and two of them will put up the money and one of them will put up the labor, the electrical work, the contracting, the plumbing, and everything else. If that were to be done and then they sold the building at a profit, how would those profits be taxed to each individual?

Mr. SOLOMON. The partnership is a flow-through entity, so when the partnership sells the property, the character, which in this case presumably would be capital gains, would flow through to all the partners according to their partnership agreement.

Senator CRAPO. So the partner who contributed, effectively, his labor would have his income treated as capital gains?

Mr. SOLOMON. Under current tax rules, that is the case and has been the case for small and large partnerships for a long time.

Senator CRAPO. Now, you indicated in your testimony that there were sort of three alternatives as to how we could approach this in terms of tax and carried interest. I kind of took from your testimony, and I want to ask you directly, do you believe that each of the three alternatives you described are inferior to the current model and the current way that we do tax partnership income?

Mr. SOLOMON. Certainly the three proposals that we described in our testimony raise significant issues. For example, one of them would tax the receipt of the profits interest at the very beginning, which would result in double taxation in a partnership situation, which is clearly not the intent of the partnership rules.

Senator CRAPO. Thank you.

With the time I have remaining, I want to move to you, Ms. Mitchell. And I do not know whether you will be able to answer this question. I just want to see if I can flesh this out a little bit.

Let us assume that the United States were to change its partnership tax law along the lines of the idea that has been put out here with regard to carried interest. Could a company like yours, a private equity or hedge fund simply move its operations to London and obtain a more favorable tax climate and still conduct their business?

Ms. MITCHELL. I do not know about the hedge fund or the private equity side of things, but on the venture side there are certainly funds being formed in Asia in particular, because there is a lot of activity happening there, and the governments are very interested in sponsoring that.

These foreign governments will help with lots of other infrastructure around those companies. So, there are funds being formed and the flows of capital are international at this point into these kinds of funds. Everybody wants to take advantage of the growth, and so those funds are being formed overseas today.

Senator CRAPO. Would anybody else like to jump in on this issue? Mr. Orszag, I saw you expressing some interest.

Mr. ORSZAG. I think it is important to distinguish the location of the partnership from the location, ultimately, of the partner, the general partner. The key issue here is, the general partner will often be a partnership itself, but ultimately income, and the tax due on that income, goes back to an individual.

Unless the individual is going to give up U.S. citizenship or make other extreme changes, which is difficult to do under U.S. law, it is very difficult to avoid that tax. This is different than a corporate setting, basically.

Senator CRAPO. So are you saying that they would have to give up U.S. citizenship or would they just have to move to London?

Mr. ORSZAG. No. My understanding—and I will defer to the tax professionals—is that not only would they have to give up U.S. citizenship, but that it is difficult to avoid the tax. Even in that case there are protections against that happening.

Senator CRAPO. Mr. Solomon, is that correct? Would a U.S. citizen not be able to just conduct business in London and avoid the U.S. tax structure?

Mr. SOLOMON. I would think that there would be flexibility in order to try to rearrange one's business affairs.

Senator CRAPO. Ms. Mitchell? Oh, I am sorry. My time is up.

The CHAIRMAN. Thank you very much.

Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman. Mr. Chairman and colleagues, the tax system in this country is broken. It is an incoherent mumbo-jumbo made up of millions of words, with three changes being made to the tax code for every working day for several decades. Today's hearing on carried interest is a textbook case for why it is time to drain the tax swamp, specifically through tax reform and tax simplification.

On the carried interest issue, knowledgeable people cannot even agree on the problem, let alone a remedy. Chairman Baucus and Senator Grassley say their legislation is needed so that certain partnerships do not gain an advantage over corporations, while our Secretary of Treasury, Mr. Paulson, opposes the Baucus-Grassley legislation on the grounds that it singles out those partnerships for different treatment from other investment businesses. So I think right at the heart of this is the need to simplify the tax code. I do that in my proposal, the Fair Flat Tax Act.

What I would like to do is start with you, Mr. Solomon. What does it say about the grotesque complexity of the tax code when the chairman of the Finance Committee and the Secretary of Treasury cannot agree on whether the legislation eliminates an existing tax preference to level the playing field or singles out one type of business for different tax treatment?

Mr. SOLOMON. I agree with you, Senator Wyden, that we need to simplify the tax code. It is extremely complicated, and this hearing is a testimony to how complicated it is. I would also note that our corporate tax system is very complicated and it is distortive in that it imposes two levels of tax.

The only observation I would make is that, in moving to any kind of new tax system, we still may have to deal with issues similar

to these. For example, we would still need to have rules about partnerships, which is a very important part of the discussion that we are having today.

Also, presumably in any new tax system we would still have a differential in tax rates between ordinary income and capital gains and dividends, and that differential is also an important part of our conversation today.

Senator WYDEN. Mr. Orszag, rather than increasing the complexity of the tax code by defining carried interest as an exception to capital gains, so you would have one rule for ordinary income and a different rule for capital gains, and then still another rule for carried interest, would it not be better to go back to the approach that Ronald Reagan and Bill Bradley came up with back in 1986, where all income was treated the same?

Mr. ORSZAG. I think there are a lot of factors that need to be taken into——

Senator WYDEN. Excuse me. On the question of, would it be simpler to go back to what Ronald Reagan and Bill Bradley talked about?

Mr. ORSZAG. It would be simpler. There are obviously other considerations also.

Senator WYDEN. Let me ask you then, because I have asked all of the witnesses who have come before our committee. I may have to do this on the second round. In 1986, Ronald Reagan and Bill Bradley said it made sense to keep marginal rates down. That was enormously important to President Reagan and Bill Bradley. They also said you ought to clean out a lot of the clutter and keep progressivity.

But the two men said, on a bipartisan basis at that time, that they did not think preferences were all that important in generating the kind of economic growth we needed. They thought marginal rates were very important, but they did not think preferences were critical. Could you respond to that? Because I think you have, in some of your analysis, said almost the same thing, and I think it would be helpful to get your assessment of the impact of preferences.

Mr. ORSZAG. There is pretty widespread agreement among economists that a broader base and lower marginal rates associated with that is a preferable tax system to one in which there are higher rates and lots of scattered tax expenditures throughout the tax code.

Senator WYDEN. Mr. Chairman, I will, on the next round, ask what I have asked 16 witnesses before the Finance Committee, whether on balance, rather than to continue to add clutter and one bauble here and one bauble there, we ought to, on a bipartisan basis, take the principles of 1986.

And I gather from the nods of some of our panel of witnesses, I might have an opportunity to get witness 17 on behalf of my effort. Ms. Mitchell, do you think by and large that the principles of 1986—not all of the details and the like, but the principles of 1986, remain sound today?

Ms. MITCHELL. The principles, I think, of 1986 remain very sound. I would argue that what we are talking about today, the Partnership Tax Code that has been in effect for over 40 years, also

operates simply. What we have been doing with our companies is no different than we did 40 years ago.

It has not been distorted, it has not gotten more complex. The goal being getting cash out of mattresses and short-term savings into high-risk start-ups to get people to spend their time, not in large, safe jobs, but to go work with riskier companies that create jobs and long-term value.

Senator WYDEN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Senator Bunning?

Senator BUNNING. Thank you, Mr. Chairman.

I do not think that anything that Senator Wyden said was new since 1986. I have sat 8 years on the Ways and Means Committee and 4 years on the Finance Committee now and, for every time we change one tax rule or one thing, we change the tax code. So, we have added how many thousands of pages since that time, Ron?

Senator WYDEN. The experts say that there have been 14,000 changes, three for every working day.

Senator BUNNING. Thank you very much.

I would like to ask Mr. Solomon and Mr. Orszag, when a founder of a business builds up a profitable company over a long period of time and then sells the company, Congress never has attempted to tax the gain except as a capital gain.

We recognize that whenever an asset is held a long time, part of that gain is simply inflation. Part of it. That is part of the reason for the lower tax rate, because of the inflation that has taken place. Do you believe it makes sense, is it fair, to tax gains from inflation just like salary income, and how would you avoid taxing inflationary gains on carried interest? I would like to get an answer from both of you.

Mr. SOLOMON. Senator Bunning, you raise a very important point here. A sole proprietor begins a business, starts it from scratch, and, through a combination of capital and a lot of skill and labor, builds it up over many years and it creates goodwill and going concern value. Many years later, if the sole proprietor sells the business to someone else, it will result in capital gain, taxed at the lower rate.

Mr. ORSZAG. On the question of inflation, economists would generally argue that it would be better not to tax the inflationary component of a capital gain.

Senator BUNNING. In other words, subtract it out?

Mr. ORSZAG. Subtract it out. However, it is important to remember that on the deduction side, with regard to interest payments made, that you would also have to make a correction there or else you would create opportunities for tax arbitrage. So if one is going to take inflation out of capital gains, it also needs to come out of the deduction side.

Senator BUNNING. On both sides of the equation then, you should subtract the inflationary spiral or whatever took place during the entity's length of time before it was sold.

Mr. ORSZAG. There is an economic argument for doing so. That would need to be weighed against the complexity and other things that would be introduced.

Senator BUNNING. All right.

Mr. Solomon, since you are more with the Treasury than anyone else——

[Laughter.]

Senator BUNNING [continuing]. I have to ask you the question about other countries. Mike talked about it. If I were someone that was starting a venture capital company, or a partnership, or something like that, no matter where I lived, and I went to London, is the climate there better or worse?

Mr. SOLOMON. I cannot speak with precision about the climate in other countries. I do know that other countries are very eager to have venture capital and other entrepreneurial businesses come to their locations. So as a person starting a new business, I would certainly take tax considerations into account in deciding where I start my business.

Senator BUNNING. Right. And, therefore, that entity, whatever it might be—partnership, venture capital company, whatever—would be taxed in England and then the persons responsible for that money would be responsible for paying, wherever they lived, the tax due in that country that they lived in.

Mr. SOLOMON. Our tax laws are very complicated, but there are tax planning techniques that are used in order to——

Senator BUNNING. Avoid. It is called avoid.

Mr. SOLOMON [continuing]. Decide where to do business and where tax is paid.

Senator BUNNING. All right.

Well, I just thought it was important because we are talking about losing our stock exchanges and a lot of other things in the capital centers of the world from present locations, and I want to make sure that we do not add another peg in that problem. Thank you.

The CHAIRMAN. Thank you, Senator. I might add for the record, though, that the U.K. is going very deeply into the same question, very deeply. There have been hearings in Parliament, inquiries, the exchequer, the old Prime Minister, the new Prime Minister, former head of the exchequer, they are deeply examining these very same questions that we are examining in today's hearing.

Next on the list is Senator Salazar. I might say, though, before you proceed, we are scheduled to have a vote at 11:30. Why don't you proceed? Senator Grassley will continue. I am going to leave right now to get there at the beginning of the vote, and then I will come right back as soon as that vote occurs. We will just keep going here. You are next.

If you do not mind, Senator, if you could just take over and I will come right back. Next is Senator Bingaman after Senator Salazar.

Senator SALAZAR. Thank you very much, Senator Baucus. Let me just say that I agree with the chairman in terms of his remarks relative to the objectives as we undertake this examination, and that is that we do not want to stifle the mother of investment. At the same time, we want to move forward and we want to have a fair and equitable tax code.

I am going to ask this question of all of you. I went out and picked up a copy of the tax code, and it has gotten a little bigger since the time I actually studied this and did a little bit of work on it in the 1980s.

But it is very interesting. Even over the last 25 years, subchapter K, in most of its essential parts, has not been changed. I was looking at section 702(b), which you said, Professor, is a place where we ought to have a fix with respect to this issue of carried interest.

That section, the relevant part, is very straightforward. It says, "The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share" under the foregoing section "shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership."

It is the flow-through concept of the partnership down to the individual partners so you do not have the double taxation that I think is a central concept of partnership law.

But my question to each of you is this: Professor Gergen has said that we could do a fix with respect to 702(b) that would address the issue of carried interest. My question is, what would be the consequence of that in terms of the venture capital industry that has been playing such a significant role in our economy to date?

Maybe what we could do is just start down the line. First, with you, Secretary Solomon, and then just coming across. What would be the impact if we were to take Professor Gergen's suggested change with respect to 702(b)? What would that do to the venture capital industry in America today?

Mr. SOLOMON. It would change the returns to the parties. The deal between them would have a new tax aspect. Presumably they would negotiate their deal in a slightly different way and reduce——

Senator SALAZAR. I know the consequences. Would we have less venture capital in the U.S. because of a change in the tax code to 702(b)? Would it dampen what is happening with venture capital in America today? Give me a paragraph's statement about the consequences of that in terms of the venture capital industry that we have.

Mr. SOLOMON. As I said, it would affect the deal between the parties. It would reduce the return to the parties and, therefore, have consequences with respect to venture capital.

Senator SALAZAR. Peter?

Mr. ORSZAG. It would have a variety of effects. To the extent that the investors in the funds are taxable entities, it actually could increase the benefits to participating because, if you provide ordinary income to the general partner, there has been a corresponding deduction provided to the limited partners making the investment.

That deduction is more valuable than the current tax treatment. So, to the extent that there are taxable entities or taxable individuals investing in the venture capital world, the change would actually, if anything, encourage more capital flow rather than discourage it.

Senator SALAZAR. So your view, then, from the Congressional Budget Office, is that it would encourage more venture capital?

Mr. ORSZAG. No, no. I said I agree that most of this is a reallocation across different types of partners, but to the extent that someone is taxable, and if you are just looking at relative tax burdens for the general partner and the limited partner, ordinary income

deduction flowing through to the limited partner could be more valuable than the current tax treatment.

Senator SALAZAR. All right.

Mr. Donohue?

Mr. DONOHUE. I do not believe I necessarily bring any particular expertise to this discussion on this point, so I will defer to my colleague in Treasury.

Senator SALAZAR. Ms. Mitchell?

Ms. MITCHELL. I respectfully differ with Mr. Orszag, that I think it would result in less capital going into venture. One of the issues we have with the venture asset class is not only is it cyclical, high-risk, and long-term, it is small.

It is inefficient for these pension funds, endowments, and private charities to put money into all these small funds. So, already we are an asset class that is less attractive because we are less efficient for them.

If the cost of doing business becomes higher for the funds, it is going to be one more issue that makes us less attractive overall for limited partners who want to put money to work, which will reduce the number of new companies that are formed.

Senator SALAZAR. Thank you.

Dr. Gergen, it is your idea. What is the consequence here on venture capital?

Mr. GERGEN. I am not an economist, but Ms. Mitchell's concern assumes that the people who are providing labor and venture capital have just as good alternatives where they can make just as much, and so, if you lower the yield to them by a fraction, they are going to go do something else. I am dubious.

Senator SALAZAR. All right.

Ms. MITCHELL. Well, I would remind folks that I can lose money in this business, too. It is not just making money, I can lose it. That is different than the other opportunities that I have.

Senator SALAZAR. All right. Thank you not only for the response to my questions, but for the excellent testimony today.

Senator GRASSLEY. Now, Senator Bingaman.

Senator BINGAMAN. Thank you, Mr. Chairman. Thanks for having the hearing.

I was talking to a partner in a private equity firm, and his comment to me was, there is no justification for giving me different tax treatment on carried interest than you give someone who spends 5 years writing a book. I would be interested in any of you responding to that. Is there a justification for giving him different tax treatment than you give somebody who spends 5 years writing a book? Mr. Solomon?

Mr. SOLOMON. I think there is. The partnership tax system and the partnership system as a whole is about pooling ideas and skills with capital and bringing them together and allowing the partners to allocate the economics of their deal. Therefore, I think there is a benefit to allowing the pooling of capital and ideas.

Senator BINGAMAN. The fact that capital is added to the equation in the case of a partnership gives adequate justification for charging 15 percent for the compensation for the individual who does not put capital in?

Mr. SOLOMON. I would look at it in a slightly different way, that the manager in a particular case could go out and borrow money himself and engage in a similar enterprise and get capital gain treatment.

For example, the person who has the idea about buying a particular stock. Rather than having another investor, he could presumably go out and borrow the money from a third party and make the investment entirely by himself. If the property is held for more than a year and is sold, he would get a 15-percent tax rate on the gain.

Senator BINGAMAN. Mr. Orszag, did you have a thought about this comment as to whether there is a justification for different treatment for someone writing a book and someone managing money or investing money through one of these organizations?

Mr. ORSZAG. Well, there certainly is a difference relative to investing money through one of these organizations, but I would go back to the broader point that I had emphasized, which is that there is a wide variety of performance-based labor income that occurs in the United States. The example you were putting forward was one of them.

Most analysts believe, to the extent the general partner is providing management services to the limited partners, that is a form of performance-based labor income.

Senator BINGAMAN. Another example of performance-based labor income, it would seem to me, would be contingent fees on lawsuits. I mean, if a lawyer agrees to take a case and works at it for 5 years and then gets a judgment, and has agreed that he will take no fee unless that judgment is successful or that case is successful, we currently tax that as ordinary income to that lawyer, as I understand it. Why would we do that? Why do we not give him capital gains treatment on his part of that judgment or that contingent fee?

Mr. ORSZAG. I would view the question slightly differently. That is to say, it is ordinary income in that case, whereas, if I buy stock or participate in a joint venture to buy stock, the underlying gain is capital gain.

It is important to note that, with respect to carried interest, it is not all capital gain. That is to say, it is a flow-through from the partnership and therefore it depends on what the underlying income is.

If the underlying income was from some sort of contingent fee that the law partnership earned, it would be taxed as ordinary income. If the underlying income was from the acquisition of a capital asset, it would flow through and be taxed at capital gains rates.

Senator BINGAMAN. I guess the concern I have had, though, and I think, Ms. Mitchell, you made the point several times, is that these are investments that venture capitalists make for the long term, and also that these are risky.

I mean, I think you could find a lot of lawyers who would say, if I take a contingent fee case, it is a long-term commitment because it takes a long time to get one of these things to judgment, if at all, and it is risky because I may wind up with nothing after 5, 10 years of work on an issue. Why should we not give capital

gains treatment to that lawyer on his part of the judgment, on his contingent fee?

Ms. MITCHELL. Well, my understanding of the intent behind the original capital gains treatment was to attract long-term capital, to build jobs, to build growth, and to build exports. The difference between what the lawyer gets is, he gets his own payment. He has certainly put time at risk.

We are building companies—again, the Starbucks, the Genentechs, the eBays—and that is what the tax code is meant to encourage, the building of entities that will contribute overall to the U.S. economy and go beyond any individual ultimately, and hopefully build a lot of jobs so a lot of people benefit from that entity being formed.

That was the objective of encouraging people to spend time and contribute capital together in a partnership to build that kind of business generation and to fuel what we have done successfully in the U.S. economy.

Senator BINGAMAN. My time is up. Thank you, Mr. Chairman.

Senator GRASSLEY. Senator Kyl?

Senator KYL. Thank you, Mr. Chairman. I always learn something at these hearings, but I am not sure that what I learn is always true. Director Orszag, your concept that a higher tax rate could actually encourage investment, I put into that category.

Mr. ORSZAG. Well, can I——

Senator KYL. No. I think your explanation of that would take far too long, given the brief amount of time I have.

Let me ask you this instead: do you think there is any connection between the Bush tax cuts and the lower tax rate on investment income, like capital gains and dividends, and the fact that revenues grew from $1.78 trillion in 2003 to almost $2.5 trillion in 2006, about a 35-percent increase?

Mr. ORSZAG. There is some evidence that the tax reductions that were enacted in 2001 and 2003 had some beneficial effects in spurring economic activity. Most of the revenue gain that has occurred since 2003 has occurred in the corporate income tax and not in the individual income tax, when you view revenue as a share of the economy.

Senator KYL. Let me also ask Professor Gergen, synthesizing what you said, I think, it is not fair to tax labor income at the capital gains rate. That is a significant summary of what you said. But I gather that the reason for that is, ordinarily we are taxing the capital gains at the lower rate because it is on income that has already been taxed at least once. Is that the primary theory for that?

Mr. GERGEN. It is a theory. Inflation is another theory. There are many explanations for the capital gains rate.

Senator KYL. But the idea is, there is a rationale, a justification for imposing a lower tax there because there has already been some other payment.

Let me ask Secretary Solomon a couple questions. Is the current tax law treatment of carried interest consistent with the main reasons that Congress enacted the lower individual tax rate for long-term capital gains, in other words, to encourage entrepreneurial risk-taking, reduce double taxation, and to some extent permit locked-in effects?

Mr. SOLOMON. Yes. The current tax treatment of partnerships with a single level of taxation is consistent with that. Corporations, as you mentioned, have two levels of taxation: first, earnings are taxed at the corporate level at 35 percent, and then there is a second level of tax, at 15 percent, with respect to shareholder dividends or capital gains. So, to the extent that one can reduce the level of taxation on dividends and capital gains, you would reduce the distortions caused by the double taxation.

Senator KYL. And as a follow-up to that, regarding potential distortions, anyway, given the broad use of the carried interest structure across a variety of different kinds of business and investment forums—and I have in mind, for example, real estate, which I am somewhat familiar with, to venture capital, to small start-up businesses, the kind of things that Ms. Mitchell is talking about—would it be rational tax policy to recharacterize the treatment of carried interest for some types of businesses but not for others?

Mr. SOLOMON. From a tax policy viewpoint, you would want to have a consistent rule for all businesses. So in considering these issues, you would want to look at all the different kinds of businesses that you referred to, both small business and large business, and all types of business. For example, real estate is a very good example where these concepts are used. Carried interest is a concept in real estate that has been used for decades.

Senator KYL. And with regard to your conclusion that changing the carried interest rule alone as opposed to the second question that Senator Grassley asked which you were less clear in your answer on, these are two of the rationales for not making a change in the carried interest rule then, the two questions that I have asked you, the differential that would have to then exist if you tried to differentiate different kinds of businesses, number one, and second, the encouragement of the entrepreneurial risk-taking and the like.

Mr. SOLOMON. I agree with both of those points.

Senator KYL. All right. Mr. Chairman-to-be-in-the-future-I-hope-soon-Grassley, thank you. [Laughter.]

Senator SCHUMER. Not if I have anything to do with it.

Senator GRASSLEY. Senator Ensign?

Senator ENSIGN. But if I have anything to do with it. Thank you. Thank you, Senator Grassley. Thank you for your kind words welcoming me to the committee. I am very excited to be here. My time over on the Ways and Means Committee on the other side of the Capitol gave me a real passion for the issues that we deal with.

Senator Wyden, I thought, said some very good things about the complexity of the tax code and the inconsistencies that we have in the tax code, and the way that that skews investment many times. Venture capitalists know, they look for ways, and one of the reasons that money flows certain directions sometimes, almost it flows in the direction of least resistance.

If we want to look at other countries as models, we look at Ireland. Ireland is a great example of one of the worst economies in Europe to now one of the best, if not the best, economy in Europe. They did it based on several different policies. One of the major policies they did there was based on their tax policy and lowering their tax rates.

Lowering tax rates attracts capital. The idea that we would now want to raise rates—and make no mistake about it, if you go from a capital gains rate to an ordinary income tax rate, you are raising tax rates—and hurt investment in this country, I think is an absolutely dangerous idea. The fact that we would be taxing partnerships and taxing the sweat equity in those partnerships is also a very dangerous precedent.

I can speak from experience. I was a veterinarian who started a practice, had investment capital in the building and land, but had zero investment in my practice. When I sold my first practice I had built up sweat equity. One hundred percent of it was sweat equity, taxed as a capital gain.

To try to go after the mega-rich in some of these private equity firms and the like, you are going to be setting a dangerous precedent. That is why, actually, I am glad that Mr. Gergen is here, because he has clearly laid out that he wants to go after all labor and tax it as ordinary income.

So I am glad he his actually very, very clear on what he wants to do, and I think that is good that he was here to lay that out. I think that if we start this precedent of going after labor and taxing it as ordinary income instead of a capital gain, I think that we are setting a precedent to do it across the board.

As Mr. Solomon has laid out, we need consistency in our tax laws across the board. To try to pick and choose who is going to get this carried interest and how it is going to be treated, I think, is a very dangerous road for us to go down.

Another comment I would like to make, is this idea that capital does move around the globe at the speed of light today. It literally goes in places, and is going to be invested in places.

And whether you are a U.S. citizen or not, the fact that, if you look at these private equity funds, who is investing in these private equity funds, it is not just American citizens. It is the Chinese government, it is governments from all over the world. We want that capital to come to the United States.

We do not want to say, no, do not bring it here. We are going to tax you at a higher rate, so do not bring it here. So the fact that this proposal that has been floated out there is being taken seriously, I think, is wrong-headed. We need to be looking at policies that make us more competitive, not less competitive.

We need to attract more capital, because capitalism is a simple prospect. Without employers, you do not have employees. Well, without capital, you do not have employers, which means you do not have employees. What you are doing in the venture capital market is creating jobs. It is a good thing: taking risks, rewarding entrepreneurs.

That is a good thing and we should be looking, this committee, as policymakers, at rewarding risk-taking, not at taxing them at higher rates and basically punishing them. And so I think that we have to look at what these policies are going to do, not only with the direct consequences, but also with the unintended consequences.

Sarbanes-Oxley. Mr. Chairman, you brought up the fact that Great Britain was looking at this. When we were considering Sarbanes-Oxley, they said that Great Britain and Europe were looking

at doing Sarbanes-Oxley-type things. Now look. Is it a better place to go into the public markets in New York City or in London? If you are going to go on the public markets today because of Sarbanes-Oxley, it is better to go over to London because the regulatory climate is better there. Once again, there is less resistance.

So, Mr. Chairman, I would have loved to spend the time asking some questions, but I thought it was important to get some of these statements on the record because the precedents that could be set here and the unintended consequences of some of the legislation that is being considered here, I think, are very, very serious and we need to take a very cautious approach to this.

The CHAIRMAN. Well, thank you.

Senator ENSIGN. I thank you for your time.

The CHAIRMAN. Thank you, Senator. Welcome to the committee. Senator Schumer?

Senator SCHUMER. Thank you, Mr. Chairman. And I very much appreciate it. I apologize to the witnesses that I have not been here on an issue of great concern to me. We have Sara Taylor testifying in the Judiciary Committee on the U.S. Attorneys, so, as luck would have it, two of the most important hearings I could attend are exactly at the same time.

First, I want to thank the chairman and ranking member for these hearings. I appreciate that the chairman and ranking member are trying to learn as much as they can, and that they have not rushed to introduce a more comprehensive bill, but rather we are studying this issue carefully.

Obviously, being the Senator from New York on the Finance Committee, my phone has been ringing quite a bit lately since the recent bills have been introduced in the House and Senate.

I have been trying to learn as much as I can about the issues at hand, and I am carefully studying the Baucus-Grassley and Levin-Frank bills. I want to spend a moment to talk about some of the issues that are important to me and the pros and cons of taking action in this area, because these issues are important not just for New York, but for capital formation in the whole U.S. economy.

On the pro side of taking action is the issue of pay-go. Previous Congresses did not keep the commitment to pay-go. I believe we are doing the right thing by reinstating the rule. If Congress wants to undertake new initiatives, we should be able to pay for them so we do not run up the debt burden of our kids even further, and we need new programs in education, infrastructure, energy, just to name a few. We should be paying for them.

Another reason is that, if we must raise revenues, and we must, the likely and logical place to do it should be at the very highest end of the income scale where average tax rates have actually been declining. Wealth and income have been agglomerating to the very richest in our economy at an amazing rate, not necessarily because of the actions of government, but because of the ways of the world and the economy. They have changed. When you deal with intangibles, which we do, wealth agglomerates to the top.

Consider some of these statistics, keeping in mind that the top 1 percent means families earning over $400,000 in today's income: the top 1 percent of households in income received 22 percent of all

pre-tax income in 2005. That is up from 14 percent in 1990 and 10 percent in 1980.

There are different estimates out there. Nearly all of them show the share of income going to the top 1 percent has more than doubled in the last 25 years. On capital gains, implicit in today's discussion, the top 1 percent received 60 percent of all capital gains income in 2004, up from 49 percent in 2000, 38 percent in 1979.

So, if we are going to raise revenues to pay for things, we have to look at the highest income earners because they are earning so much more. This is not to say we should reflexively raise taxes on the wealthy at every opportunity; I do not believe in that. But it is simply to point out that incomes at the top have been going up rapidly, while average tax rates have been declining.

But there are also things to consider on the other side. I think it is important for our tax code to continue to provide incentives for risk-taking and entrepreneurship, because new ideas and businesses create good jobs. I have never had a problem with general tax preferences for capital gains and dividends, and I have supported lower capital gains rates in the past, particularly when we were in more of a surplus situation.

Another important consideration vital to me is that, no matter what we do ultimately about these issues, the United States and New York must remain the leading country and city in the world for financial services and capital formation, and we should not do anything to jeopardize that position and make it easier for capital and ideas to flow to London or anywhere else. I will fight as hard as I can to protect the interests of New York and ensure that it remains the preeminent financial center of the world.

Along these lines, I am also concerned we make sure all forms of businesses and partnerships are treated fairly and equally, that we do not single out one type of business because people in that line of business are making a lot of money, have their names in the newspaper, or come from one particular region of the country.

In the end, I will not stand for treating financial service partnerships one way while all other partnerships are treated another way. This is not to say that we should make no changes. I am wrestling with these issues about carried interest, how hedge funds are taxed. But treat everyone fairly.

If we are going to change how we tax financial partnerships, we should treat oil and gas, and venture capital and real estate, and everything else the same. My State may depend on financial services; Texas may depend more on oil and gas. It is unfair to treat one region differently than the other when you are dealing with the same structure.

So I want to thank the chairman for being thoughtful and deliberative in this. My question to the panel, since I have one second left, I see here, is just this: what is your view on how imposing any of these taxes will affect New York as the preeminent financial capital of the world? Anyone? There is a dispute.

Some people say it will not affect it at all, some people say it will. Some people say some of the issues will, some will not. When you are dealing with personal income, it is a much bigger change because you have to become a citizen of another country. Fire away.

The CHAIRMAN. Briefly.

Senator SCHUMER. Briefly. They could submit them in writing if you want, Mr. Chairman.

The CHAIRMAN. No, go ahead. If you want a response here, briefly.

Mr. SOLOMON. We should be cautious about making significant and potentially unsettling changes in the tax law in an area that has worked well to support entrepreneurship and risk-taking for many decades.

The CHAIRMAN. Mr. Orszag?

Mr. ORSZAG. Again, I would come back to some of the earlier discussion. Proposals that are under discussion do not change the tax treatment for the limited partners who are putting up almost all of the capital in these types of partnerships; therefore, it is not clear that there would be any significant effect from the types of changes that are being considered.

The CHAIRMAN. Mr. Donohue? I will give you a shot.

Mr. DONOHUE. One of the statutory missions of the Securities and Exchange Commission is really the promotion of capital formation. We would urge the panel and the Senate in considering these issues to look to the promotion of capital formation with respect to any changes that might be made.

The CHAIRMAN. Ms. Mitchell?

Ms. MITCHELL. Senator Schumer, from the venture capital perspective, there are really two issues. One, you do have a fledgling—and I would say far beyond fledgling—venture capital business in the State of New York, Silicon Alley, I think it is called there, and it is doing quite well. I think there would be less capital that would be attracted to that, and as a result, fewer IPOs that would be going public on the domestic exchanges.

Mr. GERGEN. I would think it odd if a marginal increase on the tax on returns to labor at the highest sector in the economy had any significant effects on the allocation of capital.

Senator SCHUMER. As you can see, this is what makes my job a particularly hard one here.

Could I just ask unanimous consent that I ask some follow-up questions to all of the panel on this?

The CHAIRMAN. Yes.

Senator SCHUMER. Because my time has expired, and I have to go vote.

The CHAIRMAN. Fine. Thank you.

Senator SCHUMER. Thank you.

The CHAIRMAN. Thank you very much, Senator.

[The questions and answers appear in the appendix.]

The CHAIRMAN. I am a little curious. Is there a difference among industries? That is, if, clearly, services were compensated at the ordinary rates and capital contribution on gain was compensated at capital gains rates, is there a difference among industries, private equity, hedge funds, venture capital, real estate, oil and gas, farmers, ranchers, other partnership entities? Is there any difference at all?

If this committee is going to go down this road of trying to separate out what is capital, what is services and say the character of income obviously is ordinary for services and capital gains for cap-

ital gain, is there any difference among the industries that basically use this feature of carried interest? I will just go down the line here, very briefly. Mr. Solomon?

Mr. SOLOMON. I think the issue is the same across all industries. The basic situation here is that someone puts in capital and someone puts in know-how. There is an allocation of some of the income to the person who put in the know-how. That is true for all kinds of partnerships.

The CHAIRMAN. So you say it is basically the same.

Mr. Orszag?

Mr. ORSZAG. I think the underlying issues are basically the same.

The CHAIRMAN. All right.

Mr. Donohue?

Mr. DONOHUE. I would concur.

The CHAIRMAN. Ms. Mitchell?

Ms. MITCHELL. I concur.

The CHAIRMAN. So you do not think the VC folks put a little more extra sweat equity into developing Googles and so forth than other industries? You think it is all the same?

Ms. MITCHELL. I can only speak to mine because I am not an expert on theirs. I think the hard thing is, how do you define it? The investment class, it is almost a continuum, and so it is hard to segment what is venture capital versus buy-out.

I am not as familiar with the hedge fund business in particular, so I think the hard part is differentiating it. I do think that the thing that venture does is create more jobs, and I think that is a positive. But I would say that there are probably arguments that will be made in your second hearing that may address this.

The CHAIRMAN. All right.

Professor Gergen?

Mr. GERGEN. There are two differences. One, partnership tax law is very complicated. Small businesses really cannot comply with current law, and many of them do not. That is just one dirty secret of partnership tax law. The system is more than most small firms can comply with.

But the second, and really the tough issue here, is not the sweat part, but the equity part. When somebody is bringing not just labor but also intangible assets they might well characterize as capital, that raises an interesting question: which of these are we going to actually see as capital contributions, and then treating them as capital contributions.

Should this be ordinary income because under 1221 it is like a painting, or is this more like the goodwill you have built up in a business that we do not treat under that rubric?

I think as we went across industries we might come to different judgments on that conclusion. That is, the actual know-how that they are contributing, intangible property.

The CHAIRMAN. That leads to my next question. You touched on assets, Mr. Orszag. Although it adds additional complications, does it make sense to get some kind of a blend, some kind of an assessment that is an intangible, that feels like, sounds like, walks like capital and should be taxed at capital gain rates? Whereas, other labor and whatnot should not.

I mean, do we want, if we go down this road, a bright-line test or should it be a blurred line test which adds in more complexity? Mr. Orszag, you raised the issue a bit so I will start with you.

Mr. ORSZAG. Yes. And I do think there is a perspective that many outside analysts embrace, that when you get 20 percent of the profits on a fund it is as if the limited partners are letting you borrow for free 20 percent of the capital, and so that one could then treat the carried interest as having two components.

One is the implicit interest on that loan transaction, which is basically effectively the bond rate of return, treat that as ordinary income, and then anything above and beyond that would be treated as capital gains or capital losses. I think that there are people who believe that that would be the appropriate treatment to adopt in this case.

The CHAIRMAN. Do you have a view on that?

Mr. ORSZAG. I am not allowed to have views any more. [Laughter.]

The CHAIRMAN. All right. In some sense, that is true.

Mr. Donohue?

Mr. DONOHUE. I do not have a view on that.

The CHAIRMAN. All right.

Ms. Mitchell?

Ms. MITCHELL. Well, most of what we contribute are intangibles, contacts, all the work that we provide. I think one of the difficulties—and I will probably offend at least half the people in the room when I say this—is it will probably mean a lot more business for accountants and lawyers, trying to differentiate intangibles from other effort. I think it will make the process of implementing this more complex rather than less.

The CHAIRMAN. All right.

Professor Gergen?

Mr. GERGEN. Intangible assets make it more complicated.

The CHAIRMAN. But is it worth the effort? And to argue in favor of services as ordinary income, though you say it is not totally black and white. Is it worth the effort?

Mr. GERGEN. I think if you did something that allowed people to avoid the problem by making the 20-percent interest, in effect, a non-recourse loan, and then you had a very low imputation rate, in effect you have now solved the problem because they will avoid the complication, avoid hiring the accountants, take a modest hit of what is compensation, which is a low imputation rate on a non-recourse loan. So, you have picked up at least some ordinary income on some of the labor.

On the other hand, you could make it complicated, deny them that option, and then the tax law looks really, really, really complicated and it is hard to enforce. We try then to nail down what is an intangible.

The CHAIRMAN. Thank you.

Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman.

Let me start with you on the point that Senator Schumer just made, because I think it is an important one. The *Wall Street Journal* columnist Alan Murray recently wrote: “All sorts of partner-

ships, including real estate, oil and gas, rely on the same tax tricks, essentially, as investment partnerships."

So what he says is, in effect, if you make the kinds of changes that I am advocating, essentially what Reagan and Bradley agreed to in 1986, that you eliminate the carried interest problem and that you address Senator Schumer's important concern, that you are not, in effect, advantaging one part of the country or one industry over another.

Tell me how you would disagree with Alan Murray on that point.

Mr. SOLOMON. From your description, what is a little uncertain to me is whether the different treatment for capital gains and dividends would continue to exist as compared to ordinary income.

Senator WYDEN. No. He is advocating the abolition. He says that there is plenty of investment capital out there now. He, like me, believes that marginal rates are hugely important in terms of investment, as they did in 1986, but not preferences. I am just curious whether you disagree with any of that.

You have said very favorable things, much to my delight, about the 1986 approach in the past. I just want to see if you still think that that kind of frame is fundamentally sound. It definitely is a solution to this carried interest question.

Carried interest is more complexity, more lawyers, more mumbo-jumbo. It will be a lawyer's full employment program and it will add another batch of changes to the code. I think there is a solution out there, and I am wondering if you disagree, particularly with what Mr. Murray had to say.

Mr. SOLOMON. I think lower tax rates are good, but I do believe that the preferential rate for capital gains and dividends promotes economic growth.

Senator WYDEN. Mr. Orszag, do you want to assess what Mr. Murray said? Mr. Murray also went on to say—and maybe you have an assessment of this as well—with the world awash in investment capital, there is no need for a tax incentive to encourage more.

In effect, the argument would be, if all capital gains, including carried interest, were treated as ordinary income, how would that take away opportunities for investors to go to venture, private equity, hedge funds, everything else and do it in a way that did not compound Senator Schumer's problem? Mr. Orszag?

Mr. ORSZAG. Well, there are lots of considerations in evaluating the capital gains tax rate. The most traditional is the effect on capital formation and economic activity. CBO has previously stated that empirical evidence on such effects is modest, that is, that there is only a modest effect from a preferential rate on economic activity, saving behavior, what have you.

Another factor that does need to be taken into consideration is the complexity and the potential distortions of behavior that come from taxing different types of income in different ways, and the complexity that we are struggling with today is a manifestation of that.

Senator WYDEN. Well, that is sure helpful for my case, and I appreciate that.

Professor, would you like to add something to it? You have been a tax reformer. What is your take, particularly on the basic prin-

ciples of 1986 providing a solution to this carried interest question, and also moving our country in the right direction in terms of tax policy?

Mr. GERGEN. If you get rid of the capital gains preference, you make the problem worse. If you get rid of the capital gains preference and do not fix anything else, you make the problem worse.

Senator WYDEN. Well, we would, of course, do exactly what was done in 1986. Yes. I am not talking about just capital gains. I am talking about lower marginal rates, cleaning out clutter, ensuring progressivity, having a 1-page 1040 form, and, yes, having all income treated the same.

Mr. GERGEN. It is a wonderful idea, except the real problem with trying to tax investment yields is not the preference, it is the timing option, the ability to realize it when you want to realize it and the basis step-up in debt. That led to lots of games-playing, so you had capital gains shelters in the late 1990s and early 2000s, and the ordinary income tax shelter fix did not address that.

Senator WYDEN. But the late 1990s is when we brought it back.

Mr. GERGEN. That is not a function of the capital gains preference. The capital gains preference is trying to fix an already very, very leaky ship, or trying to at least adjust it in a way where we do not think it will run on a reef.

If you really want fundamental tax reform, go to a cash flow consumption tax or a value added tax and stop trying to tax returns on capital. That would then solve this problem and you would have something simple. But if you do not fix the realization rule, you are not going to make the tax code all that much simpler.

Senator WYDEN. We will put you down, and I will ask the rest in writing, as the first person of the 18 witnesses before the Finance Committee who did not think the 1986 approach made some sense, and we will look forward to talking to you about it some more.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Hatch?

Senator HATCH. But what would we do without the IRS and all of those employees? I mean, my goodness. I just cannot imagine the upheaval that would occur. I think we all want tax reform. Personally, I agree with you and Mr. Gergen. The best and most simple way to do it might be a consumption tax. Then people could spend whatever they want and pay whatever taxes they want. However, getting there is a very, very tough thing to do.

Ms. Mitchell, I would like to just spend a little time with you. I remember years ago when limited partnerships were primarily used to find tax losses and to give people tax benefits and tax breaks rather than actually create businesses, but you are in a different era.

You are running a venture capital firm that literally, among many others—we have had hedge funds that have 13,000 or more businesses—that basically are stirring the venture capital drive in this country and helping companies to grow.

Let me just ask you this. You mentioned that you have invested in biotechnology through your fund. As I understand it, the average new biotechnology therapy—I hate to call them drugs, because they

are large molecules and are really not drugs, but let us call them drugs for the purpose of simplification. It costs about $1.2 billion to develop a major biotechnology drug, is that not correct?

Ms. MITCHELL. It can be that much.

Senator HATCH. So it is a very risky business, right?

Ms. MITCHELL. Absolutely.

Senator HATCH. So when you ask people to invest with you so that you can then invest in biotechnology, you have a pretty high risk there. Is that right?

Ms. MITCHELL. And it takes 16 years from the origination to the time you can——

Senator HATCH. If you are lucky.

Ms. MITCHELL. And at the end you may not succeed.

Senator HATCH. I only chose that one issue to show, if we do not have these venture capital firms, we might not have the future in front of us with regard to development of biotechnology, which may be one of the ways we might be able to ultimately keep health care costs down, although they are enormously expensive right now because of the amount of capital that has to be invested. Right?

Ms. MITCHELL. That is the hope. Exactly.

Senator HATCH. And you are really rolling the dice when you invest in some of these ventures, are you not?

Ms. MITCHELL. They can be hugely binary risks: you can put a lot of money and a lot of effort and——

Senator HATCH. Do you always make profits in your business and in your investments?

Ms. MITCHELL. No.

Senator HATCH. About what percentages? This is maybe a little unfair to do this to you.

Ms. MITCHELL. No, I would be happy to. Forty percent lose money, 40 percent get very modest returns, simply return the capital to the fund, and only 20 percent, in a good fund——

Senator HATCH. So if you are lucky, with a good fund, 20 percent of your investments make——

Ms. MITCHELL. And some of the investments do not make money. There are entire funds that are unsuccessful in making money.

Senator HATCH. Could you tell us some of the successful companies that you have helped?

Ms. MITCHELL. Well, one is in the State of Utah, a company called Omniture that went public about a year ago.

Senator HATCH. Sure.

Ms. MITCHELL. It has been quite successful. We have been invested in a company, a biotechnology company, called Orexigen that also went public this last year. A company in Washington, Seattle Genetics, as well, with, again, very early cancer therapies.

Senator HATCH. But would you have done that, would you have invested in these——

Ms. MITCHELL. No.

Senator HATCH [continuing]. These idea companies if you did not have the current track——

Ms. MITCHELL. Absolutely. I agree. Senator Hatch, the issue is, there is a lot of investment capital out there. The issue is, can you find venture partners and founders who are willing to spend the

time working those for that long period of time to get to that fruition.

Senator HATCH. It is unfair to ask you about hedge funds, but the fact of the matter is, we have 11,000 or 12,000 of those. Maybe I can turn to Mr. Solomon on hedge funds. Not all of them make money, is that not right?

Mr. SOLOMON. That is correct. Not all of them make money.

Senator HATCH. But the ones who are successful, who really make the correct investments, as Ms. Mitchell has done, at least 20 percent, and maybe 40 percent if you count just modest returns, they can make some pretty good money out of the hedge fund business. But it is really a matter of capital risk, is it not?

Mr. SOLOMON. That is correct.

Senator HATCH. And if you do not have the incentives for capital risk, then it is tough to get the capital to do it. Right?

Mr. SOLOMON. That is correct.

Senator HATCH. Well, what concerns me is, I am basically a tax cutter and I really believe that we have benefitted tremendously from the Reagan tax cuts, from the Bush tax cuts. I believe those are some of the things that are driving this economy right now. Would you agree with that, Mr. Solomon?

Mr. SOLOMON. Yes. I believe that the lower tax rates, and the lower rates for capital gains and capital investment, have contributed to economic growth.

Senator HATCH. Now, Mr. Gergen, you did not quite agree with that, as I understand it.

Mr. GERGEN. I think there are mixed effects. CBO has found there are two effects from a tax reduction. One is, to the extent it is deficit-financed over the long term, that imposes a drain on the economy.

Then there are effects from lower marginal rates that can encourage economic activity. The net impact over the long term is from both of those components, and you usually get pretty modest effects, either positive or negative, as a result.

Senator HATCH. But these are marginal rates that are benefitting Ms. Mitchell.

Mr. GERGEN. I'm sorry?

Senator HATCH. These are mainly marginal rates that are benefitting Ms. Mitchell.

Mr. GERGEN. If we are now talking about the specific case, again I would just come back to, to the extent that the limited partners are tax-exempt, you are not changing any tax treatment for them, and they are the ones who are putting up the capital in these funds.

Senator HATCH. Yes. But Ms. Mitchell, as the leader, is taking the risk of being sued, of going through untold bankruptcy, maybe, and other types of difficulties. That is why we did this to begin with.

I have real difficulties thinking we are going to just start taxing because some people make a lot of money. I want people to make a lot of money because they create businesses and opportunity. I know I am taking a little bit more time than I should, Mr. Chairman, but we are the only two here so maybe I can get away with it. [Laughter.]

The CHAIRMAN. Briefly.

Senator HATCH. Just briefly, I want to congratulate you, Ms. Mitchell, and all of those companies that are spurring America on, in spite of Sarbanes-Oxley, which I think has been highly detrimental.

It was well-intentioned, but now highly detrimental because we in Congress overreached. We need to step back a little bit and relook at that so that we do not stultify the development of benefits that this country has always relied upon. But I just want to say I have appreciated the testimony of every one of you.

You, too, Mr. Gergen. I do not agree with you on some of these things, but by gosh, you are certainly an expert. I just would hate to have to go up against you on some of these issues, except that I know I would win. [Laughter.] I am only kidding.

The CHAIRMAN. Thank you, Senator. Thank you very much.

A couple of points I think are worth stating. We are very proud of our country and capital formation in America, entrepreneurship, creativity, and innovation. Clearly, we want to, in this committee, help enhance that, not detract from it. There is no doubt about that.

Senator Schumer mentioned New York, the U.S., with financial capital. Our country is historically based on creativity and innovation, and it has made America great. We are very proud of that. There will be more Googles, more Microsofts, and so forth the more we maintain that creativity and that innovation.

On the other hand, nobody likes paying taxes. I do not know of anybody who wants to pay more taxes. Everyone wants to pay lower taxes. That also, I think, is a truism. The question is, what is the proper level of taxation, and who should pay it at what level? That is what we are trying to do in this committee.

I think the more we answer that question correctly, the more we are going to correctly solve both truisms: (A) we are going to continue to be creative and innovative; and (B) we will find ways where people will grumble in paying taxes, but they will realize it is the proper level and the proper way.

I just want to make clear, my intention in this committee is to again find out what is right here. That is the goal we are trying to pursue here and that is the reason for having this hearing and subsequent hearings.

I do have some more questions, though. First, I might ask you, Mr. Donohue, about maybe the Blackstone offering, and I guess KKR is talking about going public, and others as well. I get the sense that some of these firms think the window might be closing a little bit so they are going to rush to move these offerings, maybe to cash out at an appropriate time. But for whatever reason, they are rushing to offer them in public offerings.

A couple of questions here. It is curious. Your private equity firms, they are buy-out companies. They buy out publicly held companies, arguing that this is the way to help drive companies to be more efficient and enhance performance, et cetera. On the other hand, the managers are going public. That is a little interesting to me.

Nevertheless, some say—those who argue in favor of the publicly held partnerships going public—that now there is greater trans-

parency to investors, that they are going to know what is going on, because after all, as you know better than anyone in the room, at least there is going to be the '33 Act, or whatever, there are going to be filings, 10(k)s, and so forth, quarterly reports and yearly reports.

So my question is about the confusion of what is actually going public. Are investors who provide these shares purchasing the share of a private equity fund or a hedge fund, or are they purchasing a share of the managers' fees?

Mr. DONOHUE. I will start off by saying that one of the most important analyses that we do relates to that very question of what is it that investors are purchasing. That is why we go through our status analysis on whether or not what they are purchasing is actually an investment company or whether it is an interest in an ongoing enterprise.

We also do an analysis of whether or not the offering of firms like Blackstone or Fortress represents the distribution indirectly of any of the underlying funds, and the conclusion we reached was that investors that were investing in Fortress and in Blackstone were clearly obtaining an interest in an operating company, a firm that manages other people's monies, and the success of that organization will be related certainly to how successfully they do that on behalf of other investors in those underlying funds, but will also be related to how well they run their business.

The CHAIRMAN. Correct. But they are not purchasing a share in the underlying funds. They are purchasing a share in the management.

Mr. DONOHUE. That is correct.

The CHAIRMAN. Not the underlying funds. So if Blackstone, Fortress, whomever goes public, the partnership goes public, the investors who are purchasing shares in that offering are investing in the management fees, not investing in the underlying investments that the managers operate.

Mr. DONOHUE. That is correct.

The CHAIRMAN. All right. Thank you.

Now, the next question. How much can an investor in these managers determine from the public filings? Can they determine the amount of leverage in the public filings of the partnership going public, the amount of leverage that the firm is undertaking? A lot of these funds have a lot of leverage, as we well know.

Mr. DONOHUE. I would make a distinction here between the amount of leverage that might be employed in underlying funds that they manage and the amount of leverage that the company itself has. Certainly the amount of leverage that Blackstone, Fortress, or similar companies might have, public companies, is determinable from the registration statement and filings.

The CHAIRMAN. But there is no way to determine the leverage in underlying funds.

Mr. DONOHUE. No.

The CHAIRMAN. From the filing.

Mr. DONOHUE. Some may. I am not sure I could.

The CHAIRMAN. But basically they are not there.

Mr. DONOHUE. Yes.

The CHAIRMAN. I mean, the disclosure is not there with respect to the underlying funds.

Mr. DONOHUE. That is true.

The CHAIRMAN. What is public, what is disclosed, is, again, the managers' operation, it is not the investment strategy or investments undertaken through underlying funds.

Mr. DONOHUE. That is correct.

The CHAIRMAN. All right. Thank you.

So can an investor figure out what assets are owned by the fund, by the managers?

Mr. DONOHUE. As a general matter?

The CHAIRMAN. That is disclosed with the public filing, the partnership filing, public filing.

Mr. DONOHUE. From the public filings, it would be difficult unless it was material to the issuer of the securities, which would be the operating company. It would be difficult. You would not be able to determine that.

The CHAIRMAN. Does a person who invests in a publicly held partnership have voting power over what the manager does or does not do, as is typically the case with someone who buys a share of corporate stock?

Mr. DONOHUE. They do have the rights that are accorded to them under the organizational documents for that company and consistent with State law.

The CHAIRMAN. Correct. And what does the S(1) say on this point, right on the front page? I have read it. What does it say?

Mr. DONOHUE. They do have rights to vote on certain things, but because——

The CHAIRMAN. No, they do not.

Mr. DONOHUE. But because of the amount of ownership that they have, it is very limited.

The CHAIRMAN. It is basically no right. I read that front page and it is right there. I used to work at the SEC a long time ago and was involved in a lot of filings. It is just very clear what it says. There is no voting power, basically.

What rights does this person have that are similar to the rights of a common stockholder?

Mr. DONOHUE. Well, they have the rights that are accorded them under State law with respect to their ownership interest in those companies.

The CHAIRMAN. Right. So what are the different rights, generally, that a person who buys one of these shares of a publicly held partnership has compared with the person who buys stock of, say, General Motors, or shares of General Motors?

Mr. DONOHUE. They have similar rights to their economic interests.

The CHAIRMAN. They do not have voting power.

Mr. DONOHUE. They have voting power, but remember, if Blackstone was in a corporate form and only 10 percent of the ownership interest was being distributed to the public, the public would have very limited rights to change anything because 90 percent of the voting rights would be residing with some other party.

The CHAIRMAN. I know. But that is not the issue. I am sorry, that is an obfuscation. That is a little smoke-and-mirrors. The

same would apply if the institution owned most of the shares of the publicly held shares, too.

Mr. DONOHUE. That is correct.

The CHAIRMAN. So that is not a fair answer, to be honest with you. I do not think that is a fair answer. The basic point is whether someone has a controlling interest or a non-controlling interest in a publicly held partnership, and they do not have the same voting power that someone with a controlling interest would have when holding shares of common stock in a company.

Mr. DONOHUE. Mr. Chairman, if I could make a point here with respect to what the role is of the SEC with respect to public companies. Under the '33 Act, the SEC's role is to make sure there is adequate disclosure with respect to points similar to what you have pointed out, and also make sure that there is no fraud or other things going on.

The CHAIRMAN. Right. I appreciate that.

Mr. DONOHUE. So there was a point of time, I believe, back in the 1990s when the Commission had taken action to move towards one share/one vote, and it was overturned by the courts.

The CHAIRMAN. That is another issue. Thank you very much.

Senator Hatch?

Senator HATCH. Well, is it not true, Ms. Mitchell, that virtually every investment that comes your way is done because you believe in management?

Ms. MITCHELL. Absolutely.

Senator HATCH. Is it not true, Mr. Donohue, that almost everybody who invests in the stock market, if they have any brains, are investing because of management?

Mr. DONOHUE. I would hesitate to agree that almost everyone.

Senator HATCH. To be that broad?

Mr. DONOHUE. But generally I would agree with you.

Senator HATCH. All right. I will let you slip off just a little bit there.

How about it, Mr. Solomon?

Mr. SOLOMON. Clearly, the investors make their decision about whom to invest with based on the track record of the managers.

Senator HATCH. Sure.

Now, Ms. Mitchell, do the people who invest with you have any liability if something happens, if you go bankrupt?

Ms. MITCHELL. The limited partners?

Senator HATCH. Yes.

Ms. MITCHELL. No, they do not.

Senator HATCH. No. So they get limited liability for investing with you. That is a tremendous benefit. Once they make the investment, they are off the hook, right, except for the investment?

Ms. MITCHELL. Right.

Senator HATCH. And if they are lucky enough to be part of that 20 percent that really hits it big, then they get the rewards from that. Is that right?

Ms. MITCHELL. That is their goal.

Senator HATCH. All right.

Well, I think what I am saying is this. I believe everybody should pay fair taxes, but I also believe that one of the things we ought to consistently try to do up here on Capitol Hill is make it possible

for people to not only get a return on their investment, but for the public at large and the country at large to benefit from those investments in a better economy.

Now, let us face it. There are some people in general partnerships who make a fortune every year because they are very good managers, and there are some people up here on Capitol Hill who do not like that, that they are making that much money.

On the other hand, it is amazing how, in this country, those who reach that status of making a lot of money seem to come from the bottom sometimes. Those who are millionaires today may not be tomorrow, but there will be a lot of new millionaires if we continue to have the incentives to be able to invest and to use those investments wisely, which I believe you have done.

I think Mr. Gergen is right, too. Our tax code is so complex that there is lot of unfairness in the code. It would be wonderful if we could somehow or other make it fair for everybody. I think most of my colleagues want to do exactly that.

On the other hand, the one thing I do not want to do is stifle investment, stifle economic development, stifle economic opportunity, stifle the right of people to be able to invest with people like you, Ms. Mitchell, who have been successful, who have spurred on some of these smaller companies. You mentioned eBay, you mentioned Google.

Ms. MITCHELL. Right.

Senator HATCH. I deal in the intellectual property world all the time, but I have to say that those are some of the most risky investments at the start. The dot-com bubble turned out to be exactly that when it burst, and there were very few companies that really made it big.

But there were companies that made it big because of, I guess, good management and the ability of people to risk-assess their investments in spite of the fact that you are rolling the dice in some of the start-up companies.

Ms. MITCHELL. Right.

Senator HATCH. I just want to personally thank all of you for your testimony here today because it has been very, very important to me personally, and I think to the public at large.

But I am very loathe to tax partnerships just because they make a lot of money, and because the partners make a lot of money. There is a lot of risk to it. And having tried some of these cases, I have seen people's whole lives just destroyed because the dice they rolled did not come up right.

Ms. MITCHELL. Right.

Senator HATCH. And they made mistakes, or for some reason or another the economy went down and their particular investors lost their money and they wound up, some in jail, many in bankruptcy. But those who do the job, I do not begrudge the money to them because that money is not generally squirreled away in mattresses. What do you do with that money when you make big money? The partners come back with more, do they not? Am I wrong?

Ms. MITCHELL. You raise your next fund and you invest it in more start-ups to create more jobs.

Senator HATCH. Right. Well, that is the way our country has been the greatest country in the world. I do not want to see us go

downhill just because we resent some people who make a lot of money. Of course, I have to admit, we all do resent them from time to time, do we not? [Laughter.]

Well, I just want to thank each and every one of you for your testimony. It has been very enlightening to me, and right across the board every one of you have been very, very interesting.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

On a lighter side, I was just sitting here thinking, we can get the opinion maybe of Professor Gergen, you know, there are a lot of lobbyists in this town who have been hired on this issue. I wonder, could they form a partnership——

[Laughter.]

The CHAIRMAN [continuing]. And convert their fees into carried interest so some will get capital gains treatment? I am just curious. I mean, there is an awful lot of money on this issue in town and I am just curious if they could form a partnership to accomplish that result.

Mr. GERGEN. Let me spin off of that. Not the lobbyists, but give me a group of plaintiffs' lawyers who have lawsuits where the damages will be capital gains. If we could get past the rules on champerty, which I think we can, we can convert that into a limited partnership where their contingency fees become capital gains. All we have to do is get past the rules on champerty that bar the assignability/salability of a lawsuit. They are not as strong as you might think.

The CHAIRMAN. Which raises an interesting question. Irrespective of whether it is proper policy or not, does it enable certain people to get greater after-tax income? That is, the current partnership rules with respect to carried interest. How many other entities would be looking at this and saying, hey, why not us? Why should we not convert to a partnership form in order to take advantage of this phenomenon?

Senator HATCH. Well, I hope there will be a lot of them.

The CHAIRMAN. I am just asking the question. Is it easy or not easy to do?

Mr. GERGEN. You would have to have an entity where you are performing labor with capital from other people, where the yields on the capital or capital gains are taxed at some other tax-preferred rate. So that would define the universe of possible companies.

The CHAIRMAN. All right. You are right.

Mr. GERGEN. How large that universe is, I just have not tried to think. If I was in the business of making money instead of teaching, I might. [Laughter.]

The CHAIRMAN. Ms. Mitchell, I am just curious. You said that there is a real down side for the general partner.

Ms. MITCHELL. Yes.

The CHAIRMAN. We all know the down side of limited partners is, they lose their investment.

Ms. MITCHELL. Right.

The CHAIRMAN. Could you explain in a little more detail so we can more fully understand what the down side is for the venture capital firm?

Ms. MITCHELL. Yes. I will give you two quick examples. One is, we could have a situation—as you will recall, we invest the money in companies, we draw our management fees to cover our expenses, then we have companies that go public or get acquired and we first take all that capital and repay that to the investors.

So during the period of the fund, before I actually have earned my carry, which is after all that capital is returned and all of the fees are returned, I may actually have a taxable event on a gain because there is an early gain in the fund, but yet I have not gotten the cash for it.

And it may turn out that the rest of the investments that I make throughout the rest of the fund, because my partnership is formed around a collection of companies, not an individual company, the rest of my companies may lose money.

So at the end of the day, I simply return the capital and the management fees to the investors and there is no capital gain. I will have paid tax in earlier years because there was a gain in a given year on a partnership taxed to me on a flow-through basis that I will pay taxes on that I will never have a gain on to offset against out of that fund.

The CHAIRMAN. But in the meantime do you earn a fee?

Ms. MITCHELL. Yes. That is taxed as ordinary income. Absolutely.

The CHAIRMAN. You have the manager's fee independent of carry?

Ms. MITCHELL. Yes. When we sat down with our limited partners to negotiate, which we did, actually, most recently at the beginning of this year, the objective of that fee was just—just—to cover our operating expenses.

They really wanted us to have all of our up side in the carried interest, not fees. They do not want us to make money and get wealthy off of the fees, and that is not the intention of the fund that we formed. Our up side, our hope that we are working hard for, is the capital gains that happen down the road.

The CHAIRMAN. But on a net basis, you get your fees, you pay tax on some early distributions.

Ms. MITCHELL. Yes.

The CHAIRMAN. On a net basis, I am just trying to get a feel for how much of a down side is there, independent of carry.

Ms. MITCHELL. There is a second example I could give you where I could lose real money. If, in fact, we have such a large winner that early on—that early example I just gave you—and this is actually a real-life example, not from my fund, from another fund, where it earned so much that actually the general partner got a distribution of stock in this given company.

Again, the later results of the fund—and this is one of the first investments of the fund. All the later results—this was, I believe, a bubble fund—all the rest were losses. We have a contract clause with our limited partners called a claw-back, and, if at the end of the day I receive a distribution of stock, as in this example's case, and at the end of the day we did not make money, I have to give that back to my limited partners because I did not, on the full portfolio, earn enough.

In this particular example, what happened with that, the stock was dropping during a lock-up period. The value of the stock went to almost zero. So the general partners actually had to write checks to close out the partnership for this claw-back that, (A) they had paid taxes on, and (B) no longer had an asset to liquidate in order to both pay the taxes and pay the claw-back.

The CHAIRMAN. I appreciate that.

Senator Grassley?

Senator GRASSLEY. Thank you very much.

Professor Gergen, would you please comment on Senator Crapo's question that came very early in the hearing regarding the movement of investment funds offshore? Would it be so easy to avoid U.S. tax by moving offshore? It is my understanding that U.S. citizens are taxed on their worldwide income no matter where they live.

Mr. GERGEN. It is a very complicated question. To the extent we are taxing it as compensation and not as capital gains, it is harder to avoid U.S. tax without giving up your U.S. citizenship. But it is not impossible. You can use various shielding devices.

On the other hand, to the extent we are taxing them as capital gains or other returns, it is much easier to keep the funds offshore and never pay U.S. tax on them. So if we are worried about that, something that tries to tax these as compensation is less likely to see funds shifting offshore, but you are still going to see some evasion. Hanging on to the U.S. tax base is very, very complex.

Senator GRASSLEY. My next question is about Senator Ensign. I think he said something about his veterinarian business and the sweat equity he had in it. I think he was trying to make the point that we were going to tax that sweat equity.

What is your response to points like that about sole proprietorships and founders' equity?

Mr. GERGEN. I actually was almost tempted when he said that—I would like to go back and look and see what he did, because he may not have complied with the law when he sold his veterinary business. [Laughter.] I do not know. If he was in a corporation, we are not going to tax the sweat equity. We treat it as a sale of corporate stock.

If it is a true sole proprietorship that he does not hold through a corporation, some of the gain is likely to be ordinary income unless it was structured as a sale of assets good will.

Indeed, some of the more complicated rules in subchapter K would prevent people from taking a sole proprietorship and turning it into a partnership and be able to convert what would be ordinary income on sale into capital gains. But that is when we were just talking about the single person.

Coming back to the point about founders' capital. If you give them a credit for their capital contribution, to the extent they have actually made a capital investment, we are not going to be taxing returns on that as ordinary income.

Then I will give my example where A and B would start a company, they grow it in value to where it is worth $2 million. Only that $2 million would be taxed as ordinary income, and that is only if we taxed as ordinary income if they were holding it as a sole proprietorship on their own under the general rules of section 1211.

Any remaining returns on their capital, their founders' capital, would be taxed as capital gains as pro rata returns on their capital.

Senator GRASSLEY. Thank you.

Peter, I would like to ask you, but before I ask you the question, I kind of recall lobbyists in Washington, and typically it seems to me they have a weak hand when they tell me the reason we should not close a tax loophole, not because it is going to hurt that lobbyist's client, but it is going to hurt somebody else.

We are seeing right now, with the private equity and hedge fund lobbyists, they are trying to say that the best reason not to have managers of hedge funds and private equity pay the same rate as everyone else is because it would hurt the pension funds.

We just had a story this morning, *Bloomberg,* a report that pension officials strongly disagree with the decision by Congress to have hedge funds and private equity managers pay the same rate as everyone else, that that is going to hurt workers' retirement. So, a few quotes: "'This argument that this is about the interests of retired public employees is ludicrous,' said Orin Kramer, who manages the State Pension Fund in New Jersey, 'and places billions of assets in private equity firms and hedge funds.'"

Then there is Michael Musraca, who sits on a union pension board that also invests billions in private equity, who said, "Suggesting that changing the tax status on carried interest would lead to public sector pensions being jeopardized is taking a pretty extreme view of their importance."

So do you agree with the statements of these officials who manage and invest for pension funds, that Congress should look at the merits of deciding these issues and not the impact on pension funds, and, if there is an impact, it is going to be negligible?

Mr. ORSZAG. In general, yes. And let me just explain, briefly. To the extent that the limited partners are tax-exempt entities, changing the tax treatment of the income flowing to the general partners does not have any direct effect on them. The argument you would have to make is that somehow the tax benefits of the general partner would be shared with the limited partners, and the evidence in favor of that is at least unclear.

I want to also then come back to an earlier question. To the extent that the investors in these funds are taxable entities, and I am just coming back to the question Mr. Kyl asked, the flip side of higher tax for the general partner is a tax reduction or a tax break for the limited partner. Those are mirror images of each other.

For tax-exempt investors, that latter part is not relevant because they are tax-exempt. But for taxable investors, you need to look at both sides of the equation.

Senator GRASSLEY. All right.

And my last question is both for Mr. Solomon and Mr. Donohue. In their registration statements filed with the SEC, some management firms going public as partnerships assert that they are not properly treated as investment companies under the Investment Company Act of 1940 because they are performing asset management and investment advisory services and are not investing in securities.

At the same time, the rules of the tax code limit permitted income of publicly traded partnerships to certain types of passive in-

come, including capital gains, dividends, interest, and other specified types of income.

Two questions, and I will ask them both at once. Do you perceive any inconsistency in these positions, and might one view any potential inconsistency as regulatory arbitrage, as some commentators have called it, by taking opposing positions under different regulatory regimes to get the best of both worlds?

Mr. SOLOMON. Focusing on my lane, which is the tax side, the question is whether the income constitutes capital gain. That is the specific question asked in the tax code.

To the extent that the income is ordinary income, it is treated as such, and to the extent that it is capital gain, it is treated as such. That is the analysis that one would do under the tax code to make the determination under the particular section that you are mentioning.

Senator GRASSLEY. Mr. Donohue?

Mr. DONOHUE. From our perspective, when we were doing the analysis of whether or not the entities were investment companies, we looked to the reality of the situation and we concurred with the view of the company with respect to the character of what they were doing and the ownership. They were not investing their own assets, they were investing on behalf of others.

The fact that they had, some might view, a contrary view of what their tax status should be, they had tax opinions from counsel that were part of the registration statement with respect to whether or not that was correct. From the disclosure point, that was in their registration statement.

Senator GRASSLEY. All right.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Hatch?

Senator HATCH. Thank you, Mr. Chairman. I think that this has been a very interesting hearing and a very interesting panel. I appreciate all of you being here. Thank you.

The CHAIRMAN. I just have a question. I apologize. This may have been addressed. I have been absent for part of the hearing and somewhat distracted sometimes on other matters.

I hear from those who oppose changing the tax treatment that if, generally, the general partners have to pay ordinary income tax on, say, the proportionate share of contributions, they get capital gains on their proportionate share of the capital they contribute, otherwise it is ordinary income for the services they perform and so forth, that that will have a detrimental effect on the underlying investments, that somehow the agreements—this is all so complicated, I do not understand it.

But somehow, in the contracts and the agreements, either among the partners or with some of the subsidiaries that the general managers largely operate, that those contracts will have to be changed or renegotiated. It even goes to pension funds and endowments.

Somehow, as a consequence, the rate of return for the pension funds or the university endowments will not be as great because somehow the general partner will have to take it out of the hides of the endowment or the pension fund. So, I hear that argument, and I just wonder if somebody could address it.

Mr. ORSZAG. I will take a crack at that. Let us take a case where the investors, the limited partners are tax-exempt and the general partner is a taxable entity. You could make two different arguments. One is that the tax benefit to the general partner is shared with the limited partners, or you could say that the general partner retains the full tax benefit.

In the case in which the general partner is retaining the full tax benefit, there is no effect on the limited partners, and changing the tax treatment of the general partner would not affect things at all.

To the extent that things are being shared, and there is offset to the limited partners, then some of the arguments about entry into being a general partner, et cetera, would also be attenuated.

That is to say, if you can lay off a lot of the tax change onto your underlying investors, your net return is then changed less and your incentives to participate in this kind of activity is basically the same as it was before.

I think it is more likely that the general partner is retaining more of the tax benefit in this case, in which case changing the tax treatment to ordinary income would not really affect the limited partners and underlying investors that much.

It may affect the incentives to be a general partner as opposed to an executive at a financial services firm or a manager of a public investment fund, but there seems to be plenty of people willing to do those types of activities also.

The CHAIRMAN. Any other response to that question, anybody? Mr. Gergen, do you have a view?

Mr. GERGEN. Well, it just depends on, as you were saying, the elasticity of supply of these sort of management services. A lot of us think it is very inelastic. You raise the tax rates slightly, you are not going to affect the supply of it.

Then the question is to what extent these tax benefits are flowing to the people who invest, the capitalists. If they are not, you are not going to affect their yields at all. So, my hunch is the same as yours, but it is finally an empirical question.

Ms. MITCHELL. I strongly disagree with that statement. I think you hit that at the very end of your comments, the incentive—you know, if I am the sweat equity in a small company, or let us say a large one—but in a small company, why would I spend my time in an early speculative deal that I can lose money in when I could alternatively get——

The CHAIRMAN. But do you lose money? That is not the point. You own a large cash contribution.

Ms. MITCHELL. No. But again, in the example I gave you previously, we actually can lose money as part of our——

The CHAIRMAN. Can. But ordinarily, customarily, with the fees that you get, management fees——

Ms. MITCHELL. It is not as rare as you would think.

The CHAIRMAN. All right.

Ms. MITCHELL. The issue really is, why would I do that? Why would I want to spend—we sometimes found companies, as an example, and actually within our offices incubate it, write the business plan, attract the entrepreneurs ourselves.

Why would we do that versus, let us say, a later stage investment or an entirely different form of investing that has much less

risk associated with it, much less time and effort, much fewer intangible contributions we need to give in terms of trying to work and make that happen? I think, naturally, you would find fewer time, money, individuals.

I think that will be the issue. There will be a lot of capital available, looking for people who are willing to, in essence, speculate their time over the 7, to 10, to 12 years it takes to hopefully be successful, and you may not find them.

The CHAIRMAN. Well, I deeply appreciate all of the time that you have dedicated to the hearing this morning. You have been very forthright, very helpful, and I thank you very, very much. We will obviously be looking at this for some time now, but, just, thanks. I cannot thank you enough.

The hearing is adjourned.

[Whereupon, at 12:47 p.m., the hearing was concluded.]

CARRIED INTEREST, PART II

TUESDAY, JULY 31, 2007

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Bingaman, Kerry, Lincoln, Wyden, Schumer, Stabenow, Salazar, Grassley, Hatch, Lott, Snowe, Kyl, Crapo, Roberts, and Ensign.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order.

The Apostle Paul wrote of this world, "Now we see through a glass darkly." We could say as much about the world of hedge funds and private equity. The world of hedge funds and private equity is opaque.

Today we will hold our second hearing on carried interest. We will try to shine a little more light through the glass on the operation of private equity funds, hedge funds, and real estate funds.

Private equity funds use a variety of strategies. They acquire companies and take them private. They provide structured financing for deals. Because private equity funds are not transparent, some misunderstand what private equity managers do. These hearings will try to help us see some more facts.

We see how private equity has a tremendous appetite for taking companies private. A cup of coffee from Dunkin' Donuts is produced by a company held by private equity. Private equity funds have incredibly diverse holdings, from hotel chains to toy stores. The ability of private equity funds to grow and expand is impressive. These are fantastic times for private equity.

Hedge funds serve an important role. They manage nearly $2 trillion in assets. Much of that money comes from pension funds, foundations, endowments, and other nonprofit corporations.

The returns of some funds are stellar. Some funds create tremendous wealth for investors and managers alike. The strategies that hedge funds use are not transparent. There is a reason for that. Very bright managers spend a great deal of time creating strategies to generate these returns for their investors. They want to keep those strategies secret. They would prefer that other managers not replicate their strategies.

But secrecy can also increase risk. We will try to see how risky some hedge fund investments are. Take, for example, leverage, the amount of debt that hedge funds take on to enhance their investing capacity.

There is a lot of misinformation, or downright disinformation, about how hedge funds use leverage to achieve investment goals. I talk about disinformation because, in a meeting in this very building, a hedge fund association implied that leverage in hedge funds is 1:1, that is, they are borrowing about as much as they hold in equity.

The reality is that hedge funds are generally leveraged at a minimum of 3:1, and more likely leveraged at least 10:1. That is, they are borrowing 3 to 10 times what they hold in equity. The public does not know the amount of leverage in any of these deals.

There is leverage at the fund level, and then depending on the strategies employed, the securities themselves could be highly leveraged. I hope that we can have an honest discussion. I hope that the many lobbyists employed by hedge funds in private equity will not make the glass even darker than it already is.

A manager of a fund receives two types of income, a management fee of around 2 percent of capital, and a carried interest of 20 percent of the profits. The management fee is generally taxed at the ordinary income rate.

A carried interest is the interest that the manager has in the profits of the investment partnership. The manager receives the interest when the fund is created, and the manager 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.

As we discuss whether income from carried interest should be treated as income from a service or receive the character determined at the partnership, there are also issues that could cloud the view.

For example, many private equity fund managers convert portions of their management fees into additional carried interest. Some managers aggressively convert management fees into carried interest on a quarterly or annual basis.

Many hedge funds use Cayman Island or other off-shore corporations to bring in foreign and nonprofit investors. With the off-shore part of the fund, the manager receives an incentive fee of 20 percent of the profits from the foreign sale of the fund. This fee is taxed at the ordinary income rate. For the domestic part of the fund, the manager has a 20 percent carried interest that is taxed as capital gains income.

Economically, I do not see the difference between the incentive fee and the profits interest. Both give the manager 20 percent of the profits, whether off-shore or on-shore.

There is little difference between a large private equity firm and a Wall Street investment bank. Both offer merger and acquisition services. Both provide mezzanine financing for transactions. Both offer a wide array of investment strategies for their clients. But only one claims that the income from an active business is passive and is subject to capital gains treatment.

Once again today, we have a balanced panel of actual managers of alternative investment funds who can discuss how profits inter-

est plays a role in their deals. For now, we may see through a glass darkly. We will try to see face to face. For now we may know in part, but we will try to know more completely. We can hope, perhaps with a little charity, maybe a little change, that our faith in our tax system will abide.

Senator Grassley?

OPENING STATEMENT OF HON. CHUCK GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. Yes. Mr. Chairman, thank you very much for holding this hearing. Beyond the short remarks I am going to make this morning, I have a long statement that is going to be included in the record, please.

This is our second hearing on the tax treatment of carried interest. At the last hearing we had a balanced approach. We have the same here today. This hearing, and the committee's inquiry, is about the distinction between capital income and labor income.

This issue arises frequently in partnerships when a person receives a carried interest or an interest in the partnership's profits in exchange for performing services for the partnership as opposed to contributing capital.

This hearing is not about well-settled principles regarding capital assets or the propriety of current capital gains rates. It is not an attack on the investor class or capital formation. We are not questioning the tax treatment of the return on any partner's invested capital. That return is, and should continue to be, taxed at preferential capital gains rates.

This hearing is also not about a revenue grab for Congress. It is not about whether alternative asset managers are good or bad for society. We are not here to have a hearing on each industry and to measure its value to society, and assign the tax rate accordingly.

This hearing is about our responsibility to ensure that the tax code is operating fairly and consistently with the intent behind enacted policies. If it is not, then there is an unintended subsidy being provided to some, while others pay for it with higher taxes.

There are a lot of sound, pro-growth tax policies that Congress needs to advance to keep our economy strong. The individual capital gain preference is an obvious one. Like I have done before, I will be working to get that policy extended.

Another policy is our corporate tax rate, which is the second highest among OECD countries. We are standing still while our trading partners are lowering their corporate tax rates.

Economists tell us to make our system more efficient by lowering rates and broadening the base by eliminating preferences for specific industries. Well, we are looking at a potential base-broadening here. But if we cannot even examine these kinds of issues in a deliberate, thoughtful way, then I am afraid that we are never going to get into a position to talk about lowering rates and being competitive worldwide.

Folks on both sides of the aisle ought to roll up their sleeves, move away from partisan talking points, and join Chairman Baucus and me in finding the facts. The carried interest issue is complicated, and some might say headache-inducing, but this com-

mittee is responsible for getting the policy right, so we need to take our aspirin and wade in.

Mr. Chairman, you may remember a TV series, "Dragnet," and the character, Sergeant Joe Friday and his partner Bill Gannon.

The CHAIRMAN. I do.

Senator GRASSLEY. Sergeant Joe Friday used to say, "Just the facts, ma'am." Like Joe Friday, we are here to get the facts. We have not made up our minds yet. With that open mind, I look forward to today's discussions.

I will also look to submit for the record my response to some of the criticisms of our publicly traded partnership bill. The two arguments I respond to are: first, it singles out private equity and hedge fund management firms and, second, it would result in an unfair triple tax on private equity management firms that go public. I disagree with those arguments, but, rather than taking too long to go through those detailed responses, that is what I have asked to be put in the record.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Grassley.

[The prepared statement of Senator Grassley appears in the appendix.]

The CHAIRMAN. Before I introduce the witnesses, Senator Roberts has asked me—maybe he wants to, himself, indicate what he wants me to do. Senator Roberts?

Senator ROBERTS. I thank the chairman and I thank Sergeant Friday. [Laughter.] Mr. Chairman, I have a personal commitment to see if I can get this cast off my arm at 10:30—with a doctor, by the way—so consequently I would like to submit my statement. I would like to insert my statement at this part of the record, and ask unanimous consent that I do so.

[The prepared statement of Senator Roberts appears in the appendix.]

Senator ROBERTS. I have several questions for the witnesses, if I could submit them for the record. But like Douglas McArthur, I shall return when I can.

The CHAIRMAN. They will be included. Thank you very much, Senator. Good luck.

[The questions appear in the appendix.]

The CHAIRMAN. All right. Our panel is very distinguished. We have a lot of panelists here. It is a great opportunity for us.

First, Professor Joseph Bankman, professor of law and business from Stanford Law School; second, Charles Kingson, lecturer at the University of Pennsylvania Law School and New York University Law School, and former International Tax Counsel at the Treasury in the 1970s; third, Professor Darryl Jones, professor of tax from Stetson University Law School. Thank you.

Next, Mr. Adam Ifshin, president of DLC Management Corporation; fifth, John Frank, managing principal of Oaktree Capital Management, LP; and next, Mr. Bruce Rosenblum, managing director of Carlyle Group and chairman of the board of the Private Equity Counsel; finally, Bill Stanfill, founding partner of Trailhead Partners, LP, a venture capital fund.

Thank you all for coming. If you have longer statements than the allotted 4 minutes, they will be included in the record. But I do

urge you to stay within your allotted times because we have a lot to go over this morning.

Mr. Bankman?

STATEMENT OF JOSEPH BANKMAN, RALPH M. PARSONS PROFESSOR OF LAW AND BUSINESS, STANFORD LAW SCHOOL, STANFORD, CA

Mr. BANKMAN. Thank you. May I ask, we cannot see the clock over here. Is it possible to scoot it around this way?

The CHAIRMAN. We will turn it around just like that.

Mr. BANKMAN. There we go. All right.

The CHAIRMAN. Well, you have already taken 30. We will give you an extra 30 seconds. [Laughter.]

Mr. BANKMAN. Thank you. Chairman Baucus, Senator Grassley, members of the committee, thank you for inviting me to speak today.

I support taxing carried interest as ordinary income. The change will make the tax law more efficient by reducing economic distortion.

Students at Stanford and elsewhere who are interested in business become investment bankers, management consultants, and they can become executives and pay tax at a maximum rate of 35 percent on their income. The same rate is true of students or anyone else who goes into virtually any other occupation you can imagine.

Alternatively, these students can become fund managers or other profit participants and pay tax on their income, much of it, at a maximum rate of 15 percent. This two-tiered tax system distorts career choice and in so doing reduces rather than expands the size of our economic pie. It is also unfair. Why should a surgeon, a school teacher, or a CEO pay tax at twice the rate as a fund manager?

I would like to briefly respond to some of the arguments that have been made in support of the present rule. We are told that fund managers do a terribly important job, and of course that is true, but so do members of the other occupations.

We are told that fund managers will work less if we tax them at the same rates as everyone else. If that is true—and it is a big if—the same reasoning applies to members of every other occupation. We are told that taxing fund managers might hurt investors on the thought that investors indirectly benefit from the low tax rate on fund managers.

The same reasoning would imply that we have the same low tax rate on lawyers or anyone else who helps out investors. If Congress wants to reduce the tax rate on investors, they do not have to adopt a Rube Goldberg scheme where we first reduce the tax rates on high-paid professionals and then hope that some of the benefit goes to investors. Congress can simply reduce the tax rate on investors directly through accelerated depreciation or lower taxes on investment income.

We are told that we should keep this low tax rate on investors because certain industries benefit. First of all, it is going to be an inefficient way to benefit any industry for the reasons I just described. If you want to benefit an industry, you should do so di-

rectly and not benefit the professional income of some individuals who work some of their time within a particular industry.

Moreover, I would hope that Congress decides not to try to benefit a particular industry. Our economy works best when we have the same tax rates across all industries. If high tax rates are a problem, we ought to reduce them across the board and maybe use the revenue you gain from changing the law here to do so.

Fund managers have been compared to entrepreneurs, but the two groups are really quite different. An entrepreneur may spend a decade or more pursuing a single idea at little or no pay, betting her and her family's financial future. Fund managers receive handsome annual compensation and perform services connecting investors with companies and rendering certain advisory services.

If those services are successful, there is an additional payout in the form of carry. That is similar to an incentive bonus that a CEO might get. The CEO is taxed on that incentive bonus at ordinary income rates in the year he receives it. Under the proposal Professor Gergen and I favor, the same would be true of the fund managers.

I do share one concern that some of the opponents of change in this area have voiced. Changing the law here will require certainly ancillary changes in subchapter K, and those changes may make life difficult, at least temporarily, for some of the smaller partnerships. It is also true that in the smaller partnerships the profit participants do resemble entrepreneurs.

Eric Solomon, in the July 11 hearing, brought up the example of the clothing store owner. I think you could find that same kind of entrepreneurial resemblance in a partnership involving more significant activity in terms of asset size.

So while I favor changing the law here, I would urge the committee to consider applying the new rule only to the larger, or even largest, partnerships. My sense is that might be a good balance of equity and concern for compliance costs, and still get the committee most of the revenue and equity advantages that that change would bring.

The CHAIRMAN. Thank you very much. That was very succinct.

[The prepared statement of Mr. Bankman appears in the appendix.]

The CHAIRMAN. Mr. Kingson?

STATEMENT OF CHARLES KINGSON, ADJUNCT PROFESSOR, NEW YORK UNIVERSITY LAW SCHOOL, NEW YORK, NY; AND LECTURER IN LAW, UNIVERSITY OF PENNSYLVANIA LAW SCHOOL, PHILADELPHIA, PA

Mr. KINGSON. These are my individual views. The issue is whether amounts received for managing capital assets should be treated as selling capital assets. It is phrased as how to tax a carried interest, but it is not what tax law means by a carried interest at all.

A carried interest was something in oil and gas law, which Congress repealed and redefined as mortgage debt in 1969. Even when it was in force, nobody said that you look through to the underlying assets outside mineral interests. A court said, basically, you do not have an economic interest in the assets just because your right to payment is measured by profits, dividends, farm crops, or the like.

The question is then, what is the right analogy? You have people running pooled brokerage accounts on a contingency. What they get depends on what the client gets. The closest analogy I can see is people who did this for a long time, and they are tort lawyers. They have contingent fees. I mean, they get a percentage of how much they recover for the client.

Two years ago, the Supreme Court ruled that a tort lawyer, who got a percentage of the recovery that his client got, did not own the claim even though State law gave him a lien on it. The court said basically, he got a fee, and I think these are contingent fees. The same distinction between selling property and furnishing services obtains for artists as well as hedge fund managers, and it is again based on risk. If I pay Andy Warhol for a picture of a soup can or Marilyn Monroe, he is selling a painting. If, on the other hand, I pay an artist to paint a portrait, he is performing a service—because he has no risk of loss in the property.

Now a partnership is supposed to change this, but it is not really an economic partnership. A partnership is for richer or poorer, for better or worse; but these guys are just in for richer and better. They do not put up any credit, they do not put up any money, they do not bear any losses. If they do not put up anything but services, what they get is compensation.

What is more, they themselves do not even believe in the partnership. As the chairman said, basically, when foreign investors come in they could, if partners, be deemed to be doing business here. The managers then say, well, let us make it a performance fee, and it is really the same deal.

Even if the managers are partners, the amounts they receive are taxable as compensation if it is a capital interest. They say, no, it is a profits interest. Well, a profits interest is like Professor Bankman's clothing store. If I get 20 percent of the profits by being out on the floor and selling the stuff, that is a profits interest. But I do not share in the gain from sale of the building. Profits and capital interests distinguish between ordinary operations and appreciation in assets.

Hedge funds are all about appreciation in assets—that is their business. But to claim capital gains on the ground because you own the fund's assets, and to then say, well, you never got a capital interest in those assets, that, to me, makes no sense.

My conclusions rest on looking at language, but that is what tax law does. Tax law analyzes the meaning of words; and tax avoidance usually rests, as in this case, on distorting their meaning.

Supreme Court tax cases usually turn on the meaning of words like "gift," "dividend," "debt," and "sale." Here, the difference between services and the transfer of property is one that is fundamental to tax law.

I mean, misconstruing it reverberates all through the code. Two aspects are retirement plans and employment tax: characterization of hedge fund fees as a sale of property may avoid over $180 million a year of Medicaid taxes. Another example, particularly with the rise of intangibles and commerce over the Internet, is determining how and where Americans and foreigners earn their income. Internationally, under source rules, how you earn income determines where you earn it. Whether we tax foreigners may depend

on whether they are performing services in their own country or selling intangibles in this country. Definitions apply to more than one industry and for more than one country.

So, although this hearing is about raising taxes on a few people who manage pooled brokerage accounts on a contingency basis, it is really more than that. It is what fundamental concepts like "sale" and "services" mean in tax law. I do not think that my interpretation of services is changing the law. If what is received really is compensation, this has been the law all along. This is not a change: what has happened is that the law has not been enforced. These people have gotten a free pass for so long, they think it is a constitutional right.

If they dispute this, I would like to see it tested. I would really like to see the Internal Revenue Service directed to audit these people on the issue for all open years. I would like to hear it explained to a judge how, when someone is advising foreigners, he is performing services and, when he is advising Americans, he is selling stock.

One other item. A significant portion of amounts received by managers at private equity funds is attributable to their eliminating tax on an acquired corporation. Thus, in a very real sense, what is being asked is reward under the tax code for fostering avoidance of the tax code.

The CHAIRMAN. Thank you, Mr. Kingson, very much.

[The prepared statement of Mr. Kingson appears in the appendix.]

The CHAIRMAN. Mr. Jones?

STATEMENT OF DARRYL JONES, PROFESSOR, STETSON UNIVERSITY COLLEGE OF LAW, GULFPORT, FL

Mr. JONES. Thank you, sir. I would like to start by saying that taxation of carried interest is to the tax code what the Abu Graib scandal was to the Iraq War. I am not speaking in hyperbole. I will explain that in just a minute.

But the capital gains tax rate is justified in theory by a logical, and even an elegant, theory. I hate teaching the mechanics of the capital gains tax rate, but I love the theory. I think the theory is unassailable. Students, too, hate the complexity of the number crunching, but they love the theory. But an ugly, unchecked incident, though, can undermine even an elegant theory.

In the Iraq War, we went in with an elegant theory and we had an ugly, unchecked incident or ugly incident that undermined a theory. The same analogy applies to carried interest.

If carried interest continues to be taxed as capital gains, it will severely undermine the elegant theory that I think Senator Grassley referred to that justifies the lower rates on invested capital.

Just yesterday, for example, the *Washington Post* published an editorial calling for the repeal of the capital gains preference, citing as evidence the abuse that is going on with the taxation of fund manager compensation. So you can have an elegant theory and, if you allow an abuse, you undermine the integrity of that theory.

The first hearing, Carried Interest I, suffered, I think, from a conspicuous absence of critical discussion about the purpose of the capital gains tax rate and whether that purpose is even furthered

by the application of those tax rates to the variable income fund managers receive.

In his opening statement during Carried Interest I, Senator Grassley stated that we justified the lower rate on capital gains as a remedy against the double taxation of investment income and the resulting benefits of economic growth.

On the other hand, certain testimony—that of Ms. Kate Mitchell and Mr. Eric Solomon—suggested that capital gains tax rates are justified to encourage taxpayers to assume greater risk than would otherwise be rational and, without that risk assumption, society would suffer from a lack of innovation.

Senator Grassley's statement is accepted tax law doctrine; Ms. Mitchell's and Mr. Solomon's are not. In neither case, though, do the doctrines support capital gains taxation in this instance, that is capital gains taxation of fund manager compensation.

Senator Grassley's simple and universally accepted statement deserves further scrutiny. You have a taxpayer who earns $100 after tax and then takes that money and purchases a piece of property for $100 during a time when annual inflation is 6 percent. They sell it next year or a year later for $106, and they get taxed on $6 of gain even though they really only have a nominal gain. They do not really have an economic gain, the gain is merely inflationary.

The taxpayer would have been better off immediately consuming the $100 in a selfish manner rather than investing that money in some way that generated jobs or some other social benefit. Likewise, a taxpayer who did invest the $100 would be better off not taking that investment out of some old technology. For example, the taxpayer might have invested it in 8-track players when CDs were all the rage. Instead of selling the 8-tracks and buying the CDs, they would stay in 8-tracks because the tax cost would be an economic barrier.

Implicit in Senator Grassley's observation is that there are beneficial savings, referred to as "investment," of previously taxed income. In the typical case, fund managers have never been taxed on income subsequently invested in long-term assets such that we should be concerned about the deleterious effect of taxation on nominal, as opposed to real, economic gain.

Fund managers are untaxed human capital, what Ms. Mitchell referred to as "sweat equity," not previously taxed financial capital, so the tax on human capital is a single tax and it will not discourage innovation that the managers claim will happen if we apply ordinary rates.

I see my time is up, so I will stop there. Thank you very much.

The CHAIRMAN. Thank you very much, Mr. Jones.

[The prepared statement of Mr. Jones appears in the appendix.]

The CHAIRMAN. Mr. Ifshin?

STATEMENT OF ADAM IFSHIN, PRESIDENT, DLC MANAGEMENT CORPORATION, TARRYTOWN, NY

Mr. IFSHIN. Thank you, Chairman Baucus and Ranking Member Grassley. My name is Adam Ifshin. I am the incoming chairman of the International Council of Shopping Centers' Economic Policy Committee, and I am the co-founder and president of DLC Manage-

ment Corporation, an owner, developer, and redeveloper of shopping centers, headquartered in Tarrytown, NY.

I am appearing today on behalf of the ICSC, the global retail real estate trade association for the shopping industry, the Real Estate Round Table, and other real estate organizations whose members will be significantly impacted by proposals to tax the return of all carried interest as ordinary income.

Simply stated, I believe if such a policy is enacted it will be the most sweeping and potentially most destructive tax increase on real estate development, real estate investment, and value creation in real estate since the modification of the passive loss rules of the 1986 Tax Reform Act.

I started DLC Management when I was 26 years old. I had no money and the commercial real estate industry was struggling to overcome the damage caused by the savings and loan crisis and the aforementioned 1986 Tax Act.

Since starting from the ground floor, my company has grown to become one of the Nation's preeminent owners and mid-sized operators of retail shopping centers, with 70 such centers located across 25 States.

Over the past 16 years I have led DLC to focus on revitalizing older existing properties in infield first-tier suburbs, cities, and some small towns. DLC is dedicated to creating value, primarily through redeveloping older, distressed properties in challenging environments which often include older suburbs and cities such as Peekskill, NY, environmentally challenged brown field properties in places like Levittown, PA, and inner city Baltimore.

We typically reinvest most of our capital gains in new projects to make long-term investments in communities that would not otherwise see such revitalization. The differential in the tax rate between ordinary income and capital gains is an important driver in our ability to recycle capital into new projects.

At ordinary rates, the return simply would not justify such risks that we take in many cases. Imbedded in our business plan is the concept that a material component of the return sharing is the general partner's profit participation taxed at a capital gains rate.

Real estate development involves substantial risk, and the reward on the back end is what makes that risk worth taking. Capital gains treatment for the long-term commitments we make to the investment is part of that reward. That assumes, of course, that there will be a reward in the end.

Many real estate developments never get off the ground, others fail or fall short of their investment goals. In all of these cases, the general partner typically receives no compensation other than nominal fees.

We take on significant risk every time we acquire a property. The general partner is typically at risk personally on construction loans, construction completion guarantees, and environment indemnities for all manner of real estate loans.

In sum, the general partner is taking risks beyond their investment in any given real estate project, and the carried interest is earned in part for taking that entrepreneurial risk.

Many of our projects are not short-term in nature. Many of mine have taken 5 to 10 years to reach full stabilization. If the carried

interest were to be taxed at ordinary rates, the material shift in the risk/reward trade-off for the developer would mean that fewer developers would take such long-term risks and that those that did would do it in higher-income, central business districts and fancier suburbs.

The key for us is that the tax treatment allows us to take risks that we would not otherwise take in places such as Newborg, NY, Spring Valley, NY, and inner city Baltimore, where there is a fundamental under-served nature for the consumer. Our developments typically lower the prices of basic commodities like milk and bread for people who can least afford to pay.

According to IRS statistics, in 2005 46 percent of partnership tax returns came from the real estate industry. The statistic is significant, as it clearly shows that carried interest applies to many more businesses than just hedge funds and private equity firms with which it is now being associated.

Thank you.

The CHAIRMAN. Thank you, Mr. Ifshin.

[The prepared statement of Mr. Ifshin appears in the appendix.]

The CHAIRMAN. Mr. Frank?

STATEMENT OF JOHN B. FRANK, MANAGING PRINCIPAL, OAKTREE CAPITAL MANAGEMENT, LP, LOS ANGELES, CA

Mr. FRANK. Mr. Chairman, Senator Grassley, members of the committee, I am here to address the proposed Publicly Traded Partnership (PTP) legislation and the adverse impact it has had on the mutual funds and other investment funds that invested in our firm just this past May, on behalf of individual investors and retirement funds across the country.

Oaktree is a leading alternative investment manager. We manage about $47 billion in 17 different strategies. Private equity is part of that, but a reasonably small part, about 18 percent.

Each strategy that we manage focuses on a non-mainstream asset class that some people might consider risky, but that we attempt to manage in a very conservative, risk-controlled way. No one has ever lost any money invested in Oaktree, and we have a very successful track record over a long period.

We are proud to manage money for 128 corporate pension plans, the pension plans of 28 of the 50 States, including, I think, more than half of the States represented on the panel, 225 colleges, universities, and charitable endowments.

As I indicated in May, just a couple of months ago, we sold about 16 percent of our equity to a group of mutual and other investment funds. As a result, we are now a publicly traded partnership. There is nothing unusual about our status as a publicly traded partnership and it does not push the envelope of any existing tax law.

In undertaking the offering and in becoming a publicly traded partnership for tax purposes, we consciously subjected a substantial portion of our income to a corporate-level tax, whereas in the past it had never been subject to such a tax because we were a partnership, as are essentially all of our competitors.

When we made that decision, we had no way of anticipating that the chairman's bill and the ranking member's bill relating to the PTP legislation might be introduced.

When we made the decision to make an offering, it was a close call. We weighed the disadvantage of additional tax against the advantage that we thought we would obtain by creating liquidity for our equity and a public valuation for our equity, an advantage that we primarily sought in order to compensate and retain our employees.

Now, the proposed legislation, had it been enacted, might well have caused us to change our view. In my judgment, it will cause others to become less likely to go public, others in our industry.

I think that is a disadvantage, and it causes me to doubt the merits of the legislation. I think it will result in less transparency for our industry, it will result in less access to the investment opportunity represented by our industry, which has historically only been available to the wealthy, and for those reasons I doubt the merits of the legislation.

But if the committee deems it appropriate, nonetheless, to go forward with the legislation, notwithstanding those considerations, then we very strongly urge that appropriate transition relief be granted.

As was indicated in the chart which was attached to my testimony, our outside investors, these mutual funds that represent money for individual Americans and their retirement funds, lost over $100 million overnight when the proposed PTP legislation was announced, and that was with a 5-year transition rule contemplated by the legislation.

When subsequent news reports indicated that that 5-year transition period might be in jeopardy, the stock lost another $50 million attributable to the portion held by the outside investors.

So we would urge the committee, if you move forward with the legislation, to grant all of the publicly traded partnerships that were in existence prior to the announcement and introduction of the legislation, at least a 10-year grandfather provision.

The last time the committee addressed this issue in 1987, it granted 10-year relief, which it later made permanent. In our case we think it should be at least 10 years. We do not believe it will provide any competitive advantage to the firms benefitted, either in the competition for investment dollars or in the competition for investments.

I see my time is up. I would be happy to answer any questions.

The CHAIRMAN. Thank you, Mr. Frank, very much.

[The prepared statement of Mr. Frank appears in the appendix.]

The CHAIRMAN. Mr. Rosenblum?

STATEMENT OF BRUCE ROSENBLUM, MANAGING DIRECTOR, THE CARLYLE GROUP, WASHINGTON, DC; AND CHAIRMAN OF THE BOARD, PRIVATE EQUITY COUNCIL, WASHINGTON, DC

Mr. ROSENBLUM. Mr. Chairman, Ranking Member Grassley, and members of the committee, thank you for inviting me to appear on behalf of the Private Equity Council to present our views on taxation of partnership carried interest.

First, a few points about the private equity industry. It is not just large firms like Carlyle. It includes hundreds of firms, large and small, located in all parts of the United States. Even today's

largest firms were small start-ups as recently as 15 to 20 years ago, and they are still owned in significant part by their founders.

Over the years, numerous companies, including such household names as AutoZone, J. Crew, and MGM have been turned around or improved by the focused strategies that characterize private equity investment.

Private equity has benefitted tens of millions of Americans through superior investment returns delivered to pensions, endowments, and foundations, and carried interest ownership structures are integral to the private equity business model.

Let us examine the arguments underlying proposals to raise taxes on carried interest. First, we hear that private equity firms are exploiting loopholes to avoid taxes on so-called compensation for services.

But a carried interest is not compensation, it is a feature of an ownership interest. It has been used for many years in many contexts. Its tax status is well settled, and it is anything but a loophole.

A second argument is that taxing carried interest allocations as capital gains is inconsistent with the principles underlying differential long-term capital gains rates. It is clear that the companies we own are capital assets and that the sale of those assets produces capital gains, but some say that our share of those capital gains should be recast as pay for performance.

This might make more sense if we were employees of the limited partners of our funds, but quite the contrary, a private equity fund is an enterprise established by its sponsor which sets investment strategy and makes all business decisions.

The sponsor raises capital from limited partners, offering them an interest with defined ownership rights, the first allocation of profits until they have received a minimum return, and 80 percent of the profits once this minimum has been achieved. The sponsor retains an ownership interest that entitles it to the remaining profits. We are co-owners with our limited partners, not their employees.

Finally, some say that private equity firms should not be eligible for capital gains treatment because we do not have capital at risk. For starters, this is not accurate. Private equity firms contribute substantial cash and intangibles to their funds and also retain the residual risks of a general partner.

But leaving this aside, 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 capital asset.

Sole proprietors of small businesses may invest very little capital and may generate most of their ownership value through personal efforts, but when they sell their businesses the profit is capital gain.

The founder of a technology company receives capital gains from the sale of a substantial stock interest even if he or she contributed only a tiny fraction of the company's capital. These straightforward rules apply even-handedly to everyone.

They reward entrepreneurial risk, whether that risk involves investing cash or investing years of time, effort, and vision. Strangely, the recent proposals on carried interest taxation would adopt a

policy that only those with money to risk should qualify for capital gains tax benefits.

A tax change of this magnitude is not without consequences. Private equity investment will not wither and die, but over time there will be deals that will not get done, there will be entrepreneurs that will not get funded, and turn-arounds that will not be undertaken, and it will likely mean lower returns for pensions and other investors. I urge you to proceed carefully before risking this adverse impact on entrepreneurial activity that has been a positive force for the U.S. economy.

Thank you, Mr. Chairman. I would be happy to answer questions.

The CHAIRMAN. Thank you, Mr. Rosenblum, very much.

[The prepared statement of Mr. Rosenblum appears in the appendix.]

The CHAIRMAN. Mr. Stanfill?

STATEMENT OF WILLIAM STANFILL, FOUNDING PARTNER, TRAILHEAD VENTURES, LP, DENVER, CO

Mr. STANFILL. Chairman Baucus, Ranking Member Grassley, members of the committee, my name is Bill Stanfill, a founding partner of Trailhead Ventures, a private venture capital partnership focusing on information technology.

At the outset, I would like to make it clear that I speak not on behalf of my firm, I certainly do not speak on behalf of the industry, rather, I speak as a private citizen who has been involved in the venture capital business for 25 years.

In 1982 at the Centennial Funds of Denver, I was responsible for a fund that invested in 30-some venture partnerships around the country, which in turn invested in 600 to 700 venture-backed companies. These portfolio companies were scattered across the United States from sea to shining sea, from Massachusetts to California.

I, too, have read Kate Mitchell's testimony from the first hearing about the wonderful things that we venture capitalists do. I think it is an idealized view of our industry; a vision of the Wizard of Oz comes to mind—before Toto pulled back the curtain. [Laughter.] Ms. Mitchell and I simply come to different conclusions about the tax treatment of our compensation.

It seems to me that all workers add value to a greater or lesser extent. Randy Testa is a gifted teacher. He inspired and challenged our son David and his 3rd grade classmates, enriching human capital as he went, yet the tax rate on my carried interest is less than the tax rate on his salary.

There has been more than a hint of Chicken Little and the dire predictions of the havoc that these tax changes will cause. In my judgment, few, if any, of them will come to pass any more than the end of the automobile industry which was predicted when seatbelts and gas mileage were mandated.

I do not think many, if any, firms will move off-shore or that limited partners will stop investing. This change does not affect their taxes. Most of them are non-taxable entities anyway.

I do not think losing the carried interest tax break would drive other venture capitalists out of the field. We get ample compensation, financial and psychic, from the work that we do and the risks

that we take—with other people's money, by the way—in the form of a share of the profits. I have been in the business for 25 years, and the base compensation structure of 2 and 20 has survived all the tax changes over that period of time.

How long will we tolerate the ever-widening gap between rich and poor? Though my preference is for major tax reform, major tax reform is not on your agenda. However, I do believe that it is fair, equitable, and appropriate to work on the issue of tax equity where we can. We should not do nothing because we cannot do everything.

I am especially disturbed by suggestions that we cannot afford to provide health insurance for low-income children or first-rate medical care for our injured soldiers. I am disturbed that these and other human priorities are unaddressed while we pretend that we can afford to continue such tax breaks.

In conclusion, our earnings are compensation in my view and should be taxed the same as compensation for everyone else in the country. It is just not fair for teachers and firefighters to subsidize a special interest tax break that costs billions of dollars a year.

We, and our representatives in Congress, have a choice. We can change the tax code in favor of equity and fairness, or we can come to the same conclusion reached by Walt Kelly. You remember Walt Kelly and his mouthpiece, Pogo: "We have met the enemy, and he is us." Thank you.

[The prepared statement of Mr. Stanfill appears in the appendix.]

The CHAIRMAN. Thank you. This has been an interesting hearing. We have had Sergeant Friday, we have the Wizard of Oz, and we have Pogo here. [Laughter.] Things are looking up.

I would like to address a point that a lot of the private equity people are raising and hedge fund people are raising, basically that, if carried interest is taxed as ordinary income, that pension funds and other investors in limited partnerships will suffer a lower rate of return.

I would just go down the table here a little bit and ask people's reactions to that point, the degree to which that is actually going to happen. I am wondering if, frankly, pension funds might go shopping, looking for the best deal, because this is a competitive business. There are a lot of hedge funds out there, a lot of private equity firms.

But the private equity people raise the argument that, well, gee, if they have to pay ordinary income on the carry, that they are going to take it out on the pension funds. So there are lots of questions I want to address, but that is the one I want to address at this moment.

Mr. Rosenblum, I will give you first crack.

Mr. ROSENBLUM. First of all, I do not want to engage in hyperbole or pretend that I have the crystal ball that sees all the consequences, but I think it is just simple economic common sense that when a massive tax shift happens, there will be things that ripple through the system.

I think you are absolutely right that this is a market-driven set of terms between investors and sponsors of private equity firms,

but in that environment the best private equity firms will be able to look for ways to balance out these types of adverse changes.

Some people have also pointed out the obvious—I have read some tax commentary—which is that an alternative to raising limited partner investments to some degree may be to borrow funds and just bear that interest cost, but retain more than 20 percent of the profits in the fund.

So I think these things will work through the system, but it is naive to think that it will not cause an economic change. I think the proof of that is that there are many pension funds themselves that have expressed concerns and believe that this will be the case.

The CHAIRMAN. Mr. Stanfill, your reaction to that question?

Mr. STANFILL. I cannot imagine that it would have a serious disruptive effect. I really do not have anything more to add to that.

The CHAIRMAN. All right. I am going to ask some of the academic community.

Mr. Bankman?

Mr. BANKMAN. Subsidizing highly paid professionals is a really inefficient way of helping out investors. Our economy works best when we have the same rates across all industries. So pension funds, like any other investor, would benefit from equal rates across all industries and the elimination of preferences. And if high rates are a problem, again, putting any additional revenue to work at lowering rates for all industries would benefit investors.

The CHAIRMAN. Does anybody have a reaction to that basic question, the degree to which pension funds would be adversely affected if—maybe even transitioning over a period of time—the carry was taxed at ordinary rates? Anybody else want to take a crack at that? Mr. Frank?

Mr. FRANK. Mr. Chairman, if I may, one thing I think the committee should be aware of in the spirit of how the hearings were opened, let us just get to the facts. There has been a lot of discussion that assumes that the carry is synonymous with capital gains income, and I just wanted to point out, at least in the case of our firm, about two-thirds of the income that we generate is not capital gains income, so the carry is not synonymous with a preferential rate of tax, necessarily.

In terms of the impact that a change in law would have on the pension plans that are our clients, I am sure that there are plenty of people who would be very happy to manage the pension funds' money.

The CHAIRMAN. Professor Bankman raised an interesting question, that maybe there is a difference between, on the one hand, private equity and hedge funds, and perhaps maybe VC, real estate, on the other. It is the clothing goods store, the dry cleaning store that two people start. One brother puts in the capital, the other does the work.

On the surface, it seems to have an appealing argument that the person who puts in the work should get a percentage of the gain of the sale of the business when it is later sold. To what degree does it make any sense to have some kind of differentiation according to size?

I think it is true, frankly, that this interpretation of the law by the IRS, its genesis was back in the oil, gas, and other era when

we did not have private equity and hedge. And maybe things have changed a lot. Maybe it has something to do with size, something to do with the character of the business. My time has expired, so you are lucky the bell has rung. But that is a question in my mind that I would like to address.

Senator Grassley?

Senator GRASSLEY. On the first question, I would like to ask the entire panel yes or no, and then ask you, if you are not satisfied with just saying "yes" or "no," to supplement it with a written response.

I have read reports in the press that rather than change the tax treatment of carried interest, some think it would be more fair and equitable to raise the top marginal tax rate to 40 percent and the capital gains rate back to 20 percent.

That would leave the fund managers with a 20 percent rate preference, while raising taxes on everyone else, including small business owners, households with two wage earners, investors who actually put their capital at risk, and retirees who depend on investment income.

So to the panel, would this make the tax system more fair and equitable than changing the treatment of carried interest? Mr. Bankman?

Mr. BANKMAN. No.

Senator GRASSLEY. Mr. Kingson?

Mr. KINGSON. No.

Senator GRASSLEY. Mr. Jones?

Mr. JONES. No.

Senator GRASSLEY. Mr. Ifshin?

Mr. IFSHIN. Yes.

Senator GRASSLEY. Mr. Frank?

Mr. FRANK. This is a complicated issue.

Senator GRASSLEY. Well, then answer in writing.

Mr. Rosenblum?

Mr. ROSENBLUM. No. I will supplement.

Senator GRASSLEY. Mr. Stanfill?

Mr. STANFILL. No.

Senator GRASSLEY. All right.

The CHAIRMAN. I might say, Senator Grassley, I would apologize to you and I apologize to everybody here. I have to go to the floor to manage the Children's Health Insurance Program bill. But I care deeply about this subject, trying to get the right answer here. I do not want my departure to be interpreted as disinterest in this subject. I really care about this.

Thank you, Senator Grassley.

Senator GRASSLEY. Thank you.

This one is to Professor Bankman about the publicly traded partnership bill. The Private Equity Council opposes our bill because they say it unfairly singles out private equity firms and imposes a triple tax. My response is that we have singled them out, and the triple tax problem, if it exists for private equity firms, is a problem that affects all corporations, and the tax code should not provide preferences for financial buyers over strategic buyers when both have access to public markets.

Which side of these arguments would you come down on?

Mr. BANKMAN. I share your position, Senator. The line in the sand that has been drawn says that actively managed, publicly traded enterprises are taxed as corporations. If that is the line in the sand, I think that we have a problem with organizations like Blackstone not being taxed as corporations.

Like almost all academics, and probably like you, Senator, I would support an abolition of the second-level tax on corporations if we could manage it. But that is a mega-change that I would support for all corporations and not simply a small subset of actively managed enterprises.

Senator GRASSLEY. All right.

On this question I am going to ask Professor Bankman, and I think we will have time. I am going to ask him four questions, and then I would ask Professor Jones and Mr. Kingson whether they share the Professor's views, or do you have other views.

Under Professor Gergen's approach, and he testified a couple of weeks ago, income from carried interest would be taxed at ordinary rates when realized by partnerships. Four questions. Why is this the right way to look at what is going on?

Mr. BANKMAN. I think it is similar to the incentive compensation a CEO might get if she has done a great job. It is additional compensation for services. We would tax a CEO on that at ordinary income rates in the year that the income is received, and we are doing the same thing here.

Senator GRASSLEY. All right.

Some view the proper treatment as a mix of ordinary income and capital gains. If that is right, will the right answer not be somewhere between your proposal and the present law, and would that be administrable?

Mr. BANKMAN. Peter Orszag, among others, expressed that belief. It is true that under Peter Orszag's theoretical framework, some of the income recognized by fund managers would be capital gains. On the other hand, that framework would tax fund managers in the year they get a profits interest whether or not, and before, they get any cash. In that sense it would accelerate tax liability and be less favorable than the approach that Professor Gergen and I favor.

In addition, if the investments did not work out, it would stick fund managers with a combination of ordinary income and probably unusable capital loss. In that respect, it, too, would be less favorable than the rule that I favor.

So on balance, I think the expected tax consequences of the simpler and much more administrable rule that Professor Gergen and I favor are about the same as the "theoretically correct" rule that Professor Orszag proposes.

Senator GRASSLEY. How do you respond to the claim that carried interest is like founders' equity? You say that it is "more sensible to compare fund managers to the far greater portion of their cohorts who are taxed at ordinary income." Who would that be?

Mr. BANKMAN. That would be any corporate executive, anybody who goes into the business internally to a corporation, be it an investment banker, a management consultant, anyone who starts their own business and lives off the profits, anyone who goes into sales. More broadly speaking, it would be accountants or lawyers who work for a business. Really, the list is almost endless.

Senator GRASSLEY. I am not going to ask the fourth question because I think that I ought to ask Mr. Kingson and Mr. Jones if they want to agree or disagree at this point.

Mr. KINGSON. On the first question, I agree with Professor Bankman that it is compensation. It seems to me that it does not really matter what you call it. When you say "carried interest," I assume you mean that you do not share expenses and that you do not put up anything.

To me, contrary to what one of the other witnesses says, if you do not put up any money and you get money, then you must be performing services. Once you are performing services you can call it a carried interest, but to me it just means there is no risk. No risk, as recent computer regulations have indicated, that equates with services.

Senator GRASSLEY. Mr. Jones, maybe a 10-second response.

Mr. JONES. Yes, sir. I agree with Professor Bankman and Mr. Kingson's discussion of the first question. There have been some statements in the literature that the tax code already treats a carried interest under code section 707(a)(2)(a) as ordinary income, that is, that 707(a)(2)(a) could be interpreted—reasonably, I should add—as taxing service income at ordinary rates as if the service partner were a stranger to the partnership.

Senator GRASSLEY. All right.

I call on Senator Bingaman. But Senators Lott, Kerry, Roberts, Wyden are the next few, assuming everybody is here.

Senator Bingaman?

Senator BINGAMAN. Thank you very much.

Let me just ask a question that has been raised to me. If this change in the law were to occur and, if we were to determine that what has been carried interest taxed at capital gains rates or eligible for capital gains treatment if it is held long enough, that that is now going to be taxed as ordinary income.

It is not possible for the folks operating private equity or hedge funds to rewrite their contracts with their limited partners in such a way as to continue to get the lower capital gains treatment on the lion's share of their own income. Professor Bankman, is that a real prospect or not?

Mr. BANKMAN. I do not think it is. There have been a lot of so-called work-arounds that have been suggested. I think the only work-arounds that are feasible will still result in substantial amounts of ordinary income being recognized by fund managers.

Senator BINGAMAN. So you do not think that a general partner could rewrite the contract to become a co-investor and get the benefits that any investor would get, the capital gains benefits to a much greater extent than is currently the circumstance?

Mr. BANKMAN. I do not think they could do it without dramatically changing the economics of the deal. For example, they are not going to want to give up their management fees, which you simply do not get as a co-investor. So I think, while there have been work-arounds proposed, on balance the bill will still raise substantial amounts of revenue.

Senator BINGAMAN. All right.

Anybody else have a thought on that? Mr. Stanfill?

Mr. STANFILL. It strikes me that we are capable, or to the extent we are capable of investing in our own activity, we enjoy capital gains rates on that investment just as our limited partners would. So, I think that is my response.

Senator BINGAMAN. It just strikes me that you could have some kind of contract which says we, the general partners, are going to be co-investors in these various projects; we are going to get our stock for 10 percent of what you, the limited partners, have to pay for your stock in these ventures.

Mr. STANFILL. I have never seen that done in the venture capital industry. I cannot imagine that our limited partners would not push back on a provision like that.

Senator BINGAMAN. Mr. Rosenblum?

Mr. ROSENBLUM. Yes. Senator Bingaman, I do not know what all the alternatives are, but I think one thing that gets lost in this discussion is that our current carried interests earn ownership interest. We form a venture and we finance it a certain way by raising limited partner capital and giving out limited partner rights.

There are certainly alternative ways to structure a venture to buy companies, and I mentioned earlier the possibility of borrowing additional funds, which is an economic equivalent. So I do think it is wrong to think the status quo will stay as it is forever and ever, even if the tax treatment is radically changed.

Senator BINGAMAN. Let me ask a sort of more general question that just may be for some of the academics here who understand the tax code much better than I do. As I understand our current tax code, the increase in the value of musical compositions is treated as capital gains. The increase in the value of literary compositions is treated as ordinary income. How is that explained?

Mr. BANKMAN. That is a good question. It is somewhat of an accident of history. We have more favorable treatment for, say, patents than we do for literary compositions, and maybe it is that we are a Nation of investors rather than artists, I do not know, Senator Bingaman. It is a question I often put to students.

Senator BINGAMAN. All right.

Are there some changes that any of you would anticipate seeing in the private equity markets if this tax change were made, the one that Senators Baucus and Grassley have proposed? Are there some obvious changes there? Mr. Rosenblum, did you have some change that you think is certainly going to occur?

Mr. ROSENBLUM. I cannot say anything absolutely occurs, other than the fact that people will look for change and that it will happen in some way or another. I mean, we are not going to rip up our contracts with our limited partners. We have made a commitment to them. Even if the rules are changed in the middle of the game, we are not going to walk away from that commitment.

But for the next generation of funds and other types of business ventures, I am sure they will structured differently, or people will at least try. Whether that ends up reducing the amount of tax revenue that at the end of the day is generated by this change or whether it results in the limited partners sharing in some of that tax paying, I think all of the above is a distinct possibility.

Senator BINGAMAN. All right. I think my time is up, Mr. Chairman. Thank you.

Senator GRASSLEY. Thank you. I will pass over Senator Lott and go to Senator Kerry.

Senator KERRY. Thank you very much, Mr. Chairman.

Mr. Kingson, it is my understanding that your testimony stated that these funds do not take risks and they do not invest their own capital. Is that accurate?

Mr. KINGSON. I said that the managers of the funds do not take a risk.

Senator KERRY. Well, they often do. That is not accurate.

Mr. KINGSON. Well, no. But it is unrelated. Basically they want the managers to put up their money so the managers will not throw it away, but the managers may put up 1 or 2 percent of the capital. To that extent, they will be treated, and it seems to me they deserve, capital gains. But the discrepancy between 2 percent and 20 percent, that is a pure profits interest, pure, really, compensation because they do not put up any money for that 20 percent. If they put up 2 percent, they will get 22 percent because obviously——

Senator KERRY. Well, they do not get 22 percent if the deal goes south.

Mr. KINGSON. No, but they do not risk anything either.

Senator KERRY. But that is not accurate. They risk a certain percentage. I mean, a lot of the deals that I have seen structured and have been inquiring about, they are required to put up a certain amount of money and they put it up in order to show good faith to other people to attract their capital.

Mr. KINGSON. And to the extent that they put up their money, I think they deserve capital gain.

Senator KERRY. Well, what is the difference then between some fellow who goes out, or woman who goes out, has no money, and goes to somebody—a friend, a banker, whoever—and says, look, I want to start this store and I don't have any money to invest, but would you put it up, and you will get 60 percent of the business, or 30 percent, or whatever it is, and I will keep the other piece of it.

They are getting a certain piece of the business which, when they start it, is not really a viable concern and is not a business, correct? They go out, and every day they work it. They get up in the morning and they make the decision about whom to purchase from, what to purchase, where to sell, how to sell, and they build the business up off no money, non-recourse loan.

After 10 years, somebody comes along and says, I am going to buy your business, and they sell their business. Whatever the percentage is of their ownership, they get it as an asset that has appreciated and they get capital gain.

Mr. KINGSON. Absolutely.

Senator KERRY. So what is the difference between that and somebody who happens to be sitting on top of a fund, who goes out and says, well, we are going to put a small percentage of our money in this and we are going to go raise some money and we are going to buy this business, and it is failing, and we are going to turn this business around by putting in a better management team, by working day to day. We are going to find a different strategy. We are going to go out and appreciate this asset. At the end of appre-

ciating that asset, they sell it and they get it treated as an appreciated asset gain.

Mr. KINGSON. Well, first, if you start a business and the business has nothing, let us say it has $100 in it, you have a capital interest and you pay $100 for that capital interest, you do not have any income. If you grow the business, that is fine. But this is not a business. This is investments. So investments, it is not a matter of putting in your effort to building a business, it is a matter of buying and selling capital assets.

Senator KERRY. Well, we do that every day in the stock market. You do not put any effort into it. You buy a stock. The stock is sold after it is appreciated and you get capital gain.

Mr. KINGSON. That is exactly what I am saying, that if you put money into it, if you buy the stock, then you deserve capital gains. If you do not put money in it and just advise on it, you get ordinary income.

Senator KERRY. But there are all kinds of value put into something. Take the example of a professor who leaves a college who has a brilliant idea at MIT, and all he puts in is his intellectual capital.

Mr. KINGSON. He puts in his intellectual capital, but people are not considered to perform services for themselves. You do not get paid. You do not have income when you drive the——

Senator KERRY. See, I think the distinction is a very slippery slope.

Mr. KINGSON. I am sorry, Senator. I respect that. But it seems to me that, if you do not put up any money in a business in which—it is not a question of inventing something or getting good will. For instance, if I were to say to Dow Jones that I can get a premium——

Senator KERRY. Do you know something we do not know? [Laughter.]

Mr. KINGSON [continuing]. That I can get a premium for you above the $60 that Murdoch is offering and that I want a percentage of that premium, I would think that, if I negotiated, unless I got $2 above, $62, people would say, well, you negotiated it and you advise it. They would not say I sold part of Dow Jones.

Senator KERRY. But there is also a mythology about that.

Senator GRASSLEY. Senator?

Senator KERRY. I know my time is up. We do not have time to go into it, but I understand that within the hedge funds and elsewhere, a huge percentage of the income is already taxed at ordinary income rates because there is a flow-through and it is treated according to whatever the particular business or income was. So unless you appreciate this asset—you know, it seems to me, Mr. Chairman, the thing we have to think about carefully in the committee are the downstream impacts of how you begin to treat this.

I can understand the impulse to try to sort of single something out here, but the fact is, probably the more real question the committee ought to be considering is the overall tax rate at certain levels and what has happened to it. If you single out one piece and say we are going to get our chunk here on some theory, that theory may well have a lot of impact on how other deals are made and how other capital is treated.

One of the things we have to be careful of, we have a pretty efficient—we always pride ourselves on it—capital formation structure in this country, the most efficient in the world. I was here when we did what we did in 1986 and 1989 and saw what happened with the Resolution Trust Corporation and real estate and so forth. I think you have to think carefully, particularly in this market with what is happening with debt, how we are going to move.

Senator GRASSLEY. I think that is what this hearing is all about.

Senator KERRY. I understand. I am just trying to underscore it in light of some of those concerns.

Senator GRASSLEY. Thank you.

Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman.

Mr. Rosenblum, you were asked earlier what would happen if the Grassley legislation passed, and I am going to start with that because I think the one thing that is known for certain is that, the day after that bill passes, scores of lawyers and accountants are going to go to work to try to find new loopholes in a broken, out-of-control tax code.

So it seems to me, instead of lurching from one convoluted tax proposal to another, the country ought to get onto the topic of broader tax reform. I want to start with you, Mr. Bankman.

Ronald Reagan supported getting rid of the capital gains differential altogether when there was a proposal with low marginal rates, got rid of all the clutter and kept progressivity. I have introduced legislation that is identical to what Ronald Reagan proposed. What is wrong with going back to those kinds of principles along the lines of what Ronald Reagan advocated?

Mr. Bankman?

Mr. BANKMAN. Well, there were some signal achievements of the 1986 Tax Act that you are referring to. It widened the base, it lowered the rates, it simplified the law. Anything that does it would be another signal achievement, so I would support that. Of course, there are different ways of doing that. One way is to do something similar to 1986. Then there are some more expansive proposals, like progressive consumption tax. But either move would be an improvement over what we have now, in my opinion.

Senator WYDEN. Professor Kingson?

Mr. KINGSON. I agree with the Professor.

Senator WYDEN. I think you are supporting me, so I want to make sure everybody can hear it.

Mr. KINGSON. Yes. I agree with Professor Bankman.

Senator WYDEN. All right.

Let me then turn to you, Mr. Frank, because I would like to get somebody on the record who is working with these funds. I will tell you, coming from a State that has large investments in private equity with our pension funds, I am looking at this very carefully.

It seems to me that the kind of thing that I am advocating which picks up on what Ronald Reagan built for this country in terms of tax reform still makes sense to someone in your shoes because you have people who are willing to take risks. Risk and entrepreneurship is what built this country. But, if there was an approach that in effect updated the 1986 Tax Reform Act, is that not something

that would still encourage the kind of investment that your folks come to work every day to promote?

Mr. FRANK. Absolutely. No one can doubt that the tax code needs to be reformed. We agree.

Senator WYDEN. I would like to give anybody else a chance, maybe starting with you, Mr. Stanfill, because I think this is a very hopeful coalition, Mr. Chairman. What we heard from Mr. Frank, as the managing principal of a firm that every day focuses on the issues in the Baucus-Grassley bill, is that he could support what Professor Bankman and Professor Kingson are talking about. I think that is the common ground that is good for this country. I have been sort of running a lonely outpost here on the Senate Finance Committee for several years, trying to promote it. I am going to see——

Mr. FRANK. Senator, may I make clear that we support comprehensive reform? We do not support the one-shot——

Senator WYDEN. I understand. I think that makes my case. That is why, when Mr. Rosenblum said we are not sure what is going to happen the next day after a Baucus-Grassley proposal passed, I agree with you. I do not think anybody knows, other than what I said is the certain reality. Tax lawyers and accountants all across the land take out these codes which are taller than me, and I am 6-foot-4, and punch the next loophole into it.

What we have here with Mr. Frank and Professor Bankman is, I think, a very promising opportunity to move forward in a direction that will promote growth, make us competitive in tough global markets, and Mr. Frank's people will come to work looking for investment opportunities and we will have a stronger, more vibrant economy that is good for all of us.

Mr. Stanfill, the last word for you.

Mr. STANFILL. I agree with that, Senator. But I would also say, short of that——

Senator WYDEN. Let us not stop short of that. Because if you stop short, the lawyers and accountants go out and run the tables.

Mr. STANFILL. That has been our shared experience, sir.

Senator WYDEN. Very good.

Thank you, Mr. Chairman.

Senator GRASSLEY. Thank you.

Of the people who are here, Senator Salazar is next, then Senator Ensign, Senator Kyl, Senator Lincoln, and then Senator Hatch.

So, Senator Salazar?

Senator SALAZAR. Thank you. Thank you very much, Senator Grassley. I appreciate your interest in this issue and the leadership of Chairman Baucus on this issue as well.

It is very interesting to sit up here and to watch the debate go on between the panelists, because you have very different points of view. I was just trying to count who would support a change in how we tax carried interest, and I think we have four in favor and three opposed.

So, somehow this group of political people up here who are not tax experts and who are not in the business are somehow supposed to figure out how we move forward, whether we move forward at all.

So I did have a couple of questions. The first question is to the non-academic folks, those of you who are in the business. Three of you say no change. Bill Stanfill from Colorado, you say, yes, we ought to go ahead and change and we ought to tax carried interest at ordinary rates.

The chilling effect. People have said if we go ahead and we change how we are taxing carried interest, what that is going to do is put a chilling effect on the investment community that currently is involved. I would ask each of you to very briefly, in 30 seconds, tell me what you think that chilling effect would be, how dramatic it would be. How would you quantify it? Why do we not start with you, Mr. Ifshin, and just move down the table this way.

Mr. IFSHIN. Senator, the chilling effect would occur in the following manner in our business from a consequences perspective. Entrepreneurs in real estate are motivated to take risk, in part, because of the tax treatment that they receive on their carried interest. We are out looking to increase value, and while we are increasing that value we are creating jobs. We are creating both long-term construction jobs, and then we are creating permanent jobs in the properties that we build.

Senator SALAZAR. Do you have a sense, though—you reached that conclusion conceptually. But what is a quantification in terms of the impact that it would have in the investment area in your case with respect to real estate development and redevelopment?

Mr. IFSHIN. In our case, our motivation to take that risk, which very frequently involves the general partner personally guaranteeing a construction loan or guaranteeing the completion on a redevelopment loan, would be significantly removed because you are talking about a dramatic——

Senator SALAZAR. So the motivation would be significantly removed. You and the industry do not have a quantification or a projection on what chilling effect that would have at this point?

Mr. IFSHIN. Not to my knowledge yet.

Senator SALAZAR. Mr. Frank?

Mr. FRANK. I think I would like to echo what Assistant Secretary of Treasury Solomon said when he testified before the committee a few weeks ago, which is the carried interest pervades the American economy. It has existed for decades. As the committee and the Congress alters it, I think you need to be very conscious of the potential consequences, which I do not think anyone knows.

Senator SALAZAR. All right.

Mr. Rosenblum?

Mr. ROSENBLUM. I think it will reduce incentives for venture capital and private equity investing. That reduction in incentives is most likely to be felt at the smaller firms or the riskier deals than it is at the larger firms that have more room to maneuver. I think it will give a lower cost of capital to foreign investment, both foreign private equity firms and foreign governments looking to invest in this country. And as I said before, I think one way or another it will result in a mix of some of the tax paying being taken back through restructuring and some of it being passed on.

Senator SALAZAR. Mr. Stanfill?

Mr. STANFILL. Senator, I would reiterate that the 2 and 20 compensation system has survived 25 years of tax changes. But I think

the chilling effect, the only one I know of for certain, would be the expectation of my children on the one hand, and perhaps the Outward Bound school in Colorado, which I support.

Senator SALAZAR. Thank you very much.

Let me ask a quick question of all of you. I just want maybe a show of hands here. When I look at what is going to happen with our tax code on down the road, I look at the Bush tax cuts that are going to be expiring in 2010, I look at the spiraling deficit and national debt that we have in this country, and I see a tax code that I think everybody on this panel would talk about as being overly complicated and nobody can understand.

So my thought on this initially as I approach this issue is that we are taking a shot at one small area of the tax code, and maybe what we need to do is to do something more comprehensive. The President tried, with former Senator Breaux, Connie Mack, and others in coming up with a commission and a comprehensive reform proposal. It did not work.

But following up on Senator Wyden's comments, do you think that that kind of comprehensive approach is something that we ought to make a higher priority than the issue of carried interest in this Finance Committee? If your answer is yes, raise your hand. If you think we ought to go ahead and just keeping focusing on carried interest for the next several months, tell me that also. How many of you would say yes to my question on the comprehensive reform?

[A showing of hands.]

Senator SALAZAR. All right. I see two of the academics. So the two at the end, Mr. Bankman and Mr. Kingson, you would say no?

Mr. BANKMAN. I love comprehensive reform, but I would not let the best be the enemy of the good.

Senator SALAZAR. All right. Thank you. Thank you very much.

Thank you, Mr. Chairman.

Senator GRASSLEY. All right. Now it is Senator Ensign, then Senator Kyl.

Senator ENSIGN. Thank you, Senator Grassley.

A couple of comments, first. When we are looking at the whole private equity issue, and, Mr. Bankman, when you were talking earlier about equalizing the tax code and rates, the one thing that I think at least I would share in common—I am not sure if this is what you were alluding to—I would like to see corporate tax rates lowered. The idea that we are thinking about raising some because others are too high makes no sense.

We should be looking at lowering the other tax rates in the country. In this global marketplace that we are in today—I made this point a couple of weeks ago in the hearing—I think it is important that we are looking at ways to attract capital to the United States.

It has been said by several that some think that there will not be any effect. There is going to be an effect. If you raise these rates, there is going to be an effect. There is going to be change, whether it is drastic, overnight. Some would argue that there would be, some would argue there would not.

But there is going to be change. You only have to look across the world and look for lessons, in that capital flows to the place of least

resistance, where it is the most welcomed, where it is going to provide the best return.

Part of that return is taxation. I made the observation that Ireland is a perfect example of that. It is called the Celtic Tiger for a reason. One of their big policies that they changed, is they lowered the tax rates. The United States has the second highest corporate tax rate of any industrialized country.

For us to be raising others to personal income tax rates on this idea of the carried interest and taxing partnerships, first of all, I think it is very difficult to distinguish, at what level do you make the change?

Mr. Bankman, in your testimony when you talked about, well, for the small firms, at what level? Is there a gradual? Is there a cliff? Do we make the tax code more complex? That is another thing that makes us less competitive in the United States, is the complexity of our tax code. I agree with Senator Wyden, we should all be looking at overall tax reform instead of making one little shot across the bow here because some people think that some folks are making too much money.

It is very important in this global economy that we are providing an avenue for capital to create jobs, or that capital will travel overseas. A lot of the folks who are investing in these private equity firms, in hedge funds, in venture capitalists are not just Americans. They are the Chinese Government, they are investors from Europe, they are investors from all over the world.

Well, it is very easy for them to just invest in other countries where it is more attractive if we raise our rates, and that is one of the points that needs to be made here.

The other point is, there is a difference between capital gains and other income, for several reasons. One, and it has been talked about because of the idea of inflation devaluing your asset over time, but the second is that we want folks looking at long-term investments. A lot of the corporate income, a bonus for a public corporation today—we hear it all the time that public corporations, that CEOs and corporate boards think way too much about short-term investments.

The private equity markets look more on long-term investments. The average, I think, is around 5 years for their investments. And looking long-term is healthier for the economy. That is something that cannot be overlooked, Senator Grassley, when we are thinking about doing some of these changes to the tax laws.

The law of unintended consequences is the worst law that we pass around here. It is something that no one sees. I fear, in this particular situation, if we go forward, that is what is going to happen.

I am going to make a terrible prediction, what I think is going to happen with this. I think next year that the Majority in the Senate and the House is going to tie this to the Alternative Minimum Tax, and they are going to set it around a 25- or 26-percent rate, and you all will feel like you got off, but they are still going to be raising your taxes.

That is my prediction that I think is going to happen, because they are going to be looking for revenue raises because there are pay-go rules on taxes. I think that it is going to be a bad con-

sequence that I think will do damage to our capital markets in the United States.

I wish I had time for questions. If I have time to stay around for a second round, I would like to be able to ask some questions of the panel. But I thought it was important to get some of those statements on the record.

Thank you.

Senator GRASSLEY. Did you want Senator Hatch to go next? Senator Hatch?

Senator HATCH. Well, thank you, Senator Schumer and Senator Grassley. I appreciate it. I think he is trying to get even for picking on me last Sunday on television.

Senator SCHUMER. You handled yourself extremely well, Senator Hatch.

Senator HATCH. We are good friends.

Mr. Rosenblum, you quoted an editorial in *Pensions and Investments* magazine that indicated that there would be pension funds, endowments, foundations, and other tax-exempt investors who would end up paying the extra tax from a change in how we tax carried interest. Would you care to elaborate on this a little bit?

Mr. ROSENBLUM. Well, yes. We have discussed a little bit what the consequences would mean of changing the effective tax cost of doing business for private equity firms. As I have said, I think it is hard to predict exactly how this plays out.

But one of the distinct possibilities is that over time, fund structures will get reworked, for one, and some level of activity in this sector will be reduced. I think there will be a potentially significant reduction.

Both of those things is likely to reduce the opportunities for pension funds that have been probably the single biggest category of investors in private equity and have benefitted a great deal from superior returns out of those investments.

I noted another article after this was submitted just this morning with the head of the Washington State pension fund expressing very similar concerns. I think the fact that this is coming from the pension community as opposed to private equity sponsors is meaningful. I think we all see this as a potential consequence.

Senator HATCH. Well, here is another question for any of you who care to answer. Mr. Rosenblum, I will start with you. Changing the taxation of carried interest would likely make the U.S. less competitive, and the next generation of private equity entrepreneurs may set up shop in more hospitable locations overseas. Now, do you see this as a real threat? Maybe we will just go across the table.

Mr. BANKMAN. Well, the funds are already off-shore entities. In order to get around this, you would actually have to have the managers of these funds effectively move off-shore, and that would really require something almost akin to giving up U.S. citizenship. So, I do not see that as the next realistic alternative.

Senator HATCH. All right.

Mr. Kingson?

Mr. KINGSON. I had a client who was foreign and moved to Bermuda and could not stand it. [Laughter.]

Senator HATCH. All right.

Mr. Jones?

Mr. JONES. Yes. I agree with Professor Bankman. I think that so long as the management expertise is domestic, then that is where the money will flow.

Senator HATCH. All right.

Mr. IFSHIN. In the domestic real estate industry, we do not have that option. The jobs we create are here and they are not outsourceable. To the extent that there is less development as a result of a change, then the impact is going to be less job creation, less value creation in our own domestic communities.

Senator HATCH. I see.

Mr. Frank?

Mr. FRANK. Senator, in my judgment it is a real concern. Already, 25 percent of our employees are located overseas. We see— I think many investment managers like us see—a disproportionate number of attractive investment opportunities overseas. I think that legislation of this type could conceivably encourage investment managers to concentrate their hiring overseas because it could be beneficial to them and their employees to locate them overseas.

Senator HATCH. I see.

Mr. Rosenblum?

Mr. ROSENBLUM. I think the professors are missing the point. I am not planning to move overseas, and I do not think my partners in New York or Washington are planning to move overseas. But capital is global. We are not the only private equity managers in the universe. There are people who operate today out of foreign countries. If the tax incentives for private equity operations flow more to other countries and not the U.S., you will absolutely see an increase in the foreign component of capital, and it will likely be directed to foreign markets as well.

Senator HATCH. Mr. Stanfill?

Mr. STANFILL. Senator, I reside in the State immediately east of yours and I cannot imagine leaving Colorado, if only because I can visit the canyon lands of Utah.

Senator HATCH. You sound like a very reasonable person, is all I can tell you. [Laughter.]

Mr. STANFILL. Well, I would add that the richness in both depth and breadth of investment opportunity from Texas, Colorado, Utah, to the West Coast will keep us home and investing happily in our own backyard.

Senator HATCH. I just have a few more minutes.

Mr. Bankman, is it not true that investments in many different industries commonly use carried interest and the partnership form as a way of structuring investment vehicles, and that these industries include oil and gas, real estate, venture capital, timber, health care, biotech, restaurants, cable television, cellular telephones, and many others. How long have these structured existed? Has the current tax law been challenged or has it been a settled area of law in these areas?

Mr. BANKMAN. I think, by and large, it is a reasonably settled area of law. So what the committee is considering is whether it is the right rule, not whether it is the actual rule.

Senator HATCH. All right. Thanks.

Senator GRASSLEY. Senator Schumer?

Senator SCHUMER. Thank you. Thank you, Mr. Ranking Member. I want to thank you and Senator Baucus for holding these hearings.

As you know, I have a particular interest in these issues because this is an industry that is so important to New York. I look at this the same way as, say, Senator Baucus would look at it if someone were proposing a fundamental change in the way ranchers were taxed. I look at it in the same way as if somebody wanted to do away with tax credits for ethanol. I am sure the ranking member would have a keen interest, as he should.

Senator GRASSLEY. Try me.

Senator SCHUMER. Yes, I know. I have. [Laughter.] I have. Every Senator pays attention to the industries with big footprints in their States, as they should. So, that is how I look at this issue.

It is not about keeping taxes low for wealthy hedge fund owners or private equity partners. In fact, I have been very clear about how I believe the country needs more revenues to pay for certain priorities and that the wealthiest Americans, who have seen their average tax rates decline in recent years, should be the first to pay more.

Partners in hedge funds and private equity firms are counted among the Nation's wealthiest people, and their taxes probably should go up. But I do not think it is right to target one particular industry for higher taxes when other industries use the exact same practices.

As I think about the interests of my State, I want to make sure that New York partnerships are not singled out for different tax treatment when many other partnerships around the country use the exact same structure to pay lower taxes.

What possible tax policy justification could there be for taxing one partnership's carried interest differently than another's? As we touched on in the first hearing, oil and gas, real estate, venture capital, timber, biotech, and restaurants are just a few of the businesses that commonly use carried interest.

If an oil and gas partnership in Texas or a venture capital firm in California are using 2 and 20, how is that different from a private equity firm or a hedge fund in New York using 2 and 20? It certainly seems that, as a matter of fundamental tax policy, it is unfair to single out one type of partnership for different tax treatment than all the others when they are using the same structure.

I am also concerned about the effects that doing so could have on New York's economy. If an industry that predominated in New York had a high tax and an industry with the same exact structure in, say, Texas had a low tax, would capital flow from one to the other?

There is an additional argument, this one to be made about revenues. One of the driving factors behind the effort to change the tax treatment of carried interest is to raise the necessary funds to make investments in education, health care, or pay for AMT relief for the middle class. Under the new pay-go rules which this Congress has adopted and which I am proud of, you cannot just deal with the AMT without finding the way to pay for it, for instance.

But simply raising taxes on private equity or hedge fund partners does not generate nearly enough. For example, I have seen es-

timates saying that the Levin bill in the House would raise about $4 to $6 billion, and that is about one-tenth the cost of fixing the AMT for one year, which people estimate will be about $52 billion.

Most of us do not enjoy raising taxes, but, if we have to raise taxes on the wealthiest Americans to pay for other priorities or AMT relief, we should strongly consider doing it for everyone, not just one industry.

Some have said that expanding this beyond investment partnerships will kill any bill. That is not my goal. My goal is two-fold: increasing fairness and raising the maximum amount of revenues in a way that does not distort our economy.

If the Finance Committee decides to move in this direction, broadening the pool of those affected will improve fairness and bring in more revenue at the same time, making it easier to meet our pay-go requirements.

Now, my question. The fundamental issue here, or one of the fundamental issues, and I think it is an interesting panel, I did not hear any of you make an economic case for taxing financial services partnerships differently from partnerships in other industries that use identical structures or very similar structures.

So just to confirm, I want to go down the line one by one. Is there any member of this panel who believes it would make economic sense, tax sense, to tax carried interest for investment partnerships differently than carried interest for oil and gas, or venture capital, or real estate, or ethanol, or anything else?

Again, all of you may have different views on how the carry should be taxed in the first place, but can any of you make the case for when private equity and hedge fund partners should be taxed differently from other partners? Let us just go down the line, and then I will get some comments.

Do you think that there is a justification to treat them differently?

Mr. BANKMAN. No.

Senator SCHUMER. No.

Mr. Kingson?

Mr. KINGSON. No.

Senator SCHUMER. Mr. Jones?

Mr. JONES. No. And I think that once you do this, you will have to change the proposed rules regarding all service partners.

Senator SCHUMER. All right.

Mr. Ifshin?

Mr. IFSHIN. No.

Senator SCHUMER. Mr. Frank?

Mr. FRANK. No.

Senator SCHUMER. Mr. Rosenblum?

Mr. ROSENBLUM. No.

Senator SCHUMER. Mr. Stanfill?

Mr. STANFILL. No.

Senator SCHUMER. All right.

Does anyone want to elaborate? Yes, Mr. Jones?

Mr. JONES. Yes. I mean, the Service has recently proposed regulations regarding the treatment of partners who receive a profit interest for services, and those regulations suggest that there would

be no tax consequences, and in fact the profit interest could be eventually realized as capital gains.

I think that if the Levin bill passes, it necessarily requires that the proposed regulations would have to be redrafted so that all service partners who get a profit interest for services eventually recognize ordinary income. So I think you are absolutely right, it would not be consistent.

Senator SCHUMER. Anyone else? Mr. Ifshin?

Mr. IFSHIN. To the extent that the carried interest has been imbedded in the concept of real estate partnerships for in excess of 50 years, Senator, in addressing the issue, clearly the maintenance of a differential to incentivize entrepreneurial risk-taking in real estate is an important component for us to keep the type of job creation we do and the development and value creation we do in local communities.

Senator GRASSLEY. All right. Senator Roberts?

Senator SCHUMER. Thank you, Mr. Chairman.

Mr. STANFILL. I had just a brief remark. It strikes me, if the probability of your suggestion is low, fairness and equity would dictate that you chip away at the margins.

Senator SCHUMER. But that is not from an economic or fairness point of view, that is a practical, political point of view.

Mr. STANFILL. And fairness.

Senator SCHUMER. All right. Thank you.

Senator GRASSLEY. Senator Roberts?

Senator ROBERTS. I had thought that people would hush to let me give my medical report, Sergeant Friday. Free at last! Free at last! My cast is gone. I am supposed to squeeze this little ball. It is a globe, which means I can serve on the Foreign Affairs Committee and be like everybody else in this body, either be a General or a Secretary of State. So, I am squeezing away. [Laughter.]

I would like to associate myself with the remarks by Senator Hatch, and also by Senator Ensign, who pretty well asked most of my questions. But in Senatorial fashion, I will ask them again.

I share the concerns raised, especially by Senator Hatch, on the university endowments and the pension funds, which I think is something that we really have not thought of.

Mr. Ifshin, you noted in your testimony that, because of your company investments, hundreds of jobs have been created and communities have been revitalized. We desperately need that in our rural areas as well as our urban areas.

I am concerned that during this debate we talk about this as a Wall Street issue, and I thank you for pointing out this is also a Main Street issue that affects communities and pensioners and individuals all across the country.

So my question is—and I know what you are going to say—would anyone else care to comment on the impact that these types of entrepreneurial investments have on Main Street? What is the benefit to communities in terms of job creation investments in local economies? Would these investments continue to be made at the level they are made now if taxes on carried interest were to increase? The answer, of course, is no.

So we will start with Mr. Bankman and just go right across.

Mr. BANKMAN. Well, I think investors are better served with breaks that get to them directly rather than a preferential rate on one class of highly-paid professionals. So if we want the biggest economy, I think that all investors, including Main Street, would be better served by lower rates overall.

Mr. KINGSON. I agree.

Mr. JONES. I think that the subsidy, if that is how we want to classify this, is poorly dispersed and it could be better spent directly in the inner city, for example. I do not think that giving fund managers a significant tax break has any significant impact on blighted areas in the inner city. I just do not believe that.

Mr. IFSHIN. And we clearly disagree, because that is a major component of what we do. To the extent that we are full-time real estate entrepreneurs, real estate capital flows historically flow to primary first-tier major metropolitan areas, with the exception of those portions of those areas that are blighted or distressed.

So to the extent that the carry incentivizes entrepreneurial—the tax treatment of the carry as it is currently constructed incentivizes entrepreneurial risk-taking, whether it is my firm redoing a center in Carbondale, IL that had a derelict and empty Kmart for 5 years and turning it into a Dick's Sporting Goods, or us going into inner city Baltimore and taking a center that had been foreclosed and was falling apart and investing millions of dollars in it to create not only retail, but a major health clinic for the community, then that incentivization is crucially important both in the inner city and in rural communities because those are the places where capital typically does not naturally flow by market forces.

Senator ROBERTS. We are going to have to invite you to Greensburg, KS, the town that blew away. Maybe we can make some investments out there.

Please?

Mr. FRANK. Senator, I do not think anyone can seriously doubt the positive impact on the Nation of the various investment firms in the country as a group, both in terms of the investments they make in revitalizing businesses around the country and in terms of the returns they generate for the beneficiaries, their investors who are typically retirement funds, pension plans, charitable endowments, and whatnot. The appropriate taxation of carried interest, obviously, is a different issue. It is a complicated issue. It is why we are having hearings today, and I share your views on the substance of that.

Mr. ROSENBLUM. Well, thank you, Senator. I think private equity investing affects and benefits Main Street in several ways, first through the revitalization of companies, and while the job growth statistics are not comprehensive or definitive, what there is suggests that private equity companies do grow jobs at a faster rate than other companies.

I think also that, while Senator Schumer pointed out there is a large concentration of private equity firms in New York, there are private equity firms in every State of the Union, and they are not just large firms. They may have $5 million to invest and they may be a critical part of supporting local and regional businesses.

Finally, as has been mentioned before, Main Street benefits when tens of millions of pension participants receive better returns

out of private equity investments, when universities and foundations receive those returns. So, it really does permeate throughout the country.

Mr. STANFILL. Well, essentially I agree with Professor Bankman, Senator.

Senator ROBERTS. All right. Thank you very much. My time has expired. But could we not level the playing field that has been talked about if Congress were to lower the corporate tax rate as other countries have done? If a level playing field is what we are really after here, that would be my suggestion, Mr. Chairman. Thank you for your time.

Senator GRASSLEY. All right. Thank you.

Now Senator Hatch has one question, and then I will have three or four questions, but they will not take very long and then we will be done.

Senator HATCH. Let me just ask Mr. Ifshin: several witnesses here today have discussed the idea of a hurdle rate. It seems to me that in your business of turning around aging shopping centers, the hurdle rate may be a key determining factor of whether a deal gets done or not.

Can you tell us how your industry, or you in particular, view hurdle rates and how they play into the decisions made by your industry and your firm, specifically, and how the proposal to charge the taxation of carried interest might affect hurdle rates?

Mr. IFSHIN. Well, in most private real estate partnerships that I am aware of—and I can certainly speak to how we structure ours, and this is a place where real estate partnerships frequently differ from other forums—the limited partners, the cash equity investors, typically receive an annual compounded preferred return and their return of capital prior to the general partner receiving anything that is allocated to their profits interest or their carried interest, whatever you prefer to call it.

In most real estate transactions, that hurdle rate may range between anywhere from, call it 8 percent on the low end, to 14 or 15 percent on the high end. So in essence, the general partner's profit participation is subordinated to that hurdle rate. So there is no guarantee that there is going to be any compensation there whatsoever, that there is going to be any profit there.

In fact, there are many terrific real estate developments that have occurred that have never met their hurdle rates because of various things such as interest rate fluctuations, construction cost overruns, failure to meet your leasing or your sales projections.

So the hurdle rate is a key component in a real estate entrepreneur deciding whether or not to undertake a development, a redevelopment, or an acquisition. So the key thing to understand is that, if the real estate entrepreneur does not believe that they are going to significantly exceed that hurdle rate, such that the remuneration, the profit that they receive at the end when they sell the development, justifies the risk that they may have to take—which in a new development or redevelopment may include risk beyond the capital they have invested in the form of some guarantees to their lenders—then that deal may never occur.

If the concept of how much of that carried interest that entrepreneur is going to get to keep shrinks because the taxation rate

moves to ordinary income from the current capital gains treatment, then you are creating a significant disincentive, because then the deal would have to exceed the hurdle rate by so much more for the developer, the real estate entrepreneur to have a motivation to undertake those risks.

In essence, that is very similar to the founder's equity scenario. Every single project that we undertake is, in essence, an individual business that we are starting from scratch and we are taking start-up risks from scratch. Until such time as that performs and we pay our investors their hurdle rate and their return of capital, we have not made anything. So, that is the analogy I would like to leave you with as it relates to hurdle rates.

Senator HATCH. Thank you.

Thank you, Mr. Chairman.

Senator GRASSLEY. All right. A couple of questions. Actually, maybe just one question for Mr. Rosenblum, Mr. Frank, and Mr. Stanfill.

Fund management firms that have gone public have stated to the Securities and Exchange Commission and to their investors that their income, including carried interest, is from the provision of services rather than owning investments.

Do you view your business as owning investments with financing provided by others or as managing the investment owned by others? If you view it as owning investments, how do you explain the seemingly opposite statements made by firms that have gone public?

Mr. Rosenblum, Mr. Frank, and Mr. Stanfill?

Mr. ROSENBLUM. Well, I think we view ourselves as owning ventures, partnerships, funds that engage in private equity investing. We provide services certainly to those funds. We get paid management fees for those services, as well as having an ownership interest in those funds.

We, for security's purposes, act as the investment advisor to those funds in the sense that we are the ones who direct which investments to seek out, how to run those businesses, et cetera. I think what you are referring to is the Investment Company Act requirements about engaging in that kind of active business.

I do not see any inconsistency with that level of activity on behalf of funds, as a general partner of those funds, and the fact that we own a piece of those funds and that our ownership interest produces some capital gains.

Senator GRASSLEY. Mr. Frank?

Mr. FRANK. Senator, I just wanted to reinforce that. It has been suggested, I know, that perhaps there is some inconsistency, that a firm like ours is not an investment company for purposes of the Investment Company Act, and yet it is engaged in certain activities which qualify as passive income for purposes of the PTP rules.

As I believe the witness from the Securities and Exchange Commission indicated, and as I think was consistent with the testimony of the Treasury Secretary, this seemingly apparent inconsistency, in fact, is not inconsistent at all.

It is an example of our Nation's laws using similar words and totally different contexts for different purposes. They are interpreted

differently, and this is by no means the only example of that in the law.

Senator GRASSLEY. Mr. Stanfill?

Mr. STANFILL. Senator, it has always been my mind-set that I manage a portfolio of private companies on behalf of my investors. I receive compensation for that in management fees and carried interest, and I see no inconsistency in taxing both of those at ordinary tax rates.

Senator GRASSLEY. All right.

And my last question is a little different, to Mr. Rosenblum. I have heard that at least half of all private equity firms convert management fees into carried interest. This technique is described in various tax treatises on carried interest.

Some managers convert their fees on an annual or quarterly basis. Does this conversion not indicate that at least some of the carried interest is really for services? Why should the service income be entitled to capital gains treatment?

Mr. ROSENBLUM. First of all, Senator Grassley, I do not believe that there are many private equity firms that convert management fees into carry. I should say at the outset that at my firm the arrangements are very straightforward.

For every fund that we have, we have a management fee and a fixed rate. It runs for the life of the fund. We have a retained profits interest at a fixed rate that runs for the life of the fund, and that is all there is to it. I am aware of techniques that are used by some firms, and I have no idea whether it is 50 percent, 20 percent, or 10 percent, that are more complicated than that, but I would not call them conversions.

What they do, essentially, is define that over time the level of management fee changes, gets reduced as capital is invested, and that the general partner participates in a portion—usually a small, additional portion—of that invested capital with a contingent profits interest. I think it is a more complicated version of what has been described simplistically here as 2 and 20, but I am not sure that it differs much in its basic features.

Senator GRASSLEY. All right.

For Senator Baucus, me, and the committee, we appreciate very much your participation. We thank you for it. This is an ongoing discussion that we will have until some of us make our minds up whether or not this is compensation or whether it is capital gains.

Thank you very much.

[Whereupon, at 11:55 a.m., the hearing was concluded.]

CARRIED INTEREST, PART III

THURSDAY, SEPTEMBER 6, 2007

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:05 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Rockefeller, Stabenow, Cantwell, Salazar, Grassley, Smith, Crapo, and Ensign.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order.

Thomas Carlisle said, "No man sees far; most see no farther than their noses." This committee has the responsibility to see as far as we can, however—far beyond our noses. Before we choose a path, we would do well to look down the path. We must understand how our decisions will affect taxpayers and the economy months and years down the road. That is why we hold hearings.

In July, we held two hearings on carried interest. Today's hearing follows up on our hearing of July 31st. At that hearing, one of the witnesses argued that increased tax liability for private equity managers will be paid by pensioners. Today, we look into that claim.

We have held these hearings on carried interest to consider whether the current tax treatment of carried interest is fair. Is carried interest compensation for services? If so, then fairness would point to application of ordinary income tax rates. If carried interest is not compensation for services, then capital gains treatment is probably appropriate.

Today's hearing is not about whether or not carried interest is compensation for services. Today I would ask all of you to set aside this important debate and ask, what if? If carried interest were taxed at the ordinary income rate, how would that affect pension funds?

We need to address two basic questions. First, to what extent would an increase in tax liability for fund managers be passed through to investors? Second, to what extent would this pass-through affect retirees in pension plans?

As to the first question, how much would an increase in tax liability pass through to investors? The effect, if any, would depend in large part on how dependent pension funds are on private equity

investments. In fact, most pension funds have a modest level of investment in private equity and hedge funds.

A survey of large pension plans by the newspaper, *Pensions and Investment,* showed that 36 percent of those pension plans had hedge fund investments. That means 64 percent of those large pension plans had no hedge fund investments.

The folks at Money Market Directories estimated that, as of July 2006, American pension plans held about $350 billion in alternative investments, including private equity and hedge funds. That is a lot of money. But in July of 2006, the same date, American defined benefit pension plans had more than $5 trillion in assets, so they held less than 7 percent of their total pension assets in alternative investments. Two surveys of American public pension funds found an even lower percentage, about 4.5 percent of assets, held in alternative investments.

On the other hand, in 2006, about 10 percent of hedge fund capital came from U.S. pension plans. This data says to me that hedge funds and private equity funds may need pension funds more than pension funds need private equity or hedge funds. That means that hedge funds and private equity funds may not have the economic power simply to pass through increased costs to pension funds. All that is not to say, however, that these alternative investments cannot play an important role in pension security.

Turning to the second question, assuming there is a pass-through of significance of cost, how would that affect retirees and how would that affect pension plans? Most pension funds that invest in private equity are defined benefit plans.

Defined benefit plans promise their retirees a fixed benefit, and the sponsors of defined benefit plans have to make sure that they have enough money to pay that benefit. Thus, additional fees passed through to private pension funds would generally flow through to the sponsors of defined benefit plans—that is, the employers, not the retirees—so it is the employers who have the obligation to pay these benefits.

The situation for public pension funds is somewhat different. Public employees generally pay part of the cost of retirement benefits and increased costs could be borne, in part, by employees. For public plans, the employer is really the taxpayer. Taxpayers support the public retirement system, so taxpayers would bear most of any additional costs that get passed through. Some public plans pay additional benefits if investment earnings exceed specific levels, so a reduction in return could affect retirees.

I am very pleased that we have experts here, people who know their stuff. Thanks very much for coming to our hearing so we can better understand the role of private equity and hedge fund investments in financing pension plans, and for helping us to see how a change in taxation of these arrangements might affect pension plans.

This is an important subject. It is also a very fascinating one, intellectually very interesting, and I look forward to seeing what we can learn from today's panel.

Now I would like to turn to Senator Grassley.

OPENING STATEMENT OF HON. CHUCK GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. Thank you, Senator Baucus.

Earlier this year, Chairman Baucus and I asked the Government Accountability Office to look into pension plan investments and hedge funds. Since making that request, we have been studying the tax treatment of carried interest. One argument against making any changes is based upon what Senator Baucus spent so much time raising the questions about—legitimately so—the concern of higher taxes on fund managers if it is going to be passed on to make pension funds' returns somewhat less.

In response, Chairman Baucus and I intend to update our request, asking the Government Accountability Office to examine pension plan investments, hedge funds, and other alternative investment funds like private equity funds. So I am glad for today's hearing because, as has been made very clear, we need some facts on this.

Immediate reports and some of our preliminary findings indicate that pension plans only invest a small percentage of their portfolio in private equity and hedge funds. There are some outliers, however. That is that there are some pension plans that have an alarming amount of the plan's assets invested in these risky investments and in funds that are not registered with the SEC. This ought to give all of us some pause. I hope our witnesses today will inform the committee about the decision-making and due diligence process associated with pension investments in private equity and hedge funds.

This includes the thought process that is required of those representatives of pension funds who serve in a fiduciary capacity. The economics of the decision to invest plan assets in particular investments must also be considered. Balancing risk and return and the costs associated with an investment in one financial instrument over another is an aspect that cannot be overlooked. Investment decisions are generally based upon net returns. Net returns means the gross earnings, less fees and expenses.

Economics 101 tells me that, if the expected rate of return of an investment is diminished, I would consider moving my investment elsewhere. Let me be clear. I understand that, when two sophisticated investors get together, these sophisticated investors enter into complex business and legal negotiations involving multiple economic variables. It may be difficult to discern whether a change in one variable will change the outcome of the negotiations, but a change in one variable will surely have an impact on the overall negotiation process.

So I am going to ask the panel to describe the negotiations that take place between a pension fund and, for example, a private equity fund manager. I want to emphasize that I do not believe that pension plans should be prohibited from investing in private equity and hedge funds. Strong argument can be made that these investments round out a well-diversified and well-balanced investment portfolio. In addition, the capital that is provided through pension investments could have a positive effect on the economy.

I do, however, think that the plan fiduciaries must tread lightly when assessing the risk and return and the costs associated with

those types of investments. Plan participants' retirement security obviously depends on it, and this hearing is all about finding out whether that is going to be reduced in some way.

I fear the day that a pension plan would go under because a hedge fund or sectors of the private equity industry have trouble. As we examine the taxation of carried interest with these concerns in mind, it is appropriate to ask the question then, to what extent will a change in the way carried interest is taxed adversely affect pension plan participants? That is what this hearing is all about.

Thank you.

The CHAIRMAN. Thank you, Senator, very much.

I would now like to introduce the panel. First, Alan Auerbach, director, Center for Tax Policy and Public Finance at the University of California. Mr. Auerbach will discuss how the market will affect fund managers' ability to pass on tax increases to investors.

Second, Russell Read, the chief investment officer with the California Public Employees' Retirement System, otherwise known as CALPERS. Mr. Read will explain how and why CALPERS invests in private equity and hedge funds, and how fees affect investment decisions in negotiations.

Third, Donald Trone, president of the Foundation for Fiduciary Studies. Mr. Trone will discuss how an increase in fees affects decision-making under risks and the Prudent Man investment rule.

Thanks, everyone, for coming. If you have longer statements than the allotted 5 minutes, they'll be admitted in the record. But since there are only three witnesses today, I think this could be a pretty productive hearing.

Thanks, Dr. Auerbach, very much.

STATEMENT OF DR. ALAN J. AUERBACH, ROBERT D. BURCH PROFESSOR OF LAW AND ECONOMICS AND DIRECTOR, ROBERT D. BURCH CENTER FOR TAX POLICY AND PUBLIC FINANCE, DEPARTMENT OF ECONOMICS, UNIVERSITY OF CALIFORNIA, BERKELEY, BERKELEY, CA

Dr. AUERBACH. Thank you very much, Mr. Chairman, and other members of the committee. I am really pleased to be here to talk about this issue. As you and Senator Grassley said in your opening remarks, a reason for being interested in this is the impact that taxation of carried interest might have on the returns of pension funds and their beneficiaries.

The proposal to tax carried interest, as was already mentioned, has one important motivation: a lot of people view carried interest as compensation, and so it seems logical to many proponents that taxing carried interest as ordinary income would make more sense than as capital gains. I will return to that issue, briefly.

I cannot help but mention a second concern that a lot of people have, that the managers of the funds that would be affected are among the most highly paid individuals in the economy. Many are disturbed that such high-income individuals face such low tax rates on what appears to be ordinary compensation.

But on the other hand, there are concerns about the prospect of taxing carried interest as ordinary income. One, which was already mentioned, is the possibility that these taxes, while assessed on

high-income fund managers, may ultimately be borne, at least in part, by pension funds and their beneficiaries.

Second, I know that issues have been raised in previous hearings—and I think these are serious issues to consider—about potential problems of tax avoidance, in terms of restructuring of compensation or financial arrangements so as to avoid, at least in part, some of the taxes that are increased.

To the extent that serious possibilities of avoidance are present, that ought to temper one's enthusiasm about the measures, not necessarily because they would not be good things to do in principle, but because they may be difficult to do in practice. But I will leave that concern aside for others to consider at other times.

It is difficult to formulate precise predictions regarding the economic effects of increased taxation of carried interest because there is a lot of uncertainty here. Also, the data concerning these activities are not as good or as complete as in other situations that economists study. But I can come to three conclusions.

First, assuming that the tax increase can be effectively enforced—that is, leaving aside the issues of tax avoidance—taxing income from carried interest as ordinary income would be equivalent for the affected funds to roughly a 10- to 20-basis point increase in annual costs. That is as if the funds affected had a 10- to 20-basis point increase in their operating costs each year.

Now, a key question is how the burden of this increase would be split between fund managers or other employees of the funds themselves and their investors.

There are a lot of considerations that need to be taken into account when deciding the share of taxes that would be borne directly by the managers and the share that would be shifted to investors, including how responsive the level of activity is in the market, the degree to which the market is a competitive one, and the degree to which there are alternative investments available to the investors—the extent to which, if costs are increased by providers, investors can go somewhere else.

After looking at each of these factors, I conclude that at least some of the costs would be passed on to pension fund investors, although it is hard to say how much. It is going to be true, given the small share of investments of pension fund investors in affected funds, that the costs to their overall portfolios would be on the order of less than one basis point annually in terms of annual returns.

Finally, I have to remark that the problem of carried interest is one of a larger class of problems that arise from the favorable tax treatment of long-term capital gains. There are alternative ways to favor capital investment and saving without having that large differential, and removing the differential would alleviate problems such as affect carried interest and other investments as well.

Thank you.

The CHAIRMAN. Thank you, Dr. Auerbach, very much.

[The prepared statement of Dr. Auerbach appears in the appendix.]

The CHAIRMAN. Mr. Trone, you are next. Well, I introduced Mr. Read. Mr. Read, why don't you go next?

STATEMENT OF RUSSELL READ, CHIEF INVESTMENT OFFICER, CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM, SACRAMENTO, CA

Mr. READ. Terrific. Thank you, Chairman Baucus, Ranking Member Grassley, and members of the committee. It is a pleasure to be here today.

I am Russell Read, chief investment officer of the California Public Employees' Retirement System. I am here on behalf of 1.5 million California public employees and their families who depend on us for retirement security, and also for the taxpayers who help to fund our system. Our State constitution directs the California Public Employees' Retirement System to act as a trustee to maximize investment returns and minimize contributions required to workers and public employees.

Our investment returns pay 75 cents of every pension dollar. The rest is split between the employer and the employee. CALPERS is governed by a 13-member board and is fully funded for retirement benefits. It has nearly one-quarter of a trillion dollars in total assets. More than $17 billion of these assets are currently invested in private equity, representing approximately a 7-percent allocation. This may seem small, but we believe it is incrementally significant, particularly in terms of the impact that it has on the returns of the overall fund.

Our Alternative Investment Management program, or AIM program, which manages our private equity allocation, began in 1990. Since then, it has consistently out-performed its public equity benchmarks in all relevant periods and added billions of dollars of incremental returns. Those returns mean that we do not need to raise taxes in that equivalent amount, so we believe this is a very significant amount.

The AIM program's most recent 1-year return was 28 percent. Moreover, we are increasing both our allocation percentage and dollars committed in general to private equity investments because of not only the high historical returns, but also the high prospective returns, because private equity also helps us to reduce our risk in the portfolio because of diversification, and because private equity offers us certain opportunities that we cannot access easily through the public markets.

For example, our board is considering one potential investment of many billions of private equity dollars in infrastructure projects that are seriously under-funded and long overdue, both here and abroad. We have also committed $700 million to a new private equity initiative aimed at generating attractive returns, while helping to improve U.S. health care delivery.

We have invested another $600 million also in private equity to finance clean technology alternatives in order to help us to meet the challenges of climate change and peak oil prices. Through private equity, we have deployed approximately $23 billion in the U.S. economy and $28 billion globally, including over $6 billion in current commitments to venture capital, creating businesses and jobs that otherwise would simply not exist.

Our private equity investments also include hundreds of millions of dollars in under-served California markets that have been overlooked by traditional sources of investment capital. It is through

these programs, such as the California Investment Initiative, the Clean Technology Initiative, and the Health Care Investment Initiative, that we have the biggest and most positive impact on the environment and on health care.

CALPERS is a limited partner in several hundred private equity partnerships, and more than 5,000 companies have received fresh capital through our efforts. My written testimony provides the details of how these partnerships work, including fees.

Essentially, each private equity investment has its own unique terms and conditions, which we heavily negotiate with each general partner. The level of fees charged by a general partner is but one consideration of our analysis in negotiations for all of our private equity investments.

Our objective is to pick the very best general partners and negotiate the strongest possible alignment of interests with them in order to achieve the best possible performance, net of all fees. A delicate balance exists for an investor like CALPERS to be successful. We need to achieve access to the very best private equity investments, while at the same time negotiating appropriate financial incentives for the general partners.

In short, our experience with private equity investment has been highly positive since we began investing nearly 2 decades ago. If done well, we believe private equity investment can be of great benefit to all institutional investors, including public pension funds, and provide fresh capital and benefits to the American economy. We are pleased that the committee is giving this important issue full consideration and the deliberation that it deserves.

I thank you for the opportunity to address the committee and would be happy to address any questions.

The CHAIRMAN. Thank you, Mr. Read, very much.

[The prepared statement of Mr. Read appears in the appendix.]

The CHAIRMAN. Mr. Trone?

STATEMENT OF DONALD B. TRONE, PRESIDENT, FOUNDATION FOR FIDUCIARY STUDIES, CORAOPOLIS, PA

Mr. TRONE. Mr. Chairman, members of the Senate Finance Committee, there are more than 5 million men and women who serve as investment fiduciaries, who serve as trustees and members of investment committees of retirement plans, foundations, endowments, and personal trusts. In turn, these 5 million investment stewards are responsible for managing the majority of our Nation's liquid investable wealth.

As critical as their function is to the fiscal health of this Nation, we still do not have a single Federal or State agency that is providing education and training to the 5 million. Nowhere is this problem more pronounced than when we begin to examine the absence of sound fiduciary practices by many retirement plan sponsors when they make investments into hedge funds and private equity.

Good morning. My name is Donald Trone, and I am the president of the Foundation for Fiduciary Studies and the founder of Fiduciary360. I have more than 20 years of experience in writing, lecturing, and preaching about the subject of investment fiduciary responsibility.

I appreciate the opportunity to appear before you today and, as requested, my testimony will address the investment fiduciary issues associated with the use of hedge funds and private equity, including the likely impact a proposed change in the tax treatment of carried interest received by hedge funds and private equity managers may have on the decision-making process of an investment fiduciary.

To address the latter first and to cut to the chase, a tax on hedge funds and private equity fund managers likely will have no more impact on the inappropriate use of these investment strategies than a hike in the capital gains tax would have had on investors during the dot-com bubble.

Unfortunately, in many cases where investment fiduciaries have invested in hedge funds and private equity, speculative hubris has supplanted procedural prudence. Most investment fiduciary legislation is based on the flexible doctrine that gives consideration to incorporating changes in the types of asset classes, asset strategies, and financial products made available to investors. At the root of this doctrine is the concept of a process standard and the requirement that the investment fiduciary demonstrate their procedural prudence.

No asset class is ever inherently imprudent. It is the way it is built and how it is used that determines whether the prudence standard has been met. While even the most aggressive and unconventional investment strategies, such as those employed by hedge and private equity funds, can meet the standard if arrived at through a sound process, the most conservative traditional asset classes may be inadequate if a sound process is not implemented.

Our Foundation for Fiduciary Studies has identified 22 practices that provide the details of a fiduciary's prudent investment process, and a listing of those practices is contained in Enclosure 1. Three of the more significant practices are the requirements that the fiduciary demonstrate the due diligence process that was followed in the evaluation, selection, and monitoring of each investment option.

There are numerous factors that should be considered which are determined by facts and circumstances, such as size of the portfolio, the investment expertise of the fiduciary, the liquidity of the investment option, the degree to which the investment option is diversified, the degree of regulatory oversight, and the ability of the fiduciary to perform appropriate due diligence.

Now, compare the due diligence process just outlined to the process described in a recent *Wall Street Journal* article entitled, "Venture Firms vs. Investors." A full copy of that article is provided in my written testimony.

The reporter describes how some investment fiduciaries are strong-armed by venture firms into investing into unproven funds in order to remain within the good graces of the venture firms. Quoting from the article, "These investors—including big university endowments, foundations, and pension funds—worry that, if they don't comply, they could damage their relations with the venture-capital firms and possibly lose out on the chance to get into the firms' more typical funds, which invest in small start-ups."

The investment fiduciary also has a duty to control and account for all investment-related fees and expenses, including the duty to

identify all parties that have been compensated from these fees, and a duty to demonstrate that an assessment was made as to whether each party is receiving compensation that is fair and reasonable for the level of services being rendered.

The well-publicized exorbitant fees that investment fiduciaries are willing to pay for access to hedge funds and private equity provide convincing evidence that we are witnessing yet another investment bubble. All bubbles have the same characteristics, best summarized as “the too’s”: too much product is brought to market too soon, it is not being properly vetted, and it is too expensive.

Specific to the impact a proposed tax on hedge funds and private equity managers would have on the fiduciaries’ decision-making process, a tax hike would have the impact of reducing the investment’s return, as well as reducing the attractiveness of the investment’s expected risk/return profile.

Unfortunately, even knowledgeable and responsible investment fiduciaries often are not capable of accurately modeling a hedge fund’s risk/return profile because of the lack of portfolio transparency and the absence of an audited track record.

In theory, a tax hike would have the effect of making hedge funds and private equity investments less attractive in a prudently diversified portfolio. In reality, the current unbridled exuberance for these investment strategies means that a tax increase will have little to no effect.

Thank you.

The CHAIRMAN. Thank you, Mr. Trone, very much.

[The prepared statement of Mr. Trone appears in the appendix.]

The CHAIRMAN. Let us start with you, Dr. Auerbach. If I heard you correctly, you say that basically 7 percent of pension fund assets are invested in alternative investments. Is that correct?

Dr. AUERBACH. As was mentioned in the opening statements, there are different ways of measuring this percentage, but I think it is likely under 10 percent; maybe 7 percent, maybe 4 percent. It is a small number. It is growing because the size of the industry is growing, but I think 7 percent is in the ballpark, yes.

The CHAIRMAN. And you also said, if I heard you correctly, that the net effect of taxing carried interest—that is, the carry part—as ordinary income would be a reduction in investors’ return of about one basis point.

Dr. AUERBACH. Or less.

The CHAIRMAN. Or less.

Dr. AUERBACH. Yes.

The CHAIRMAN. And one basis point is 1/100th of a percent.

Dr. AUERBACH. That is correct.

The CHAIRMAN. Or less.

Dr. AUERBACH. That is right.

The CHAIRMAN. Which is to say it is barely an asterisk on a total basis.

Dr. AUERBACH. Well, it is being multiplied by a large number.

The CHAIRMAN. I mean, to the investor, though.

Dr. AUERBACH. The pension fund sector is trillions of dollars. Annual returns being reduced by one basis point, to you or me would not be very much money. To them, it is more money, but not as a share of their investment returns.

The CHAIRMAN. But at least to the employee, if we are talking about public.

Dr. AUERBACH. It would be a very small effect.

The CHAIRMAN. I mean, less than 1/100th of a percent.

Dr. AUERBACH. It would be a small effect.

The CHAIRMAN. Right.

Let me ask you, Mr. Read. I appreciate very much all of CALPERS's investments in alternative investments. I think that is creative. It is good for a lot of reasons.

What effect would changing the character of the taxation from capital to ordinary income have on your activities and what CALPERS does in investing in private equity?

Mr. READ. Well, we would be very pleased if the answer were one basis point. That would be a terrific outcome. From our perspective, it is really hard to know. It is a very complex negotiation that actually occurs. We are looking for the best after-fee returns.

But we know that, historically, there has not been a material change in terms as tax rates have shifted. This is but one factor of many that would enter into our negotiations. The competitive landscape, the amount of capital in the asset class, the number of people who are looking for the best private equity managers, those are all important factors, determining the terms of our engagement.

From our perspective, the most important thing is to have an appropriate alignment of interests. So, all in all, it is difficult for us to know exactly what the effect would be of a change in taxation on carried interest, but we do not have a view whether, right now, that would be significant or not based on the complexities.

The CHAIRMAN. You do not have a view right now? That is interesting. If that is the case, and since you are so involved in this area, it kind of sounds like it would not have a great effect. If you do not know what the effect would be, it sounds like it would not be very great.

Mr. READ. Not knowing what the effect would be really is not knowing what the effect would be. [Laughter.] Our hope is that it would be small, but it is hard to know. We would certainly have to see.

The CHAIRMAN. I am just a little curious. Why do you not know? I know you do not know precisely and specifically, but, since you are so involved in this area, I would think you would have some off-the-top-of-your-head gut response.

Mr. READ. The reason why it is more difficult for us to actually know what the effect would be, is that this is a highly evolving industry and a highly evolving set of negotiations. The negotiations between an investor and the private equity firms changes dramatically over the course of the year, for a number of reasons. This would simply be another factor among many. So, that is why it is hard for us to know exactly.

The CHAIRMAN. When you are looking at alternative investments—I am just asking for my own information here—it kind of sounds like you have more options available to you than, say, private equity does to them. That is, you have lots of differing alternatives. You are very diversified in many different investments, I am supposing. Is that correct?

Mr. READ. Absolutely. One of the important things for our success is having access to great investors, both inside the organization and outside the organization. One thing that has been important about the private equity industry is that it has represented some very creative capital. So when we talk about the hundreds of partnerships that we have invested in, that we have done due diligence on, it has represented some of the most creative investment minds, we believe, possible.

The CHAIRMAN. Right. But I am just trying to get at, I am wondering—again, I do not know—you may, all things being equal, have a little more bargaining advantage when bargaining with private equity or hedge than they do with you in the sense that you have many more choices. They have, relative to you, fewer choices.

Mr. READ. Although it might seem that way, I will sort of extrapolate, not only to private equity, but also to hedge funds. We are an important investor. We represent billions of dollars in capital. But our ability to dictate terms is very limited. It is part of the negotiation. I think there are four important areas that we view as subject to the negotiation. They involve questions of suitability, they involve questions of transparency, liquidity, and fees. So all four of those are wrapped into our negotiations. I would say it is a fairly even bargaining position. We are probably on——

The CHAIRMAN. My time is expiring. But among the four, are those evenly weighted, roughly, or are they disproportionately weighted?

Mr. READ. I would say we have certain thresholds for transparency and for liquidity, which are absolute requirements for us. Fees are certainly negotiated. We have a number of different programs, as you pointed out, so private equity for us is actually a big area.

The CHAIRMAN. Sure.

Mr. READ. It is many types of investments. We help set up some of the private equity firms ourselves. Our Health Care Investment Initiative, as an example, is something which we helped to set up. So we are kind of maybe not in a unique position, but we are both investors as limited partners, but we also have an ownership interest in about a half a dozen private equity firms.

The CHAIRMAN. CALPERS has a great reputation for being very creative, very successful. Thanks very much.

Senator Grassley?

Senator GRASSLEY. Mr. Read, I want to state four questions to you all at once, taking off from Professor Auerbach's testifying that special characteristics of the private equity industry suggest that at least some of the fund managers' higher tax costs would be passed on to pension plans.

Describe negotiations that take place between CALPERS and fund managers generally. What factors enter into negotiations of the carried interest percentage and fee structure in the various alternative asset funds? If Congress were to change the taxation of carried interest, would you expect fund managers to seek changes in their fee structures to make up the extra tax cost?

Then, did the fee structures change in any of your alternative assets' investments in response to changes that we have had in rate differentials? Like, in 1986 we had 28 percent for both capital gains

and ordinary income, and then capital gains went down to 20 percent, and now 15 percent.

Mr. READ. Taking the last question first, we have taken a look at what the effect has been on changes in taxation on our negotiations, and also on fees. In the past, there has not been a discernible relationship. There is an important caveat, which is, many of the changes since 1990, since we entered into the private equity space, have been favorable tax changes in terms of more favorable taxation rates for capital gains.

As we go the other way towards something which is less favorable, it is hard to state with confidence that there would be no change in our negotiations. In fact, my personal expectation is that this will be a factor. How large a factor it will be is a really open question, very difficult to know. Again, I would be very pleased if it were a one basis point sort of adjustment in our returns.

What goes into our negotiations, though, is a more complex mix. I should describe what actually transpires. We look for the very best managers. There are really three things that we are looking for: great past performance, a great existing team, and a great investment thesis going forward. So, all three of those have to be in place.

Once we identify a team that is compelling, that we have confidence that they will deliver terrific investment returns in a particular sector of private equity, we then begin the negotiating process. Again, the factors that are important to us include transparency and liquidity. Fees are part of it, but it is really the after-fee return that we are most interested in. So we have to make an assessment. We make an assessment of what the after-fee return will be.

One of the important things about the way that this sector is compensated is, most compensation is given in terms of incentive compensation, which is performance-driven. So there have been big fees that have been paid. We, ourselves, have paid, certainly, big fees to our private equity partners, but it has been related to real success. So, if they do not perform, if they do not deliver the returns, they do not generally get paid terribly well.

So the fact that the high fees are associated with high performance is a real positive. It leads to a very different view of fees than we have in most other areas, namely we tend to pay the most fees at the time that we get the best returns, so that is a very positive characteristic.

The other thing that is important is that there is a wide dispersion of returns associated with different private equity managers. Now, this is actually greater in the private equity area than in many other asset classes. So, for instance, having access to the top quartile of managers is very significant. We are actually not as interested in private equity as a general asset class, just being exposed to private equity. What we are interested in is having access to the best of the private equity industry.

What this means, also, is that they tend to be among the players who command the highest level of fees. So this is different, again, I think, than some other asset classes in many of the public equity markets and fixed income markets. Having access to those markets is of preeminent importance.

Here, having access to the best managers is what is most important, so they do tend to command the best terms. I think it gets back to one of Chairman Baucus's points, which is, you would think that we would have the upper hand in these negotiations, but because we are seeking to negotiate with the finest private equity managers, it is a fairly even negotiation. We do not find it straightforward to simply dictate terms.

If Congress were to change the taxation of carried interest, I would personally expect that, again, that would come up in the negotiations. How it would manifest itself would be very peculiar on every situation. For instance, for those private equity situations, the managers that we helped to create, we do not believe it would have any effect whatsoever; on others, we think it could be significant. So it is sort of a rich and complex area.

The CHAIRMAN. Thank you, Senator.

Senator Stabenow, you are next.

Senator STABENOW. Thank you, Mr. Chairman.

Thank you to each of the witnesses. In listening to all three of you, we are basically hearing, Dr. Auerbach, you said in your testimony, we are looking at 1 to 2 basis points at most of difference. Mr. Trone, you are saying, as a practical matter, because of the exuberance in the market and what is happening—and I am concerned about the bubble that you talked about—that there would be little to no effect.

Mr. Read, you are saying you do not know, but on the other hand, indicating—obviously you are negotiating point by point, but with the managers you deal with you just indicated there would be no effect. I am not sure you are willing to say that. So it looks to me like, from the perspective of the panel, we are not seeing a great concern about moving in some direction as relates to more tax equity.

I do not know if anybody would want to disagree with that, but it appears to be what we are hearing. I am wondering a couple of things. And Mr. Read, not to pick on you, because you have been getting the bulk of the questions, I know the chairman has gotten two different letters from the National Conference on Public Employee Retirement Systems, the first one saying that members were concerned, and then the second one that we have, while some of the members feel that the bills could affect public plans, the majority of the members do not share that opinion.

Is that your analysis as well, in working with the National Association, that the majority of the members with public employee plans do not share the opinion that it would have a negative effect?

Mr. READ. I think my view is that we believe that tax policy can have a very significant effect. In particular, in negotiations it can be significant. We have not taken a position, nor do we anticipate taking a position, as a public pension plan, particularly an artifact of the State of California. We are very reticent to weigh in on Federal tax policy. There are lots of very important issues for you to weigh, and we take that as our starting point.

So the NCPERS letter that you are referring to, we know was retracted. That was important. We were not consulted on that particular letter. NCPERS's official position is, at this point, equiva-

lent to ours, which is that tax policy, we think, is very important and also should not be in the realm for us as a public policy issue.

Senator STABENOW. If I might just follow up, we have been talking about impact overall as it relates to availability of capital in private equity firms. And certainly coming from the State of Michigan, there are many positive things that are happening, and we welcome investment and appreciate the partnerships that are taking place. But from the perspective of public retirement systems, it seems to me there is a different kind of equity question.

That is, you have firefighters, police officers, school cafeteria workers, and public employees who are paying into a retirement system, and they have been taxed at regular income tax rates, and then there is a question whether or not the fund managers who defer their payments would pay something less than that, 15 percent capital gains rather than 25 percent, or 30 percent, and so on in addition to the question of very large bonuses. Clearly, folks have done very, very well under the system.

Does anyone want to speak to that? Mr. Read, from your standpoint, you represent those folks. You represent their pension plans, people who are paying regular income tax rates and counting on and looking for equity in the tax system to work for them as average Americans. Any comments about the question of equity in that? Mr. Trone, you might, as well. I do not know if you would have any comments on that.

Mr. Read?

Mr. READ. Sure. What you raise are very important questions. For me, it is a more narrow focus, which is providing the best possible returns and diversification for the plan that our members will be most benefitted for as providing the best returns for their retirement security. So I think the concerns you have raised are important, and we view it as inherently out of our purview.

Senator STABENOW. All right.

Mr. READ. The purview that we have is much more narrowly focused. So, we will simply take whatever decisions and policies you determine and we will take that as our starting point.

Senator STABENOW. I appreciate that. I know my time is up, but Mr. Trone, you wanted to say something. If you might just quickly respond. I know my time is up, Mr. Chairman.

Mr. TRONE. What I would add to that is, when you started reading off the list of firefighters, police, sanitation workers, and teachers, we need to also understand, they comprise half the membership of the investment committees that we are talking about.

So when we talk about the need to train and educate the 5 million investment fiduciaries, that includes firefighters, teachers, police who are now making these investment decisions to invest in these private equity and hedge funds, and they lack the training and understanding of the fiduciary practices and prudence associated with that.

Senator STABENOW. Thank you.

The CHAIRMAN. Thank you, Senator.

Senator Crapo?

Senator CRAPO. Thank you very much.

At a time when many of us are raising concerns about the competitiveness of the United States in global capital markets, it seems

to me that the last thing we want to do is to create a disincentive by increasing taxes and encouraging the movement of business away from the United States to London and other capital markets.

Just yesterday, the U.S. Chamber of Commerce released a first phase of a two-part study of the impact of increasing carried interest taxes on the U.S. economy. The purpose of the study was to better understand how carried interest affects the economy as a whole, and how different sectors and industries may be impacted by this proposed tax increase.

This study concluded that carried interest is an element of partnership finance in every sector of the U.S. economy engaged in capital formation. Increasing the tax rate on carried interest would lead to changes in the structure of partnership agreements, and incremental tax collections would be small.

To the extent that the tax increase could not be avoided by restructuring, the study concluded that the costs would be borne by all the members of the investment process, including general partners, limited partners, and their beneficiaries, as well as owners and employees of portfolio companies.

Increasing carried interest taxes, the study concluded, would reduce the amount of long-term capital available to the U.S. economy and undermine investment, innovation, entrepreneurial activity, productivity and growth, and, accordingly, the ability of U.S. companies to compete in the global markets.

This study reinforces testimony that this committee heard earlier from Treasury Assistant Secretary for Tax Policy Eric Solomon, who concluded that the current taxation of carried interest encourages the pooling of capital, ideas, and skills in a manner that promotes entrepreneurship and risk-taking.

I guess my first question is to you, Dr. Auerbach. Do you agree with those general conclusions of this study?

Dr. AUERBACH. Yes, I do.

Senator CRAPO. In your testimony, you stated that it was difficult to predict the actual costs that the impact of this tax would produce, and then you gave us your best prediction. Have you looked at the predictions of others, and, if so, could you give me a range of the kinds of predictions that are out there from other economists and analysts?

Dr. AUERBACH. I am not aware of quantitative predictions. The predictions that you mentioned are of a qualitative nature, that is, these are the kinds of effects that would occur, and I agree with those. In my testimony I tried to nail down, to the extent possible, what the quantitative effect would be.

The thing I have the most confidence about is the size of the effect. The increase in costs for all these affected funds is on the order of 10 to 20 basis points annually. The hard question is the extent to which those increases in costs could be avoided through restructuring of arrangements and, if not avoided, the extent to which they could be passed on to investors.

Of course, the passing on involves a lot of other changes in behavior, such as a reduction in activity, which is one of the concerns you mentioned in the report, and lower returns available to investors because there would be less competition in the industry. That is a lot harder to predict. This is the kind of thing one has to con-

front whenever a tax increase is considered. We think that all tax increases are going to have deleterious effects on the economy, but the money has to come from somewhere.

The question is whether these particular taxes are less advisable than others. There are two things to weigh here. On the one hand, these seem to be logical taxes to raise because the income in question really does seem to be compensation, and it also is income of very high-income individuals, which perhaps makes it more appropriate for taxation.

But on the other hand, because of the avoidance possibilities and because of the fact that there is a lot of productive activity going on in these sectors, one has to be concerned. So, it is a difficult policy question.

Senator CRAPO. In terms of the question of how many dollars will this proposed tax increase actually produce for the economy, or for the Treasury, are you aware of the Knoll study?

Dr. AUERBACH. No, I am not.

Senator CRAPO. All right. That is one that was quoted in the U.S. Chamber of Commerce's report, which indicated that they predicted about $3.2 billion would be raised, assuming that there was not any restructuring. But you are not familiar with that?

Dr. AUERBACH. I am afraid I cannot comment on that.

Senator CRAPO. All right.

My time is just about up. I want to just ask you one question, Mr. Trone. You indicated in your testimony that, in theory, a tax hike would have the deleterious effect of making hedge funds and private equity investments less attractive. I assume that that theory you are talking about there is the same kind of thing that the U.S. Chamber of Commerce was talking about in terms of the predicted response to this proposed tax increase.

But in any event, if I understand your testimony correctly, are you basically saying that there is so much exuberance out there that the managers of these various funds engaged in these entrepreneurial activities are not acting rationally? Is that your testimony?

Mr. TRONE. A large number, yes. I would like to add to that, Mr. Read is a great counterbalance to my testimony today. CALPERS is an example of an excellent investment fiduciary that is making prudent investment decisions into these asset classes. But they are atypical, as opposed to the typical investment fiduciary.

Senator CRAPO. All right. Thank you. I see my time has expired. Thank you.

The CHAIRMAN. Thank you, Senator.

Next, Senator Ensign.

Senator ENSIGN. Thank you, Mr. Chairman.

In your testimony, gentleman from CALPERS, you talked about, when you are looking at negotiating, one of the things that attracts you to a particular private equity fund is the talent level. Is that correct? And you also said in there that one of the things that attracts some of the most brilliant minds to these private equity funds is the return, the amount of money that they can make. Does it seem logical, at least, that if you raise their taxes, you decrease the amount of money they can make?

Mr. READ. The answer is, of course, it is a concern. This has been a particularly important sector for us in that it has attracted some of the finest investment minds in the business.

Senator ENSIGN. Right. The point I wanted to make—because I think all of you have said this—is that it is impossible to predict exactly what the policies will do or the consequences of the policies that Senator Baucus and Senator Grassley are proposing, what effect they are going to have on the markets, what effect they are going to have in the economy. It is impossible to tell that.

The CHAIRMAN. I might remind the Senator, neither Senator Grassley nor I have proposed anything.

Senator ENSIGN. As far as what has been publicized and been attributed to you. I apologize.

The CHAIRMAN. There is no bill, no legislation. These are just questions. Nothing has been proposed.

Senator ENSIGN. All right. I will say, Congressman Levin's proposal in the House of Representatives, which there is a proposal on that.

The bottom line is that the consequences could be fairly significant, and we do not know that. Because some of the things that are happening with the private equity funds and the hedge funds, they have actually generated a lot of positive economic consequences out there. It would seem to me—and this is one of the things that I have been talking about—we ought to tread lightly in this.

On its surface, Dr. Auerbach, you talked about compensation. On its surface, yes, all right, that makes sense. It is fees. It looks like income, it should be treated like income. But you also said in your testimony, what about sweat equity? You talked about ideas. Those are treated as capital gains. How do you tax the private equity and the carried interest on private equity and not tax the idea of one partner and their sweat equity? Why is that not just income? He has not risked any kind of capital, he has just risked his sweat equity. Could you address that?

Dr. AUERBACH. Well, yes. As I said in my testimony, trying to be guided solely by consistent treatment, that is, saying this looks like compensation so it should be taxed as compensation, is not really enough because there are so many inconsistencies in the tax code, as, for example, entrepreneurs who start companies whose returns are taxed as capital gains. You are never going to get fully consistent treatment.

I also said in my testimony that I thought that we could probably get rid of the entire capital gains differential and solve both of those problems if we made offsetting changes to the tax code that did not damage the economy the way an increase in the capital gains rate alone would do.

There are other measures we can use to spur capital formation and the other objectives that a lower long-term rate is supposed to accomplish without having a lower long-term rate. If we did not have a lower long-term rate, that would pretty much take care of the issue of carried interest, as well as some of the other inconsistencies that we experience.

Senator ENSIGN. Getting back, because that obviously is a separate issue and a lot of us would like to work on overall tax reform

and simplifying our tax code, which I believe would make us a lot more competitive in the world, but, if we are just dealing with this issue that we have before us today, it did not make sense on your one basis point.

What did not make sense to me is, if CALPERS has invested the kinds of dollars that they have invested, and just using an article that was in *Bloomberg* talking about the Blackstone Group, raising their taxes, in the chairman's opinion it would lower their market cap by about 40 percent. Well, if their market cap drops by 40 percent, even if he is a little bit off, it would seem to have a little more of an effect than the one basis point that you are talking about with investors like CALPERS.

Dr. AUERBACH. There are a couple of things going on here. First of all, if you had a tax increase and some of it were borne by Blackstone or other companies, even if the tax increase is small on an annual basis, if the investors see that that company is going to be yielding a lower return for a long time, then all of it will be immediately impounded in the value of the company. So you might see a larger one-time decline in the value of the company, even if it really plays out as a small decline in the rate of return over time.

Second, you can have a large impact on individual companies, hedge funds, private equity funds, and so forth, but it only matters to pension funds to the extent that pension funds are actually holding them. So if pension funds are holding 5, or even 10 percent of their assets in this form, then any effect on these individual investments has to be divided by 10 or 20 in figuring out what the effect on the overall returns of the pension fund would be.

Senator ENSIGN. Well, my time has expired. I appreciate it. Mr. Chairman, maybe in writing I could get from CALPERS, and, if any of you want to put it in writing as well, if you think it would be good for your investors if the private equity funds that you are invested in go down by 30, 40 percent in market cap.

The CHAIRMAN. Thank you, Senator.

Senator Cantwell?

Senator CANTWELL. Thank you, Mr. Chairman.

Mr. Read, I think the CALPERS experience has been similar to what the Washington State Investment Board has experienced in the past, so thank you for your testimony and insights.

We all know that private equity has outperformed the public equities. Are you concerned about the impact of credit and the credit crunch and the impact that that might have on those investments in the future?

Mr. READ. The answer is yes, but there is also a complex interplay that is going on. We have seen, for instance, a tightening of credit, which has been more difficult for some of our private equity partners and hedge funds. It has also allowed us to succeed in other transactions because we are not a leveraged player in general, so we have been able to succeed in other areas because of a change in the cost of capital and in credit.

So what ends up happening is, something that hurts us on one side can benefit us with some of our other investments. So, we do have a concern about changes in credit and cost of credit, but it is both bad and good.

Senator CANTWELL. I know that is not the subject of today's hearing, but how do you think that they should best plan for that as it relates to these changes in policy? I mean, do you think they should consider it a more risky environment?

Mr. READ. What we have noticed, and what we have been particularly impressed by in the private equity community, is their creativity, much more so than in any of the other sectors, many of the traditional sectors. They have an eye both in terms of geography and in terms of structuring for identifying some of the most attractive investment opportunities.

So one of the interesting points to us, and why we view them as key partners for us, is that we believe they have a very good sense for credit and the amount of credit that they can take and maintain. But also, it is something that, if that becomes more expensive, they will contract and they will move into other ways to make money.

Senator CANTWELL. Thank you.

Dr. Auerbach, thank you for elaborating on your last dialogue with Senator Ensign about your testimony and your focus on long-term capital gains.

Since this is all a very delicate balance here, I do not think there is any policy discussion that we do not have in this committee that is not a pull-the-string-here-and-get-an-effect-there challenge for us. How would you suggest that this committee might approach dealing with carried forward interest and the larger issues of our tax problem as it relates to entrepreneurship? How would you suggest we best tackle that in a way that would be constructive?

Dr. AUERBACH. If you are thinking about entrepreneurship in particular, there are two approaches one can take. One is a lower long-term capital gains rate. Another approach would be a much more targeted approach, such as the 1993 capital gains exclusion for new small business equity, or the section 1244 provision for more liberal treatment of losses for small companies.

Entrepreneurship is very important in the economy, but it accounts for a very small share of the capital gains that are realized in any given year. So a long-term capital gains differential is a pretty blunt instrument to be using to encourage entrepreneurship. If spurring entrepreneurship is the objective, then measures targeted more closely toward entrepreneurship would be much more efficient methods of encouraging that activity.

Senator CANTWELL. And I do not mean to be obtuse, but when you say "entrepreneurship," what are you referring to?

Dr. AUERBACH. Private equity, if you like. New companies, fast-growing sectors of the economy as opposed to the more mature bread-and-butter sections of the economy: smaller businesses, newer businesses, emerging industries.

Senator CANTWELL. In an information age, is access to capital not even more critical than in an industrial age as it relates to spurring more entrepreneurship?

Dr. AUERBACH. Sure.

Senator CANTWELL. So would you say it is more important today that we get this tax policy right as it relates to spurring entrepreneurship?

Dr. AUERBACH. I think there are many reasons why it is more important today. It is more important for that reason. It is also more important, given the fiscal challenges that we face, to whatever extent that we find that we need to raise taxes in the future. I know that is something that is easier for a witness to mention than a member.

The CHAIRMAN. Thank you, Senator, very much. We have very limited time left before the vote, so I am going to have to truncate things a little bit.

Senator CANTWELL. I thank the chairman for the hearing.

The CHAIRMAN. Thank you. Thank you, Senator.

Senator Smith?

Senator SMITH. Mr. Read, we are the little State between you and Washington. Oregon's Public Employee Retirement System has roughly $7 billion in private equities. What does California have?

Mr. READ. We have in our system about $17 billion currently invested, and a little over $30 billion in commitments.

Senator SMITH. And yet, if you have that much more than Oregon and you say you are on an equal basis when you negotiate these arrangements with these firms, what would that do for Oregon? Is $7 billion enough to make them equal?

Mr. READ. Seven billion is a big number. You are on a pretty good basis, you will be happy to know.

Senator SMITH. How much, when you negotiate these arrangements—and I assume you deal with a number of these firms, Blackstone and others—do they allocate to management fees which are ordinary income as to taxation, and how much usually to carried interest that gets capital gains treatment?

Mr. READ. It depends on the specific private equity deal/program. But you can think of management fees as being roughly between 1 and 2 percent, so it is a fixed management fee. An incentive fee generally hovers in the range of 20 percent. That can be more or less, again, depending upon conditions. It is 20 percent of the upside past certain performance thresholds.

Senator SMITH. All right.

Do those fluctuate depending on the deal that they may be coming to you with, an entrepreneurial deal with a lot of risk versus less risk?

Mr. READ. Absolutely. They differ by firm, they differ by program, our involvement in creating the program or not creating the program. So there is a high level of negotiation that is done. So, when we talk about this program, literally we have hundreds of private equity partnerships that we are invested in, each one of which is negotiated very differently.

Senator SMITH. If carried interest and management fees are the same as to taxation, then what is your best guess as to what would happen to the entrepreneurial opportunities that you have taken advantage of?

Mr. READ. What makes it difficult for us, is that we know on some of the programs it will have no effect, on others it will have a great effect. That is what makes it sort of complex for us. What is the net effect in our returns? It is very difficult to know, given the moving parts and given the differences in the relationships. We know it will have some effect. I would be more than pleased if it

were simply one basis point. We are certain it will probably be more. But it would be one of many factors.

Senator SMITH. Can you tell me, the more risky the opportunity is, does the carried interest, as a percentage, go up?

Mr. READ. I would say it is less a function of the risk than on the prospective return. For instance, if you have a team with a great track record that is intact with a great investment thesis going forward, that is going to command generally a greater incentive fee that will seem more attractive to investors and they will be able to command better terms.

Senator SMITH. Mr. Chairman, I know you and I have to make a vote. I am certainly here because I am trying to keep an open mind on this. But it seems to me we are brought to this hearing because of the extravagant lifestyle of one person in Blackstone and the publicity that that got, and we may be looking at using a sledgehammer on an issue that may be more delicate in terms of its consequences than we realize. So I will keep my mind open, but I am trying to understand how this will impact Oregon's public employees, because I do not think that this is a small consequence. That is my hunch. Thank you.

The CHAIRMAN. Thank you very much, Senator.

We have a couple of minutes here, yet. Mr. Read, you mentioned that currently some managers' compensation is taxed as ordinary income and some is not. Does the current tax treatment affect negotiations? That is, when you negotiate, some managers' fees are carried interest, some services. You talked to lots of different firms. What effect does the tax treatment of one versus the other, fees versus capital gains, have in your negotiations?

Mr. READ. The key for us is, we are trying to come up with estimates of what the returns will be to us when everything else is accounted for, the net return. So this is part of the negotiations that we are focused on, what our expectations are of the net returns, all the factors that will go into it, the particular sector, the importance of the investment thesis. So you might say that the tax issue is not directly important to us, but it is indirectly important to us because it is directly important to the private equity firm.

The CHAIRMAN. What about Dr. Auerbach's point that they could just restructure their management fees, restructure their compensation if, say, it is taxed as ordinary income?

Mr. READ. We expect that they probably would react by changing the structure of their incentive fees, or certainly could. Again, our focus is going to be on that. What does this mean in terms of the net expectations of returns and opportunities? So it will indirectly affect us because it will be of central importance to the private equity firms and we will react to it afterwards.

The CHAIRMAN. If I understood you correctly, the lack of historical changes in fees when tax rates have changed—that is, I do not know. I do not know how much the gain was passed on to you, or when compensation is treated, what capital gains rates went into effect so the tax burden on managers is less and how much of that gain was passed on to companies like yours, or plans like yours.

Mr. READ. We have taken a look at that particular issue. In the past, it is absolutely true that we believe that there has been no discernible change in the past on our negotiations and fee levels

based upon those changes in tax rates. That being said, there is a directional importance here. Would we have the expectation that, if there is an increase in tax rates, will it be a factor? I would actually expect that it would be a factor to a greater or lesser degree. But certainly based on history, there is not historical evidence to support that.

The CHAIRMAN. Basically, the conclusion is, everybody wants more.

Mr. READ. Unfortunately, that is true, including us. [Laughter.]

The CHAIRMAN. When I started to ask that question, I thought that would be your answer.

Thank you very much. I am sure there will be additional questions provided by members of the committee, and I would ask you to please respond to those. But thank you all, very, very much. We have progressed several steps forward. I do not know how many more steps we have to take, but this has been very constructive and helpful. Thank you very much.

[Whereupon, at 11:20 a.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Carried Interest Taxation and Pensions

Testimony before the Committee on Finance, U.S. Senate

by

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September 6, 2007

Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to offer my views on the effects of potential changes in the taxation of carried interest on the economy, notably on the investment returns of pension funds.

Income from carried interest represents an important component of the earnings of general partners in venture capital, private equity and hedge funds, rapidly growing financial sectors among whose investors pension funds are prominent. Under current law, tax on carried interest is deferred until the carried interest income itself is actually received, rather than when the rights to it are established. Further, the tax, when assessed, is at least partly at the long-term capital gains tax rate, which is substantially below the tax rate on wage and salary income. Recently, there have been a number of proposals to limit the tax benefits accorded carried interest, either by taxing a greater share of carried interest income as ordinary income, by reducing the deferral of tax on carried interest, or both. These proposals have at least two important motivations. First, proponents argue that, as a component of the compensation that fund managers receive in exchange for their efforts, income from carried interest should be taxed as ordinary income, rather than as capital gains. Second, fund managers have been among the most highly paid individuals in the economy, and many are disturbed that such high-income individuals face such low tax rates on their compensation.[1]

On the other hand, the prospect of raising taxes on carried interest raises concerns as well. Here, again, one may highlight two issues. First, increased taxation of any economic activity is likely to discourage that activity and encourage tax avoidance, and some believe that the responses will be particularly important in this instance. Second, while the increase in tax liability may be imposed on fund managers, the ultimate burden of this tax increase may be

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[1] For further discussion, see Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, University of Illinois, June 13, 2007.

borne at least partially by others in the economy, notably by the investors in the affected funds, including pension funds and, ultimately, by these funds' beneficiaries. Each of these concerns, if valid, should temper one's enthusiasm for the proposed tax changes.

It is difficult to formulate precise predictions regarding the economic effects of increased taxation of carried interest, because there is uncertainty about a number of relevant factors, including the availability of legal alternatives to avoiding the tax increase and how the structure of managerial compensation might respond to tax changes. Still, I can offer the following conclusions based on the analysis that follows:

1. Assuming that the tax increase can be effectively enforced (i.e., that simple tax avoidance can be prevented), taxing all income from carried interest as ordinary income would be equivalent to an increase in costs on the order of 10 to 20 basis points annually.

2. The burden of this increase in costs would be shared by fund investors and fund managers, but the split between the two groups is unclear. Even if only some of the tax burden were borne by fund managers, the tax change would be highly progressive.

3. The problem of carried interest taxation is one of a class of problems caused by the favorable tax treatment of long-term capital gains. Whatever the benefits of our current tax treatment of capital gains, the tensions this treatment introduces in defining the border between capital income and compensation increase the complexity and administrative cost of our tax system. These tensions would be substantially reduced under an income tax with low and uniform marginal tax rates that would preserve the current tax system's incentives for saving and capital accumulation.

In short, the proposed tax changes, if they can effectively be enforced, would be progressive but also would reduce returns to investors, including pension funds, somewhat. Dealing with particular sectors and transactions, however, does not eliminate the underlying problems caused by attempting to maintain a significant distinction between ordinary income and capital gains.

PENSION FUND EXPOSURE TO PROPOSED CHANGES

This committee has already heard testimony discussing the logic of reducing the favorable tax treatment of carried interest, and I will not dwell on it for a long time. As carried interest income is a form of compensation, it is not clear why this income should be taxed at a lower rate than other forms of compensation. Yet, there are other instances in which compensation effectively receives such favorable tax treatment, as when an entrepreneur contributes ideas and effort to an enterprise and reaps the eventual rewards as capital gains, or when a savvy individual investor, through his own research efforts, does well in the stock market. Drawing analogies to sections of the tax code is an inadequate approach to determining the "correct" tax treatment, for complete consistency will generally be impossible. Neither the current tax treatment of carried interest, nor the treatment under different proposed alternatives, is fundamentally "correct" under our current tax system, with its pervasive inconsistencies. We must simply weigh the economic costs and benefits of moving from one approach to another.

Taxes on carried interest income could be raised by increasing the tax rate, most simply by reducing or eliminating the qualification for treatment as long-term capital gains. Taxes could also effectively be increased by speeding up tax payments, by imposing some tax prior to the actual receipt of the carried interest income, when the rights to receive a share of investment earnings is initially granted by investors. If there were no economic responses to these tax changes, the basic result would be an increase in tax revenues, at the expense of very wealthy individuals.[2] But economic responses are certain to occur, with two important potential consequences. First, productive economic activity in the affected sectors may be reduced, as those affected by taxation seek to reduce their exposure to taxation. Second, some of the burden of higher taxation may fall on investors, rather than on the managers themselves. It is this latter potential consequence that would have the most direct bearing on pension funds.

Just how much of an impact the tax changes might have on pension funds depends on the importance of the sectors in question in overall pension fund portfolios. While exact statistics are not readily available, one can piece together rough estimates from various sources. According to the Joint Committee on Taxation[3], as of 2003, private and public pension funds accounted for 42 percent of all investment in venture capital funds. Applying this ownership share to a recent estimate that venture capital funds had $268.7 billion under management at the end of 2005[4] yields an estimate that pension funds had $113 billion invested in venture capital funds at the end of 2005. According to recent Congressional Budget Office testimony before this committee[5], pension funds directly accounted for 33 percent of private equity investment in 2005. Applying this ownership share to a recent estimate that private equity funds had $513 billion under management at the end of 2005[6] yields an estimate that pension funds had $169 billion invested in private equity funds at the end of 2005. According to various estimates[7], hedge funds had as much as $1 trillion or more under management at the end of 2005. Public data on investor composition for hedge funds is not as readily available, but a pattern similar to that of venture capital funds and private equity funds would suggest holdings of $350-400 billion at the end of 2005, for a grand total of roughly $650 billion of pension fund assets in venture capital, private equity, and hedge funds at the end of 2005. By comparison, defined benefit private pension fund assets were $2.1 trillion at the end of 2005[8] and state and local government employee retirement fund assets were $2.7 trillion[9]; if these two categories of pension funds

[2] Steven N. Kaplan and Joshua Rauh, *Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?* University of Chicago, July 2007, attribute a substantial portion of the recent increase in earnings at the very top of the income distribution to financial service sector employees from investment banks, hedge funds, private equity funds, and mutual funds.

[3] Joint Committee on Taxation, *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests*, JCX-41-07, July 10, 2007, Figure 2.

[4] Kaplan and Rauh, *Op. Cit.*, Table 3b.

[5] Statement of Peter R. Orszag, CBO Director, *The Taxation of Carried Interest*, Testimony before the Committee on Finance, U. S. Senate, July 11, 2007, Table 1.

[6] Kaplan and Rauh, *Op. Cit.*, Table 3b.

[7] Joint Committee on Taxation, *Op. Cit.*, pp. 32-3; Kaplan and Rauh, *Op. Cit.*, Table 3a.

[8] Board of Governors of the Federal Reserve System, *Flow of Funds Accounts*, June 7, 2007, Table L.118b.

[9] Board of Governors of the Federal Reserve System, *Flow of Funds Accounts*, June 7, 2007, Table L.119.

account for all pension fund investment in venture capital funds, private equity funds and hedge funds[10], such funds would have accounted for roughly 13.5 percent of pension fund holdings at the end of 2005. But as some of the pension fund investments are from outside the United States, the percentage of U.S. pension fund holdings is likely substantially lower than this.

POTENTIAL EFFECTS ON RETURNS

Some portion of any tax increase on carried interest may be shifted by the affected taxpayers to their investors, in the form of lower investment returns. The size of the tax increase, relative to assets, provides a measure of how large the reduction in returns would be if the entire tax increase were shifted to investors, and therefore provides a measure of the likely maximum potential impact on investor returns.

Let us consider the change in law requiring that all carried interest be subject to taxation as ordinary income, as proposed in the 110th Congress under H.R. 2834.[11] Under this change, carried interest income currently treated as long-term capital gains would be taxed as ordinary income and subject to self-employment tax; for top-bracket taxpayers, this would mean an increase in the total federal tax rate from 15 percent to 37.2 percent[12] or a reduction in after-tax income equal to 22.2 percent of carried interest income.

The impact of this tax increase on fund managers and the investors in their funds cannot be determined simply by estimating the expected annual revenue that would be generated, because the earnings that come from carried interest are very volatile. Tax revenues based on such earnings will be volatile as well, and this pattern of tax payments acts, in a sense, as a form of insurance for taxpayers: tax payments will be higher when the funds do well, and taxpayers have plenty of cash on hand, than when the funds do poorly and cash is less available. Taxpayers should prefer such a pattern of tax payments to one that is not sensitive to actual earnings, so a simple measure of expected tax payments that fails to take account of this preference will overstate the tax burden on carried interest. An alternative approach is needed to convert taxes on carried interest into an equivalent certain value.

An accepted method of valuing the carried interest income itself is to use the mathematical tools of option pricing. Based on this approach to valuing carried interest, we can then estimate the burdens imposed through the taxation of carried interest income. Valuing taxes is particularly straightforward in the case of carried interest, for which the relevant asset basis is zero. That is, managers who receive carried interest income as compensation pay tax on the entire amount received, so the value of taxes on carried interest is simply the tax rate, say 15 percent, multiplied by the value of the carried interest.

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[10] The other categories of pension funds in the Federal Reserve data are federal government retirement funds, which largely hold nonmarketable government securities, and private defined contribution plan funds (including 401(k) plans), which seem much less likely to invest in the types of partnerships discussed here.

[11] Details of the proposal are provided by the Joint Committee on Taxation, *Op. Cit.*, pp. 42-4.

[12] This equals the top ordinary income rate of 35 percent plus the 2.9 percent tax on 92.35 percent of self-employment earnings above the OASDI payroll ceiling, net of the deduction against income of one-half of self-employment taxes.

According to recent option-pricing based estimates, the value of carried interest was somewhat lower than that of management fees, averaging 61 percent of management fees for venture capital funds and 55 percent of management fees for private equity buyout funds.[13] As most funds charge annual management fees of 2 percent of assets, this translates into an annual value of carried interest of 1.1 – 1.2 percent and hence a tax increase of around 24– 27 basis points. Another recent estimate, for hedge funds, arrived at a similar measure.[14] Thus, if all carried interest income were currently taxed as long-term capital gains, the tax change would increase the taxes on managers by the equivalent of around 24 – 27 basis points.

Only a portion of carried interest income is currently taxed as long-term gains, however, for the returns must also satisfy the one-year holding period requirement. The qualifying portion will vary by the type of fund and its investment strategy. For example, venture capital funds typically invest with a horizon of several years, while some hedge funds may rely substantially on short-term strategies. One recent witness before this committee[15] suggested that "in the paradigmatic private equity case, most profits arise from long-term capital gains," while "a hedge fund's income from securities trading, by comparison, usually constitutes a short-term capital gain or ordinary income." Given the estimated asset breakdown among different types of funds for 2005 presented above, this split would suggest that somewhat less than half of carried interest income in these sectors currently qualifies for long-term capital gains treatment. But we lack hard information here. With the likely maximum increase in taxes equivalent to 24 – 27 basis points annually with all carried interest taxed as long-term capital gains, it seems a reasonable estimate that the actual tax increase would fall between 10 and 20 basis points.

POSSIBLE BEHAVIORAL RESPONSES

As stated earlier, if taxes on carried interest were increased without any subsequent taxpayer response, the outcome would be simple: the taxes – an annual amount on the order of 10 – 20 basis points on assets under management – would come out of the after-tax income of fund managers. But affected taxpayers will respond in a variety of ways.

First, they will seek to restructure financial and legal arrangements in search of alternative methods of conducting business that are similar in substance to those used at present but manage to avoid the tax increase. For example, it might be possible to use nonrecourse loans from limited partners to general partners to convert some or all carried interest income received for performance of services into returns on general partners' invested capital[16], or to restructure the allocation of payments within partnerships[17] or to eschew the partnership form entirely[18] in

[13] Andrew Metrick and Ayako Yasuda, *The Economics of Private Equity Funds*, University of Pennsylvania, March 13, 2007, Table VI.

[14] Kaplan and Rauh, *Op. Cit.*, page 20.

[15] Orszag, *Op. Cit*, page 8.

[16] Howard E. Abrams, "Taxation of Carried Interests," *Tax Notes* 116, July 16, 2007, p. 183.

[17] Michael S. Knoll, *The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of Taxing Profit Interests as Ordinary Income*, University of Pennsylvania, August 16, 2007.

[18] David A. Weisbach, "The Taxation of Carried Interests in Private Equity Partnerships," *Tax Notes* 116, August 6, 2007, p. 505.

order to gain a more favorable tax treatment. While I have no doubt that such alternatives might exist, I am unsure the extent to which they provide an easy way to avoid taxes. Even if they would provide an alternative under particular proposed legislative reforms, it may be possible to modify legislation in such a way as to restrict taxpayers' ability to take advantage. This is not an issue on which I claim great expertise, but it is one that this committee should take seriously. If you determine that it will be difficult to prevent taxpayers from engaging in wholesale avoidance of the proposed tax increases then these tax increases should not be attempted; they would then have little impact other than to enrich those with sufficient expertise to design the necessary rearrangements in legal and financial structures. I will return to this question below, but for the moment leave it aside to consider other types of behavioral responses.

If an increased tax on carried interest cannot be avoided simply through the restructuring of legal and financial arrangements, then behavioral responses with actual economic consequences may be expected, as the affected taxpayers seek to lessen their tax burdens. One possible response might be a shift in the composition of fees. With carried interest treated less favorably than by the current tax system, firms might shift toward fixed fees and away from carried interest. This shift would alter managerial incentives, for general partners' incomes would be less exposed to fluctuations in their market performance. But this alteration in incentives would not necessarily be for the worse, given that the tax system currently distorts the choice of managerial compensation by favoring those types of compensation (e.g., carried interest) that qualify as long-term capital gains. Increasing the tax on carried interest would lessen this distortion.

Most fundamentally, perhaps, an increase in the tax on carried interest represents an increase in operating costs in the affected sectors of the financial industry. Standard methods of economic analysis predict a variety of responses to such cost increases, depending on the characteristics of supply, demand, and competition in the affected markets.

First, suppliers of these financial services may reduce their levels of productive activity, or shift to other activities on which taxes have not been raised. It may strain credulity to suggest that these very high-income individuals would find their after-tax incomes inadequate after a tax increase and therefore stop working, but shifts into other highly compensated activities within the financial industry are less hard to imagine.

Second, a reduction in the level of activity may reduce competition among fund managers and make it possible for general partners to shift some of their tax increase to their investors in the form of higher fees. The extent of this shifting will depend on other factors as well, including how unique the sector's investment opportunities are and how competitive the sector is in the setting of its fees. The greater the decline in the number of competitors, the more unique the sector's investment options, and the less competitive the sector's pricing, the greater the possibility of shifting the tax increase on the sector's general partners to the sector's limited partners, i.e., its investors, including pension funds.

The fees currently charged by venture capital funds, private equity funds, and hedge funds are substantially higher than those charged even by actively managed mutual funds. Some might view such high fees as prima facie evidence of a lack of competition, but the industry's

rapid growth suggests the absence of strong barriers to competitive entry. Firms have been able to charge high fees because, the evidence suggests, they have been able to deliver good returns to their investors even after the deduction of fees.[19] The fact that fees are high does not necessarily imply that it would be easy to raise them further, if doing so would make the returns after fees less competitive. On the other hand, the activities of individual firms in this sector are not as easily replicated as those of a fund that tracks the Standard and Poor's 500 index, so while an increase in an index fund's fees might cause a considerable loss of business, an attempt to pass along part of an increased tax on carried interest would likely have a much smaller impact on the size of a firm's investor base.

It is difficult to predict how much of a tax increase on carried interest would be passed along, but the special characteristics of the industry suggest that at least some of the burden would fall on investors.

THE BIGGER PICTURE

This hearing is about the taxation of carried interest. But it is important to keep in mind that the issue we are considering relates to the broader question of whether it makes sense to provide a favorable tax rate on long-term capital gains. Those who drafted the Tax Reform Act of 1986 concluded that it does not. An important argument for their position was that taxing capital gains at the same rate as ordinary income would lessen or eliminate the problems of distinguishing among different types of income, as we are here struggling to distinguish capital gains from compensation. In the years since 1986, the tax system has moved back toward one that strongly favors long-term capital gains, even though legal and financial innovation have made it harder to draw lines that distinguish capital gains from other types of income.

I have argued recently that the major objectives that underlie the favorable treatment of long-term gains can be satisfied without a lower tax rate on gains.[20] It is possible to avoid the important potential economic costs of raising the capital gains tax rate, such as locking investors into their existing portfolios, raising the cost of capital, or discouraging entrepreneurial activity, by making other adjustments in the tax code. None of these other adjustments would provide any incentive to shift the characterization of income from compensation to capital gains.

Taking a more comprehensive approach by reforming the tax treatment of all long-term capital gains would deal effectively with the taxation of carried interest. Indeed, a comprehensive approach would be more effective than a specific solution in attempting to deal with carried interest, because the general approach would lessen the scope for possible avoidance transactions. As these transactions involve recasting carried interest as earnings on invested capital, eliminating the lower tax rate on capital gains as well would make the avoidance transactions less attractive.

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[19] See, for example, the survey of hedge fund performance in René Stulz, *Hedge Funds: Past, Present and Future*, Ohio State University, February 2007 and the analysis of the performance of venture capital and buyout funds by Steven N. Kaplan and Antoinette Schoar, "Private Equity Performance: Returns, Persistence and Capital Flows," *Journal of Finance* 55, August 2005.

[20] Alan J. Auerbach, "How to Tax Capital Gains," *Wall Street Journal*, August 16, 2007.

SUMMING UP

An increase in the tax on the carried interest income earned by managers of venture capital funds, private equity funds and hedge funds is a logical step, given that such earnings represent a portion of managerial compensation. But, given the various inconsistencies in the tax code, there is some logic to maintaining the current tax treatment as well, and there may be various avenues for tax avoidance that make the prospective tax change difficult to effect.

If carried interest taxes can be effectively raised, the impact is likely to be equivalent to an increase in annual costs of 10 to 20 basis points. Even if some of this cost increase is shifted to investors, the tax increase would still be quite progressive, given the location of fund managers in the income distribution.

Though pension funds account for a significant share of the assets under management by the firms that would be affected by the proposed tax increases, such assets are still only a small portion of all pension fund assets. If half of the tax increase were shifted to investors, this tax burden would imply a reduction of at most around 2 basis points in the annual return on these pension funds' assets, and quite possibly much less.

Changing the taxation of carried interest might improve our tax system, depending on the severity of the avoidance possibilities already discussed. But a more comprehensive approach based on reforming the taxation of long-term capital gains would deal more effectively with the issue of carried interest and with many of our tax system's other problems as well.

U.S. Senate Committee on Finance Hearing
Carried Interest, Part III: Pension Issues
September 6, 2007

Questions for the Record From Dr. Alan Auerbach

Questions from Ranking Member Grassley

1. Professor Auerbach, This hearing is not about the settled policy of lower rates on capital gains; it is about the potential impact on pension plans of a change in the taxation of carried interest. However, since you brought it up in your testimony, I'd like to ask you a question.

You argue that the bigger issue here is the tax preference for capital gains, and that "major objectives that underlie the favorable treatment of long-term gains can be satisfied without a lower tax rate on gains."

To be clear, I am a strong supporter of the lower capital gains rates. But I am interested in what you think are the major objectives of the lower tax rates and how else you would satisfy those objectives.

The major objectives of lower capital gains rates, in my view, are to encourage capital formation, limit the disincentives to realize capital gains, and to spur entrepreneurial activity and business formation.

Capital formation depends on the cost of capital, which is influenced by a variety of taxes on capital income, including corporate taxes. Capital gains taxes have a smaller impact on capital formation than other capital income taxes, because a large share of capital gains tax revenues are not associated with new capital investment. So an increase in the capital gains tax rate, coupled with a reduction of similar magnitude in other taxes on capital income, is likely to reduce the cost of capital and spur capital formation.

The decision to realize capital gains does, of course, depend on the capital gains tax rate; the higher the tax rate, the lower the incentive to sell assets. But other modifications in tax rules could encourage capital gains realizations, including indexing of capital gains for inflation and taxing capital gains on assets held until death. The latter modification could be considered as part of a package that included a permanent reduction in estate taxes.

Entrepreneurial activity is encouraged by a low tax rate on capital gains, because a large share of the returns to successful new enterprises comes in the form of long-term capital gains. But many such enterprises fail, and most long-term capital gains in the economy do not derive from new ventures. Thus, more targeted incentives that provide more liberal capital loss deductions and a favorable long-term rate for new, small enterprises seem more appropriate to achieve this objective.

2. Professor Auerbach, you point out that carried interest for hedge fund managers is mostly short-term capital gain and already subject to ordinary income rates, while private equity managers typically receive more income taxed at capital gain rates. Yet, the fee structure across these various fund types is rather standardized at "2 and 20" despite the tax rate differentials for fund managers. Two questions:

(1) What explains the general uniformity here? Is it competition among various asset managers for investment capital?
(2) Does this suggest that fund manager compensation isn't so sensitive to tax rates on fund managers?

These are important questions, because the nature of pricing and competition in the industry will influence the extent to which general partners in these funds can pass tax increases on to their investors. As I say in my testimony, market returns in this sector appear to have been sufficient to allow investors to pay managers the "2 and 20" and still achieve reasonable net returns. It is my understanding that there is some deviation among firms from the standard "2 and 20" fee structure, with more successful operations sometimes able to extract higher levels of compensation. Thus, fees do seem to some extent to be determined by performance, so managers would not necessarily be able to pass them on to investors without being able to produce higher returns before fees.

On the other hand, fund investment strategies differ and this gives managers a certain degree of "market power" that is absent, for example, among index mutual funds, where companies offer essentially the same product and therefore are led to compete intensely when setting fees. Thus, I would expect at least some of the tax increase to be passed along to investors, but I am very uncertain as to the extent.

3. Professor Auerbach, In your testimony, you attempt to estimate the impact of a change in the taxation of carried interest on pension fund returns, concluding that if half of the increased tax cost is passed on to investors, pension plans annual returns would decline by about 1 basis point, that is one one-hundredth of a percent.

Do you know of any historical data that would suggest a correlation between pension fund returns on private equity investments and tax rates on fund manager compensation?

I am not aware of any historical evidence that would be particularly helpful here. There are two problems in finding such evidence. First, this is a relatively new and rapidly developing industry, so historical data might not be particularly useful. Second, although we have had recent changes (in 2003, for example) in the tax rate on long-term capital gains, that change applied to all long-term gains, not just to carried interest. Leaving aside the question of whether tax increases and tax decreases would have symmetric effects on behavior, a general tax change, such as occurred in 2003, would be expected to have different effects than a much narrower change such as is being considered here.

Questions from Senator Hatch

Professor Auerbach, I have a couple of questions for you. First, though you suggested that implementing the proposed changes in the taxation of carried interest would have an effect on the behavior of fund managers, you did not attempt to quantify such a change. While coming up with an estimate may be difficult or impossible, is it fair to say that such a change could have a chilling effect on certain investment decisions that could otherwise lead to job creation and general economic growth?

Yes. Unless the tax increase is entirely avoided through changes in legal and financial arrangements, I would expect some decline in economic activity within the affected investment sector.

Professor, you estimated that the outcome of increasing the taxes on carried interest, not counting taxpayer response, could be in the order of 10 to 20 basis points on the assets under management. Could you translate this estimate into dollars of possible revenue to the Treasury? And to be sure I understand, this amount would be the possible maximum amount before behavioral response is factored in, so that the actual amount that might be collected would almost surely be less, and likely much less – is this correct?

I am wary of offering a revenue estimate, because I do not have access to enough data about the industry to provide an accurate forecast. The staff of the Joint Committee on Taxation is in a much better position than I to do this.

As to the 10-20 basis point impact, yes, this represents a "static" estimate that does not take into account taxpayer responses in the form of tax avoidance and reductions in the scale of operations, either of which would reduce the initial estimate. The static estimate is useful in assessing the impact of a tax increase on managerial behavior and the returns of pension fund investors, but is not adequate for a final revenue estimate.

I should also caution that the 10-20 basis-point measure is one that has been adjusted for risk. That is, revenues from taxes on investment returns are likely to be quite volatile; my measure attempts to convert this volatile revenue into what economists and finance professionals call a "certainty-equivalent" amount, an amount that fund managers would treat as having the same burden as the actual uncertain revenue stream. Again, this approach is useful for my analysis of the impact on fund managers, but it might not be desirable when constructing revenue estimates.

Questions from Senator Smith

The Oregon Public Employees Retirement Fund has about $7 billion invested in private equity funds. These funds have performed well for the fund. For 2006, the fund's private equity investments had a 25.1 percent return. For 2005, it was 38.8 percent.

Some have argued that a change in the taxation of carried interest may have a negative impact on the returns of pension funds that invest in alternative asset funds, such as private equity. And I certainly don't want Congress to do anything that would negatively impact the investment returns of the Oregon Public Employees Retirement Fund.

What are your thoughts on whether a change in the taxation of carried interest would negatively impact the returns of pension funds that invest in private equity funds?

When a business is hit with new fees, regulations or taxes, is it normal that these costs are ultimately passed on to the consumer – or in this case the investor?

I would expect a change in the taxation of carried interest to have a negative impact on the returns of pension funds, but that this effect would be small for the typical pension fund, because the typical pension fund holds only a small share of its assets in private equity funds that would be affected by the tax change. Any particular pension fund might be affected more or less, depending on its current portfolio allocation strategy.

The extent to which new fees, regulations or taxes on a business can be passed along to that business's customers depends on conditions within that sector. As I discuss in my testimony, I believe that conditions in this sector are such that at least some of the tax increase would be passed on to investors.

Question from Senator Wyden

Do you think the approach taken in the 1986 Tax Reform Act – to simplify the tax code, eliminate most of the preferences, and lower marginal tax rates – would be a sound approach now? Would this approach help address problems such as the carried interest issue?

The issue of carried interest taxation provides an excellent illustration of the benefits of a broad-based, low-rate tax system such as was adopted in 1986. Were capital gains and ordinary income taxed at the same marginal tax rate, the problem of how to tax carried interest would largely disappear. As financial innovation makes it more and more difficult to determine how to classify income in financial markets, the appeal of a tax system that makes few distinctions grows.

Senate Committee on Finance Hearing

July 31, 2007

"Carried Interest Part II"

Testimony of Joseph Bankman
Ralph M. Parsons Professor of Law and Business, Stanford Law School

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.

STATEMENT FOR SENATOR BUNNING
SENATE COMMITTEE ON FINANCE
"Carried Interest, Part I"
July 11, 2007

Thank you, Mr. Chairman.

I welcome the opportunity to hear from this distinguished panel about the taxation of carried interest and publicly traded partnerships.

It has been a long time since Congress carefully examined taxation of unincorporated business entities, and I welcome the opportunity to review this important area of our tax laws. The landscape has changed dramatically since the last major tax reform act that addressed partnership taxation. Business forms that were rare then, such as hedge funds, private equity firms, and venture capital, have become commonplace today. Partnerships had $13.7 trillion in assets under management at the end of 2005.

These unincorporated firms have become strong engines of growth in our economy, and we must be careful not to interfere with the success they have brought us by taxing them out of existence. I have concerns about some of the legislative proposals introduced in the House and the Senate to directly tax these firms, and I look forward to hearing more about these and other proposals today.

One of the most important goals that Congress tries to achieve in tax legislation is horizontal equity. That is the principal that similarly situated taxpayers should pay the same tax. The question we must answer today is how to apply that principle here. How should private equity and hedge fund managers be taxed to preserve horizontal equity and still encourage these talented people to work for the common good and enrich our country?

I thank the Chairman for holding this important hearing and I look forward to the testimony and discussion today.

Thank you.

Statement for the Record

Senator Maria Cantwell
Senate Finance Committee Hearing
Carried Interest – Part 1
July 11, 2007

Mr. Chairman, thank you for holding this hearing today. I applaud the work that you, Senator Grassley, and your staffs have done to take a careful, deliberative approach. It is important that we have a full understanding of these issues before we decide what course of action to take.

We have a vibrant and dynamic economy in the United States that Congress should work hard to foster, not stifle.

Washington state knows a bit about innovation, risk, and entrepreneurial development. I am proud of the record of success we have had in taking good ideas and making them profitable, job creating enterprises.

As Kate Mitchell cites in her testimony, venture capital investments were instrumental to the growth of Microsoft, Intel, Google and eBay. But for every success venture capitalists have, there are many more enterprises that do not ever get off the ground.

These entrepreneurs and investors are willing to take these risks in the hope of great returns. We should be careful not to stifle them with overly burdensome or unfair taxes.

Nonetheless, we know that taxes are a cost of doing business in our society. And it is the responsibility of this committee to make sure that the tax code is grounded by consistent policy goals and is fair to all types of business enterprise.

Unfortunately, the patchwork system of numerous rules and exceptions we have today creates an unlevel playing field.

On more than one occasion, witnesses have testified before this committee that the current tax system is too complex, inefficient, and harmful to U.S. businesses trying to compete and succeed in the global marketplace.

The issues, presented by the increased press attention on private equity funds, publicly traded partnerships and hedge funds, are just another example of the inconsistencies inherent in the tax code. They raise deep questions that go to the heart of the current system.

Our focus here should not be about whether alternative investments are "good or bad." The marketplace and the high returns on those investments answer that question.

As I see it, the real issue is whether our tax system is "old and cold." Are the concepts that applied in the past simply out of step with today's financial markets, business and compensation practices and global marketplace?

Business practices have evolved. It may be time to update our tax rules to reflect the way we do business in the 21st century.

We have tremendous fiscal challenges facing us in the coming years. We will need a stable revenue source to fulfill those obligations and we must have sustained growth in our economy.

If we are to meet those challenges, we have to take a serious look at restructuring our tax code so that it is fair for individuals and business taxpayers and that it contributes to—not puts at risk—our ability to grow jobs and encourage investments.

Thank you.

Statement for the Record

Senator Maria Cantwell
Senate Finance Committee Hearing
Carried Interest – Part II

July 31, 2007

Mr. Chairman, thank you for holding this hearing. As we continue to sort through these issues, it is important we hear from those who would be most directly affected by the policy changes we are considering.

As I have said before, we are facing some tremendous fiscal challenges ahead and we have to begin working to make sure our tax system is adequate to meet our needs.

Just yesterday, Treasury Secretary Paulson sent a letter to the House Ways and Means Committee informing the Congress that the U.S. Government is likely to hit the $8.97 trillion debt ceiling in early October.

The path we are on, of borrowing to meet our needs, is not sustainable. Our nation's staggering debt imposes an unfair burden on future generations. The expiration of a big piece of our tax system in 2010 should motivate us to rethink how we collect the revenues we will need in an efficient, fair, and fiscally responsible manner.

I welcome the input of our witnesses here today because they provide not only academic insight but also real world experience. When your tax base is income, the first order of business is making sure you properly define what is—and is not—included in that taxable income base.

The issue of how to define "compensation" is not new to this committee. In September of 2006, for example, the committee held a hearing on how top executives were being compensated in public companies and whether the tax rules were encouraging behaviors that made rich executives richer at the expense of the company, the employees and the shareholders.

What struck me about that hearing was how much of the discussion focused on the unintended consequences of Congress' earlier attempt to rein in excessive compensation by imposing a $1 million cap on the amount of executive compensation a company could deduct.

There are lessons to be learned from that hearing. We should not look at complicated tax issues in a vacuum. Rather, the issues presented today must be considered carefully and in a comprehensive fashion. How compensation is defined and treated under the tax rules will influence how wealth is created and distributed in this economy.

If we are going to strive for a tax system that is fair to workers, investors, and business entities alike, it is the responsibility of this committee to make sure that the tax code is grounded by consistent policy goals that reflect the way business is done in the 21st century.

Thank you.

Statement of Senator Maria Cantwell
Senate Finance Committee Hearing
Carried Interest, Part 3
September 6, 2007

The testimony that has been presented to the committee so far has been very helpful. I commend you, Chairman Baucus, and Senator Grassley and the committee staff for putting together three thoughtful hearings on these complex issues.

Often Congress is criticized for acting without regard to the possible unintended consequences of our actions, so I am particularly pleased you are holding this hearing today given the importance of alternative, private investments to our public pension funds.

It is important that we hear the perspective of the pension fund managers on what the tax code changes Congress may be considering will mean to the way they assess how best to invest the critical dollars that our public employees are counting on for their retirement. Let me describe where we are in Washington state. As of March 31, 2007, the Washington State Investment Board had $79 billion in total assets under management. The market value of their private equity class of assets at that time was $10.9 billion.

WSIB's investment earnings in recent years have exceeded expectations and as a result the workers' compensation system has more money than is anticipated will be needed to pay future health-care benefits for injured workers.

Thanks to these investment returns, Gov. Gregoire implemented a six-month partial rate holiday for employers beginning July 1. By the time it ends January 1 of 2008, employers and workers will have saved $315 million in premiums.

As you can see, the investment performance of the WSIB is important to all Washington state employers and workers, in addition to the public employees, teachers, school employees, law enforcement officers, firefighters and judges whose pension funds are directly managed by WSIB.

Because there is a lot at stake, I have taken a deliberative approach with respect to the proposals that have been introduced so far. If we make any changes to the tax law, I want to understand what the full impact may be.

As I think about the specific issues of carried interest, I can't help but wonder if these questions really are one symptom of a much larger problem with the tax code overall.

Clearly there is an impression out there that something is out of balance when average workers feel wealthy investors are paying less—and they are paying more—than their fair share of taxes. We have to be sensitive to those concerns.

At the same time, it is our ability to access capital and the free flow of that capital that has produced the vibrant and dynamic U.S. economy that benefits all Americans—workers and investors.

Our tax laws have to be grounded by consistent policy goals that promote economic growth and are fair to workers, investors, and all types of business enterprise.

There are tremendous fiscal challenges facing us in the coming years. If we are to meet those challenges, we have to take a serious, look at how we raise revenues. And, we have to take very seriously the effect of our revenue-raising policies will have on economic growth.

Taxes are a cost of doing business in our society. The balancing act is to raise the revenue we need without stifling economic vitality.

Perhaps it is time we take a fresh look at the code and craft legislation that will help move our economy into the future.

- Taxpayers are facing increased financial pressures.
- Business practices have evolved.
- The ways that risk and work are rewarded have changed.

It may be time to update all of our tax rules to reflect the way we live and do business in the 21st century.

Thank you.

Testimony Concerning Initial Public Offerings of Investment Managers of Hedge and Private Equity Funds

Andrew J. Donohue
Director, Division of Investment Management,
United States Securities and Exchange Commission

Before the Committee on Finance

United States Senate

July 11, 2007

Chairman Baucus, Ranking Member Grassley, and Members of the Committee:

I am pleased to be here today to discuss the Securities and Exchange Commission's perspective with respect to initial public offerings of investment advisory firms that, among other things, manage hedge and private equity funds. As the head of the Commission's Division of Investment Management, I have responsibilities for overseeing and regulating nearly 1,000 investment company complexes with over $11 trillion in assets and more than 10,000 investment advisers that manage more than $37 trillion in assets, as well as administering the federal securities laws applicable to registered investment companies (including mutual funds) and investment advisers.

A number of issues have been raised about the recent IPOs of investment advisory firms that, among other things, manage hedge and private equity funds ("alternative asset managers"), specifically the offerings by Fortress Investment Group LLC ("Fortress") and The Blackstone Group L.P. ("Blackstone"). I am pleased to be able to offer the Committee my knowledge and expertise, especially as it relates to the question of whether alternative asset managers are investment companies and thus subject to the substantive provisions of the Investment Company Act of 1940 (the "Investment Company Act").

Relevant Law for Investment Company Act Status Determinations

Congress enacted the Investment Company Act to provide a separate and different regulatory structure for investment companies, as compared to industrial, or operating, companies. Among the Congress's stated goals was to minimize the risk that an investment company might be managed in the interests of its managers or certain shareholders rather than for the benefit of all shareholders. Unlike operating companies, investment companies are subject to comprehensive substantive requirements in areas such as: limitations on capital structure, *e.g.* borrowing restrictions; limitations on the ability to transact business with affiliates; and limitations on how the investment company must maintain custody of fund assets. Investment companies also are required to maintain specific books and records, which are subject to examination by the Commission. Section 3 of the Investment Company Act has two main tests for determining whether an issuer is an investment company:

- The first test is whether the issuer is primarily engaged (or holds itself out as being primarily engaged) in the business of investing in securities. (*See* section 3(a)(1)(A) of the Investment Company Act.) This "orthodox investment company" test defines issuers that hold themselves out, or otherwise are clearly recognizable, as investment companies.
- The second test is whether the issuer (a) is engaged in the business of investing, reinvesting, owning, holding, or trading in securities and (b) owns investment securities, the value of which exceeds 40% of its total assets. (*See* section 3(a)(1)(C) of the Investment Company Act.) Companies that fall within this "inadvertent investment company" test are often referred to as inadvertent or prima facie investment companies, presumably because they view themselves as industrial or operating companies rather than investment companies.

The Investment Company Act provides a number of exclusions from these tests for certain companies that appear to meet one or both of the tests but that Congress believed should not be regulated as investment companies. Notably, section 3(b)(1) excludes a company that is engaged primarily in a business other than investing, reinvesting, owning, holding or trading in securities. In addition, section 3(b)(2) excludes an issuer that the Commission declares by order is engaged primarily in a business other than investing, reinvesting, owning, holding or trading in securities, and the Commission has adopted rules under this authority, such as rule 3a-1, which codifies the standards that the Commission has applied over many years in processing individual requests for orders under this section.

SEC Staff Process for Reviewing Investment Company Act Status Issues

Many of the more complex Investment Company Act status determinations arise in the context of companies that view themselves as engaged in an operating business, and not in the investment company business. Consistent with this understanding, these companies file their registration statements and periodic reports with the Commission, and these filings are reviewed initially by the staff of the Commission's Division of Corporation Finance. When an issue arises as to whether a purported operating company should be treated as an investment company, Division of Corporation Finance staff will refer the issue to the Investment Management Division. With regard to the recent IPO registration statements of Fortress and Blackstone, Corporation Finance staff did just that.

The staff reviewed these filings in the normal course and consistent with past review practices. Under the federal securities laws, an issuer of covered securities is strictly liable to investors to assure that a registration statement is in full compliance with the federal securities laws and discloses all material information that a reasonable investor would need to make an investment decision. Consequently, as noted in required legends in all registered public offerings, the Commission does not approve or disapprove of the securities being offered nor does it pass upon the adequacy or accuracy of the disclosure in the prospectus. If the staff is satisfied that the registration statement is in compliance with the federal securities laws, the staff declares the filing effective pursuant to delegated authority by the Commission, which means that the company is allowed to engage in the transaction it has described in that registration statement. However, the issuer remains liable for the statements contained in that statement.

The staff carefully considers whether a company is an investment company in light of the definitions of investment company under the Investment Company Act and consistent with the Commission's long-standing interpretations of these definitions. The staff considers the status of the relevant entity prior to offering, as well as giving effect to the offering. They also monitor the Investment Company Act status of certain companies on an ongoing basis. In some cases, the staff will determine that the company properly is treated as an operating company. Often, these companies will include risk disclosure in the offering documents about their status under the Investment Company Act, and the consequences to their businesses if they were required to register as investment companies. In other instances, the staff may disagree with a company's investment company status analysis, and request that it either register as an investment company or restructure its business or securities holdings so as to no longer be an investment company. The Commission will bring an enforcement action against the company in appropriate circumstances.

SEC Staff Views on Investment Company Act Status of Fortress and Blackstone

The staff carefully reviewed the registration statements and other information provided by Fortress and Blackstone to determine whether they were investment companies and required to register as such under the Investment Company Act. I am pleased to provide you with the details of our analysis. As described earlier, the Investment Company Act includes two relevant tests for determining Investment Company Act status: one for orthodox investment companies, and one for inadvertent, or prima facie, investment companies.

Orthodox Investment Companies Test

As a general matter, under the orthodox investment company test, the focus is on the investment of the issuer's own assets, not the assets of others (otherwise, all investment advisers might be deemed to be investment companies).

As is described in detail in the registration statements, neither Fortress nor Blackstone is an orthodox investment company. Fortress and Blackstone are engaged primarily (and hold themselves out as being engaged primarily) in the business of providing asset management and financial advisory services to others and not primarily in the business of investing in securities with their own assets. In its registration statement, Fortress described itself as a "global alternative asset manager ... We raise, invest and manage private equity funds, hedge funds and publicly traded alternative investment vehicles." In its registration statement, Blackstone described itself as a "global alternative asset manager and provider of financial advisory services" whose "businesses include the management of corporate private equity funds, real estate opportunity funds, funds of hedge funds, mezzanine funds, senior debt vehicles, proprietary hedge funds and closed-end mutual funds" and whose business also includes the provision of "various financial advisory services, including corporate and mergers and acquisitions advisory, restructuring and reorganization advisory and fund placement services."

The Commission traditionally assesses the "primary engagement" of a company by examining the composition of its assets, sources of its income, the investment activities of its officers and employees, the company's public statements, and its historical development in order to compare

the securities and non-securities businesses of the company. Also, the Commission traditionally considers the nature of the assets and income to be the most important factors in this analysis.[1]

Based on the analysis described in the section below (see "Inadvertent Investment Companies Test"), we determined that the assets of Fortress and Blackstone are primarily indicative of an operating, and therefore non-investment company, business.

We believe that the other factors that form the basis for the "primary engagement" test provide further evidence that Blackstone and Fortress are engaged primarily in the business of managing money for others, and are not primarily in the business of investing for themselves. In each case, their income and revenues are primarily derived from their asset management business and not from their own investments; they hold themselves out as money managers and not as investors or investment companies; and they spend most of their time managing others' money, not their own.

As a result, the staff concluded that Fortress and Blackstone appear to be primarily engaged in a non-investment company business.

Inadvertent Investment Companies Test

With respect to determining whether Fortress or Blackstone would constitute an inadvertent investment company, the key test established by Congress in the Investment Company Act is whether more than 40% of a company's assets are investment securities.[2]

Alternative asset managers typically have a variety of assets. In the case of Fortress and Blackstone, as is described in their registration statements, the main assets relevant to the inadvertent investment company test are the general partnership and limited partnership interests in their underlying funds. While limited partnership interests are treated as investment securities, under existing law, general partnership interests are not securities, if the profits relating to those interests generally come from the efforts of the general partners, as opposed to the efforts of others.[3] In the case of Fortress and Blackstone, the issuers maintain control over the day-to-day

1 *Tonopah Mining Company of Nevada*, 26 SEC 426 (1947).

2 Although the meaning of "securities" under section 3(a)(1)(A) is different than the meaning of "investment securities" under section 3(a)(1)(C), those differences are not relevant to the analysis of Fortress and Blackstone.

3 *See, e.g., Williamson v. Tucker*, 645 F.2d 404 (5th Cir. 1980). For example, a general partnership interest can be designated a security if the investor can establish that: (1) an agreement among the parties leaves so little power in the hands of the partner that the arrangement in fact distributes power as would a limited partnership; (2) the partner is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership powers; or (3) the partner is so dependent on some unique entrepreneurial or managerial ability of the manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership powers. *See id.*

management of the underlying funds, with senior employees exercising such management through wholly owned subsidiaries. The profits to the general partnership interests result from the efforts of the managers, not others, and the general partnership interests would thus not constitute securities. The fact that the public investors in the securities sold by Fortress and Blackstone have no voting rights with respect to the management of the underlying funds would not change this conclusion. Thus, the general partnership interests would not be securities and therefore not "investment securities" for Investment Company Act purposes.

After determining which assets should be treated as securities and which as non-securities, a value must be assigned to each. The Investment Company Act requires that in making these valuations, an issuer must assign a fair value to general partnership interests like those at issue in the Fortress and Blackstone filings. In order to make such a valuation, an alternative asset manager may consider, among other things, its right to "carried interest" in the underlying funds. This right, which is part of the compensation for managing the underlying funds, entitles the manager to share in the profits of the underlying fund. Typically, an underlying fund must return the capital given to it by limited partners plus any preferential rate of return before the manager can share in the profits of the fund. The manager will then receive a carried interest, which is calculated as a percentage of the profits. Fortress and Blackstone calculate the fair value of their general partnership interests in the underlying funds to include their rights to receive carried interests because such rights are inexorably linked to the general partnership interests.

Applying the principles laid out above, the Division of Investment Management staff concluded that neither Fortress nor Blackstone appears to hold investment securities with a value exceeding 40% of total assets. Put another way, in the context of both Fortress and Blackstone, the value of their "investment securities," (*i.e.,* their limited partnership interests in the funds that they manage and their other securities investments) is less than 40% of total assets. Conversely, the value of the assets that are not "investment securities," (*i.e.,* the general partnership interests, including the right to receive carried interests in the underlying funds) is more than 60% of total assets. This asset composition is indicative of an operating company business, rather than investment company business.

Even if the staff concluded that Fortress or Blackstone held investment securities with a value exceeding 40% of total assets, those entities may have been able to rely on certain exclusions from the definition of investment company under section 3. In particular, section 3(b)(1) of the Investment Company Act excludes a company if it is engaged primarily in a business other than investing in securities. Under section 3(b)(1), the analysis of the entity's primary engagement is similar to that discussed above.[4] In addition, Commission rule 3a-1, which modifies the traditional 40% asset test in certain ways, may also have been available to these entities.[5]

Two final notes about the analysis performed by the Commission's staff: First, both Blackstone and Fortress included disclosure in the risk factors section of their offering documents regarding

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4 *See* Fortress registration statement, at p. 48 (Feb. 9, 2007); (Blackstone registration statement, at p. 60-61 (June 25, 2007).

5 *See* Fortress registration statement, at p. 48 (Feb. 9, 2007).

potential uncertainty relating to whether they might be deemed to be investment companies under the Investment Company Act, and the impact that registration under the Investment Company Act could have on their businesses. Second, each has an opinion of counsel stating that it is not an investment company.

Finally, it is important to consider that the public investors are buying a share of the entity managing these funds, rather than a share in the underlying funds. Thank you for this opportunity to appear before the Committee. I look forward to working with you to meet the needs of our nation's investors, issuers, and markets, and I would be happy to answer any questions you may have.

Carried Interest Part I
Questions for the Record
July 11, 2007

Questions from Chairman Baucus

1. *Mr. Donohue, why do private equity funds and hedge funds try to avoid the Investment Company Act of 1940? How would this Act affect a typical private equity or hedge fund?*

The Investment Company Act of 1940 (the "Investment Company Act") imposes comprehensive requirements on the organization and operation of investment companies. Among other things, the Investment Company Act and the rules thereunder limit or prohibit transactions with affiliates, and impose limitations on capital structure and purchase and sale transactions that may involve leveraging of fund assets (*e.g.*, short selling and derivatives investments). In addition, registration of a private equity or hedge fund under the Investment Company Act may trigger certain limitations under the Investment Advisers Act of 1940 on the performance fees paid by the fund. These limitations would materially adversely affect the business of a typical hedge fund or private equity fund.

In addition, managers of private equity funds and hedge funds generally try to avoid the Investment Company Act for similar reasons. More specifically, Blackstone included disclosure in its offering document that provides a typical description of how the Investment Company Act would impact a manager of private equity funds and hedge funds:

> The [Investment Company] Act and the rules thereunder contain detailed parameters for the organization and operation of investment companies. Among other things, the [Investment Company] Act and the rules thereunder limit or prohibit transactions with affiliates, impose limitations on the issuance of debt and equity securities, generally prohibit the issuance of options and impose certain governance requirements. We intend to conduct our operations so that The Blackstone Group L.P. will not be deemed to be an investment company under the [Investment Company] Act. If anything were to happen which would cause The Blackstone Group L.P. to be deemed to be an investment company under the [Investment Company] Act, requirements imposed by the [Investment Company] Act, including limitations on our capital structure, ability to transact business with affiliates (including us) and ability to compensate key employees, could make it impractical for us to continue our business as currently conducted, impair the agreements and arrangements between and among The Blackstone Group L.P., Blackstone Holdings and our senior managing directors, or any combination thereof, and materially adversely affect our business, financial condition and results of operations. In addition, we may be required to limit the amount of investments that we make as a principal or otherwise conduct our business in a

manner that does not subject us to the registration and other requirements of the [Investment Company] Act.[1]

2. *Did Fortress, KKR, Oaktree, Blackstone and Ochs-Ziff place a value on future streams of income from their carried interest and incentive fees? For SEC purposes, are these valuations reliable?*

Blackstone, for purposes of its Investment Company Act status determination, did place a value on future streams of income from their carried interest. More specifically, in order to determine its status under section 3 of the Investment Company Act, Blackstone had to value all assets for which no market quotations were readily available (such as its general partnership interests, including carried interests, in this case) using fair value as of the end of the most recent fiscal quarter. Fair value under the Investment Company Act is determined in good faith by the board of directors (or in the case of a partnership like Blackstone, by persons performing similar functions) and means the amount which the owner might reasonably expect to receive upon a current sale. In making this determination, directors must satisfy themselves that all appropriate factors relevant to the value have been considered. Value can be determined fairly in more than one way, and when determining fair value, different boards, when valuing identical securities, could reasonably arrive at different values.

The Commission staff does not have any reason to believe that Blackstone's valuations for these purposes were unreliable. It is important to note that the obligations to assure that a registration statement is in full compliance with federal securities laws rests with the issuer of the securities being offered to the public and other offering participants. The Commission does not conduct investigations or audits in connection with its reviews of registration statements. As noted in the Commission's Rules of Practice, "Registration is not a finding by the Commission as to the accuracy of the facts disclosed."

Fortress did not place a value on future streams of income from its carried interest and incentive fees for purposes of its Investment Company Act status determination.[2] In addition, Commission staff currently is reviewing the registration statements of KKR and Och-Ziff. As a result, we are unable to respond to this question with regard to these entities at this time. With respect to your question about Oaktree, it is our understanding that Oaktree has not publicly offered its securities, and has made no filings with the

[1] Blackstone registration statement, at p. 61 (June 25, 2007). Fortress included substantially similar disclosure. *See* Fortress registration statement, at p. 48 (Feb. 9, 2007).

[2] *See* Fortress's January 18, 2007 letter in response to comments from Commission staff (available at http://www.sec.gov/Archives/edgar/data/1380393/000095013607000245/filename1.htm) (summarizing how the board determined fair value without accounting for *future* income streams).

Commission indicating an intent to do so. As a result, Commission staff does not have the information necessary to answer this question with regard to Oaktree at this time.

3. *Why would a private equity or hedge funds manager decide to go public?*

A private equity or hedge fund manager may decide to go public for a number of reasons. We believe that the reasons given by Fortress, Blackstone, Och-Ziff and KKR in their registration statements generally are representative:

Fortress represented that it was going public in order to meet four needs:

- People - to increase our ability to provide financial incentives to our existing and future employees through the issuance of publicly-traded equity securities that represent the value and performance of the company as a whole. In a highly competitive market for investment professional talent, publicly-traded equity securities provide us with a valuable additional compensation tool;

- Permanence - solidify our institutional presence as an ''investor.'' Being a public alternative asset manager will benefit us as institutions and individuals increase the portion of the capital they allocate to us;

- Capital - to more efficiently access capital that we can use to grow our businesses and create new investment products; and

- Currency - to provide us with a publicly-traded equity security that we can use to finance future strategic acquisitions.

Blackstone represented that it was going public:

- to access new sources of capital that we can use to invest in our existing businesses, to expand into complementary new businesses and to further strengthen our development as an enduring institution;

- to enhance our firm's valuable brand;

- to provide us with a publicly-traded equity currency and to enhance our flexibility in pursuing future strategic acquisitions;

- to expand the range of financial and retention incentives that we can provide to our existing and future employees through the issuance of equity-related securities representing an interest in the value and performance of our firm as a whole; and

- to permit the realization over time of the value of our equity held by our existing owners.

Och-Ziff represents that it intends to go public for the following reasons:

- To enable us to implement our growth strategy and continue to attract and retain the finest investment management talent in the world.

- To continue to develop new investment strategies as we identify strategic opportunities around the world.

- To offer existing and prospective partners and employees direct participation in our success, which will align the interests of our partners and employees with those of our investors.

- Each of our existing partners will invest 100% of the after-tax proceeds received by him in connection with this offering in the investment funds we manage, including funds we may offer in the future. We believe this will assist us in building a track record and ultimately raising additional capital for our funds.

KKR represents that it intends to go public because:

- We Want to Leverage Our Industry and Company Research Efforts by Building New Businesses. We believe that significant opportunities exist for us to build new businesses by leveraging the intellectual capital of our firm and increasing the utilization of our people. While our private equity teams conduct in-depth research and have developed specific views on trends and participants in their industries, a large number of our private equity efforts do not result in actual private equity transactions. Historically, when we were unable to complete a private equity transaction, much of the work that we had completed remained unutilized. With our integrated efforts in debt and public market investing, we have in recent years been able to leverage the work and contacts of our private equity teams and deploy capital behind our ideas. We believe that becoming a public company will enable us to invest more heavily behind these activities and the ideas that we develop in the normal course of our business.

- We Want to Reduce Our Reliance on Third Party Sources of Capital. Since our inception, we have completed or announced more than $410 billion in private equity transactions, while investing or agreeing to invest approximately $42 billion of our own funds' equity in those transactions. The balance of the financing consisted of debt and equity that was syndicated to others, including other private equity firms. We recently launched a new capital markets initiative to capture a greater share of the economics in the transactions we originate and increase the operational control that we are able to exercise over our private equity investments.

We expect to expand these capital markets activities utilizing a portion of the proceeds from this offering.

- Going Public Will Provide Us with a Currency for Potential Future Acquisitions. We believe that our strong brand name in the financial services industry will support growth through acquisitions or combinations with similarly strong franchises that will complement our existing activities. By adding our products and brand to the products of acquired companies, we believe we will be well positioned to create significant value for our stakeholders. While we do not have any current acquisition plans, becoming a public company will provide us with a currency that we may use to pursue those alternatives when attractive opportunities arise.

Question from Senator Cantwell

1. *Mr. Donohue, in your testimony, with respect to Fortress and Blackstone, you noted that "it is important to consider that the public investors are buying a share of the entity managing these funds, rather than a share in the underlying funds." Can you elaborate on why this is an important distinction.*

An investment in Fortress or Blackstone, which through subsidiaries manage underlying private equity and hedge funds, is not the same as an investment in the underlying funds. The investment in a publicly offered holding company, such as Fortress or Blackstone, that holds operating alternative asset managers, is dependent on the success of the alternative asset managers in all of their businesses, not just the returns that the managers achieve when investing for the funds that they manage. An investment in an underlying fund, on the other hand, results in a direct interest only in that pool, and is dependent solely on the success of the investments held by the pool. While the investment skill of the manager of a private equity or hedge fund certainly affects how well the fund's investments perform, the return of the fund is limited to the increase in the value of the investments in that pool.

This distinction is important because the underlying hedge funds and private equity funds cannot offer their shares to the public. In general, each underlying fund relies on certain exclusions to avoid registration as an investment company under the Investment Company Act that are based partly on the fund not making a public offering of its securities.

Senate Committee on Finance Hearing
July 31, 2007

"Carried Interest, Part II"

Testimony of:
John B. Frank, Managing Principal
Oaktree Capital Management, L.P.
Los Angeles, CA

Good morning. My name is John Frank and I am the Managing Principal of Oaktree Capital Management, L.P. I'm here to address the merits of the proposed PTP legislation (S.1624) and the adverse impact it has had on our unitholders, such as mutual funds managed by Fidelity, Lord Abbett and Marsico, and the many individual American savers who invest through these intermediaries.

As an initial matter, allow me to observe that there are thousands of investment firms managing perhaps as much as $2 or $3 trillion that are loosely referred to by many as "private equity" and "hedge" funds. As I am sure the Committee appreciates, the investment strategies pursued by those firms, and the business principles they observe, range from conservative to aggressive. We think we fall on the conservative end of the spectrum.

Oaktree is a leading global investment firm focused on non-mainstream and alternative markets. Unlike mutual funds, which traditionally invest only in publicly-traded equities or investment grade bonds, our investments are concentrated in less well-known "alternative" asset classes or strategies. We invest about $47 billion in a wide range of strategies, including high yield bonds, distressed debt, private equity (including power infrastructure), convertible securities, real estate, emerging market equities, mezzanine finance, and Japanese equities. No one strategy predominates among our offerings. Private equity, as of June 30, 2007, constituted about $8.5 billion, or 18% of our assets under management. As best we know, no client has ever lost money investing with Oaktree.

We believe that our investment success stems from our focus on the avoidance of loss rather than the pursuit of outsized gains. Thus our overriding belief is that "if we avoid the losers, the winners will take care of themselves."

What we do – and do well – is invest money on our own behalf and on behalf of our clients and the beneficiaries and the investors they represent. Our clients include 128 corporate pension plans; the pension plans of 28 of the 50 states; 225 college, university, cultural or charitable endowments or foundations; and 38 insurance companies. We are not an investment bank – that is, we do not offer financial advisory services, we do not help companies buy or sell other companies, we do not trade or underwrite securities as a

business, nor do we offer mutual funds. Our competitors are other investment managers, including hedge and private equity funds.

Unlike many of our competitors, our firm has benefited from broad-based employee ownership virtually since its inception. We now have about 85 employee-owners. Other owners include a state pension plan and several charitable endowments.

In May of this year, we sold a 16% interest in Oaktree to a large group of institutional investors – mostly mutual funds and other investment funds – through an offering underwritten by Goldman, Sachs & Co. As a result, our equity now trades on an over-the-counter market developed by Goldman Sachs for qualified institutional buyers – institutions with at least $100 million of investment assets. We limited our offering to sophisticated investors for a number of reasons, including a concern that the average retail investor might not be well-equipped to analyze appropriately and understand the long-term focus and the inherent volatility of our business.

All of our employee-owners, together with our outside owners, sold a portion of their interests on a pro rata basis in the offering. We believed having tradable equity would provide a valuation mechanism and liquidity that will help us succeed in the intense competition for talented investment professionals and facilitate an orderly transition from the current owners of Oaktree to our future leaders. Although we raised some new equity capital in the offering, raising capital was not a major motivation for us, given that our firm, like other substantial investment advisors, generates surplus capital.

Historically, our business, like that of almost all of our competitors, was structured as a partnership. As such, all the income was taxable to the partners, and not to Oaktree. Consistent with that historical practice, when we decided to undertake the offering, we sought to continue our business as a partnership by relying on the statutory exception for publicly traded partnerships or "PTPs," that permits an entity to continue to be taxed as a partnership if it has sufficient "qualifying" income. Our decision to structure ourselves as a PTP did not represent any "stretching" of the tax law – a conclusion that I believe is consistent with Treasury testimony before this Committee.

Guided by prominent accounting and law firms, we carefully reviewed each of our investments and activities to identify those that clearly satisfied the qualifying income definition under the PTP rules and those that did not. We arranged our affairs to satisfy the statutory requirements by ensuring that any non-qualifying income – including all of our management fees and the income generated by our mezzanine finance and real estate strategies – flows into a corporate subsidiary and is subject to corporate tax. At no time was there any suggestion that anything we were doing was beyond the letter, or even the spirit, of the law.

I think it's worth emphasizing that, as a result of our offering, we have now subjected a substantial portion of our income – including the management fees that have historically represented between one-third and one-half of our income – to a corporate level tax. As a private partnership, Oaktree did not pay tax on any of its income, only its partners did.

Even though we were raising the tax burden on the business and thus placing ourselves at a competitive disadvantage vis-à-vis the vast majority of our thousands of competitors (who continue to operate as private partnerships), we believed that the benefits of our offering and public ownership would exceed the additional tax burden.

In making that judgment, however, we had no reason to believe that legislation would be proposed just weeks after we offered our units for sale that would subject all of our income to corporate tax and our distributions to a second level of tax. If we had understood that a bill like this would be proposed, and retroactively applied to transactions consummated before the change in law was even proposed, we might well have pursued a different route to establish a valuation mechanism and to provide liquidity for our equity.

While we think fair tax policy requires greater transition relief if the Committee changes the PTP rules as proposed, we first and foremost urge the Committee not to adopt the proposed legislation. We believe passing the PTP legislation will discourage the salutary trend of alternative investment firms going public, will increase the relative attractiveness of non-U.S. capital markets, and will target unfairly a single industry.

While a small number of our competitors announced an intention to go public after the legislation was proposed, we believe that this legislation will generally discourage other firms from doing so. Our business tends to generate surplus capital, meaning that firms like ours do not need to access public markets to raise capital. If Congress adopts legislation that in effect imposes a penalty on going public, we believe that many firms like ours will conclude that the burden exceeds the benefit.

In my judgment, that would be unfortunate. If we could turn the clock back just a few short months, we would find that primary concerns about private equity and hedge funds were that their private operation shielded the funds from public scrutiny and that the ordinary investor had no access to ownership of the companies doing business in this asset class – leaving it to the wealthy who have historically benefited from the diversification it offers. If this legislation were to go forward, it would discourage public offerings of firms like Oaktree, the industry would continue to operate largely out of the public eye, and the average investor would lose the ability to participate in these investment opportunities.

Imposing a corporate tax on investment PTPs, like Oaktree, also raises larger questions regarding the competitiveness of the United States capital markets. Historically, the United States has been the preferred location to raise capital. But our capital markets no longer hold the allure they once did. Many other nations are moving aggressively to cut tax rates and take other steps to attract capital. At the same time, many investment managers believe that the most attractive investment opportunities are disproportionately abroad. As a result, many investment firms are already locating or expanding their operations and employment abroad – a trend that will only increase if multiple levels of tax are imposed upon our industry.

Moreover, I do not know of any principled justification for disallowing PTP status for qualifying investment management firms, while continuing to permit such status for firms in other sectors of the economy. It strikes me as unfair and inconsistent that the proposed legislation would impose a corporate tax on the *passive* income of PTPs (dividends, interest, and capital gains) in our sector, which would result in some cases in triple taxation of income, while continuing to shield from the corporate tax the *active* income of PTPs in certain other favored sectors. For these reasons and others, we believe policy considerations favor preserving the current tax treatment of PTPs.

If, however, the Committee adopts this legislation, equity and fairness require that Oaktree, and any other PTP trading before the introduction of the proposed legislation, should receive transition relief for a period of at least ten years. As you know, when Congress adopted the PTP rules in 1987, it provided a ten-year transition period. At the end of that period, in 1997, Congress went further and provided for permanent relief for grandfathered PTPs. A ten-year transition period would be consistent with past precedent and reduce the economic harm suffered by the outside investors from the introduction of the PTP legislation.

And that is the reason I am here today. In connection with our offering, I traveled with my colleagues all over the country speaking with potential investors about Oaktree and our business. In those meetings, we emphasized that we were seeking long-term investors comfortable with our management approach and long-term focus and with the staying power to ride through the inevitable ups and downs of our business. We met with a warm reception and our offering, which was oversubscribed, began to trade on May 22, 2007.

When S. 1624 was introduced on June 14, 2007, our unit price plummeted almost ten percent overnight – representing a loss of over $500 million in our market capitalization and close to $100 million for our new investors – notwithstanding the proposed five-year grandfather provision. The market had not anticipated the change in law contemplated by the bill. After a subsequent House bill was introduced with no grandfather provision (H.R. 2875), and a House bill changing the treatment of carried interests was introduced (H.R. 2843, by Representative Levin and Chairman Rangel on June 22, 2007), our unit price slipped an additional five percent. A chart showing the decline in value resulting from the proposed legislation is attached.

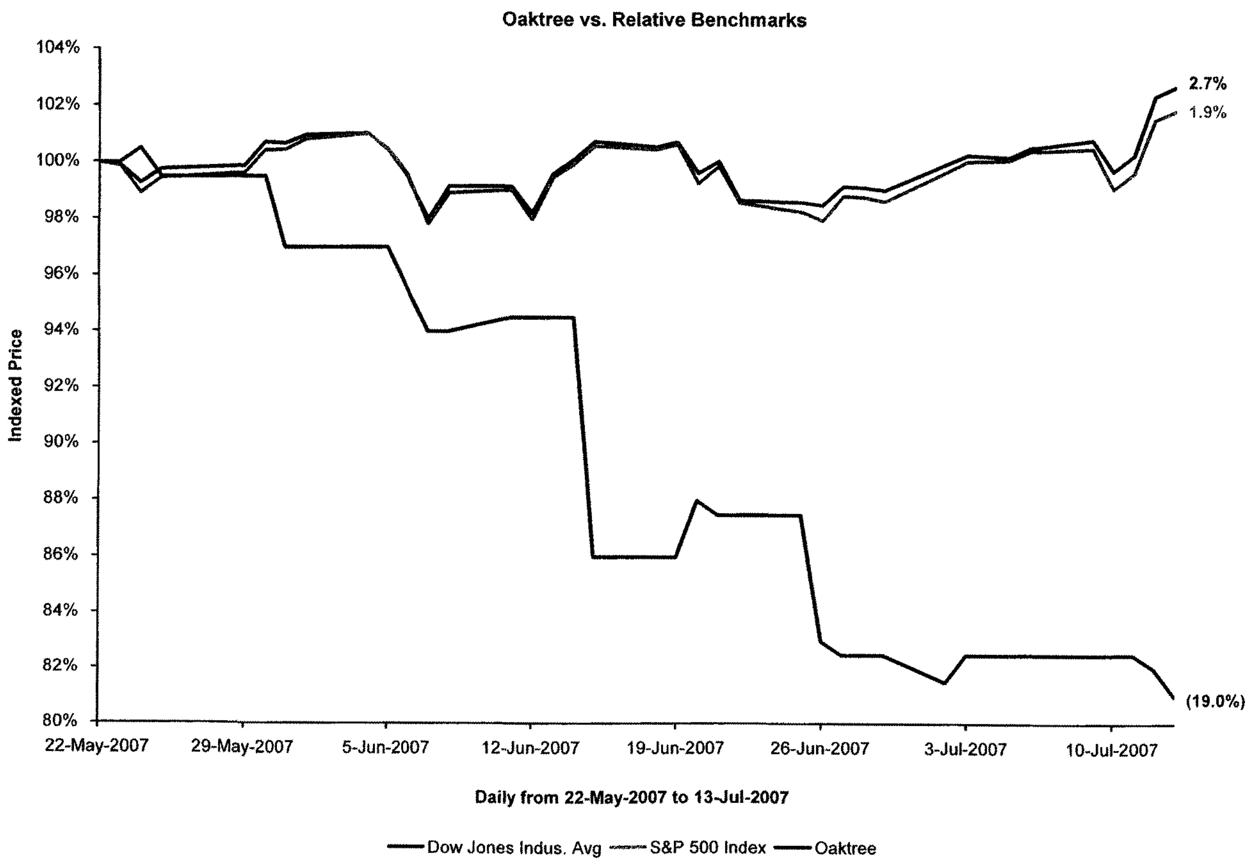
As a result, our outside investors – pension funds, mutual funds and other investment funds managing the personal savings and retirement funds of working Americans – have lost close to 15% of their investment. Although I had no idea this legislation might be proposed, I feel an obligation to do everything I can to see that the losses suffered by these investors are recovered.

In that connection, it's important to note that our investors, and the investors in the PTPs that preceded us, are the only outside investors that were adversely affected by the proposed legislation. While our investors were aware, of course, that our nation's laws are subject to change, they had no reason to anticipate a fundamental change to the

taxation of PTPs just a few weeks after their purchase. In this respect, the position of our outside investors is quite different from those that may invest in a PTP subsequent to the introduction of the proposed legislation. Those investors, unlike ours, were on notice that the tax regime might change, and the price they paid for their investment presumably reflected that uncertainty.

Some have suggested – mistakenly in my view – that transition relief for our outside investors would provide Oaktree some unfair competitive advantage. While transition relief would ameliorate the loss suffered by our outside investors, it would not afford Oaktree a competitive advantage in the areas crucial to its continuing business operations – attracting capital for its funds or bidding on assets for investment. Whether an investment firm structured as a PTP is taxed as a partnership or corporation is irrelevant to the competition for client capital – which is the main source of capital for investment and the main area of competition among firms in our business. A transition rule that protects the investment expectations of the outside investors who invested in Oaktree will not give Oaktree an advantage in the competition for investment clients or enhance its investment opportunities.

Thank you for allowing me this opportunity to speak with you today. I would be happy to address any questions that you may have.


Oaktree vs. Relative Benchmarks
104%
102%
100%
98%
96%
94%
92%
90%
88%
86%
84%
82%
80%
Indexed Price
2.7%
1.9%
(19.0%)
22-May-2007
29-May-2007
5-Jun-2007
12-Jun-2007
19-Jun-2007
26-Jun-2007
3-Jul-2007
10-Jul-2007
Daily from 22-May-2007 to 13-Jul-2007
Dow Jones Indus. Avg
S&P 500 Index
Oaktree

Carried Interest Part II Questions for the Record
John Frank
July 31, 2007

Questions from Sen. Baucus:

1. Many hedge funds have a master feeder structure in which foreign and nonprofit investors invest through a corporation incorporated in a low tax jurisdiction, such as the Cayman Islands. In such a structure, the hedge fund manager enters into a contract with the foreign corporation to provide investment services, and the manager receives remuneration in the form of an incentive fee instead of carried interest. Economically, how is an incentive fee different from a profits interest?

Profits interests and incentive fees carry with them different bundles of legal rights and associated economic risks. For example, an incentive fee entitles the recipient to the rights of a third party creditor, which, in bankruptcy, have similar priority to other creditor claims. In contrast, a profits interest represents equity ownership in a partnership and ranks behind all creditor claims in bankruptcy.

2. At the July 11, 2007 hearing on carried interest, Mr. Solomon stated in his written testimony that a profits interest partner has an immediate ownership interest in the enterprise.

A. What does a profits interest partner own?

A profits interest partner owns a partnership interest with all the attendant rights and obligations under state law and the relevant partnership agreement. The economic rights of a profits interest partner depend entirely on the relevant partnership agreement, but generally entitle the partner to a specified share of any future income of the partnership or any future appreciation in the partnership's assets. A profits interest resembles stock in a corporation, but without a current liquidation preference. As in the case of stock, the value of a profits interest depends on the performance of the enterprise.

B. What can a profits interest partner receive upon liquidation of the partnership?

By definition, a profits interest partner does not have a share in the liquidation proceeds of a partnership at the time the interest is granted. Thereafter, such a partner would typically have a share in the liquidation proceeds to the extent of subsequent appreciation in the partnership's assets or undistributed profits.

3. Some panelists stated that the general partner in a hedge fund, real estate, venture capital, or private equity partnership has entrepreneurial risk. What risks does a profits interest partner have in a partnership?

Like stockholders of a corporation, a profits interest partner bears the risk that the partnership will fail to generate profits. Many of the entities that issue profits interests invest in highly risky ventures, including distressed debt, start-up businesses, and struggling larger companies. Recent events demonstrate that many investments carry with them significant risk of loss. Testimony before this committee stated that, in the

venture capital industry, which also frequently uses profits interests, forty percent of all investments lose money. When hedge fund investments decline in value or venture-backed companies fail, the profits interest partners in these enterprises receive nothing. This is similar to other equity ownership interests – when a corporation loses money for example, a stockholder may receive little or nothing for his stock.

4. You assert that Oaktree should be able to go public without paying corporate tax. Why is your company different than GLG, Goldman Sachs, Citibank, or any other investment company that went public in corporate solution?

First of all, unlike those companies, Oaktree is not an investment bank and offers virtually none of the services offered by investment banks. Investment banking firms provide merger advisory services, underwrite public offerings of debt and equity, and often act as retail brokers for investors. In contrast, Oaktree invests money on behalf of its principals, certain employees, and investors in "alternative" asset classes and strategies that produce income in the nature of dividends, interest, or capital gains.

More importantly, it is not our position that Oaktree should be able to go public without paying corporate tax. Rather, we believe that there is no basis to alter the long-standing principle that income in the nature of dividends, interest, or capital gains should not be subject to corporate tax. To the degree that Oaktree generates income from operations, such as management fee income and income from the active management of real estate projects or the issuance of mezzanine debt, the publicly traded partnership's share of that income is, in fact, subject to corporate tax, because a corporate subsidiary owned by the publicly traded partnership earns that that income.

5. A general partner's profits interest is subject to a "clawback." A clawback means that the general partner will be required to return part or all of the income received on a profits interest if the fund fails to meet a specified return for the limited partners. How frequently are clawback provisions exercised?

Although Oaktree's partnership funds provide for "clawbacks," none have ever been invoked, largely because Oaktree only receives its carried interest after its investors have received all of their capital back, plus a preferred return. I do not know how whether or how often other firms' clawbacks have been invoked.

6. What percentage of capital does a general partner invest in a fund?

Oaktree's present policy is to invest the greater of $20 million or 2.5% in each of its funds in which it has a profits interest. I do not know what percentage others in the industry invest.

7. Does the partnership agreement for a fund contain a clause that provides for binding arbitration between the general partner and the limited partners?

No. Oaktree's fund documents do not provide for binding arbitration.

Questions from Sen. Grassley

1. *At the hearing, I asked you for a yes or no answer to the following question:*

> *I have read reports in the press that, rather than change the tax treatment of carried interest, some think it would be more fair and equitable to raise the top marginal rate to 40% and the capital gains rate back up to 20%. That would leave the fund managers with their 20% rate preference while raising taxes on everyone else, including small business owners, households with two wage earners, investors who actually put their capital at risk, and retirees who depend on investment income. Would this make the tax system more fair and equitable than changing the treatment of carried interest?*

If you wish, please elaborate on the answer you gave at the hearing.

We believe that in seeking new revenue for the government, Congress should seek to broaden the tax base rather than raise the tax rates. However, broadening the tax base through a targeted denial of capital gains treatment for carried interest could create serious problems for the tax system. Income indistinguishable from carried interest would continue to be eligible for capital gains taxation if earned outside a partnership – a powerful tax incentive for taxpayers to avoid partnerships. Substantial new complexity would result. We believe the better course would be for Congress to consider the treatment of carried interest and partnerships in the context of broad reforms of the tax code, as occurred in 1986.

It is important to recognize that carried interest arrangements are not unique to the investment management industry – they pervade our economy, from sophisticated hedge funds to small businesses in every town in America. These arrangements have been permitted for many decades and have helped foster the entrepreneurship that has fueled our economy. While it's certainly appropriate for Congress to reconsider the fairness and wisdom of such arrangements, there is no justification for singling out and changing the tax treatment for just one industry. Whatever modifications are made to the carried interest rules ought to apply to everyone – whether they are an investment manager, a real estate developer or any other entrepreneur.

2. *A concern that Mr. Rosenblum highlights in his testimony is that pension funds, endowments, and foundations would bear the cost of increased taxes on fund managers. Others have expressed similar concerns with respect to other types of alternative asset managers. I have the following questions regarding this concern:*

A. If all income from carried interests was taxed at ordinary income rates, how much do you expect your tax costs to increase?

B. Would your firm seek to change the fee structure of its business, or otherwise renegotiate its partnerships agreements, to make up for its extra tax costs?

C. Are there other structures your firm might use to reduce tax costs, and how would those structures affect the returns of the limited partners?

D. What factors enter into the negotiation of the carried interest percentage with your firm's limited partners?

We have combined parts of this question to provide a more comprehensive answer.

Historically, between one half and two thirds of Oaktree's income has been subject to ordinary income rates, either as ordinary income or short-term capital gain.

In going public, Oaktree consciously increased its overall tax burden by adopting a structure that subjected a portion of its income to two levels of tax – the corporate tax and tax on distribution of the dividends. In connection with the sale of 16% of its equity to qualified institutional buyers, Oaktree created a publicly traded partnership through which these institutions hold their equity stake. (The remaining 84% is held by Oaktree's historic owners through a tax partnership that is not publicly traded.) The publicly traded partnership owns a portion of its equity interest in Oaktree through a corporate subsidiary. Should S. 1624 or H.R. 2843 pass, the tax burden on the publicly traded partnership would increase, because the legislation would impose a second level of tax on the remainder of the publicly traded partnership's share of Oaktree's income (in addition to the income already subject to a corporate level tax).

Oaktree competes with other alternative asset managers for capital. Therefore, Oaktree's fee structure and the size of the profits interest it holds in any particular partnership are based on what the market will bear. For this reason, when Oaktree became a publicly traded partnership, its fee structure and partnership agreements did not change even though its taxes went up. Likewise, Oaktree employs different fee structures for its different investment strategies that are consistent with fees in the marketplace for those strategies. In many cases, Oaktree invests its own capital as general partner and retains a carried, or profits, interest in the partnership. The size of that carried interest is generally consistent with the practice in the marketplace. It should be noted that the profits earned through the carried interest are determined by how well or how poorly Oaktree's investment choices perform. Thus, its interests are well aligned with those of the other investors.

With that as background, it is clear that our costs would increase very significantly if S. 1624 were adopted. Whether we could pass those costs on to our investors – or whether we would even try – is speculative. Historically, our fees have tended to be towards the lower end of the market. Conceivably, adoption of this legislation could cause us to be more aggressive, but ultimately the market will control.

Similarly, I can't really speculate on what other structures, if any, that we might employ if S. 1624 is adopted to reduce our tax costs or the potential impact of those structures on our limited partners.

However, one potential consequence of the legislation does bear noting. The investment management business is a global business. Like us, many investment managers have flexibility as to the geographic base of their investment professionals. If the adoption of this or related legislation makes it more expensive to compensate employees in the

United States than abroad, it's possible that would encourage investment managers to emphasize their foreign hiring.

E. *How much do you think the fiduciaries of private and public pension funds would be willing to pay your firm to make up for the taxation of managers' income at ordinary rates?*

F. *At what point do you think the pension funds' fiduciary obligations to beneficiaries will preclude them from paying higher fees to your firm?*

It's impossible to predict. Presumably, pension fund fiduciaries will pay whatever is necessary to obtain the investment management expertise they require. The cost of that expertise will ultimately be determined by what the market will bear.

G. *How much of your firm's tax costs do you currently pass on to the investors in your funds?*

H. *If tax costs to fund managers were reduced, how much of those savings would your firm pass on to the investors in your funds?*

The fees we charge are influenced by many factors, including our costs, the fees of our competitors, and the demand for our products. I do not think it is possible to ascertain what percentage of current taxes are borne as an economic matter by our limited partners, our investors, or our employees or to predict how a reduction of tax costs would be passed on to investors.

I. *After the Tax Reform Act of 1986, ordinary income and capital gains rates were equal at 28%. Since then, capital gains rates have dropped to 20%, and then 15%, while the top marginal ordinary rate increased to 39.6%, and is now 35%. Did your firm's fee structures change at all in response to these changes in rate differentials?*

Our firm was founded in 1995. Since then we have employed a number of different fee arrangements. These arrangements were developed in the context of the then-current economic and market conditions and affected by the particular circumstances of Oaktree and its investors. None was specifically tied to any change in tax rates.

3. *Carried interest is said to align the interests of the fund manager with the limited partners. Another way to achieve that alignment is through an incentive or performance fee, which is actually used by managers of offshore hedge funds. Other than carried interest, does your firm use other incentive arrangements to achieve alignment of interest? If so, under what circumstances and why?*

As discussed in our written statement, Oaktree engages in several different investment strategies. These investment strategies are subject to different incentive arrangements. For some strategies, Oaktree receives an incentive fee; in other investment strategies, Oaktree co-invests with its limited partners and retains a carried interest. Oaktree retains a

carried interest only in the funds in which it has invested its own capital. For all investment strategies, including those strategies that provide the general partner with a carried interest, the objective is to earn an attractive return on a risk-adjusted basis for our investors.

4. *Your management firm went public on the Goldman Sachs proprietary exchange. Please answer the following questions:*

A. *Please describe how this exchange operates.*

Our equity units trade over the counter through the Goldman Sachs trading platform and not on any exchange. Goldman Sachs limits trading on this platform to qualified institutional buyers and polices against our having over 500 equity holders, allowing us to remain a private company for purposes of the Securities Exchange Act of 1934. Only institutions having assets of $100 million or more are permitted to buy our units. Issuers who participate on the Goldman Sachs platform must make available quarterly, annual and event-related financial reports similar to those required of public companies subject to the Securities Exchange Act of 1934.

B. *Does the average investor have access to your shares?*

Average investors may own Oaktree units indirectly through the institutional unitholders, such as mutual funds, that invested in Oaktree. Mutual funds that own an interest in Oaktree include funds managed by Fidelity, Lord Abbett and Marsico.

C. *As a result of being listed on the Goldman exchange, what public disclosure is required of your firm that subjects your firm and the funds your firm manages to public scrutiny?*

We make disclosures to our unitholders and other institutions participating in the Goldman Sachs platform that are similar to the disclosures that the SEC requires of public companies. We provide annual and quarterly financial reports with a management discussion and analysis, and notify unitholders of certain material events.

D. *At our hearing on July 11, 2007, Mr. Donohue, Director, Division of Investment Management, United States Securities and Exchange Commission, testified that even for those listed on the New York Stock Exchange, since it is the fund management firm that is public, there will remain limited, if any, required public disclosure of the assets, liabilities, investment strategies, and risk profiles of the investment funds themselves. Do you have a different opinion?*

Generally accepted accounting principles require that our financial statements include our funds on a consolidated basis, even though our ownership interest in those funds is modest. Accordingly, our financial statements, which are part of our periodic disclosure reports, include the assets and liabilities of our funds. Our investment strategies are described both in our disclosure documents and in various public documents. We do not generally disclose, however, particular investments as that information is confidential and proprietary. Disclosure of such information could

make it harder for us to achieve our investment goals and thus would not be in the interest of our investors or their beneficiaries. Our posture in this respect is not unusual. Public firms do not generally reveal confidential or proprietary information, whether in the nature of trade secrets, research and development processes or investment techniques. Indeed, such disclosure would often harm the shareholders' interests by revealing competitive or market-sensitive information.

E. You provided a chart showing that the price of Oaktree's partnership units has declined, though there are several plateaus in the price, suggesting an absence of transactions during those periods. How many units and what portion of the total units, changed hands between June 14, 2007 (the day the Baucus-Grassley bill was introduced in the Senate) and June 23, 2007 (the day after the Levin bill was introduced in the House)? Please provide the daily trading volume for each day during the month of June.

Please see the spreadsheet attached as Attachment A.

5. In a pure hedge fund, most assets are held for less than a year, meaning any gains would be short term capital gains and subject to ordinary income rates.

A. What is the typical holding period for investments made by the funds you manage?

Holding periods vary widely from a few months to over ten years.

B. If much of the carried interest is taxed at ordinary income rates anyway, why are hedge fund managers opposed to changing the character of their carried interest from short-term capital gain to ordinary income?

I can't speak for hedge fund managers in general, but I can tell you that H.R. 2843 would recharacterize all of Oaktree's income as compensation for services rather than as return on investment. As a result, our publicly traded partnership would no longer satisfy the qualifying income requirement under the publicly traded partnership rules of Section 7704 and all of its income would be subject to a second level of tax. Thus for Oaktree the issue is not the tax rate on carried interest, but the threat of double taxation.

6. In their registration statements filed with the SEC, some of the management firms going public as partnerships assert that they are not properly treated as investment companies under the Investment Company Act of 1940 because they are performing asset management and investment advisory services, rather than investing in securities. At the same time, these firms take the position that they qualify to be treated as a partnership because their income is considered passive capital gain income under the Internal Revenue Code.

A. In going public on the Goldman exchange, did your firm take the same two positions?

Our publicly traded partnership is not an investment company for the purposes of the Investment Company Act and this was correctly stated in the offering documents. In addition, we, with the assistance of our advisors, carefully evaluated which of our investments met the qualifying income definition under the publicly traded partnership rules of Section 7704 of the Internal Revenue Code and which did not. Any non-

qualifying income – including management fees and income generated by our mezzanine finance and real estate strategies – is earned by a corporate subsidiary subject to corporate level tax.

B. As a non-tax lawyer, do you see any inconsistency in these positions?

No inconsistency exists: although the Investment Company Act and Section 7704 use similar words, the two statutes employ them in different contexts for different purposes, as is often the case with different statutes addressing different issues. Consistent with the testimony of both the Securities and Exchange Commission and the Treasury Department during these hearings, there is nothing odd or inconsistent about the fact that Oaktree generates passive income for purposes of the Internal Revenue Code, but is engaged in an active investment business for purposes of the Investment Company Act.

C. Did your offering document contain any disclosure that Congress was considering a possible change in tax law that would change the taxation of carried interest or deny your firm the ability to be treated as a partnership? If so, please provide the relevant text.

Our offering memorandum included the following language to insure all potential risks were fully disclosed to potential purchasers:

"[M]embers of Congress are reportedly considering legislative proposals to treat all or part of a capital gain that is recognized by an investment partnership and allocable to a partner affiliated with a sponsor as ordinary income rather than as capital gain to such partner for U.S. federal income tax purposes. Depending on the specific provisions, the enactment of any such legislation could (i) materially increase taxes payable by Class A unitholders who are individuals, non-U.S. persons or tax-exempt persons or (ii) cause such gain to be nonqualifying income under the publicly traded partnership rules, which could preclude us from qualifying as a partnership for U.S. federal income tax purposes or require us to earn such gain through corporate subsidiaries, thereby increasing our tax liability and reducing the value of our Class A units. In addition, members of Congress may be considering other legislative proposals that would preclude us from qualifying for treatment as a partnership for U.S. federal income tax purposes under the publicly traded partnership rules, again thereby increasing our tax liability and reducing the value of our Class A units. It is unclear whether any such legislation will be introduced or enacted, and, if enacted, how the legislation would apply to us."

While this risk factor was included in our offering circular (which had 29 pages of risk factors), I believe that the fact that our unit price dropped almost 10% overnight with the introduction of S. 1626 confirms that no one anticipated that legislation would be introduced targeting our ability to qualify as a publicly traded partnership. Indeed, just a couple of weeks prior to our offering, a Bloomberg article reported that Chairman Baucus had stated he was not prepared to introduce legislation nor had he decided what that legislation would be. That report may have been inaccurate, but that was the information in the marketplace.

7. You each raised concerns about the competitiveness of U.S. capital markets if the Baucus-Grassley bill became law.

A. Please explain the structures being used by PE firms who are now tapping foreign public markets through arrangements such as permanent capital vehicles. Why aren't similar vehicles being established and listed on U.S. exchanges? If they were, what would be the tax and securities law treatment?

While I am aware that several US-based private equity firms have effected offerings on European exchanges that are not subject to the United States securities laws, I have no special knowledge of these transactions or the particular structures involved. Oaktree did not consider offering its equity units on any foreign exchanges.

B. London is often cited as the chief competitor of New York in terms of attracting capital and financial management. However, a U.K. private equity firm would not be able to go public on the FTSE as a partnership it would be required to be a public limited company (plc), and thus be subject to U.K. corporate tax. For example, a large U.K. private equity firm, Man Group pic, is subject to the U.K. corporate tax.

(1) What fund managers are currently publicly traded in the U.S. and how are they treated for U.S. tax purposes?

I know of two other fund managers currently structured as publicly traded partnerships: Fortress Investment Group, which also began trading before Chairman Baucus and Ranking Member Grassley introduced S. 1626, and The Blackstone Group, which effected its offering and began trading after the legislation was introduced. In addition, AllianceBernstein, which manages investment funds and also provides investment advisory services, apparently qualified under the transition provisions of the 1987 publicly traded partnership legislation. Virtually all of Oaktree's competitors are not publicly traded and operate as partnerships, as Oaktree did prior to the offering.

(2) In what other jurisdictions have fund managers actually gone public, and how are they treated for local and U.S. tax purposes?

I do not have any particularized knowledge regarding these offerings and do not know what tax positions the fund managers may be taking.

(3) In what other jurisdictions would fund managers seek to go public?

We did not explore other jurisdictions in which to make our equity offering. I do not know which jurisdictions might offer the most attractive settings for public offerings. I would observe, however, that many jurisdictions are competing for highly mobile investment capital. To take one example, the Netherlands has recently proposed a regime that will fully exempt investment funds from corporate income tax. I have attached a description of the proposal as Attachment B.

(4) How would those entities be classified for local tax purposes?

I am not familiar with other entities' structures, and for this reason, I do not know how local jurisdictions would treat them.

(5) How would those entities be treated for U.S. tax purposes?

I am not familiar with other entities' structures, and for this reason, I do not know how U.S. tax law would treat them.

C. What considerations would be implicated if rules similar to those that apply to regulated investment companies or real estate investment trusts were to be applied to publicly traded fund managers?

As I understand it, those tax regimes have a number of requirements, particularly mandatory distribution requirements that publicly traded investment partnerships could not satisfy. Given the long-term nature of some of the investments made by investment partnerships (as well as partnership provisions allocating income and loss on an aggregate fund basis rather than based on the individual underlying investments), it may be difficult to satisfy rules that require a certain percentage of income to be distributed to the unitholders on an annual basis.

Other requirements are consistent with the investment activities of publicly traded investment partnerships. In particular, real estate investment trusts (REITs) and publicly traded investment partnerships may be similar in structure. The Internal Revenue Code requires REITs to separate their activities into qualifying activities subject to pass-through tax treatment and non-qualifying activities that are conducted through a "taxable REIT subsidiary." Several publicly traded investment partnerships – including Oaktree's – have adopted similar structures, separating their activities between the activities generating qualifying income and the non-qualifying activities that are held in a taxable subsidiary (subject to corporate tax).

Questions from Sen. Cantwell

1. I am sensitive to the issue you raise about ensuring an appropriate transition period, should the Congress adopt the changes to current law proposed by Chairman Baucus and Senator Grassley. It is important that businesses and investors have some level of certainty when they make long-term investment decisions. Change to the underlying tax policy should be structured to minimize the disruption of existing contracts and investment relationships.

My question relates to an apparent inconsistency in your written testimony. You asserted that when Oaktree decided to go public, the benefits of trading your equity in the public market outweighed the costs of making that change, presumably under the assumption that you would still be taxed as a partnership. You also stated that "Whether an investment firm structured as a PTP is taxed as a partnership or corporation is irrelevant to the competition for client capital - which is the main source of capital for investment and the main area of competition among firms in our business."

How do you reconcile those statements with your assertion that the enactment of S. 1624 would discourage funds from going public because the change in tax treatment would reverse their conclusion about the benefits versus the costs of going public?

I apologize if my testimony sounded inconsistent. There are two levels of competition. One is for investment talent and the other is for investment capital from potential investors.

In deciding to go public, we sought to create liquidity for our ownership interests to attract and retain investment talent. But even under current law, it was a close call. Had we known S. 1624 would be introduced, or had it already been law, it is possible that we would have made a different decision, concluding that the tax costs outweighed the other benefits.

Granting Oaktree transition relief would ameliorate the impact of the change in law upon our outside unitholders – the institutions that purchased our equity units in our offering – and thus help ensure that our decision to go public based upon current law was not a mistake.

But a grant of transition relief would not afford Oaktree any advantage in the competition to manage investor funds. In other words, transition relief would not afford Oaktree any tax advantage in its investment activities on behalf of its investors, nor otherwise make Oaktree more likely than others to generate superior investment returns.

Hopefully, the foregoing explanation makes clear that it is consistent for Oaktree to seek transition relief for the benefit of its outside unitholders – whose investment expectations were turned upside down by the introduction of S. 1624 – and yet maintain that such relief will not afford it an unfair advantage in the competition to make successful investments on behalf of investors.

Questions from Sen. Roberts

1. Mr. Ifshin noted in his testimony that because of his company's investments, hundreds of jobs have been created and communities have been revitalized. I'm concerned that during this debate, some have characterized this as a "Wall Street issue". Mr. Ifshin, I thank you for pointing out that this is also a "Main Street" issue that affects communities, pensioners, and individuals across this country. Would anyone else care to comment on the impact that these types of entrepreneurial investments have on Main Street? What's the benefit to communities in terms of job creation and investments in local economies? Would these investments continue to be made at the level they're being made now if taxes on carried interest were to increase?

Predicting the consequences is difficult and perhaps impossible. It is clear, however, that partnerships are a fundamental feature of our economy. Though I lack actual empirical data, I suspect that partnerships own assets or operate businesses in virtually every city and town in the country. It is very common in these partnerships for one or more of the partners to provide mostly capital and other partners to provide mostly labor. These latter

partners typically receive a "carried interest" as reward for their "sweat equity." If Congress changes the taxation of carried interests, presumably it will affect the attractiveness of these arrangements. This could reduce investment and entrepreneurship. I know others have predicted that a change in the taxation of carried interests could also drive investment activity – and investment managers – overseas in search of better opportunities. I hesitate to embrace that view, because I doubt my ability to see the future. But as I noted above, it does seem likely to me that employment could shift overseas to the degree tax changes make it attractive to replace Unites States investment professionals with overseas professionals. By the same token, it is conceivable that a change in the taxation of carried interest could afford foreign investment managers a competitive advantage versus United States investment managers by making it less expensive (on a relative basis) for the foreign managers to compensate their professionals

My overall view is that this is a complicated issue affecting a fundamental element of the tax code and that changing the taxation of carried interest could have potentially far-reaching consequences. I believe that Congress should proceed with caution in considering changes in the taxation of carried interest outside the context of broader reforms in the tax system.

2. Several witnesses have touched on the fact that the investors in private equity funds often include university endowments and pension funds who receive substantial financial benefits when their investments are successful. These returns are key to helping manage tuition costs, and to securing the pensions of millions of retirees. If the tax treatment of carried interest is changed, would it jeopardize these strong returns that have benefited college students and pension recipients?

As I noted above, it is hard to predict the impact of a change in the taxation of the carried interest. It is certainly possible that over time higher taxes on carried interest could affect the motivation of particular investment managers, or lead to an increase in fees –either of which could negatively affect returns. At the same time, I am sure there will never be a shortage of companies or individuals willing to invest money for investors.

3. Many partnerships are structured with a carried interest - oil and gas, real estate, venture capital, and health care. Isn't it a matter of fundamental fairness that the tax code not single out certain industries for different tax treatment?

Yes. There is no basis in tax policy for singling out particular industries. That is one of our main objections to the proposed legislation. We have no quibble with tax reform, but an attack upon a single industry is unfair and counter-productive.

Questions from Sen. Salazar

1. What would be the real consequences to your respective industries of an increase in the tax on carried interest? Can you say with any degree of certainty that the amount of activity in private equity, hedge funds, and/or venture capital would decline significantly?

Imposing a significant tax increase on any industry has the potential to disrupt the industry. Given the many factors that influence the market, I cannot accurately estimate its impact. As I stated in response to a question of Senator Roberts, if Congress increases the cost of partnerships through a targeted change in the tax treatment of carried interest, partnerships will decline in attractiveness as investment vehicles and investment and entrepreneurship may be negatively affected.

2. *Is it possible to tax carried interest as regular income for large private equity firms and hedge funds without it trickling down to smaller firms who make riskier investments?*

Although it is theoretically possible to draft rules that tax capital gains received on a carried interest owned by large firms as ordinary income and that tax capital gains received on a carried interest owned by smaller firms as capital gains, it is not clear what policy objective would be served by adopting different tax regimes. Imposing different tax regimes for large firms would amount to a penalty for success.

Imposing different tax regimes depending on the size of the partnership (measured either in terms of invested capital, size of investments, number of employees, or other metric) also would be difficult or impossible to administer. It is likely that partnerships would routinely change the size or form of their organization to qualify for the most favorable tax treatment. Investment partnerships are not like auto manufacturers; they do not necessarily have to be large to be successful. In the end, I believe that Congress would have to impose the higher tax on investment partnerships of all sizes to achieve its goal.

3. *What are the principal distinctions between carried interest and regular income? In each of your viewpoints, do those distinctions get at the heart of how our tax code intended to distinguish between capital gains income and regular income?*

The principal distinction between carried interest and regular income with respect to investment partnerships is that the general partner of the partnership has a co-investment in the activity. The general partner plays an entrepreneurial role similar to that played by a sole proprietor who invests his time and effort in a particular activity or a two-person partnership where one party contributes capital and the other party contributes labor.

A continuum exists between solely labor income at one end and solely capital income at the other. The activities of a general partner of a private equity fund, like that of the sole proprietor or the small partnership, fall somewhere in between.

It is difficult to design rules that distinguish among the entrepreneurial activities of a sole proprietor, a two-person partnership, and the general partner of an investment partnership or that measure the income attributable to labor and capital.

4. *On the issue of whether to tax publicly traded partnerships, what makes the difference between generating passive income for investors and actively providing financial services? In your view, are today's large hedge funds and private equity firms actively providing financial services?*

As discussed in the answer to question 4 of Senator Baucus, a significant difference exists between the nature of the activities of alternative investment firms and the traditional investment banking firms. Investment banking firms provide merger advisory services, manage public offerings of debt and equity, and often act as retail brokers for investors. The compensation they receive is from the active conduct of a trade or business.

In contrast, alternative investment firms receive income in the nature of dividends, interest, or capital gains. In the case of publicly traded partnerships, this type of income has historically been defined as passive income not subject to corporate tax. To the extent the alternative investment firms receive income from active operations, such as active management of real estate projects and the provision of mezzanine debt, then that income arises from an active business and should be taxed in a manner similar to the taxation of the investment banking firms.

That is exactly the result of the structure employed by Oaktree's publicly traded partnership. Oaktree's dividend, interest and capital gain income flows through to the outside investors free of corporate tax. The publicly traded partnership's active management activities are conducted through a corporate subsidiary and thus any associated income is subject to corporate tax.

5. *In your view, how does this issue relate to the broader issue of ensuring that our tax burden is distributed fairly? Should we feel confident in explaining to middle-class families who dutifully pay their taxes year in and year out that the way we tax carried interest is consistent with the promise of a fair distribution of our tax burden?*

Based on tax return data from the 2004 tax year, the top 1%, 5%, and 10% of individuals paid approximately 37%, 57% and 68% of the total federal income tax liability. What is a fair distribution of the tax burden is a political question that perhaps should focus both on the amount of tax liability paid as well as the rate applied to a certain type of income.

If Congress decides that the burden should be shifted more towards high-income taxpayers, it would seem to make sense to increase the tax liability of all high-income individuals, not just those individuals who manage private equity and hedge fund investments.

6. *What percentage of your ventures would not be sufficiently profitable if not for the reduced tax rate on carried interest? Why should the government encourage you to make those kinds of investments?*

Oaktree's primary focus is on generating superior risk-adjusted returns for our investors. A change in the tax treatment of the carried interest will not change that focus, nor would it affect the profitability of our investments.

Questions from Sen. Schumer

Under current law, PTPs are taxed as partnerships if they are engaged in different types of real estate, oil and gas activities, or if 90 percent of their income is from dividend, interest, or capital gains. Is there any justification for denying partnership tax status for investment partnerships and continuing to allow partnership tax status for oil and gas and real estate activities?

In 1987, Congress made a policy decision to allow pass-through tax treatment for certain partnerships that traditionally operated in partnership form or that generated passive-type income that investors could have invested in directly.

If Congress makes a policy decision to change the tax treatment for publicly traded partnerships, no justification exists for allowing pass-through tax treatment for some activities and denying pass-through treatment for investment partnerships.

If Congress decides to change the tax rules applicable to publicly traded partnerships, then transition relief should be provided to taxpayers who made investment decisions based on the tax rules that existed when they made their investment in those different activities.

Questions from Sen. Smith

Question 1 - Private Equity Firms

LEAD IN:

A couple of recent studies show that private equity firms and the companies they own have a proven track record of strong financial performance and job creation. For example, a recent study by professors from Harvard University and Boston University concluded that companies that went public again after being held by private equity firms for at least a year consistently outperformed the stock market. A recent analysis by A.T. Kearney identified more than 600,000 jobs in the United States between 2000 and 2003 that were created as a result of private equity investments.

QUESTION:

Given this track record of success, why would we want to increase taxes on private equity firms?

I see no justification for singling out and changing the tax treatment for just private equity firms.

What are your thoughts on whether increasing taxes on this industry will likely result in the loss of jobs?

I think it is difficult to predict the impact, but I believe it possible that changing the tax treatment of private equity, venture capital, and hedge fund firms may encourage investment firms to favor growth and hiring of investment professional outside of the

United States over those in the United States. The U.S. has no monopoly on investment expertise, and, every day, capital flows more easily across international borders. If this country does not stay internationally competitive, jobs could follow capital overseas, resulting in U.S. job losses.

Question 2 - Baucus-Grassley bill

LEAD IN:

Chairman Baucus and Ranking Member Grassley have introduced a bill that would tax as corporations all publicly traded partnerships that directly or indirectly derive income from investment adviser or asset management services. Because this tax change could discourage private equity firms and hedge funds from going public, some have argued that it would frustrate advocates of greater transparency among these firms. Publicly traded companies are legally required to disclose more information about their business than privately held firms.

QUESTION:

What are your thoughts on this argument?

We believe that S. 1624 will discourage other investment management firms from going public. Firms that stay private have no obligation to make the types of public disclosures that increase industry transparency. Just a few months ago, Congress and the media seemed concerned about a lack of transparency in the hedge fund and private equity industries. Public offerings in these industries have shed light on the industry and ultimately will increase understanding of these important participants in our economy. The proposed publicly traded partnership legislation will discourage this salutary trend.

Attachment A
John Frank Questions for the Record

June Trading of Class A Units (23,000,000 outstanding)

Date	Units
6/1/2007	40,000
6/4/2007	0
6/5/2007	0
6/6/2007	342,000
6/7/2007	50,000
6/8/2007	0
6/11/2007	14,100
6/12/2007	0
6/13/2007	200,000
6/14/2007	0
6/15/2007	980,000
6/18/2007	25,000
6/19/2007	16,000
6/20/2007	35,000
6/21/2007	100,000
6/22/2007	0
6/25/2007	131,000
6/26/2007	125,000
6/27/2007	75,000
6/28/2007	0
6/29/2007	60,000

LOYENS & LOEFF

Tax Flash July 12, 2007

Law proposal on introduction of a fully exempt regime for investment funds accepted.

On July 10, 2007, the Dutch Senate accepted a legislative proposal introducing a new exempt regime for investment funds (hereafter: "Exempt Fund Regime")

The Exempt Fund Regime provides for a full exemption from corporate income tax, as well as an exemption from dividend withholding tax on profit distributions.

The main conditions for the Exempt Fund Regime are as follows:

- The Exempt Fund Regime can only apply to investment funds that fall within the meaning of the Financial Markets Supervision Act (*Wet op het financieel toezicht*), which are semi-open-ended investment funds and which apply the principle of risk spreading;
- The exempt fund invests solely in financial instruments such as shares, bonds, options and similar securities. The Exempt Fund Regime will not be open to (i) (direct) investments in Dutch real estate and (mortgage) loans and (ii) investments in rights, other than through securities, on profits of a business conducted in the Netherlands.
- The legal form of the exempt fund should be either a Dutch public limited liability company (*naamloze vennootschap or NV*), a mutual fund (*Fonds voor Gemene Rekening*), or other comparable entities established under the laws of an EU Member State or under the laws of a state with which the Netherlands has concluded a tax treaty that contains a nondiscrimination clause.

Although the text of the legislation mentions that the investment fund should be open-ended, the legislator has indicated that this means that participations in the fund can be redeemed or issued at pre-determined points in time against the then applicable intrinsic value (semi-open-ended).

The requirement of risk spreading is meant to ensure that the investment fund will not engage in business activities and will be tested marginally. It has been confirmed in the legislative history that umbrella funds, fund-of-funds, feeder funds and hedge funds may qualify for the Exempt Fund Regime. A buyout fund, venture capital fund or similar type of private equity fund is generally not eligible to the Exempt Fund Regime because of the close-end character of such funds.

The Exempt Fund Regime is a collective investment scheme, as a consequence of which the investment fund should have at least two shareholders. The legislator has indicated that it is in principle irrelevant how the ownership of shares or units in the fund is divided among the shareholders. Thus making the regime potentially also available for privately owned funds. The Exempt Fund Regime does not contain other shareholders requirements.

There are no limitations as to the level of debt financing that may be incurred under the Exempt Fund Regime and qualification under the Exempt Fund Regime is not subject to an obligation to annually distribute income.

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The Exempt Fund Regime implies a full exemption from corporate income tax. Consequently, the fund will not be considered a Dutch resident for tax treaty purposes and therefore lacks tax treaty protection. The Netherlands will therefore not issue certificates of residency. A fund that applies the Exempt Fund Regime will not be entitled to a refund of dividend withholding tax on dividends distributed to such fund.

Existing entities opting for the Exempt Fund Regime are required to value all assets and liabilities at fair market value at the end of the book year prior to the year in which the Exempt Fund Regime first applies. Hidden profits and reserves will therefore be realized for Dutch corporate income tax purposes. In addition, in case of existing entities, distributions made out of profit reserves dating from years prior to the application of the Exempt Fund Regime will be subject to dividend withholding tax.

In this respect, although the legislator believes that the Netherlands is allowed to levy withholding tax from entities under the Exempt Fund Regime also if a tax treaty applies, there is considerable debate going on in the Netherlands among tax practitioners whether relief should be available.

The Exempt Fund Regime is intended to serve as an alternative to the Luxembourg SICAV regime. However, although the investment funds under the Exempt Fund Regime are subject to the Financial markets Supervision Act, they may possibly benefit from the exemption to obtain a license. This makes the Exempt Fund Regime attractive from a regulatory perspective. A detailed comparison of investment fund regimes in Luxembourg, Belgium and the Netherlands is available upon request.

The law enters into force on the first day after the law has been published in the Official Gazette. The Exempt Fund Regime can be applied to book years starting on or after the day that the law entered into force. It is allowed to have a one-time change of the book year in order to accelerate the Exempt Fund Regime in 2007.

Although this information was composed with the greatest possible diligence, Loyens & Loeff N.V. cannot accept any liability for consequences arising from the use of this information without its cooperation.

How to Tax Carried Interests

Mark P. Gergen*

There is a fairly simple solution to the problem of the taxation of carried interests: amend Section 702(b) to treat a partner's distributive share as ordinary income when the partner receives the distributive share as compensation for services rendered by the partner to the partnership.[1] The capital accounts system, which is the core of modern Subchapter K, makes this fairly easy to do. This change would also solve some other substantive and technical problems under current law.

The Carried Interest Problem

Managers of private equity funds typically are compensated for their services by being paid a base fee of 2 percent of the fund's assets plus 20 percent of the fund's profits. The 2 percent is ordinary income to the manager and an expense to the fund. The 20 percent is taxed as if it was an investment return. If the profits are in the form of capital gains, then this part of the manager's compensation is taxed at the capital gains rate (15%) and not at the ordinary rate (35% or more with phase outs). If it is interest income, then the manager avoids the self-employment tax (the 2.9% Medicare or Hospital Insurance tax has no ceiling). If it is tax exempt income, then the compensation is tax free. The unfairness of this is evident. It may also be inefficient as it may distort contract design and resource allocation.

Current Law

The question of how to tax a partner who receives a profits share as compensation for services is an old one. It has long been settled that a partner who receives a capital interest in a partnership as compensation has ordinary income, generally when the interest no longer is subject to forfeiture. Regulations proposed in 2005 would settle two open questions.[2] One question regards the measure of income. The choices are between the market value of the interest (what a buyer would pay for the interest in an arms-length transaction) and the liquidation value of the interest (what the partner would receive if the partnership sold all of its assets for their fair market value, repaid its debts, and then liquidated). The market value of an interest may be lower than the liquidation value because of such factors as illiquidity or a minority discount. The other question regards the treatment of other partners. In particular, if the partnership has appreciated assets, then do the other partners recognize gain on the exchange of the interest for services, as they would have recognized gain had they exchanged the underlying assets for the services? The proposed regulations provide the service partner is taxed on the liquidation value (assuming an election is made) and that other partners do not recognize gain or loss on the underlying assets.

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* Fondren Chair for Faculty Excellence, University of Texas School of Law.

[1] Section 1402 also should be amended to make this income subject to the self-employment tax.

[2] See Notice 2005-43, 2005-24 IRB 1221.

Debates over how to tax a partner who receives a profits interest for services generally have focused on the possibility of taxing the service partner on receipt of the interest. Two cases that are staples of the partnership tax course, *Diamond*[3] and *Campbell,*[4] hold that a service partner has income on receipt of a profits interest. In the odd circumstances of these cases, the result made sense. But there is little sentiment for generalizing the rule. It is not in Treasury's interest to try to tax profits interests on receipt because most such interests are of speculative value, and usually the right to profits is contingent on the performance of services during the period the profits are earned. The risk of forfeiture gives a taxpayer the right to elect whether to be taxed on receipt. The speculative value enables a taxpayer to assign a low value to an interest if she elects to be taxed. The combination invites strategic behavior.

Treasury responded to *Campbell* in 1993 with a ruling that a partner was not taxed on receipt of a profits interest for services, except in three limited situations not relevant here.[5] The 2005 proposed regulations maintain this position while integrating it with Section 83, which generally governs the taxation of compensatory transfers of property. Under the proposed regulations, to avoid tax on grant of a profits interest, the partnership agreement must provide for something called a "safe harbor election."[6] On the election the interest is valued based on its liquidation value at the time of grant, which is zero in the case of a profits interest. In addition, if the profits interest is subject to a substantial risk of forfeiture, which typically is the case, the service partner must make a Section 83(b) election so that the profits are not taxed as compensation when the right to them vests.

This is not a happy resolution of the matter for reasons independent of the problem of carried interests. It is not clear what tax consequences follow if people do not make the elections. If general Section 83 principles apply, then a service partner would have ordinary income equal to the market value of a right to partnership profits when her right to those profits is no longer subject to a substantial risk of forfeiture. The other partners would include the service partner's share of profits in their income and get a deduction equal to the amount of the service partner's income when her right to the profits vests. This may temporarily shift income from the service partner to the other partners if her right to the profits vests in year after they are earned. And, if the right to profits is valued at either a discount or a premium, this creates offsetting built-in gains and losses between the service partners and the other partners. [7] While it is hoped that

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[3] Diamond v. Commissioner, 492 F.2d 286 (7th Cir. 1974).
[4] Campbell v. Commissioner, 943 F.2d 815 (8th Cir. 1991).
[5] Rev. Proc. 93-27, 1993-2 C.B. 343. The exceptions were (1) an interest in a substantially certain and predictable stream of income; (2) the partner sells the interest within two years; and (3) a limited partnership interest in a publicly traded partnership. Under the proposed regulations, the safe harbor election is not available in these situations. Rev. Proc. 2001-43, 2001-2 C.B. 19, clarified that when a partner was granted a nonvested profits interest he would be treated as receiving the interest on the date of grant so long he was treated as a partner from that date.
[6] As an alternative to making the election in the partnership agreement the partners may make the election individually so long as all do so. A global election is required to prevent partners taking inconsistent positions.
[7] Consider an example. Assume A manages assets worth $1 million and the partnership earns $100,000 in year one. Her share of profits is $20,000. Assume that her right to these profits is worth only $15,000 (this

taxpayers will make the required elections to avoid these problems, it is odd to require taxpayers to make two elections to avoid a trap.

The proposed regulations also leave the carried interest problem uncorrected. Treasury is not to be faulted for it does not have the statutory tools to solve the problem.[8] But a solution is available within the general framework of Subchapter K.

The Solution Available in the Capital Accounts System

Congress could take an important step towards solving the problem of carried interests by amending Section 702(b) to provide that a partner's distributive share shall be treated as ordinary income when it is compensation for services rendered by the partner to the partnership. Section 1402 also should be amended to make this income subject to the self-employment tax.

This is only a partial solution for it creates subsidiary problems. The capital accounts system in Subchapter K solves these problems. Under current law, the capital account measures the value of assets contributed by a partner to a partnership, plus the partner's distributive share of income, minus the partner's distributive share of losses, and minus the value of distributions to the partner. In addition, when there is a non pro rata contribution or distribution from a partnership, assets generally are booked up or down to their fair market value and partners' capital accounts are adjusted accordingly. The capital account system is a linchpin of the rules on special allocations, built-in gain or loss, basis adjustments, and more. It is the conceptual framework of modern Subchapter K.[9]

The capital account makes it possible to identify when a distributive share is compensation. A simple rule would characterize a distributive share as compensation if the partner performs services for the partnership to the extent the distributive share is in

could well be the case if the profits are undistributed, A does not have the power to compel a distribution, and the interest is illiquid). Under general Section 83 principles, A would $15,000 ordinary income and the other partners would have $85,000 income (their share of profits, plus A's share, minus an expense equal to A's income). Comparing the basis of the interest and the capital account, A would have a $5,000 built-in gain and the other partners a $5,000 built-in loss. If A's right to the profits vested in a year after they were earned, then the other partners would have $20,000 income on profits that probably would ultimately go to A and an offsetting deduction of $15,000 when A's rights to the profits vests.

[8] Section 707(a)(2)(A) is not a reliable tool. It empowers Treasury to issue regulations to recharacterize allocations and distributions to a partner for the performance as services as a transaction with a nonpartner if they are properly so characterized. This rule is alongside and was enacted with the rules on disguised sales in 1984. The concern was that a partnership might avoid capitalizing an expense by giving a service provider a temporary, low-risk interest in partnership income. To solve the problem of carried interests using Section 707(a)(2)(A) Treasury would have to take the position that a fund manager was not truly a partner. This is untenable unless one is willing to take the position that to be a partner in a capital-based partnership a person must contribute and risk capital. See Mark P. Gergen, Reforming Subchapter K: Compensating Service Partners, 48 Tax L. Rev. 69, 75-81 (1992).

[9] I discuss the evolution of the system in Mark P. Gergen, The End of the Revolution in Partnership Tax?, 56 S.M.U.L.Rev. 343 (2003). Later I discovered that the principal creator of Subchapter K proposed a similar system to deal with precontribution gain and loss and related problems. See Mark P. Gergen, The Story of Subchapter K: Mark H. Johnson's Quest, Business Tax Stories 207 (Foundation 2005).

excess of the partner's pro rata share in partnership capital. There are more fine-grained ways to identify compensation that would enable partners who contribute both capital and labor to take a preferred return on capital without having it characterized as compensation.[10] The capital account system also supplies a mechanism for handling the sale or liquidation of an interest by a service partner when the interest bears unrealized profits that would have been taxed as compensation to the service partner when realized. The solution is to treat the partner as having compensation equal to the amount of compensation the partner would have had if the partnership had sold its assets for their fair market value immediately prior to the sale or liquidation. The handling of a sale follows Section 751(a). The handling of a liquidating distribution follows Section 737. The Section 704(c) regulations preserve the attribute of booked built-in gain as compensation through various events in the life-cycle of a partnership.

Different approaches are possible under the capital accounts system in the case of an asset revaluation. Assume A performs management services in a partnership with $1,000,000 assets in return for 20 percent of the profits. The assets grow in value to $1,500,000, which is unrealized appreciation. At this point $500,000 new capital is contributed to the partnership. Under current law, the partnership may elect to book up its assets and give A a capital account of $100,000.[11] At some point A should have $100,000 income treated as compensation. One possibility is to recognize the income at the time of the revaluation. But this creates a troubling disincentive for non pro rata contributions and distributions, which generally trigger revaluations. Managers would become loathe to permit non pro rata contributions and distributions if it triggered a substantial tax liability to them. Another possibility is to tag A with that much built-in gain on the assets, which will be treated as compensation when A liquidates or sells the interest. It is a mistake to push recognition past when A receives a liquidating distribution for this would permit A to take property as compensation without paying tax. This violates Section 83.

At a deeper level, the capital accounts system is consistent in principle with recharacterizing a fund manager's share of capital gains as compensation. The capital accounts system embraces the aggregate theory of partnership tax. The carried interest problem exists because Section 702(b) follows the entity theory—the character of income is determined at the partnership level. From the perspective of the fund income is a return to capital. From the perspective of the manager it is compensation.

Other Ramifications

This solves some other problems. It makes it possible to exclude profits interests from Section 83. The receipt of a right to profits need not be treated as a receipt of property to be taxed as compensation when the profits themselves will be taxed as compensation when they are earned. This eliminates the need under the proposed regulations to make one or two elections and avoids the problems that arise in the

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[10] Any such rule should cap the amount of the preferred return and require that the yield on the service partner's capital account, including the preference, not be greater than the yield on other capital.

[11] Some think this is required. Such adjustments are standard in partnership agreements, which often are drafted to track tax law rules.

absence of an election. Remaining is the question of how to handle the case where retained profits are subject to a substantial risk of forfeiture. Consistent with Section 83, the partner could make a Section 83(b) election and be taxed on the distributive share[12] or the partner could forego the election and wait and be taxed on the value of the profits accumulated in her capital account when the interest vests. If the election is not made, then the distributive share would be taxed to the other partners, who would get an off-setting expense when the service partner takes the profits into income, bringing the other partner's tax position and capital accounts into line. This leaves some differences between the taxation of a compensatory grant of a profits interest and the taxation of a compensatory grant of an option, which can be economic equivalents. This is a more general problem that results from the reluctance to treat an option holder as a partner until the option is exercised. The option arrangement enables the service partner (or any other option holder) to defer recognition of income on its distributive share until the option is exercised.

The proposed changes foreclose some other troublesome possibilities under current law. In the 1980s I heard rumors of a film deal where an actor took a profits interest. The plan was that the partnership producing the film would buy property to be used in the production. When the film was done, the actor received the property in liquidation of his interest without paying tax. Current law on profits interests allows people to evade the rules on equity compensation. For example, if an employee is given a stock appreciation right, then he will have ordinary income on the amount of any appreciation. Instead put a block of the same stock in a partnership and give the employee a profits interest in its appreciation. After the stock appreciates, distribute to the employee stock equal in value to her share of the appreciation. The employee will be taxed on only part of the gain under Section 731(c) and it will be capital gain. Under the rules I propose the actor and the employee would have taxable compensation on the distribution.

Some of the problems addressed by Section 707(a)(2)(A) would not be solved. Section 707(a)(2)(A) is primarily directed as cases such as where an established partnership that develops and holds real estate gives an architect a short term interest in its rental income in return for services designing a new building. This allows the partnership to get a result equivalent to a short-term write off of the architect's fee and to avoid capitalizing the expense. Changing Section 702(b) would treat the rent as compensation to the architect. But it would not require the partnership to treat it as an expense and to include the architect's share of rents as income to the other partners.[13]

[12] In the event the interest is forfeited, it is necessary to use either a deemed guaranteed payment or a side-agreement requiring the partner to forfeit his partnership interests to the other partners. From the perspective of the service partner, the deemed guaranteed payment is preferable because it provide an ordinary deduction to offset the ordinary income.

[13] A partnership would have the ability to treat the compensation as an expense by actually paying profits-based compensation or by making a guaranteed payment. If the profits are to be retained within the partnership, then the service partner would recontribute the payments.

In a forthcoming article,[14] Victor Fleischer explains a stratagem private equity funds may use under the rules I propose to ensure that above-normal returns to a manager are not taxed as compensation. The fund may make an interest-free nonrecourse loan to the manager to fund a capital account for the manager. The loan would be secured by the account. Interest imputed on the loan would be taxed as compensation under Section 7872. Returns above that amount would retain their character to the partnership. A partial answer to this possible stratagem is that a half a loaf is better than none—a portion of the manager's return will be taxed as compensation. If this is deemed too small a portion, then increase the imputation rate.

Scope

In principle, the rules I propose could be applied to all partnerships. They are easy to administer. A service partner who has no capital invested in a partnership will treat her entire distributive share as ordinary income (and self-employment income) whatever the character of the income at the partnership level. A partner who supplies labor and capital to a partnership will report income based on its character at the partnership level so long as distributions are in accordance with capital accounts. When partners negotiate a larger distributive share to a partner who provides services as well as capital, then presumably they understand this part of the distributive share is compensation. In principle, it would not seem to be asking too much to insist that people report what is negotiated as compensation as such.

In reality, much of Subchapter K is too complicated for the unsophisticated. This is a more general problem. While the proposed rules do not materially increase the complexity of Subchapter K, they do rest upon a body of rules that can be quite complicated in the application. Ideally, this problem would be fixed more generally. Several years ago an American Law Institute Project recommended creating a simplified body of rules (some call it K-Lite) that resemble Subchapter S and are less susceptible to abuse. This would be for individuals that do not want to deal with the complexity of Subchapter K.[15] In the meantime the changes I propose could be limited to partnerships in which capital is a material income producing factor with assets above a specified sum. There is no good policy reason to limit the changes to private equity funds, or even more oddly, to publicly traded partnerships.

[14] See Two and Twenty: Taxing Partnership Profits in Private Equity Funds, forthcoming NYU L. Rev (2008). The paper is available on SSRN.

[15] Reporter's Study, Taxation of Private Business Enterprises (July 1999).

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July 30, 2007

United States Senate
Committee on Finance
Washington, D.C.

Dear Sirs:

My answers to the July 17, 2007, written questions for the record on Carried Interest-Part I are below.

Questions from Chairman Baucus

1. Many hedge funds conduct their funds offshore in a master feeder structure. Generally, the hedge fund is incorporated in a low tax jurisdiction, such as the Cayman Islands. The hedge fund managers receive incentive fees instead of carried interest. Economically, how is that different from a profits interest?

> In principle, there may be no difference as an incentive fee may be structured to have the same pay offs as a carried interest. In the venture capital context, profits allocated to a manager often are retained and are subject to offset in the event of later losses. As I understand it, typically incentive fees are paid currently and are not subject to loss in the event a fund incurs later losses.

2. Mr. Solomon stated in his written testimony that a profits interest partner has an immediate ownership interest in the enterprise. What does a profits interest partner own? What can a profits interest partner receive upon liquidation of the partnership'?

> When the interest is not subject to forfeiture, the holder of a profits interest has a defeasible right to income from capital. The holder of a profits interest also is likely to have voting rights. They do not have capital at stake.

3. Mr. Solomon stated in his oral testimony that partners in a partnership have entrepreneurial risk. What risks does a profits interest partner have in a partnership?

Their return is dependant upon partnership profits.

4. Mr. Donohue stated in his testimony that hedge fund managers and private equity fund managers that have gone or will go public are in the business of managing other people's money. What is the rationale for according capital gain treatment to these managers for their efforts in managing other people's money?

I see no good rationale other than perhaps the administrative difficulty of identifying compensation. I think the administrative problems can be solved.

Questions from Ranking Member Grassley

1. Your proposal would generally treat a partner's distributive share of partnership income as ordinary income to the extent attributable to a carried interest.

If carried interests were taxed at ordinary income rates, what alternative structures could managers use that might accomplish results similar to the capital gain on carried interest?

One possibility is that a manager could take the position that it contributed intangible assets to the partnership, such as good will. While the manager would have a zero basis in these assets, the assets would provide the manager with a capital account. Under my proposal, this would provide a basis for treating part of the manager's distributive share as not being compensation.

Under § 704(c), a manager might be allocated ordinary income equal to annual depreciation of the good will as this is the amount book depreciation of the good will would exceed tax depreciation. However, this would happen only if the partnership elected a method other than the traditional method or if the partnership was required to use the remedial allocation method under the anti-abuse rule. If a partnership was required to use the remedial allocation method, then the manager would have ordinary income and the other partners an ordinary deduction, which would reduce the advantage to the managers of characterizing part of their contribution as intangible assets.

Could particular VC or private equity investments in corporations be structured

so that the manager initially got a low-value class of stock (perhaps in exchange for his relatively small capital contribution) that has potential to participate in 20 percent of the profits after a preferred return on the other investors' different class of stock (e.g., convertible preferred structure commonly used at the portfolio company level in venture capital)?

> As I understand the question, the manager would take the position that this was a receipt of property under § 83 but bearing little ordinary income at the time of receipt because of the low value assigned to the stock. Later returns on the stock would be capital gain, either in the form of dividends or gain on the sale of the stock. However, if a corporation was used, then there would be an additional level of tax at the corporate rate at the corporate level.

What other structures might be used to accomplish similar results?

> A variation on the above strategy could be done using a partnership by giving the manager an interest in capital and then assigning a low value to the interest because it shares in profits only after other partners receive a preferred return. The proposed regulations would prevent assigning an interest a low value by requiring the use of liquidation value. But this is elective. Under § 83, the interest would be taxed at fair market value, making it possible to assign a low value to the interest.

Could the parties structure a nonrecourse loan from the investor partners to the managing partners with at least AFR rate of return, payable as to both principal and interest only out of the profits of the business? Would AFR be an adequate interest rate for an investment with expected potential for high return? Would such a loan he recognized as a true loan for tax purposes. or might it be recharacterized as equity or as an option to acquire equity?

> Under § 7872 interest is imputed on a compensation related loan at the applicable federal rate ("AFR"), which is the Treasury's borrowing rate. Presumably the expected return on capital in equity fund or in a venture capital firm is significantly higher than the AFR because of risk. Whether there is an expected premium beyond compensation for risk I could not say. Absent such a premium, then there is an argument that imputing income at the risk-free rate appropriately captures the return to labor. As a practical matter, the government should be satisfied with imputing ordinary income at the Treasury's borrowing rate given available strategies to minimize ordinary income.

> There is not a strong argument under current law for recharacterizing a nonrecourse loan as a grant of equity or as a grant of an option.

2. Professor Gergen, under current law, managers are generally not taxed on receipt of a carried interest because of difficulties in valuation. As I understand it, your approach to carried interest would leave intact this deferral benefit, even though some view it as the central issue. Instead, you would subject all income associated with carried interests to ordinary income tax rates. I have four questions:

In your view, why is it appropriate to permit deferral?

> If a profits interest was valued accurately on receipt, then it would be better to tax the interest on receipt to eliminate the advantage of deferral. However, managers will be able to assign a low value to an interest. The value of an interest often will be speculative, taxpayers have an informational advantage, and the government always loses at the margin on valuation as only substantial undervaluation is likely to attract a challenge and a penalty. Also an interest can be structured in ways that minimize the value on receipt. The experience with family limited partnerships is instructive in all of these regards. In addition, typically an interest will be subject to forfeiture and so managers are likely to elect to be taxed on receipt only when the expected benefit of being able to under-value the interest (and so convert ordinary income into capital gain) outweighs the cost of foregoing deferral. For these reasons the § 83 regulations do not treat a service provider as having ordinary income on receipt of a non-publicly traded stock option. Instead, the service provider has ordinary income when the option is exercised. A profits interest is similar to a non-publicly traded stock option and should be taxed similarly.
>
> There are also technical problems under current partnership law with taxing an interest on receipt when the value of the interest is discounted. Probably the partner should be assigned an undiscounted capital account and tagged with an appropriate share of built-in gain, but this is cumbersome.

Your approach would treat all carried interest income as compensation as ordinary income. Is this because you view carried interest as payments for services, or do you reject the notion that sweat equity should be treated the same as invested capital?

In the usual sole proprietorship or partnership, "sweat equity" takes the form of good will that is built up in the course of the business. While this is a return to labor that may be taxed at capital gains rates on sale of the business, in the usual case the business earns ordinary income as good will gradually increases in value. In addition, an entrepenuer can convert good will into capital gain only by selling the business and, typically, structuring the sale to allocate price to good will, which diminishes the tax benefits to the purchaser. I do not propose any change in the treatment of good will. In a private equity fund and in a VC capital gains are the immediate fruits of the manager's labor.

How do you respond to the claim that carried interest is like founder's equity?

When founder's equity is in corporate stock, the corporate level tax offsets the advantage of capital gains at the investor level.

Do you think that there is at least some component that should be viewed as investment return, and if so, how would it be measured?

In principle, only non interest like returns on after-tax dollars invested in a partnership should be taxed at capital gain rates. When a manager contributes only services and zero-basis intangibles, then none of the return should be taxed at the capital gains rate, even though the returns are speculative. If managers were taxed on receipt of an interest at ordinary rates (and the interest was fairly valued), then additional gains should be taxed at capital gains rates.

Practically, some of a manager's returns will continue to be taxed at capital gains rates under any of the proposed changes. If the partners funded the managers interest with a nonrecourse loan, then returns in excess of the AFR would be taxed at capital gains rates. If managers were treated as making a capital contribution of intangibles (i.e., good will), then that share of their returns would be taxed at capital gains rates, unless the partnership was required to use the remedial method under the § 704(c) regulations.

Questions from Senator Schumer

Mr. Solomon, Dr. Orszag and Mr. Gergen

In most of the testimony at the July 11''' hearing, we focused on the financial industry. But let's look at a different situation that still uses a partnership structure where part of the gain is based on what might be called "sweat equity."

Let's say that two individuals open a bagel or knish shop in Brooklyn. Let's call them "Bagel Buddies" or "Knish Capitalists." One of them provides all of the cash, and the other provides provides the know-how, and they each take a 50-50 interest in the partnership. At the hearing, those who oppose treating carried interest as capital gain seem to be arguing that if the partners sell the business in 10 years for a substantial gain, the financial partner should have his profit treated as capital gain. and the know-how partner should have his profit treated as ordinary income, since his investment in growing the partnership wasn't a financial one and he didn't have his own capital at risk, Isn't this what is being implied when people argue that those who are providing services or labor are not making a financial investment in the enterprise?

> Under the proposed amendment to § 702(b), the service partner would have ordinary income. Note that if the business was a sole proprietorship, or if the partners contributed equal capital and "sweat equity," then they would have capital gain on the sale of the basis insofar as the sale price was allocated to good will and not to a covenant not to compete. One could preserve this result in the example above, while still taxing managers of private equity funds and VC firm at ordinary rates on their distributive share of capital gains, by not recharacterizing capital gain attributable to good will from the sale of an on-going business as ordinary income. This preserves current treatment of "sweat equity."

Question 1a (Follow-up) for Mr. Solomon, Dr. Orszag and Mr. Gergen

Now some have argued that this is not the case, that in fact Section 751 prevents the conversion of ordinary income into capital gain income for the average partnership. But my understanding is that Section 751 applies only to unrealized receivables and inventory items of the partnership partnership -not the appreciation of the value of the business as an ongoing enterprise, or the value of the building bought, or the assets used to produce income. Could you clarify for me if my understanding is correct? Wouldn't most of the gain on the sale of the bagel business be considered capital gain under current law, even for the non-financial partner?

> On sale of a sole proprietorship or partnership, insofar as the sale price as attributable to partnership assets, including good will, gain generally is taxed at capital gain rates.* Typically in the acquisition of a small

* I say generally because of a line of cases treating gain attributable to the sale of contract rights

service-based business, the buyer and seller have competing interests. The buyer prefers to allocate as much of the price as possible to a covenant not to compete while the seller prefers to allocate it to good-will (which is amortized over fifteen years). Thus, the tax benefit to the seller is offset by a detriment to the buyer. In addition, usually the owners of the business earn ordinary income as the business (and its good will) develops.

* * *

Thank you for allowing me the opportunity to testify and to answer questions.

Mark P. Gergen
Fondren Chair for
Faculty Excellence

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to perform services as ordinary income. See, e.g., *Michot v. Commissioner*, 43 TCM 792 (1982).

United States Senate
Committee on Finance

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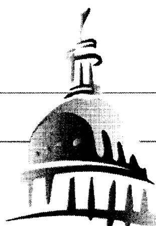

Sen. Chuck Grassley · Iowa
Ranking Member

Opening Statement of Senator Chuck Grassley
Hearing, "Carried Interest, Part II"
Tuesday, July 31, 2007

Thank you, Chairman Baucus, for calling this second hearing on the tax treatment of carried interest. At the last hearing, we had a balanced approach. We have the same here. This hearing, and the committee's inquiry, is about the distinction between capital income and labor income. This issue arises frequently in partnerships, when a person receives a carried interest, or an interest in a partnership's profits, in exchange for performing services for the partnership, as opposed to contributing capital.

This hearing is not about well-settled principles regarding capital assets or the propriety of current capital gains rates. It is not an attack on the investor class or capital formation. We are not questioning the tax treatment of the return on any partner's invested capital. That return is, and should continue to be, taxed at preferential capital gains rates.

This hearing is also not about a revenue grab from Congress. It is not about whether alternative asset managers are good or bad for society. We're not here to have a hearing on each industry, measure its value to society, and assign a tax rate accordingly. This hearing is about our responsibility to ensure that the tax code is operating fairly and consistently with the intent behind enacted policies. If it is not, then there is an unintended subsidy being provided to some, while others pay for it with higher taxes.

There are a lot of sound, pro-growth tax policies that Congress needs to advance to keep our economy strong. The individual capital gain preference is an obvious one. Like I've done before, I'll be working to get that policy extended. Another policy is our corporate tax rate, which is the second highest among OECD countries. We're standing still while our trading partners are lowering corporate tax rates. Economists tell us to make our system more efficient by lowering rates and broadening the base by eliminating preferences for specific industries. Well, we're looking at a potential base broadener here. But if we can't even examine these kinds of issues in a deliberate, thoughtful way, then I'm afraid we'll never get in a position to talk about lowering rates.

Folks on both sides of the aisle ought to roll up their sleeves, move away from partisan talking points, and join Chairman Baucus and me in finding the facts. The carried interest issue is complicated, and some might say headache-inducing, but this committee is responsible for getting

the policy right. So we need to take our aspirin and wade in. Mr. Chairman, you remember the T.V. series "Dragnet" and the characters, Sergeant Joe Friday and his partner Bill Gannon. Sergeant Joe Friday used to say, "just the facts, ma'am." Like Joe Friday, we're just trying to get the facts. We haven't made up our minds yet. With that open mind, I look forward to today's discussion.

I'd also like to submit for the record my response to some of the criticisms of our publicly traded partnership bill. The two arguments I respond to are (1) it singles out private equity and hedge fund management firms; and (2) it would result in unfair triple tax on private equity management firms that go public. I disagree with those arguments, but rather than take the time going through my detailed response here, I will just put it in the record.

Statement of Senator Chuck Grassley
Response to Criticisms of Publicly Traded Partnership Bill
Carried Interest, Part II
Tuesday, July 31, 2007

Now, I'd like to respond to a couple of criticisms of our publicly traded partnership bill. Our bill would treat investment advisory and asset management firms that go public as corporations, just like virtually any other active business that decides to go public. The bill would do this by taking away the ability of these management firms to structure the form of their compensation as capital gains in order to shoe-horn their way into a passive-type income exception. Remember, it is firms that manage investment funds we are talking about here, not the funds themselves.

One criticism of the bill is that it unfairly singles out private equity and hedge fund managers. The critics argue that these fund management firms should be allowed to go public and retain their partnership status because other active businesses, like oil and gas pipelines, for example, are able to do so. This argument sounds good, but it goes too far. This argument would support allowing any active business to go public as a partnership and avoid paying a corporate level tax.

In 1987, Congress enacted a general rule: partnerships that go public will be treated as corporations. Like most general rules, however, there are exceptions. Congress allowed certain types of active businesses, like oil and gas pipelines, to keep their partnership status. The investment advisory and asset management business, however, was not among these businesses. In fact, there was actually one such partnership that the 1987 law did not permit to remain a partnership beyond a 10 year transition period. So Congress spoke to this issue in 1987, and concluded that investment advisory and asset management businesses that go public should be taxed as corporations under the general rule.

So, then, how is it that the recent private equity and hedge fund management firms that have gone public are able to say that they qualify for an exception? These firms claim that their income qualifies for another exception – the passive-type income exception – by structuring their fees as carried interests, so that the capital gain character of the income realized at the private fund level flows through to the publicly traded management firm.

These firms view themselves as engaged in the active investment advisory and asset management business, not as investment companies. The Securities and Exchange Commission ("SEC") agrees with this view. As we heard at our last hearing, the SEC looks to reality. And in the SEC's view, these firms are operating companies, not investment companies. They are not investing their own assets; they are investing on behalf of others. To those critics who claim our bill unfairly targets these firms, I ask what other types of active businesses have tried to claim an exception intended for passive income? You could argue that our bill doesn't single out these companies; they've singled out themselves.

Our bill takes these firms at their word that they are providing services rather than making passive investments, even though they structure their fees to achieve capital gain characterization. But if they want to go the passive investment route, perhaps we should consider subjecting these firms to the code's requirements for mutual funds or real estate investment trusts. There would be no corporate level tax if these firms met these requirements. That brings me to another criticism of our bill – that it would impose triple taxation on the private equity industry.

The argument goes like this: If you tax private equity management firms as corporations, then there will be three levels of tax. Once at the portfolio company level, again at the private equity firm level (but only on its share of capital gains from the carried interest), and a third time at the shareholder level, albeit at a reduced rate. The portfolio companies don't pay much corporate tax while they are owned by the funds these firms manage, in part due to the amount of leverage put into them. But if they did, any dividends would be eligible for the dividends received deduction. While the dividends received deduction addresses the double corporate tax problem for dividends, it is a fair criticism of our corporate tax system to say that there is no mitigation of double corporate tax for capital gains on stock sales. Of course, the validity of this argument in the private equity context depends on the carried interest being properly viewed as investment income, rather than service income, which is the topic of today's hearing.

But even if the private equity firm's carry is properly viewed as investment income, the triple tax argument also goes too far. This is no different from a publicly traded corporation selling stock in an unconsolidated subsidiary. There may be a sound policy argument here to reduce the potential for two levels of corporate tax as a general matter. But there is no sound policy reason to maintain a preference for financial buyers, like private equity firms, over strategic buyers, like corporations, who can each raise capital in public markets to make the acquisition. After all, Treasury just had a conference on business tax reform, and there was universal agreement that the code contains too many preferences that favor specific industries.

UNITED STATES SENATE
COMMITTEE ON FINANCE

JULY 31, 2007

STATEMENT OF ADAM IFSHIN
ON BEHALF OF
THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS
AND THE REAL ESTATE ROUNDTABLE*

Thank you, Chairman Baucus and Ranking Member Grassley for conducting today's hearing on potential changes to the tax treatment of partnership "carried interest".

My name is Adam Ifshin and I am the incoming chairman of the International Council of Shopping Centers' economic policy committee and the co-founder and president of DLC Management Corporation, an owner, developer, and re-developer of shopping centers headquartered in Tarrytown, NY. DLC specializes in revitalizing older properties in in-fill first tier suburbs, cities and some small towns.

Founded in 1957, ICSC is the premier global retail real estate trade association for the shopping center industry. Its more than 70,000 members in over 92 countries include shopping center owners, developers, managers, marketing specialists, investors, retailers and brokers, as well as academics and public officials.

I am appearing today on behalf of the ICSC, the Real Estate Roundtable, and other real estate organizations whose members will be significantly impacted by proposals to tax all carried interests as ordinary income. Simply stated, I believe if such a policy is enacted, it would be the most sweeping and potentially most destructive tax increase on real estate since the modification of passive loss rules of the 1986 Tax Reform Act. The application of those rules to existing real estate triggered unintended consequences, namely the savings and loan collapse, the Resolution Trust Corporation, a credit crunch that caused a major downturn in the real estate industry and cost taxpayers billions of dollars.

I started DLC Management when I was twenty-six years old. I had no money and the commercial real estate industry was struggling to overcome the damage caused by the savings and loan crises and the 1986 Tax Reform Act. Since starting from the ground floor, my company has grown to become one of the nation's preeminent owners and medium-size operators of retail shopping centers with 72 centers located across 25 states. Over the past 16 years, DLC has created value in underserved markets by investing hundreds of millions of dollars in commercial real estate. DLC focuses on the redevelopment of older distressed properties in challenging environments, which often include older in-fill suburbs and cities such as Peekskill, NY, environmentally challenged brownfield properties like Levittown Mall in Tullytown, PA, and underserved rural or multi-ethnic city neighborhoods like Carbondale, IL and inner city Baltimore, MD.

We reinvest most of our capital gains into new projects in order to continue to make long term investments in communities that might not otherwise see revitalization. And I can unequivocally state that my company as it exists today could not have been built if the taxation on gains was at the ordinary income rates proposed by H.R. 2834. The returns simply would not have justified the risk in many cases. A carried interest is the return on the entrepreneurial risk that makes the deal or project happen. Embedded in the DLC business plan is the concept that a material component of the remuneration is the general partner's profit participation, taxed at the capital gains rate.

Here are some illustrations of DLC's achievements of bringing national retailers and new life into towns and properties time long forgot - - these deals were all done in a partnership format with carried interest taxed at the capital gains rate. If current law is changed to tax carried interest at the ordinary income rate, then the investment viability of projects like these will surely be brought into question - - and eventually a disruption in the real estate marketplace will take place.

- Spring Valley, NY – DLC brought Target, Bed, Bath and Beyond, Michaels Arts and Crafts, T.J. Maxx, 9 West and other recognized retailers to a 70% vacant center in a market that is 50% African-American and 30% Latino. Most of the

retail had moved out to an upscale mall three miles away, yet through our efforts, the center is now 100% occupied. During this project, 550 construction jobs were created; 650 retail jobs added. DLC paid over $30 million for the center and has spent $12 million in investments, the largest private sector investment in Spring Valley in the past 20 years.

- Peekskill, NY – DLC totally re-developed a 1950's shopping center where the supermarket anchor and the junior anchor had both gone bankrupt. We brought the first new full service grocery store, a Stop & Shop, to this predominantly minority community in 20 years. Other national tenants include a CVS, Dunkin' Donuts, Dollar Tree and Tuesday Morning. The project produced 600 new construction jobs and 400-450 permanent retail jobs. Our development was 100% privately funded and over four years in the making. DLC paid $14 million for the site and invested $19 million thereafter to redevelop it.

- Oxon Hill, MD – DLC acquired two underperforming grocery anchored shopping centers in an African-American community. We fully expanded and renovated one center and brought to 100% occupancy, featuring retailers such as Shoppers Food Warehouse, A.J. Wright and Advanced Auto. The rejuvenation of the second center is now underway with new facades, new national tenants and the Giant grocer is renovating and expanding.

- Levittown, PA – DLC tore down an obsolete 1950's open air mall. This project required major environmental brownfields remediation to address more than one million square feet of asbestos-containing material and 67 underground fuel tanks. Now there is a new center being built featuring a Home Depot, Wal-Mart Supercenter, Ross Dress for Less, Starbucks, Wachovia, Famous Footwear, Dress Barn, Day Care Center and others. Over 1000 construction jobs have been created and 1000 retail jobs. DLC bought the property for $9.5 million and will invest $60 million total, without any public subsidy. This center will be the largest commercial tax payer in the borough.

Despite having structured real estate partnership deals for close to two decades, use of the term "carried interest" was new to me and emerged only when reading recent news reports about Congressional action in this area. In real estate, "carried interest" is typically referred to as the general partner's interest, the "promote", or perhaps the back-end profit participation. Whatever you want to call it, the concept is the same, i.e., the return on the entrepreneurial risk that makes the deal or project happen.

For years, real estate deals have been structured as limited partnerships or limited liability companies (LLCs). Both types of entities are taxed as partnerships. In a typical limited partnership, there will be one or more financial investors as the limited partners and an operator or developer, serving as the general partner. The General Partner brings a combination of intangible assets, assumption of significant risk, and intellectual capital as part of arranging and operating the venture. In exchange, the General Partner receives a share of future partnership profits, typically after the Limited Partners receive a minimum compounded preferred return generally in the range of 8-12% per annum and their initial equity back. The General Partner's profits are a pre-determined percentage of the residual profits that is arrived at after the Limited Partners have attained their required minimum return on the investment.

In addition to a carried interest, the General Partner typically has two other economic interests in the partnership. The General Partner or a related entity receives a non-profit based management fee for performing day-to-day property management services. This is taxed as ordinary income. The General Partner typically also invests capital, side by side with the investor, commonly 1% - 10% of the total capital in the partnership. This is structured as a Limited Partner interest.

Real estate development involves substantial risk to the General Partner, and the financial reward on the back-end is what makes that risk worth taking. Capital gain tax treatment for a long-term commitment to the investment is part of that reward. Of course, that assumes there is a reward in the end. Many real estate developments

never get off the ground. Still others fail or fall short of their goals. In all these cases, the General Partner gets nothing other than fees.

The General Partner takes on significant financial risk every time an asset is acquired or deal negotiated. For instance, the General Partner is at risk for recourse loans, personal guarantees and completion guarantees on construction loans, and environmental indemnities for all loans. The General Partner is taking risk beyond its investment in any given real estate project and the carried interest is earned in part for that entrepreneurial risk taking.

Most real estate projects are not short term in nature. Projects frequently take 5-10 years to fully mature from concept to entitlements, to construction, to lease up, and stabilization. If H.R. 2834 were to pass the Congress some development would still occur, but the material shift in the risk/reward trade-off for the developer would mean that fewer projects would be built. Those that would be built would tend to be higher-end, fancier developments in wealthy communities and central business districts where there is less risk. What H.R. 2834 proposes makes underserved and given-up-for-dead locations far less appealing to developers because those deals are harder to put together and have greater risk associated with doing them. The net result will be to cause the greatest harm to those communities that need development and revitalization the most - - communities like Newburgh, NY, Spring Valley, NY, and the West Side of Baltimore, where there is a fundamental lack of shopping alternatives for predominantly minority consumers. A lack of retail options leads to higher prices for basic commodities like milk and bread for those people who can least afford to pay.

Community leaders where we do business fully understand and appreciate the benefits our development brings to their citizens - - more consumer choices at less cost, job opportunities, both at the construction phase and thereafter, an increased tax base and improved quality of life.

- Real estate is a vital part of our national economy contributing, over $2.9 trillion or one third of the Gross Domestic Product. Real estate asset values, residential and commercial, total nearly $20 trillion.

- Real estate creates jobs for over 9 million Americans - - and these are not "off-shored".

- America's real estate is the source for nearly 70% of local tax revenues, which pay for schools, roads, police and other essential public services.

- U.S. commercial real estate is worth approximately $5 trillion.

- Almost $250 billion is invested in commercial real estate improvements annually - - with $15 billion of that amount going to leasehold improvements. The impact of this investment doubles as it filters through the economy.

- America's 50,000 shopping centers account for over $2.25 trillion in sales and generate over $120 billion in state sales taxes.

- Housing accounts for 32% of household wealth. Total single-family (owner occupied) housing is worth approximately $15 trillion, with homeowners' equity valued at around $8 trillion.

- Publicly traded real estate investment trusts (REITs) have a total equity market capitalization of $355 billion.

- Private investments in commercial real estate done largely through partnerships have a total equity of over $1 trillion.

Conclusion

According to IRS statistics, in 2005, 46% of partnership tax returns came from the real estate industry. This statistic is significant as it clearly shows that "carried interest" applies to many more industries than just the hedge funds and private equity firms with which it is now associated. Any change in partnership tax rules will have a tremendous impact on the short-term future of the real estate industry, an industry that has been a significant economic driver in our nation's economy since 2000. At the end of the day, this is not just a tax issue, it is a major economic issue threatening job creation, economic development, and revitalization of communities across the country.

Chairman Baucus and Ranking Member Grassley, thank you for holding this hearing and for giving me the opportunity to testify. We look forward to working with you as you continue to examine this matter. I welcome any questions.

**Real Estate Trade Association Members of The Real Estate Roundtable*

National Association of Real Estate Investment Trusts
National Association of Realtors
National Association of Homebuilders
National Association of Real Estate Investment Managers
National Multi-Housing Council
National Association of Industrial and Office Properties
Pension Real Estate Association
Mortgage Bankers Association of America
International Council of Shopping Centers
Commercial Mortgage Securities Association
Building Owners and Managers Association International
American Hotel & Lodging Association
American Resort Development Association
Association of Foreign Investors in Real Estate
Urban Land Institute

Carried Interest, Part II
Questions for the Record
Adam Ifshin
July 31, 2007

Questions from Sen. Baucus

1. In your oral testimony, you referred to significant risks the general partner assumes in a real estate fund.

A. How is the general partner structured? Is the general partner a limited liability company or an S-corporation?

In most of my entities, the General Partner is a limited liability company whose members are myself and my other sweat equity partners. These include my co-founder and the Chairman of our firm, and three additional partners. There are instances where the General Partner is structured differently due to state level tax laws that do not recognize pass-through treatment of income in LLCs.

B. Please describe all of the significant risks the general partner assumes in a real estate fund.

The general partner incurs significant risk in developing or redeveloping a real estate project. Typically the limited partners do not commit to investing in the partnership until the primary critical development hurdles are satisfied. Thus, the general partner bears full risks of finding the site, negotiating and acquiring the right to buy the site, acquiring any zoning changes and permits, obtaining approval of the development plan, paying for impact fees, and dealing with ingress and egress issues, such as road widening. These risks include not only significant cash outlays, but also include the cost of time as the pre-development stage typically averages about two years. In a current transaction, the demolition of an obsolete regional mall and the construction of a new power center in an economically depressed area, we have spent over $5,000,000 at risk over four years to get to the point where we can raise outside equity. Further, the general partner will often have a completion guarantee to the lender, guaranteeing that the construction will be complete within a specific time frame and a specific cost range. Thus, the general partner is responsible for significant cost overruns, which often occur as a result of design changes. Additionally, if there is a high loan to equity ratio, the general partner can be required to guarantee the underlying construction loan. Once the limited partners join, both the general partner and the limited partners also bear the risk that the newly-built or renovated property will not be fully leased.

2. At the July 11, 2007 hearing on carried interest, Mr. Solomon stated in his written testimony that a profits interest partner has an immediate ownership interest in the enterprise.

A. What does a profits interest partner own?

B. What can a profits interest partner receive upon liquidation of the partnership?

A partner owning a profits interest owns a right to a percentage of the future net appreciation of the partnership assets and, subject to certain performance hurdles and a return of capital, a percentage of future partnership operating income. The profits interest owner becomes a partner under local law, with all of the related rights and obligations. The profits interest owner has an immediate vested right to future income. Upon the sale of partnership assets or liquidation of the partnership, the profits interest partner is entitled to be paid for its share of the proceeds representing a portion of the net profits. If there are no net profits, the profits interest partner does not receive any payment.

In the typical real estate fund, the profits interest partner will own a percentage of the net profits after the capital partners receive a minimum "hurdle" on their equity, often 8% or 9%. For example, assume that on January 1, 2007 limited partners contribute $1 million to a partnership to buy a building. The partnership agreement provides the limited partners with a 9% annual preferred return and thereafter profits are shared 80% to the limited partners and 20% to the general partner. The real estate developer in this example will typically own the 20% general partner interest plus some portion of the limited partner interests. If the asset is sold one year later for $2,090,000, the limited partners will receive their $1 million of contributed capital, their $90,000 preferred return, and $800,000 of the residual profit. The general partner will receive the remaining $200,000 of net appreciation in the asset. If this is the only asset of the partnership, this is the same amount the partners would receive upon liquidation of the partnership. If the partnership held other assets, the general partner would receive its share of appreciation in the remaining assets when they are sold and the partnership liquidates.

3. Some panelists stated that the general partner in a hedge fund, real estate, venture capital, or private equity partnership has entrepreneurial risk. What risks does a profits interest partner have in a partnership?

The profits interest partner and the general partner are one and the same. If the partnership is structured as a limited liability company under local law, then the general partner equivalent is the "managing member." The general partner of a real estate development partnership bears the risks described in my response to Question 1.B., above. The general partner's risk may come past the general partnership LLC structure in many cases. Most construction lenders, for example, require the actual individual not the LLC to guarantee the loan and its completion. Further the general partner has the risk that they will not receive any net economic return unless the overall venture achieves a net profit beyond any preferred return paid to the limited partners.

4. A general partner's profits interest is subject to a "clawback." A clawback means that the general partner will be required to return part or all of the income received on a profits interest if the fund fails to meet a specified return for the limited partners. How frequently are clawback provisions exercised?

Clawbacks are very typical in real estate transactions, particularly where the limited partners are sophisticated. Many real estate partnerships consist of an institutional investor or fund and a private general partner (the developer/operator). In most cases, the institution or the fund requires and succeeds in extracting a clawback from the developer/operator in return for investing capital. How often they actually come into play depends on the success of the venture versus its projections and the timing of disposition of the assets held by the venture.

5. What percentage of capital does a general partner invest in a fund?

I do not operate a fund. We structure our investments on a deal by deal basis. The amount of equity we invest as the general partner varies from deal to deal. The range is from 1-3% on the low end to 25% on the high end. The riskier the deal, the higher our contribution generally needs to be.

6. Does the partnership agreement for a fund contain a clause that provides for binding arbitration between the general partner and the limited partners?

In most of our individual investment vehicles for the acquisition of a single asset, we do not have this type of clause. In larger transactions with institutional partners or funds, they typically demand such a provision.

Questions from Sen. Grassley

1. At the hearing, I asked you for a yes or no answer to the following question:

   I have read reports in the press that, rather than change the tax treatment of carried interest, some think it would be more fair and equitable to raise the top marginal rate to 40% and the capital gains rate back up to 20%. That would leave the fund managers with their 20% rate preference while raising taxes on everyone else, including small business owners, households with two wage earners, investors who actually put their capital at risk, and retirees who depend on investment income. Would this make the tax system more fair and equitable than changing the treatment of carried interest?

If you wish, please elaborate on the answer you gave at the hearing.

If Congress is considering raising the tax rate on capital gains, I believe that this rate increase should not single out specific investment vehicles of specific industries. That being said, I do not believe that the tax rate on capital gains should be increased.

2. A concern that Mr. Rosenblum highlights in his testimony is that pension funds, endowments, and foundations would bear the cost of increased taxes on fund managers. Others have expressed similar concerns with respect to other types of alternative asset managers. I have the following questions regarding this concern:

A. If all income from carried interests was taxed at ordinary income rates, how much do you expect your tax costs to increase?

The answer depends on the ultimate sharing of such costs, which are determined by the market. See answer to Question 2.B, below.

B. Would your firm seek to change the fee structure of its business, or otherwise renegotiate its partnerships agreements, to make up for its extra tax costs?

The income tax cost would significantly increase our overall cost structure and would clearly be a factor in our future business arrangements. Ultimately, the market will decide the final level of sharing of these additional costs between the developer and the investor and I simply cannot predict what will happen at this early stage. The additional cost sharing could take the form of lower rates of return for the investors or simply less properties being developed due to the inability to achieve the minimum level of return needed for either the developer or the investor. In actuality, the result will probably be a combination of less properties being developed and less returns for the developers and investors.

C. Are there other alternative structures your firm might use to reduce tax costs, and how would those structures affect the returns of the limited partners?

At this time, we do not have any alternative structures. We are aware of approaches being discussed, but these alternatives have significant inherent limitations in the real estate industry.

D. What factors enter into the negotiation of the carried interest percentage with your firm's limited partners?

In measuring estimated returns, the partners use after-tax cash flows. The carried interest percentage is based on a combination of factors such as expected development costs, carrying costs, cash flow, expected returns, investment risk, the investor's target internal rate of return, the developer's target after-tax returns, and competitive investment opportunities. For example, if the investment is of a higher risk, the limited partner may demand a higher hurdle rate of return in exchange for providing the general partner with a higher back-end return.

E. How much do you think the fiduciaries of private and public pension funds would be willing to pay your firm to make up for the taxation of managers' income at ordinary rates?

As I noted in Question 2.B., above, it is simply too early to tell what kind of cost sharing will result as it is determined much more by the market overall than it is by any individual market participant. Ultimately investors look at their expected internal rate of return and whether the investment will satisfy their return expectations in a way that is competitive to other alternative investments.

F. At what point do you think the pension funds' fiduciary obligations to beneficiaries will preclude them from paying higher fees to your firm?

As noted in Question 2.E., above, this is ultimately a question of whether the investor achieves a rate of return consistent with its economic objectives that is competitive with other investments. If the cost of alternative investments such as a real estate fund increases to a point where investors can achieve a better economic return in other conventional investments, such as publicly traded stock, then such investors are likely to move their money to such conventional investments.

G. How much of your firm's tax costs do you currently pass on to the investors in your funds?

Tax costs, like any other costs, are factored into the rate of return we need to achieve to make a property development economically viable. These costs, although not directly "passed on" to the investors, indirectly affect the investors' investment returns. When we find a new investment opportunity, we model the projected gross and net after-tax returns. We need to achieve a minimum after-tax return to make the investment viable and we use that minimum return to determine the net profit sharing we can offer to the investors. Thus, the taxes, similar to any other cost, reduce our net return and thus require us to retain a greater percentage of the net profit sharing to cover these costs. The higher the profit sharing we retain, the less profit sharing the investors receive, causing them to indirectly bear all or a portion of the costs.

H. If tax costs to fund managers were reduced, how much of those savings would your firm pass on to the investors in your funds?

See the answer to Question 2.G., above. Tax costs and tax savings all factor into the minimum after-tax return needed to make a development viable and that minimum return factors into what types of returns we are able to offer investors. Ultimately, the market drives the cost sharing. If the cost or savings is relatively small, it is less likely to affect the overall sharing with the investors, but if the cost change is more significant, it is more likely to affect the sharing with the investors. This is true for both cost increases and decreases.

I. After the Tax Reform Act of 1986, ordinary income and capital gains rates were equal at 28%. Since then, capital gains rates have dropped to 20%, and then 15%, while the top marginal ordinary rate increased to 39.6%, and is now 35%. Did your firm's fee structures change at all in response to these changes in rate differentials?

I founded DLC in 1991, and made our first investment as a partnership in 1993. Accordingly, we have no historic reference points prior to 1986. Since our founding, our fee rates have not really changed much since we are not a fund and do not charge asset management fees. Our leasing commission rates, construction management rates and property management fee structures have never changed. These are property level costs and are fairly standard in the industry. To the extent that the deal structure between DLC and its limited partners have changed, that has occurred due to a variety of market forces unrelated to tax policy.

3. Carried interest is said to align the interests of the fund manager with the limited partners. Another way to achieve that alignment is through an incentive or performance fee, which is actually used by managers of offshore hedge funds. Other than carried interest, does your firm use other incentive arrangements to achieve alignment of interest? If so, under what circumstances and why?

Our funds do not use performance fees. The carried interest is the only material manner in which the interests are aligned. We are completely domestic in our domicile and investment activities.

Questions from Sen. Roberts

1. If carried interest were to be taxed at the ordinary income rate, would your company, and others like it, continue to invest and take economic risks in communities that are in need of projects that bring grocery stores, home improvement stores, and other retail stores to their neighborhoods -- investments that result in more competition and lower prices for the consumer? Or, would it make more sense for companies like yours to invest in financially-safer projects?

We would assess each investment based on the net after-tax return. If a development in a high-risk community currently produces a very low marginal return, a significantly higher tax rate would incentive us to look for investments in other areas that produce a higher or safer return. Because the nature of our business is to work in the less privileged areas, the ultimate result may be that we simply reduce our overall level of project development.

2. Mr. Ifshin noted in his testimony that because of his company's investments, hundreds of jobs have been created and communities have been revitalized. I'm concerned that during this debate, some have characterized this as a "Wall Street issue". Mr. Ifshin, I thank you for pointing out that this is also a "Main Street" issue that affects communities, pensioners, and individuals across this country. Would anyone else care to comment on the impact that these types of entrepreneurial investments have on Main Street? What's the benefit to communities in terms of job creation and investments in local economies? Would these investments continue to be made at the level they're being made now if taxes on carried interest were to increase?

My written testimony explains these types of important "Main Street" ramifications.

3. Several witnesses have touched on the fact that the investors in private equity funds often include university endowments and pension funds who receive substantial financial benefits when their investments are successful. These returns are key to helping manage tuition costs, and to securing the pensions of millions of retirees. If the tax treatment of carried interest is changed, would it jeopardize these strong returns that have benefited college students and pension recipients?

Tax costs, like any other costs, are factored into the rate of return we need to achieve to make a property development economically viable. If we need a higher pre-tax return to cover these costs, that leaves less of a return for the investors, such as university endowments. Further, to the extent that the higher costs simply make the project overall not economically viable, the investors will simply have less investment choices and less diversity in their portfolio.

4. Many partnerships are structured with a carried interest - oil and gas, real estate, venture capital, and health care. Isn't it a matter of fundamental fairness that the tax code not single out certain industries for different tax treatment?

A basic tenant of our tax system is that similarly situated taxpayers are treated similarly. Although there are definitely industry specific tax provisions, they are typically designed to encourage certain behavior within an industry, such as tax credits for low income housing or deductions for U.S. manufacturing.

Questions from Sen. Salazar

1. What would be the real consequences to your respective industries of an increase in the tax on carried interest? Can you say with any degree of certainty that the amount of activity in private equity, hedge funds, and/or venture capital would decline significantly?

Although I do not know enough to speak for an entire industry on this question, I can unequivocally say that my business would not be nearly as successful as it is today if this carried interest proposal had been the law. My projects are low margin, high risk investments. If the income tax rates had been at today's ordinary income rates, this would have reduced these margins to a point where many property developments would simply not have been economically viable.

2. Is it possible to tax carried interest as regular income for large private equity firms and hedge funds without it trickling down to smaller firms who make riskier investments?

Although it may be legally possible for Congress to devise a limited scope provision like this, it will be very difficult to administer. For example, how would the provision apply to companies that expand or contract? How would the provision apply to a small division of a large diversified company? How would the provision define "risky" investments?

3. What are the principal distinctions between carried interest and regular income? In each of your viewpoints, do those distinctions get at the heart of how our tax code intended to distinguish between capital gains income and regular income?

This is a tax policy question that is beyond my area of expertise.

4. On the issue of whether to tax publicly traded partnerships, what makes the difference between generating passive income for investors and actively providing financial

services? In your view, are today's large hedge funds and private equity firms actively providing financial services?

The publicly traded partnership issue is not relevant to my business and I therefore do not have any comments on this question.

5. In your view, how does this issue relate to the broader issue of ensuring that our tax burden is distributed fairly? Should we feel confident in explaining to middle-class families who dutifully pay their taxes year in and year out that the way we tax carried interest is consistent with the promise of a fair distribution of our tax burden?

This is a tax policy question that is beyond my area of expertise.

6. What percentage of your ventures would not be sufficiently profitable if not for the reduced tax rate on carried interest? Why should the government encourage you to make those kinds of investments?

DLC operates in a variety of different markets and makes many different types of real estate investments. We frequently make investments in areas that are significantly blighted and desperately in need of new investment to re-vitalize them. These investments are the riskiest we make. In these transactions, which are usually in multi-ethnic areas with below average income levels, we rely heavily on the capital gains treatment of the carried interest to justify the additional risk embedded in these projects. Without that treatment, we would probably not enter into 80% of the investments in these areas.

Questions from Sen. Schumer

Under current law, PTPs are taxed as partnerships if they are engaged in different types of real estate, oil and gas activities, or if 90 percent of their income is from dividend, interest, or capital gains. Is there any justification for denying partnership tax status for investment partnerships and continuing to allow partnership tax status for oil and gas and real estate activities?

The publicly traded partnership issue is not relevant to my business and I therefore do not have any comments on this question.

Questions from Sen. Smith

Question 1 - Private Equity Firms

A couple of recent studies show that private equity firms and the companies they own have a proven track record of strong financial performance and job creation. For example, a recent study by professors from Harvard University and Boston University concluded that companies that went public again after being held by private equity firms

for at least a year consistently outperformed the stock market. A recent analysis by A.T. Kearney identified more than 600,000 jobs in the United States between 2000 and 2003 that were created as a result of private equity investments.

- Given this track record of success, why would we want to increase taxes on private equity firms?
- What are your thoughts on whether increasing taxes on this industry will likely result in the loss of jobs?

I operate a real estate fund and not a private equity fund and therefore and I am not qualified to answer this question.

Question 2 - Baucus-Grassley bill

Chairman Baucus and Ranking Member Grassley have introduced a bill that would tax as corporations *all publicly* traded partnerships that directly or indirectly derive income from investment adviser or asset management services. Because this tax change could discourage private equity firms and hedge funds from going public, some have argued that it would frustrate advocates of greater transparency among these firms. Publicly traded companies are legally required to discloser more information about their business than privately held firms.

What are your thoughts on this argument?

The publicly traded partnership issue is not relevant to my business and I therefore do not have any comments on this question.

Testimony Concerning The Tax Treatment of Compensation Paid to Hedge, Private Equity and Venture Capital Fund Managers

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Before the Committee on Finance
United States Senate
July 11, 2007

Chairman Baucus, Ranking Member Grassley, and Members of the Committee:

Thank you for the opportunity to speak on this important issue of tax policy and law. It is always gratifying to know that academic study can have real world relevance and impact. I should preface my comments by noting that I do not speak on behalf of Stetson University College of Law but rather as a scholar concerned with the optimal working of the United States Tax Code.

The record pertaining to the July 11, 2007 hearing, (referred to as "Carried Interest I")[1] contains several statements that sufficiently and accurately describe the transactions by which hedge, private equity, and venture capital fund managers ("fund managers") receive income for the performance of services and whereby that income is taxed at capital gains rates.[2] Likewise, the record discusses the available options to

[1] *See http://www.senate.gov/~finance/sitepages/hearing071107.htm.*
[2] *See, e.g., Testimony of Treasury Assistant Secretary for Tax Policy Eric Solomon Before the Senate Finance Committee on the Taxation of Carried Interest,* (July 11, 2007) *available at http://www.senate.gov/~finance/hearings/testimony/2007test/071107testes.pdf;* ; Mark P. Gergen, *How to Tax Carried Interests, Statement Before the Senate Finance Committee on the Taxation of Carried Interest* (July 11, 2007) *available at* http://www.senate.gov/~finance/hearings/testimony/2007test/071107testmg.pdf.

change the law so fund managers are taxed, instead, at ordinary rates like other service providers.[3] My testimony, therefore, will not restate those facts nor will it describe the manner in which the law has evolved to its present state. There is, though, a conspicuous absence of critical discussion regarding the purpose of the capital gains tax rates and whether that purpose is achieved or even furthered by the application of capital gain tax rates to the variable income fund managers receive under what is referred to as the "2 and 20." In his opening statement during Carried Interest I, Senator Grassley stated that "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."[4] Other testimony from Carried Interest I, that of Ms. Kate Mitchell[5] and Mr. Eric Solomon[6] suggest that capital gains tax rates are justified to encourage certain taxpayers to assume greater risk than would otherwise be rational and without which that risk assumption society would suffer from a lack of innovation. Both assertions are eminently correct in the abstract, but neither supports capital gains taxation of fund manager compensation.

Senator Grassley's simple and universally accepted statement deserves further scrutiny. Suppose a taxpayer earns $100 (net after tax) or is given as a gift $100 during a time when annual inflation is 6%. The $100 is previously taxed (or exempted) and, of course, should not be taxed again or at all in the case of the $100 gift.[7] If the taxpayer buys property for $100, and after one year sells the property for $106, she will reap and

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[3] *See, e.g.,* Peter R. Orzag, Director CBO *The Taxation of Carried Interest, Statement Before the Senate Finance Committee on the Taxation of Carried Interest* (July 11, 2007).
[4] Statement of Sen. Chuck Grassley Hearing, "Carried Interest, Part 1" (July 11, 2007) *available at* http://www.senate.gov/~finance/hearings/statements/071107cg.pdf .
[5] *Testimony of Kate D Mitchell, Managing Director Scale Venture Partners Foster City Before the Senate Finance Committee on the Taxation of Carried Interest* (July 11, 2007) *available at* http://www.senate.gov/~finance/hearings/testimony/2007test/071107testkm.pdf.
[6] *See* Eric Solomon, *supra* note 2.
[7] IRC 102 (1986).

pay tax on $6.00 nominal gain. This, despite the fact that she is no richer than when she invested the $100 in the property one year ago. She has a nominal gain under IRC 1001 but no economic gain. Her $106 one year later gives her no more purchasing power than she had one year earlier. Thus, taxing the $6.00 nominal gain amounts to an additional tax on the same accession to wealth, or in the case of a gift, a partial repeal of the gift exemption. The upshot of this economic result is that the taxpayer who earns or is given $100 is better off selfishly and immediately consuming it, instead of investing it long term, presumably in a manner that would generate greater societal benefit than would immediate consumption. If she does invest her $100, she is better off not selling the property one year later even if, from a societal standpoint, there are higher and better uses for her previously taxed capital. She might continue her original investment in the manufacture of manual typewriters when laptops are all the rage. This latter point is referred to as the "lock-in" effect.

Implicit, too, in Senator Grassley's observation is that there has been a beneficial "savings" – referred to economically as "investment" – of *previously taxed or exempted income*. In the prototypical case, fund managers have not yet ever been taxed on income subsequently invested in long term assets, such that we should be concerned about the deleterious effect of taxation on nominal as opposed to real economic gain.[8] Fund managers invest human capital – what Ms. Mitchell referred to in her testimony as "sweat equity." The tax on human capital is a single tax, since we do not tax people on their mere potential to earn. If we taxed people merely on earning potential, and then again upon the financial realization of that potential, we should rightly be concerned about the

[8] To the extent fund managers make capital contributions from previously taxed or specifically exempted income, they should be granted capital gain treatment on their long term yields because in that instance the double tax or lock-in effect applies. HR 2834 would provide such treatment.

classic double taxation that would discourage earnings on human capital and the natural willingness to get a job as a fund manager or start any business with sweat equity. We do not tax earning potential so there is no double taxation nor is there a prior taxing event on earning potential that would encourage people to "lock up" their earning potential (i.e., not get a job). Clearly, then, neither double taxation nor the lock-in effect justifies the application of capital gain tax rates to fund manager compensation.

The notion that normal or even enhanced risk-taking justifies the application of capital gains tax rates to fund managers is both novel and bizarre, in my judgment. Initially, it proves too much. Every entrepreneur is a risk taker but only entrepreneurial investors of previously taxed income are taxed at lower rates, for the reasons discussed above not because they are risk takers. Suppose, for example, that my daughter buys 100 lemons to start a lemonade stand on my street or simply to corner the market on lemons that other kids need to start a lemonade stand. She hopes to sell lemons or lemonade at a nice profit. The return on her strategy is, quite naturally, risky. The risk may be very high or very low, depending on market circumstances. There is no guarantee that she will sell one, ten, fifty or 100 lemons worth of lemonade. In any event, it is both unnecessary and unwise to provide a tax subsidy to her risk taking. The market will reward or punish her risk-taking as the case may be. When the market punishes risk, it disciplines investors to the benefit of society. Softening that potential punishment via a tax break encourages irrational risk-taking and ought to be tolerated only when there is a demonstrable societal benefit that is not otherwise provided via the market. Indeed, as fund manager compensation figures show, the market more than adequately spurs the risk-taking that fund managers indulge when they put their service compensation to the

mercy of entrepreneurial risk. Capital gains taxation is, in this instance, unnecessary and unjustified because neither the double tax nor lock-in potential is sufficiently present – the lemons being the stuff of inventory and therefore not likely to generate mere inflationary (or nominal) gain, or to cause capital to be trapped in unproductive use. The more important point is that risk taking has nothing to do with capital gains taxation. Every investment – whether of human or financial capital – involves risk. A theory that capital gains taxation is appropriate for risk taking proves too much and is nothing more than a selective plea for lower tax rates for certain activities.

The latter assertion, though, perhaps overstates the case to the extent capital gains taxation can be viewed as a subsidy (rather than as a remedy) to spur what should otherwise be "irrational" but nevertheless extremely beneficial societal behavior.[9] Two examples suffice in this regard. The first pertains to the research and development tax credit.[10] We might conceptualize the research and develop tax credit as an effectively lower tax rate applied to income directed towards a certain needed and socially beneficial activity that would insufficiently occur without a tax preference. The effective rate on income used for research and development is zero because the financial cost (i.e., risk) of research and development is so high that rational people ought to spend their labor and money elsewhere. Providing a lower tax rate via a credit encourages highly risky but nevertheless socially beneficial behavior not sufficiently provided by market incentives.

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[9] There are various assertions that capital gains taxation subsidies greater wealth for the wealthy. I take no position on these assertions but instead accept the notion that capital gains taxation remedies the double tax and lock-in effect.

[10] IRC 41 (1986). "The intent of the R&D tax credit was to encourage R&D investment by the private sector. Congress believed that the private sector was not investing enough in research and development. Legislative history indicates that Congress believed that the private sector's lack of investment in research and development was a major factor in the "declining economic growth, lower productivity, and diminished competitiveness of U.S. products in the world market." Belinda L. Heath, *The Importance of Research and Development Tax Incentives in the World Market, 11* MSU-DCL J. INT'L L. 351, 352-53 (2002).

Another example involves serving in combat. As you know, the tax rate on combat pay (zero percent) is lower than the tax rate on other services.[11] Going to combat is a risky, irrational behavior with such little hope of financial reward that we should expect it never to occur without something to offset the risk. I am here speaking only in the economic terms the proponents of capital gain taxation have used in the debate; I am not referring to the higher callings that motivate my younger brothers, my niece and others like them to engage in combat. Nevertheless, in an economic sense, there is insufficient hope of market reward to motivate those socially beneficial activities. It is only when we can make that conclusion – that the market insufficiently provides needed services -- that non-ordinary taxation is justified. We simply cannot make that assertion to service as a fund manager because the *hope* of financial reward (as opposed to the guarantee) is so high that the socially beneficial behavior will inevitably occur in sufficient quantities so that society will benefit.

Ms. Mitchell's testimony, in particular, during Carried Interest I can be characterized as sentimental sophistry at best. She describes such wild successes as Google, YouTube, FedEx, and Ebay as evidence for the legitimacy of capital gains taxation. In each of those examples, though, there was sufficient hope, though no guarantee, of astronomical market reward. There was at least enough hope that the sweat equity expended would have been so expended even in the absence of a tax rate reduction. Thus, a tax subsidy – both via exemption or merely lower tax rates – was and is unnecessary because the rational hope of getting rich was sufficient to spur the behavior despite the lack of guarantee. I note, in this regard that it is the rational, realistic "hope" not the guarantee, of market reward that spurs necessary economic behavior.

[11] IRC 112 (1986).

That some entrepreneurial activity fails, therefore, cannot be viewed as a justification for a tax subsidy nor should the failure be attributed to ordinary tax rates deemed fair in every other service provider context. Tax subsidies are not meant to *guarantee* reward as that would work a distortion of the market, causing more harm than good. Thus, if the risk of reward outweighs the risk of loss, such that the activity will occur in optimal quantities, a tax subsidy is an extremely unwise use of tax dollars. Indeed, providing a tax subsidy when the market provides the sufficient hope of reward so that the behavior would have occurred in sufficient quantities is against societal interest. Tax subsidies are not limitless – money does not grow on trees. The tax subsidy -- the unnecessary tax subsidy – spent to encourage labor already in sufficient supply could have been better spent for more research and development or higher combat pay, for example.

Finally, and with due respect, Mr. Solomon's example during the Carried Interest I hearings regarding a business built with the combination of labor and capital – and the fact that upon the sale of the business both the laborer and capitalist recognize capital gain proves not that the status quo regarding carried interest normal and acceptable but rather the exact opposite. His example states:

> Entrepreneur and Investor form a partnership to acquire a corner lot and build a clothing store. Investor has the money to back the venture and contributes $1,000,000. Entrepreneur has the idea for the store, knowledge of the fashion and retail business, and managerial experience. In exchange for a 20 percent profit interest Entrepreneur contributes his skills and know how [i.e., human capital or services]. Entrepreneur and

> Investor are fortunate and through their combination of capital and efforts, the clothing store is successful. At the end of 5 years, the partnership sells the store for $1,600,000 reflecting an increase in the going concern value and goodwill of the business. Entrepreneur has $120,000 of capital gain and Investor has $480,000 of capital gain.

Note that the example asserts that the appreciation is attributable solely to the increase in going concern value and goodwill. Additional, more realistic and absolutely necessary facts clarify the true outcome. Going concern value and goodwill could not have been generated without previous realization and recognition of ordinary income via the sale of inventory and the performance of services. If the partnership is sold with inventory or accounts receivables [e.g., for services] on hand, the first part of the gain will be correctly taxed at ordinary rates, regardless of whatever value the parties apply to going concern or goodwill.[12] If instead, the store previously sold all of its ordinary income assets – haute couture clothing and services, for example – without having ever distributed a portion of the gains to the service partner (but instead increasing the sale price of the service partner's 20% interest to account for undistributed ordinary profit), the service partner would have nevertheless recognized ordinary income,[13] before being granted access to the capital gains rates applicable to the sale of the partnership interest. [14] This would, of

[12] IRC 751 (1986).
[13] IRC 702(b) (1986).
[14] Mr. Solomon's example actually only demonstrates a timing issue – whether the service partner should recognize ordinary income upon receipt of the partnership profit interest, or as profits are actually earned. I have stated elsewhere that it is at least tolerable to defer recognition until profits are actually earned by the partneship. Darryll K. Jones, *Taxing the Carry,* 115 TAX NOTES 501 (2007). Other commentators have made convincing arguments that ordinary income should be recognized upon the grant of the profit interest. *See* Lee Sheppard, *Blackstone Proves Carried Interests Can be Valued, 2007 TNT 121-2 (June 20, 2007).* In any event, there is no conversion tolerated in this example.

course, be appropriate because the undistributed ordinary income would be economically analogous to *previously taxed income invested in long term property.*

My final point echoes a statements made by the Chair and the ranking member: the efforts to "get it right" with regard to the taxation of carried interests are not motivated by envy or class warfare. As far as I am concerned we should all strive to "get rich or die tryin." God Bless us all, indeed. Our tax code, though, should reflect the integrity of our society as well as our commitment to fairness.

RESPONSE TO SENATE FINANCE COMMITTEE MEMBERS QUESTIONS IN RESPONSE TO CARRIED INTEREST II HEARING

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Questions from Sen. Baucus

1. Many hedge funds have a master feeder structure in which foreign and nonprofit investors invest through a corporation incorporated in a low tax jurisdiction, such as the Cayman Islands. In such a structure, the hedge fund manager enters into a contract with the foreign corporation to provide the investment services, and the manager receives remuneration in the form of an incentive fee instead of carried interest. Economically, how is an incentive fee different from a profits interest?

Answer:

Economically, there is no difference between an incentive fee and a carried interest. In either case, the compensation method serves to more closely align an agent's motivation to work harder in pursuit of a principal's goals. Agency theory holds that owners suffer "residual loss" to the extent managers naturally put their own interests ahead of those of the owner even as they labor on behalf of the owner. These agency costs can be lessened by a compensation structure that brings about a closer or "optimal" alignment between the manager's interests and an owner's interests. The alignment is optimal when both the manager and the owner benefit from a manager's decision making process. Thus incentive fee structures that determine compensation as a function of an owner's total profit decrease agency costs or residual loss because the owner and manager's interest coincide. A "carried interest" is merely an industry specific term for an incentive fee designed to align a manager's economic interests with those of an owner and thereby decrease agency costs.

It should be noted that IRC 61(a)(1) defines gross income to include "compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, bonuses." Treas. Reg. 1.61-1(a)(1) (2003). Thus, even variable incentive structures are within the definition of "compensation." Moreover, IRC 61(a)(1) is universally viewed as defining classic "ordinary income" taxable at the rates defined in IRC 1(a) through 1(d). IRC 1221 and 1222 together define capital gains, subject to the rates defined in IRC 1(h), as gains derived from the *sale of property* (with gains from certain properties excluded). Income from services (whether fixed or made variable to lessen agency costs) are never intentionally taxed at capital gains rates for the reasons stated in my prepared statement submitted for consideration during the Carried Interest II hearings and in my response to Senator Baucus' fourth question below.

2. At the July 11, 2007 hearing on carried interest, Mr. Solomon stated in his written testimony that a profit interest partner has an immediate ownership interest in the enterprise.

A. What does a profits interest partner own?

Answer:

A profit interest partner is more accurately describing as a person who acquires a chose in action as the result of the performance of services. The profit interest partner has no rights with regard to the underlying capital employed in the profit-seeking activity. Instead, she has only a contractual right to be compensated for services. *Compare* Rev. Proc. 93-27, 1993 C.B. 343 (defining a "capital interest" and a "profit interest"). A profit interest partner may subsequently obtain a "capital interest" in a partnership by investing actual capital in the partnership either directly or indirectly. Thus, when a partnership allocates profits to a profit and those profits are not immediately distributed, the partner is treated as having a capital interest in the firm (because the undistributed profit is being used in furtherance of the partnership's profit seeking activity). Her capital account – the record of her capital contribution – is increased by the amount of undistributed profit. It is only after paying an initial tax on capital – via the allocation of undistributed profit -- and then effectively reinvesting that capital (by not insisting on immediate cash flow distribution) that a profit-interest partner obtains a capital interest.

B. What can a profits interest partner receive upon liquidation of the partnership?

Answer:

As noted above, a profit-interest partner has no rights to share in the return of partnership capital, except to the extent she has actually contributed her own capital to the partnership either directly – via an explicit investment of financial capital (not services) or indirectly – by allowing the partnership to maintain use and ownership of her share of allocated (and previously taxed) profits.

3. Some panelists stated that the general partner in a hedge fund, real estate, venture capital or private equity partnership has entrepreneurial risk. What risk does a profits interest partner have in a partnership?

Answer:

A profit-interest partner undertakes risk similar to any mom and pop grocery store owner, legal advisor, professional golfer, horse trainer or tennis player. In each case, the entrepreneur invests human capital – "sweat equity" – and may or may not be compensated. Every economic activity presupposes risk so the fact that fund managers undertake risk is insufficient to justify capital gains taxation. If Tiger Woods, for example, does not win (or place within the top performers), he receives no compensation for his efforts. When Tiger Woods' competitor wins – in an industry with much greater

risk than venture capitalism, given the presence of Tiger Woods – the competitor's demand for taxation at capital gains rates would not be justified by the fact that Tiger Wood's presence made the investment of human capital by all other competitors extraordinarily risky in an economic sense. The market itself compensates for the decision to undertake the extraordinary risk – via extraordinary compensation – and so there is no reason to grant a tax subsidy.

4. What is the purpose of capital gains? Is it to reward or encourage taxpayers to assume greater risk?

As Senator Baucus stated in his statement during Carried Interest I, the purpose of capital gains taxation is to alleviate the double taxation of capital. There are other justifications not relevant to the taxation of carried interests. The capital gains rates are a simple, if not crude, means to assure that only the true rather than nominal yield from capital is taxed. I provided an example of how capital gains rates are intended to work in my written testimony provided to the Capital Interest II hearings. If capital gains rates were justified by undertaking extraordinary risk, the rates would necessarily apply to far more economic activities than currently qualify for capital gains taxation. The integrity and defensibility of capital gains taxation is severely undermined to the extent capital gains rates are applied to situations that are not within the long agreed upon economic justifications for those rates.

Questions from Sen. Grassley

1. At the hearing, I asked you for a yes or no answer to the following question:

> I have read reports in the press that, rather than change the tax treatment of carried interest, some think it would be more fair and equitable to raise the top marginal rate to 40% and the capital gains rates back up to 20%. That would leave fund managers with their 20% rate preference while raising taxes on everyone else, including small business owners, households with two wage earners, investors *who actually put their capital at risk,* and retirees who depend on investment income. Would this make the tax system more fair and equitable than changing the treatment of carried interests? If you wish, please elaborate on the answer you gave at the hearing. [emphasis added]

Answer:

I answered "no" at the hearing. One thing – the relative difference between ordinary and capital gains rates – has nothing to do with the other – the taxation of some service providers (fund managers) at capital gains rates and others at ordinary rates. Raising both ordinary and capital gains rates would have no impact on the horizontal inequity of treating similarly situated taxpayers differently, because the disparate treatment would nevertheless exist. Taxing carried interests at capital gains rates means that certain

service providers are treated more advantageously than others. Raising rates on both classes of services providers, while maintaining the disparate treatment amongst those service providers, necessarily maintains the horizontal inequity.

2. At the hearing, Senator Schumer asked you for a yes or no answer to the following question:

> Again all of you may have a different views on how the carry should be taxed in the first place, but can any you make the case for when private equity and hedge fund partners should be taxed differently from other partners? . . . Do you think that there is a justification to treat them differently?
>
> Each of you answered "No." Professor Jones and Mr. Ifshin elaborated and in their comments, referred to the taxation of carried interest. I have the following questions:
>
> A. If you wish, please elaborate (or elaborate further) on the answer you gave the hearing;

Answer:

It is actually the present taxation of carried interests – and not the proposed correction – by which service partners are unjustifiably treated differently than other partners and indeed other similarly situated taxpayers. Other partners have invested capital that, at some point in time, was originally taxed at ordinary rates. A partner, for example, who has worked as an employee and saved a portion of her salary before striking out on her own in partnership with others has necessarily been first taxed at ordinary rates (on the salary and the interest on her savings account or CD, for example) before being taxed at capital gains rates on the yield from her capital invested in the partnership. Even a partner who invested inherited wealth is investing wealth that at some antecedent point in time was originally taxed at ordinary rates. Thus, it is the *status quo ante* that discriminates amongst partners, not the proposed solution.

> B. In answering the question were you referring to the taxation of carried interest, or the publicly traded partnership rules?

Answer:

I was referring to the taxation of carried interest.

> C. If you were referring to the taxation of carried interest, please provide your views on the Baucus-Grassley bill. That bill would, in general, deny the ability of a partnership engaged in the investment advisory and asset management business to claim the passive-type income exception to the general rule that publicly traded partnerships are to be taxed as

corporations. For further background, please see my statement inserted into the record.

Answer:

I am aware of the bill with regard to publicly traded partnerships (PTP's). In my opinion, the only similarity between the issue with regard to the publicly traded partnerships and the taxation of carried interests is that the same group of taxpayers (fund managers) is abusing the clear intent of two different areas of law. With regard to PTP's, it is my understanding that present law is intended to protect against erosion of the corporate tax base through the use of business entities that, though not technically organized as public corporations, are capitalized and operate in the same substantive manner as public corporations. Whether our tax code should impose a corporate tax is another issue altogether. I agree, though, that substance rather than form should determine tax outcomes and therefore support the PTP bill since it merely imposes a look-thru approach necessary to identify the true substantive activities (active or passive) of certain partnerships.

Questions from Sen. Roberts

1. Mr. Ifshin noted in his testimony that because of his company's investments, hundreds of jobs have been created and communities have been revitalized. I'm concerned that during this debate, some have characterized this as a "Wall Street issue". Mr. Ifshin, I thank you for pointing out that this is also a "Main Street" issue that affects communities, pensioners, and individuals across this country. Would anyone else care to comment on the impact that these entrepreneurial investments have on Main Street? What's the benefit to communities in terms of job creation and investments in local economies? Would these investments continue to be made at the level they're being made now if taxes on carried interest were to increase?

Answer:

"Lies, damned lies, and statistics." If indeed, it is true that the present taxation of fund managers redounds to the benefit of Main Street – a dubious proposition at best – there would be much better ways to subsidize Main Street. A tax subsidy that flows through the pockets of very highly compensated service providers can only be characterized as highly inefficient. In any event, this is an empirical assertion that ought to be supported by empirical data before, not after, an otherwise glaring tax inequity is condoned. The question certainly calls for an empirical answer in support of preferential taxation of carried interests. No such empirical data has been offered.

2. Several witnesses have touched on the fact that investors in private equity funds often include university endowments and pension funds who receive substantial financial benefits when their investments are successful. These returns are key to helping manage tuition costs, and to securing the pensions of millions of retirees. If the tax treatment of

carried interest is changed, would it jeopardize those strong returns that have benefited college students and pension recipients?

Answer:

Again, the question is an empirical one and the burden is rightly placed on those demanding a tax subsidy to prove the societal benefits generated thereby. That burden has not yet been met. I would note, though, that if the taxation of carried interest is justified on the basis that it helps manage tuition, then there is indeed no justification as it is quite apparent that tuition costs continue to rise at many times the rate of inflation. By that standard, the tax subsidy granted to fund managers has been a terrible failure. *See* Lance Gay, *Skyrocketing tuition costs forcing students to find alternatives*, The Star-Ledger (Newark, New Jersey), February 10, 2000 at page 5 ("College tuition has increased about 50 percent over the last decade, outpacing inflation and forcing students to either drop out or "max out" on student loans they must pay after graduation, a Senate committee was told yesterday"); Sandra Block, *Cost of higher education gets more pricey; In some states, budget gaps push tuition up 10% or more* USA Today, July 27, 2007 at 1B ("In recent years, tuition rates have risen at a much faster rate than inflation. From 2001 to 2006, average tuition at public universities jumped 35% after adjustment for inflation, the largest five-year increase on record, according to the College Board.")

3. Many partnerships are structured with carried interest – oil and gas, real estate, venture capital and health care. Isn't it a matter of fundamental fairness that the tax code not single out certain industries for different tax treatment?

Answer:

Yes. It is as much a matter of fundamental fairness – horizontal equity – that the tax code not single out certain industries for different tax treatment as it is that the tax code not single out certain taxpayers (like fund managers) for different tax treatment. Thus, the Levin bill, for example, should prompt the Internal Revenue Service to abandon its long administrative practice from which the present preferential treatment of all service partners (relative to other workers) is derived.

Questions from Sen. Salazar

1. What would be the real consequences to your respective industries of an increase in the tax on carried interest? Can you say with any degree of certainty that the amount of activity in private equity, hedge funds, and/or venture capital would decline significantly.

Answer:

In this regard, I would refer the Committee to the statement made by William D. Stanfill at the Carried Interest II hearings. Mr. Stanfill remarked that there is more than a hint of "Chicken Little" in the dire predictions set forth by fund managers in unabashed defense

of a tax subsidy worth billions of dollars. As I point out throughout my responses to these questions, it is incumbent upon those who demand a tax subsidy to set forth empirical data proving the necessity of the subsidy. Such a method is the only way to ensure fairness and efficiency in the tax code.

2. Is it possible to tax carried interest as regular [ordinary] income for large private equity firms and hedge funds without it trickling down to smaller firms who make riskier investments?

Answer:

It is of course possible that Congress could, by legislative fiat, distinguish between firms with regard to the taxation of carried interests. As noted above, however, the level of risk has no logical relationship to preferential taxation in the absence of proof that society benefits from highly risky behavior and that the beneficial behavior would not occur in sufficient quantities in the absence of a tax or other subsidy.

3. What are the principal distinctions between carried interests and regular income? In each of your viewpoints, do those distinctions get at the heart of how our tax code intended to distinguish between capital gains income and regular income?

Answer:

Please see my answer to Sen. Baucus' questions 1 and 4 above. In short, there is no economic distinction between income earned by fund managers and income earned by other service providers, some of whom undertake greater risk than fund managers. Further, the disparate treatment of those identical forms of income (i.e., both are compensation for services) are not logically related to the theoretical distinctions between income from financial capital and income from human capital.

4. On the issue of whether to tax publicly traded partnerships, what makes the difference between generating passive income for investors and actively providing financial services? In your view, are today's hedge funds and private equity firms actively providing services?

Answer:

IRC 469 – relating to the passive activity rules – defines passive activities by reference to the extent to which personal services are rendered in pursuit of the activity. As noted in my response to Senator Baucus' first question, income generated via personal services is quintessentially "ordinary income." The regulations pursuant to IRC 469, to the extent they focus on the degree of personal services rendered in pursuit of an activity provide a logical starting point to distinguish between active and passive income for purposes of the PTP issue. By those standards, large hedge funds and private equity firms are indeed engaged in active rather than passive activities.

5. In your view, how does this issue relate to the broader issue of ensuring that our tax burden is distributed fairly? Should we feel confident in explaining to middle-class families who dutifully pay their taxes year in and year out that the way we tax carried interest is consistent with the promise of a fair distribution of our tax burden?

Answers:

The issue has everything to do with fundamental fairness, as implied by Senator Roberts, though apparently for different reasons than my own. It is fundamentally unfair and indeed inefficient to tax some service providers differently than others unless the special benefit provided to others is sufficient so that everyone else is compensated and no person is worse off. This is a basic assertion of Pareto efficiency, a theory that prevails in American taxing and spending decisions generally. Fund managers and those who support the *status quo ante* argue that society benefits from the special tax treatment granted to fund managers. This is an assertion without empirical support and must be assumed false until empirical data is offered to prove the assertion. The Congress demands no less with regard to any sort of direct or indirect subsidy.

6. What percentage of your venture would not be sufficiently profitable if not for the reduced tax rate on carried interest? Why should the government encourage you to make those kinds of investments?

Answer:

This question gets to the heart of the matter. As I noted above, those who demand a tax subsidy should first prove that a beneficial economic activity would occur in insufficient quantities in the absence of the subsidy and further, that the government ought to abandon an economically neutral stance in favor of one industry over another. In the absence of such proof, a tax subsidy distorts economic decisions and is inefficient.

Questions from Sen. Schumer

1. Last week it was announced that Morgan Stanley was moving some of its core activities and two of its more senior executives to its London office. This past Sunday, a story on the CNN/Money website said that other U.S. banks such as Citi, Goldman Sachs, Lehman Brothers (LEH), Merrill Lynch have moved divisional heads and other staff to London this year. We have all heard a great deal of discussion about whether our securities laws and legal system are encouraging new IPO's to be done in London or even Singapore. If Congress were to dramatically increase the tax on carried interest for investment partnerships – or make it much harder for them to become publicly-traded entities and still remain partnerships – might this make U.S. private equity and hedge funds less competitive in world markets than they are today? Would it hasten the trend of jobs moving overseas and gradually shift the center of gravity for those types of alternative investment firms to overseas locations?

Answer:

With respect, the question is so full of what Mr. Stanfill, a fund manager himself, referred to as "Chicken Little-ism" that it is hard to know where to begin. It is indeed surprising and shocking, though, that both Senators Schumer and Kerry can, on the one hand, absolutely skewer the President for allegedly advocating "tax cuts for the wealthy," *see* *http://schumer.senate.gov/SchumerWebsite/pressroom/record.cfm?id=269558* ("The years of favoring the wealthy and big oil companies are over," said Senator Schumer.") and at the same time list a parade of potentially horrible but largely fanciful (or at least unproven) economic consequences that might flow from withdrawing a tax subsidy from "the wealthy and big oil companies".

In any event, that certain wealthy taxpayers – individuals or entities – threaten to expatriate wealth unless the tax code bends to their demands to pay taxes at comparatively lower rates than other similarly situated taxpayers is not and never has been sufficient reason to suffer glaring inequity in the tax code. There should be a very high burden placed on those who demand special tax breaks to prove the worth of those tax breaks – not by threats and lists of horribles, but by data proving a distinctive societal benefit that cannot otherwise be obtained. That the tax code has never acceded to threats of expatriation is fully borne out by recently enacted provisions in the code that attack "corporate inversion transactions," *see* IRC 7874, as well as provisions attacking individual expatriation of wealth by taxpayers who desire only to escape their presumptively fair tax burden. *See* IRC 877.

Here, for example is what the President's Advisory Panel on Federal Tax Reform stated about the grant of tax benefits in the Code:

> *A rational system would favor a broad tax base, providing special treatment only where it can be persuasively demonstrated that the effect of a deduction, exclusion, or credit justifies higher taxes paid by all taxpayers.*

The report also notes that in many circumstances the tax code must sacrifice some degree of efficiency in support of fairness. Thus, progressive rates – which Sen. Schumer presumably supports -- impose comparatively higher rates on wealthy taxpayers than on poorer taxpayers even if those higher rates encourage defections from the United States solely to avoid taxes. Indeed, even if the parade of horribles set out by Sen. Schumer were more than "Chicken Little-ism" our tax code and our society would be better served by sacrificing some amount of economic wealth in the pursuit of fundamental fairness. As I have noted earlier, though, it is incumbent on those who advocate tax breaks for "the wealthy and big oil companies" to set forth more than anecdotes.

2. Isn't one of the fundamental tenets of the American business structure that different partners can come together in a business interest, each of them bringing different things to the table – some bring money, some bring ideas, some bring management experience, etc. – and they all work together in pursuit of a common goal? Isn't that a very basic

tenet of our economy, not only to partnership structures like oil and gas and private equity and venture capital, but also to the mom-and-pop shop on the corner where one person brings the cash and one brings the know-how? Isn't it consistent with decades of tax law that if those partners sell the business, once they address issues like inventories, the profits interest is capital gain for all the partners?

It seems to me that when you're dividing up an ownership or profits interest, those who favor changing law are arguing that only the partner who brings the capital should be taxed as if he earned a return on investment, while everyone else should be taxed as if they have provided a service. Wouldn't this be a fundamental change to the entire way millions of business [sic] are structured and taxed, not just private equity and hedge funds? What am I missing?

Answer:

The depth of what Senator Schumer is missing (if indeed he really is missing something) is significant. What Senator Schumer is missing is stated in my answer to Senator Baucus' second question. It is the norm, not the exception, that those who invest human capital in any business whatsoever, whether alone or in conjunction with other investors are taxed at ordinary rates. Under IRC 351, a person who receives stock in a corporation in exchange for services is taxed at ordinary rates. Under IRC 721, a person who receives a capital interest in a partnership in exchange for services is taxed at ordinary rates. An independent contractor who earns compensation by landscaping yards is taxed at ordinary rates. All service providers are taxed at ordinary rates except fund managers. Even partners who sell their interest in a partnership are taxed at ordinary rates not only with regard to unsold inventories, as implied and then dismissed above, but also with regard to receivables due for the performance of services. What Senator Schumer implicitly asserts as the norm (that fund managers should be taxed at capital gains rates), is rather the as of yet unsupported exception. It is certainly true that joint venturers have joined together throughout the course of our history in search of wealth. In every instance, save the present approach to fund manager, those joint venturers have paid tax at ordinary income rates to the extent their wealth is derived from the sweat of their brow.

Questions from Sen. Smith

Question 1 – Private Equity Firms

A couple of recent studies show that private equity firms and the companies they own have a proven track record of strong financial performance and job creation. For example, a recent study by professors from Harvard University and Boston University concluded that companies that went public again after being held by private equity firms for at least a year consistently outperformed the stock market. A recent analysis by A.T. Kearney identified more than 600,000 jobs in the United States between 2000 and 2003 that were created as a result of private equity investments.

- Given this track record of success, why would we want to increase taxes on private equity firms?

Answer:

We should impose the same level of tax on fund managers as on all other service providers because all service providers contribute to societal well being. A landscaper, an orange picker, a construction worker, a teacher, a soldier and a marine work just like fund managers for the good of society and yet it is only fund managers who pay lower rates.

- What are your thoughts on whether increasing taxes on this industry will likely result in the loss of jobs?

Answer:

I believe that to be dubious assertion that ought to be supported by empirical data before the tax code grants a subsidy worth billions of dollars to one industry.

Question 2 – Baucus-Grassley bill

Chairman Baucus and Ranking Member Grassley have introduced a bill that would tax as corporations all publicly traded partnerships that directly or indirectly derive income from investment adviser or asset management services. Because this tax change could discourage private equity firms and hedge funds from going public, some have argued that it would frustrate advocates of greater transparency among those firms. Publicly traded companies are legally required to disclose more information about their business than privately held firms.

What are your thoughts on this argument?

Answer:

There are simple and cheaper ways to mandate transparency. The Congress could simply impose disclosure requirements, for example, on privately held firms with assets over a level high enough that society in general should rightly be concerned about transparency. I do not know what that level is, but it is quite obvious that we need not pay for transparency via a tax subsidy when we deem transparency necessary.

Statement of Charles I. Kingson

Recent discussion suggests that amounts received for managing capital assets constitute gain from their sale. The issue is spoken of as the correct taxation of a carried interest in a partnership. A carried interest attributes to its holder both ownership of the underlying assets and income from their sale.

But since the profits interest held by the managers is not a carried interest, the argument fails. The concept of a carried interest as ownership of underlying assets and income –on which capital gain treatment rests - comes out of oil and gas law. That law is long outdated, and even when in effect applied only to taxation of mineral interests.

Instead, capital gain should be determined by how tax law treats a derivative, a concept that comes out of the financial community. Derivatives mimic ownership without having it and mimic lack of ownership despite having it. The managers' interest is a derivative, since they are intended to receive the same amounts they would have received had they owned and sold the stock.

Someone with a 20 percent interest in the appreciation of a $100 pool of assets could be considered to have invested in them by obtaining a $20 loan that he contributed to the partnership. Interest on the loan would be paid by performing services.[1] But since the loan would be nonrecourse – the manager does not bear loss on the $20 – what the money manager receives constitutes equity: the equivalent of annual stock appreciation rights.[2]

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[1] Section 7872

[2] The interests are in fact a series of annually granted stock appreciation rights (SARs) or stock options. (A SAR is an option without need to make an investment.)

The advantage of a profits interest over SARs or options can be seen with a two-year example. If in year one the fund grows from $100 to $150, the managers are entitled to $10, 20 percent of the $50 appreciation. Someone exercising a SAR or option would also have $10, but the ride would be over. If the fund grew to

Clothing the arrangement as a partnership should not change the analysis. Evidence that the partnership form makes no economic difference is that when foreign investors are concerned about U.S. taxation, the same arrangement becomes a performance fee; and when the fund is structured as a corporation, investors get A shares with $100 liquidation preference while the 20 percent fee embeds in the B shares. [3] Nor does state law control classification as a partnership.[4]

The debate over carried interests should be seen as part of a derivative free-for-all, a sort of financial check-the-box regime, in which people can choose between the tax attributes of owning or not owning property. Examples include equity swaps, tracking stock, and transactions that led to sections 1258 and 1259.

The common law of taxation has not coped with this especially well, although it is doing a far better job than its detractors (and some people facing penalties) assume. For example, almost 50 years ago the Tax Court help that a money manager's share of profits constituted compensation. [5] And a case denying carried interest treatment for nonmineral property said what should apply today: "A taxpayer does not have an economic interest merely because his right to payments is linked to profits, dividends, farm produce or the like."[6]

$250 in year two, the SAR or option holder would have no further benefit. By contrast, a manager would get an additional $20, as though he had been granted a second SAR.

The same $20 could be obtained by not exercising the SAR until the end of year two, but that delay entails risk of losing the $10. If the fund goes back down from $150 to $100, the holder gets nothing, but the manager retains his $10 from year one.

[3] Section 875

[4] Cf. reg. section 301.7701-2 and -3; S & M Plumbing, 55 T.C. 702 (1971) (acq.). Moreover, the profits interest does not share loss. If the partnership anti-abuse rule has any bite, use of a partnership to claim capital gain from performing services should have been high on the list. But conflicts apparently prevented even bar associations form raising this.

[5] Smith v. Commissioner, 33 T.C. 465 (1959).

[6] Bryant v. Commissioner, 399 F.2d 800, 806 (5th Cir. 1968).

Even if the partnership form is given effect, the managers should be considered to have received an interest in partnership capital rather than profits; and receipt of a capital interest for services is taxed as compensation. The partnership tax law distinction between capital and profits interests envisions the difference between operating income of a business and appreciation of its assets. For example, someone who becomes partners with a building owner and agrees to run a candy store there for 20 percent of the profits would not expect to share in gain from the building; and the interest is clearly a profits interest.

By contrast, for an investment fund the concept of profits runs the two together. In this context appreciation of assets **is** the operating income, and 20 percent of profits meant just that. This leads to inconsistent approaches. For compensation purposes, investment managers look to the candy store model of an income interest. For characterization, the profits interest becomes the ownership of capital assets. The managers have acquired an interest in the partnership's capital assets without ever having received an interest in its capital. For compensation to be consistent with characterization, the interest received by the managers for their services should be considered an interest in partnership capital.

The essence of tax law is to define what words mean. For example, a large proportion of Supreme Court tax cases turn on the meaning of everyday words like gift, income, dividend and sale. This hearing is about the meaning of the word "compensation," amounts received for services. Investment managers perform services. The medic in the movie "*Battleground*" knew the difference. Called out to defend Bastogne, he told the infantryman who handed him a rifle, "I want you to teach me to shoot it, not sell it to me."

Questions for the Record for Charles Kingson
Carried Interest, Part II
July 31, 2007

Questions from Sen. Roberts

1. Mr. Ifshin noted in his testimony that because of his company's investments, hundreds of jobs have been created and communities have been revitalized. I'm concerned that during this debate, some have characterized this as a "Wall Street issue". Mr. Ifshin, I thank you for pointing out that this is also a "Main Street" issue that affects communities, pensioners, and individuals across this country. Would anyone else care to comment on the impact that these types of entrepreneurial investments have on Main Street? What's the benefit to communities in terms of job creation and investments in local economies? Would these investments continue to be made at the level they're being made now if taxes on carried interest were to increase?

2. Several witnesses have touched on the fact that the investors in private equity funds often include university endowments and pension funds who receive substantial financial benefits when their investments are successful. These returns are key to helping manage tuition costs, and to securing the pensions of millions of retirees. If the tax treatment of carried interest is changed, would it jeopardize these strong returns that have benefitted college students and pension recipients?

3. Many partnerships are structured with a carried interest – oil and gas, real estate, venture capital, and health care. Isn't it a matter of fundamental fairness that the tax code not single out certain industries for different tax treatment?

Questions from Sen. Salazar

1. What would be the real consequences to your respective industries of an increase in the tax on carried interest? Can you say with any degree of certainty that the amount of activity in private equity, hedge funds, and/or venture capital would decline significantly?

2. Is it possible to tax carried interest as regular income for large private equity firms and hedge funds without it trickling down to smaller firms who make riskier investments?

3. What are the principal distinctions between carried interest and regular income? In each of your viewpoints, do those distinctions get at the heart of how our tax code intended to distinguish between capital gains income and regular income?

4. On the issue of whether to tax publicly traded partnerships, what makes the difference between generating passive income for investors and actively providing financial services?

In your view, are today's large hedge funds and private equity firms actively providing financial services?

5. In your view, how does this issue relate to the broader issue of ensuring that our tax burden is distributed fairly? Should we feel confident in explaining to middle-class families who dutifully pay their taxes year in and year out that the way we tax carried interest is consistent with the promise of a fair distribution of our tax burden?

6. What percentage of your ventures would not be sufficiently profitable if not for the reduced tax rate on carried interest? Why should the government encourage you to make those kinds of investments?

Questions from Sen. Schumer

1. Last week it was announced that Morgan Stanley was moving some of its core activities and two of its most senior executives to its London office. This past Sunday, a story on the CNN/Money website said that other U.S. banks such as Citi, Goldman Sachs, Lehman Brothers (LEH), Merrill Lynch have moved divisional heads and other staff to London this year.

We have all heard a great deal of discussion about whether our securities laws and legal system are encouraging new IPOs to be done in London or even Singapore. If Congress were to dramatically increase the tax on carried interest for investment partnerships – or make it much harder for them to become publicly-traded entities and still remain partnerships – might this make U.S. private equity and hedge funds less competitive in world markets than they are today? Would it hasten the trend of jobs moving overseas and gradually shift the center of gravity for these types of alternative investment firms to overseas locations?

2. Isn't one of the fundamental tenets of the American business structure that different partners can come together in a business interest, each of them bringing different things to the table – some bring money, some bring ideas, some bring management experience, etc. – and they all work together in pursuit of a common goal? Isn't that a very basic tenet of our economy, not only to partnership structures like oil and gas and private equity and venture capital, but also to the mom-and-pop shop on the corner where one person brings the cash and one brings the know-how? Isn't it consistent with decades of tax law that if those partners sell the business, once they address issues like inventories, the profits interest is capital gain for all the partners?

It seems to me that when you're dividing up an ownership or profits interest, those who favor changing current law are arguing that only the partner who brings the capital should be taxed as if he has earned a return on an investment, while everyone else should be taxed as if they have provided a service. Wouldn't this be a fundamental change to the entire way millions of business are structured and taxed, not just private equity and hedge funds? What am I missing?

3. Under current law, PTPs are taxed as partnerships if they are engaged in different types of real estate, oil and gas activities, or if 90 percent of their income is from dividend, interest, or capital

gains. Is there any justification for denying partnership tax status for investment partnerships and continuing to allow partnership tax status for oil and gas and real estate activities?

Questions from Sen. Smith

Question 1 – Private Equity Firms

A couple of recent studies show that private equity firms and the companies they own have a proven track record of strong financial performance and job creation. For example, a recent study by professors from Harvard University and Boston University concluded that companies that went public again after being held by private equity firms for at least a year consistently outperformed the stock market. A recent analysis by A.T. Kearney identified more than 600,000 jobs in the United States between 2000 and 2003 that were created as a result of private equity investments.

- Given this track record of success, why would we want to increase taxes on private equity firms?

- What are your thoughts on whether increasing taxes on this industry will likely result in the loss of jobs?

Question 2 – Baucus-Grassley bill

Chairman Baucus and Ranking Member Grassley have introduced a bill that would tax as corporations all *publicly traded* partnerships that directly or indirectly derive income from investment adviser or asset management services. Because this tax change could discourage private equity firms and hedge funds from going public, some have argued that it would frustrate advocates of greater transparency among these firms. Publicly traded companies are legally required to discloser more information about their business than privately held firms.

What are your thoughts on this argument?

Questions from Sen. Baucus

This is in response to Senator Baucus' requests for answers to written questions for the record from Committee Members. Since many of the questions raise the same essential issues, my response will be an overall one.

1. Whether amounts received by fund managers are ordinary income or capital gain depends on whether they are received for services or for the transfer of property. The thrust of the argument for capital gain is to conflate the two: to say that measuring the amount paid for services by the amount of gain from the transfer of property means that they constitute gain from the transfer of property. But the argument does not specify a fundamental starting point: what tax law means by services and what it means by the transfer of property.

2. A transaction that does not involve the transfer of property (giving a haircut, furnishing professional advice, transporting people) clearly constitutes performance of services. When a transaction does involve the transfer of property (a painting, suit of clothes, a written work, a building), its character depends on who has the interest in its value. For example, when Picasso transferred a picture he had independently created, he had the interest in its value (and was therefore selling property). By contrast, an artist commissioned to paint someone's portrait has no such interest (and is therefore performing services). That same criterion distinguishes J.K. Rowling from a newspaper reporter, Bloomingdale's from a tailor altering a suit, and Donald Trump from a builder agreeing to construct a home on your land. The former – Rowling, Bloomingdale's and Trump – have the interest in and risk of the property's value. The latter – the reporter, the tailor, the contractor – have an interest only in performing their tasks properly.

3. Tax law both depends on and uses this economic analysis to characterize income. In one famous case, CBS arranged with foreign conductor Pierre Boulez to make musical recordings, with the studio and orchestra furnished by CBS. Boulez was paid an amount measured by the number of records sold. If the amounts he received were for the transfer of property (royalties), Boulez was exempt from U.S. tax; but if they were for services, he was taxable. The Tax Court held that although tying the amount Boulez received to the success of the venture was typical of royalty transactions, Boulez did not own the property (the copyright right) which would be the subject of the transfer; and therefore he had performed services.

Consistent with this analysis, in 2005 the Supreme Court held that measurement of what a tort lawyer received (a percentage of his client's tort claim recovery) did not mean that what he received was the tort claim recovery.[1] Despite a lien on the claim granted the lawyer by state law, he did not own it. The Court also rejected a suggestion to treat the sharing for tax purposes as a sort of business partnership or joint venture. It quoted Judge Posner's observation that "the contingent-fee lawyer [is not] a joint owner of his client's claim in the

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[1] Commissioner v. Banaitis, 543 U.S. 426 (2005).

legal sense any more than the commission salesman is a joint owner of his employer's accounts receivable."[2]

4. Just as there should be articulated the difference between performance of services and the transfer of property, the term "carried interest" should distinguish between interests acquired for the performance of services and those acquired for the transfer of property. Senator Schumer's question does not make this distinction, on which the entire tax characterization should depend.

5. The term "carried interest" comes out of oil and gas law, where it referred to an interest acquired for property - such as oil rights to a field. (The interest is described as carried because the holder became entitled to receive money without bearing either the expense of drilling or the loss if no oil were found). At first, the holder of a carried interest was considered to have kept ownership of the oil from whose sale he was to be paid. For example, if a holder granted a developer oil rights to a field for $100 payable solely out of the oil produced, the $100 used to pay the holder would be treated as $100 of oil reserved and sold by him.

This characterization allowed a developer to purchase an oil field for $100 payable out of income taxed to someone else – in effect, allowing him to pay the purchase price out of before-tax income. By contrast, a buyer of farmland or other real estate for $100 would have to earn $150 of pre-tax income and pay $50 of tax in order to pay the $100 purchase price.[3] To equalize the situation, Congress enacted section 636 of the Code, which treats a carried interest in mineral property as mortgage debt. This results in sale of the $100 of oil being taxed to the developer rather than the holder of the carried interest. As a result the developer - like the purchaser of a farm or hotel - must earn $150 of before-tax income to pay the $100 purchase price. Section 636 remains in effect today.

That same allocation of before-tax income to pay costs (of compensation rather than property) occurs if the capital gain allocation claimed by investment fund managers is given effect. Congress has denied individual investors a deduction for their investment expenses.[4] Thus, if a fund earns $500 of capital gain and the manager is allocated $100 of that amount, an individual investor would report $400 of gain and no expense. But if the $100 is compensation,

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[2] The court declined to comment on a newly-raised theory that the arrangement constituted a partnership within the meaning of subchapter K of the Code. In an amicus brief, however, Gregg Polsky – currently professor in residence at the Internal Revenue Service – contended that the lawyer could acquire a interest in the claim through the partnership only as taxable compensation for services.

[3] Taxpayers attempted to use the oil field carried interest technique to purchase nonmineral real estate. In one case a taxpayer purchased a farm for cash plus an amount payable solely out of $100 in farm crops. An appeals court rejected this, saying that measuring price by profits, dividends, or farm crops did not give a seller ownership of the underlying property (and thus income from sale of the farm crops). The buyer rather than the seller owned the farm and was taxable on the sale of its crops (just as the investors, rather than the managers put up the money and therefore have income from sale of the stocks). Bryant v. Comm'r, 399 F.2d 800, 806 (5th Cir. 1968).

[4] Section 67(a). Recent amendments to section 707(a)(2) also intended to prevent partnership income allocations from avoiding disallowance of a deduction.

$500 of capital gain is includible in the investor's income; and he would include $500 of capital gain income but be denied the corresponding $100 deduction for investment expense.[5]

6. My testimony discussed why creation of a state law partnership should not affect the result. It is not as if the managers economically owned the stock. Not only is there is no sharing of losses: there is also no real sharing of profits. The managers are entitled to gain only in excess of a hypothetical investment return (called the hurdle rate). As a fillip, the same economic arrangement is structured as a performance fee to accommodate foreign investors.

7. Accordingly, a state law partnership should be looked at not as creating economic ownership (as in a pre-1969 mineral carried interest), but as a failed attempt to create a financial derivative simulating ownership. A derivative is a structure intended to mimic the tax result of actual ownership without having it. The state law partnership does not create ownership in the stock, for two important reasons. First, as just mentioned, the managers' interest does not bear losses and shares in gain only above the hurdle rate. Second, unlike derivatives recognized as notional principal contracts,[6] the managers' interest is not a right acquired for the transfer of property. Because it is acquired by the performance of services, it more than mimics – it parallels - the contingent fees of tort lawyers and conductor Pierre Boulez.

8. Even if the state law partnership were given effect for tax purposes, the managers should be considered to have received a capital rather than a profits interest in the partnership. (Receipt of a capital interest for services is agreed by all to constitute compensation income.) What the managers receive is often assumed to be a profits interest; and profits of course can refer to any increase in value. But in the partnership tax context, the term profits interest is used in contradistinction to capital interests. A capital interest, if anything, refers to the increase in value of capital assets.

In fact, the interest received by investment managers is the very opposite of a profits interest. A profits interest in a clothing store would receive, say, 20 percent of the profits from selling merchandise on the floor; but it would not participate in appreciation in value of the building. Here, the interest received by the managers is intended to exclude ordinary profits. Only amounts in excess of everyday profits (the hurdle rate) are taken into account in determining the amount of the override. The interest in capital appreciation above everyday profits is the very concept of a capital interest. The profits interest is the hurdle rate, retained by the investors.

9. A question refers to entrepreneurial risk. But service providers – airlines, railroads, truckers, satellite transmitters – also take considerable entrepreneurial risk and require significant capital. Class-action tort lawyers advance significant sums: in A Civil Action, the firm went bankrupt as a result. Similarly, an employee exercising a stock option for $100 when the stock is $130 invests much more than his $30 profit in the company. In

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[5] Tax-exempt institutions may likewise be relying on partnership capital gain allocations to avoid disclosure of the $100 compensation to their investment advisers.

[6] Compare Regulations section 1.863-7.

all those situations the amounts received are considered compensation for services. The question comes down to whether, with respect to the override, managers are taking an ownership risk in the underlying stock; and they are not.

10. A question has been raised about treating different industries similarly with respect to carried interests. I have two responses:

    a. Different industries are treated differently with respect to almost everything. Oil drillers are allowed to currently deduct otherwise capitalizable drilling costs; high-tech industries can currently deduct otherwise capitalizable research costs; real estate owners get generous depreciation allowances; and service partnerships can deduct expenses before the corresponding income is recognized.[7]

    b. More important, Senator Schumer's question implicitly equates carried interests acquired for services with carried interests acquired for property. That equation elides the entire point. Amounts received from carried interests acquired for services should be treated as compensation, whereas amounts received from carried interests acquired for the transfer of property should be treated as received for the transfer of property.

In order to characterize what fund managers receive, it is basic tax law analysis to specify the meaning of services and transfers of property; to say what carried interests are acquired for; and to define capital and profits interests.

11. Finally, it should be pointed out that a significant portion of profits received by managers of private equity funds is attributable to their eroding an acquired corporation's corporate income tax base. That idea that individual tax rates should reward the activity of corporate tax avoidance is to say it gently, counterintuitive. Moreover, despite claims to the contrary, affirming tax law will not result in exporting income to other jurisdictions. Justice Holmes' opinion in Lucas v. Earl – that income is taxed to the person who earns it – is still good law.[8]

Charles I. Kingson
August 31, 2007

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[7] Logically, investment fund managers should allocate a significant amount of expenses to what they claim is capital gain income.
[8] 281 U.S. 111 (1930).

Senate Committee on Finance Hearing

July 11, 2007

"Carried Interest"

Testimony of:

Kate D. Mitchell, Managing Director

Scale Venture Partners

Foster City, CA

Introduction

Chairman Baucus, Ranking Member Grassley, and members of the Committee, my name is Kate Mitchell and I am a managing director at Scale Venture Partners, a venture capital firm based in Foster City, California which is focused on investing in young, emerging technology and healthcare companies, primarily in the United States. I am also a member of the Board of Directors of the National Venture Capital Association based in Arlington, VA. It is my privilege to be here today to share with you the role of venture capital investment in emerging growth companies – and how that role intersects with the economics of carried interest and profit allocation within a venture capital partnership. Our asset class is unique in many ways – in terms of our micro- and macro-economic contribution and our risk/reward model. We appreciate the opportunity to offer a transparent view into our world and answer any questions the Committee might have.

Founded in 1995, Scale Venture Partners consists of 15 investing professionals in total. During this time, we have funded 111 companies of which 20 have gone public, 26 have been acquired, and 53 are still active. We are currently investing a $400 million dollar fund into companies that have promising innovations in industry sectors such as hardware and software, semiconductors, wireless communications, business services, biotechnology, medical devices and healthcare services and therapeutics. We are also exploring opportunities in the clean tech and alternative energy spaces. Scale employs a hands-on, thesis-based investment approach, working side by side with our portfolio companies to help them accelerate their growth and reach their market goals. In this regard, we are emblematic of venture capital firms around the country.

For the last four decades, the venture capital community has served as a founder and builder of companies, a creator of jobs, and a catalyst for innovation in the United States. This contribution has been achieved through high-risk, long-term investment of considerable time and dollars into small, emerging growth companies across the country and across industry sectors. According to a study conducted by econometrics firm Global Insight, companies that were started with venture capital since 1970 accounted for 10.4 million jobs and $2.3 trillion in revenues in the United States in 2006 and include historic innovators such as Genentech, Intel, FedEx, Microsoft, and Apple and rising stars such as Google, eBay, and Kyphon. Venture capital has differentiated the US economy from all others across the globe. In doing so, our industry has collectively earned above average returns for our country's pre-eminent institutional investors and their beneficiaries including public pension funds, university scholarship endowments, and charitable foundations. My partners and I are extremely proud of the work that we do each day because we are creating long term value for our investors, our companies, their employees, and the communities in which our companies operate.

Yet despite the tremendous value generated by the venture capital industry, our ecosystem is a small and fragile one that requires consistency to thrive. To date, Congress has demonstrated a strong understanding of the necessary environmental factors required to foster a stable venture capital environment. Today we are asking you to continue to support this consistency and continue to recognize carried interest attributable to long term venture capital investment as it has been viewed historically– as a true capital gain. Congress has a right and duty to examine tax policy and in this case you are asking very legitimate questions. We believe an examination of the economics of carried interest will demonstrate not only that it is consistent with the spirit of long-standing tax policy but also that a tax change affecting the venture industry would be incongruous with the spirit of ongoing innovation that Congress has historically supported.

Venture Capital's Economic Value and Contribution to Innovation

Every day venture capitalists seek out the most promising and innovative ideas, technologies, and processes that our country's entrepreneurs have to offer. More often than not, we become involved at the earliest stages of a company's formation. In some cases, we have founded the company ourselves and sought entrepreneurs to help us build them. While our sector expertise and investment strategies differ based on overall firm approach, the venture industry's criteria is

simple: we are looking for the most compelling business models that promise to improve the way we live or work and we are looking for the brightest entrepreneurs that have the tenacity and drive to partner with us for the long-term to build these new businesses and, if successful, create substantial value.

This formula has resulted in thousands of successful companies that have pioneered new frontiers. According to Global Insight, revenues from venture backed companies represented 17.6 percent of US GDP and 9.1 percent of private sector employment in 2006. As a whole, these companies grew jobs 2 ½ times faster than their non-ventured counterparts from 2003 – 2006 and outperformed in job and revenue growth for every industry sector measured.

These statistics stand to reason as venture capitalists have been recognized as the pioneers of entire industries such as the biotech sector, where venture-backed companies accounted for 54 percent of jobs and 60 percent of revenues in 2006. And this phenomenon is not unique to life sciences. Venture backed companies accounted for 77 percent of all semiconductor jobs, 88 percent of all software jobs and 94 percent of all computer and peripheral jobs in 2006.

And despite popular belief that our industry only resides in Silicon Valley, venture capital is a national phenomenon with investment going to all 50 states each year. While certain regions of the country – such as Northern California and New England have successfully established thriving venture-backed communities, others such as Seattle, Southern California, Texas, Washington DC, New York and Utah have grown substantially in the last five years. Still others such as Pennsylvania, Wisconsin, Colorado, Florida, Indiana, and Michigan are pursuing economic development strategies that seek to bring more venture capital investment to their states. Political leaders in these areas are seeking to do for their states what venture backed companies such as Dell have done for Austin or Medtronic for Minneapolis. The positive economic impact of a successful venture backed company headquartered in a region can be measured not only in jobs and revenues of *that* particular company but also by the spinouts of companies that inevitably emerge. A culture of entrepreneurship feeds on itself and can organically grow if the environment is properly nurtured. To this end, at Scale Venture Partners, we have investments in promising regions such as Utah, Arizona, Georgia, and Florida as well as along the entire West Coast from Seattle to San Diego.

It is important to recognize that despite the ever growing value created by venture capital, we are still a cottage industry in terms of size and aspirations. In 2006, the venture industry invested just $26 billion – representing only 0.2 percent of GDP. We currently have approximately $236 billion under management compared to the buyout or private equity industry which manages approximately $689 billion and the hedge fund industry which manages $1.5 trillion. And while venture investment numbers seem like a very small number relative to other areas of private equity, there are some in our industry who will argue that even this amount of investment is still too high. We recognize that there are a finite number of innovative companies that will return capital and that we as investors have a finite amount of time to nurture them. As an industry, we have no aspirations to scale much further than where we are today – and certainly wish to avoid the irrational exuberance that plagued our asset class in early 2000. We realize that our small investment goes a long, long way.

It cannot be emphasized enough that venture capital is all about risking time, effort and capital to create new companies that quite simply would not exist if this capital were not available. We do not rely on leverage; we do not rely on financial engineering nor do we buy and sell publicly traded securities. Instead, we help entrepreneurs create new companies and sometimes new industries, with all the jobs and the economic growth that come with them.

Venture capital has been behind such technology innovations as search engines (Google), operating systems (Microsoft), online video sharing (YouTube), and online auctions (eBay). We have supported business model innovations such as superstores (Home Depot and Staples), quality food chains (Whole Foods), and coffee houses (Starbucks). And venture capitalists have invested in life saving medical innovations (pacemakers, Integrillin, Herceptin, ENBREL, and Ultrasound). While these companies and innovations are household names today, they were at one time just ideas put forth by unknown entrepreneurs who had little experience in growing a business. The infusion of venture capital dollars and expertise moved their products to market and, in doing so, these companies created new markets that have made our lives easier, better and more productive.

Our quest for innovation is perpetual. Within the last year, our industry has set its sights on innovating in the cleantech space – alternative energy, biofuels, recycling, clean power supplies, and conservation. If precedent holds true, some of the most exciting companies in this space are being funded by venture capitalists today. To find out – stay tuned until 2020. And yes – I really

mean thirteen years from now. That is a typical investment horizon; it is often that long until we know whether our companies will succeed or fail. To this point, I would now like to spend some time on how a typical venture capital firm works.

The Fundamentals of Venture Capital Investing, Compensation and Partnerships

The Venture Capital Investing Process

Venture capital funds typically are organized as partnerships. Although as VCs we invest significant portions of our personal savings in start-up companies, the capital needed by the emerging growth sector far outpaces our individual assets. For this reason, institutional investors such as pension funds, universities and endowments, and private foundations typically provide between 95 to 99 percent of the capital for the VC fund. Venture capitalists provide the remaining amount of capital from our personal assets. The VCs and institutions join together in a VC fund as the general partner (GP) and limited partners (LPs), respectively.

Once the venture fund is formed, our job is to research markets that have the potential to grow exponentially with application of new ideas and risk capital. We then work to identify and nurture promising, innovative companies within these new markets. This nurturing takes the form of money and strategic management, including intangible guidance and goodwill – all equally important to the company's ultimate success. When we cannot find a suitable company within a target sector, we can and have founded the company ourselves and recruited a set of entrepreneurs who will partner with us to develop this new start-up.

Our job is not unlike raising a child from infancy to early adulthood. At some point in the future we hope the company reaches maturity and can go public or become acquired. But you can not just throw money at a company and expect it to succeed. As part of our investment, we take an active seat on the board of directors and provide strategic guidance for management based on our expertise. From time to time, we may also step in to help with certain management roles while the team is being built. Venture capitalists often have advanced science degrees and operational start-up expertise so our activities run the gamut from providing input on prototypes to implementing business development strategies to protecting intellectual property rights. We also instill and insist on formal corporate governance procedures including the development of formal committees and standard reporting procedures.

In addition, we make valuable intangible contributions to the companies through our knowledge of business processes, personal contacts and networks with customers, suppliers, distributors, and potential key hires. The strong reputation and goodwill established by our firm is often the key to continuously open doors which would otherwise remain closed to a start-up company throughout its life cycle. For example, consider a company such as Intel that is looking to purchase new technologies to fabricate their semiconductor chips. Given the sophistication and risk involved in the fabrication process, Intel would be unlikely to purchase a technology from a stand alone start-up company. But if that start-up had the financial backing and support of my venture firm or one of my colleague's venture firms, the start-up's product could be considered. For example, I have 3 partners with electrical engineering degrees, including the former Chief Marketing Officer of AMD, who spent most of their professional lives building products in the semiconductor industry. Additionally, our firm has sold companies to Intel, Cypress Semiconductor and JDSU.

All of this broad industry experience adds significantly to the entrepreneur's calling card when they are building their business. This is the venture capital industry's good housekeeping seal of approval and it is how start-ups break into markets that have entrenched suppliers. In this regard, our contacts and goodwill are the lifeblood of venture-backed companies. This is why entrepreneurs actively seek out venture investors who can add value to their companies.

Our sweat equity goes well beyond contacts and reputation. I typically connect with each of my company's management teams 3 to 4 times per week. Because of the level of involvement with our portfolio companies, individual VCs typically sit on no more than 5-7 boards at any one time. Currently, I personally sit on 3 boards and back up newer partners on more than a dozen. My partners have a similar threshold with an average of 6 boards per person among us. On average, we spend 70 percent of our time working with existing portfolio companies and only 10 percent making investment decisions. We spend another 20 percent of our time with professors, entrepreneurs and technology experts in order to identify and analyze the next emerging market like clean tech and then look to find the best team within that market to invest in. The network and knowledge base that we build during our investigative phase is one of the assets we bring to a start-up when we join the board.

Venture capitalists invest in companies for anywhere from 5 to 10 years, often longer and rarely less, with the ultimate goal for the company being an initial public offering or acquisition, generating a long-term capital gain. Because we focus on high-risk technological advances, many VC-backed companies fail. In fact, a venture industry analysis we recently conducted found that on average, 40 percent of all venture investments lose some or all of the invested money. The next 40 percent generate a modest profit that returns the total capital invested and repays the fund for all of our operating expenses over the life of the fund. Only 20 percent of venture investments achieve realizable and meaningful gains. It is this last 20 percent that carries the returns for most venture funds. This is the nature of our business. We dig many dry wells – the cost of which is delicately balanced by gains earned from our successful investments. This balance is critical for us to maintain support for our entire portfolio of hopeful start-ups.

Compensation Arrangements of VC Funds

For the work that we do, the venture capital firm typically receives two types of income – a 2 percent annual management fee and a 20 percent share of the VC fund's cumulative net profits. This 20 percent entrepreneurial profit share is typically referred to as the "carried interest." The management fee is guaranteed; the carried interest is entirely contingent upon a profitable fund.

While there are deviations from the norm, 2 percent and 20 percent have been consistent industry standards since the inception of the modern venture capital era, typically viewed as beginning in the 1970s when the Department of Labor's ERISA rules were revised so as to permit pension funds to invest in the asset class. Practically, this means that thirty years ago when Bob Swanson, the founder of Genentech, was looking for and found venture capital, the same carried interest structure was in place as exists today. It has worked and continues to work very well.

The 2 percent management fee is calculated annually as a percentage of the fund's total capital committed by its investors and typically declines over the life of the fund. It is used to pay for our business operations, office space and systems, technical experts, research, travel expenses to meet with companies, as well as the entire firm's salaries including administrative and operations personnel. The management fee, including the salaries that we and our staff receive, is taxed as ordinary income.

The 20 percent carried interest is negotiated between GP and their LP's as *partners* and, in the venture capital world, is dependent on the fund's cumulative net profits, as calculated over the life of the fund. Gains and losses and usually expenses are netted for purposes of determining the 20 percent profit share. In non-tax parlance, this means that our partnership must have earned a profit over and above the contributed capital, including the management fee and expenses over the life of the fund, and across the entire basket of portfolio companies nurtured by our fund before we are entitled to our entrepreneurial profit share. In this regard, there is full *alignment of interests* between the GP and the LPs to maximize the value in all of the underlying portfolio companies.

This structure results in relatively straightforward partnership taxation. In its early years, the VC fund makes investments in portfolio companies and pays expenses, so the VC fund likely will only generate a net loss from expenses. These cumulative losses generally are allocated to all partners in proportion to their capital contributions. When portfolio companies are sold at a gain, the net profit typically first "reverses" the net losses previously allocated. Thereafter, the cumulative net profit typically is allocated 20 percent to the GP and 80 percent to all limited partners in proportion to their capital contributions.

Because the ultimate net profits of a VC fund are not determinable until the end of the fund's term which is typically well over 10 years, distributions of the carried interest to the GP are typically delayed until the LPs' capital contribution has been returned to them. These contributions include capital used to purchase companies that have not yet been sold *and* capital used to pay expenses, including the GP's management fee. The return of this capital typically will not begin to be achieved until 7 years into a fund. Only then is the carried interest shared with GPs.

The VCs must pay tax on their carried interest as soon as the VC fund is cumulatively net profitable, which typically occurs in years 3-4. Because the GP carried interest distributions typically are delayed until all capital and accumulated expenses have been returned, which typically occurs in years 6-8, a type of "reverse deferral" (an acceleration of tax) is created. This requires the GP to negotiate to receive "tax distributions" from the VC fund. Like an advance or a "sales draw," these tax distributions will reduce the amount of carried interest later paid to the GP.

Carried interest is never guaranteed but it is taxed on a flow-through basis, determined by the character of income earned by the partnership. Given the early-stage nature of venture-backed companies, dividends are rare. Debt investments that might give rise to interest income, other than bridge loans, are also uncommon. Because the primary economic benefit in a VC fund arises from the value created in a pool of long-term investments, most of the VC fund's income that flows through to its partners (including the GP) is characterized as a long-term capital gain which Congress has determined to tax at a preferential tax rate. A VC's effective tax rate is often higher than the long-term capital gains rate, however, since the share of a VC fund's expenses (including the management fee) that flow through the VC fund to a VC generally are limited in deductibility or not deductible at all.

The Value of Sweat Equity and Intangibles

Consistent with current partnership tax laws, the VC fund structure encourages the pooling of labor and capital by allowing the partners to divide the profits from the enterprise – whether created by the VCs' labor or the combination of the VC and LPs' capital – in whatever manner they determine best rewards the long-term, entrepreneurial risk taken by each partner. This flexibility is essential to creating efficient and productive businesses and to attract new talent to the venture industry.

As venture investors, we assert that it is appropriate to reward investors of sweat equity with the same long-term capital gain tax benefits that investors of financial equity receive. Both will only succeed if the business builds in value – so both are subject to the same entrepreneurial risk and our interests our aligned. In fact, if only financial investors were to receive this tax benefit, then only those with existing financial wealth would be "subsidized" by the government for their investment. But if the VCs' contributions of time, effort and counsel – as well as the intangible contributions made by VCs in the form of customer and supplier contacts, business process know how, and value-building and reputation – are as valuable to the success of the business as contributions of financial capital, and if the VCs do not receive their share of that value until after the financial investor receives its share, then both should be subject to the same tax treatment.

Venture capitalists often work with scientists and professors, who have made their discoveries in government-sponsored labs and universities, but need additional support to bring their innovations to market. By enabling the commercialization of these products, we often help the

government realize further their investments in basic R&D. This is especially true in the life sciences sector where, following the doubling of the NIH budget, the VC industry now invests at least one third of all our dollars getting these innovations out of the labs and into the hands of actual patients. We operate in a similar manner in computer technologies and intend to work with government sponsored researchers to commercialize innovative clean technologies during the next decade.

Often the most brilliant scientist, doctor, or professor lacks the business experience to build the company that will ultimately bring their products to the public. In these cases, venture capitalists serve as the business minds that, when combined with the science, create the successful commercial enterprise. For instance, in our portfolio we have a hardware components company which was founded by a very intelligent and talented scientist. While the product was extremely promising, the founder had never started, let alone run a business before. He had other financing options but chose venture capital because of what we brought to the table. After we made our initial investment, we stepped in and supported this founder through such critical activities as developing a long term business plan and budget, identifying and connecting with business partners, writing job specifications for the sales and marketing positions, and helping to line up subsequent financing. Without this intangible contribution, his technology would still be just as exciting and as promising – but that's *all* it would be – just a promise. In giving these innovations a life, we are also creating a viable, sustainable company that will go on to innovate again and again -- well beyond their initial product.

I realize you may have further questions regarding venture capital carried interest. First, you might ask why my carried interest is different from an option. One reason is that I don't have the choice to walk away. My investors require that I contribute a significant portion of my own personal savings to the VC fund, so if the companies perform poorly, I will *lose* money. Second, as an actual equity owner of the VC fund, I am subject to all of the partnership tax rules which apply, not to mention legal fiduciary obligations to my partners. I must report some combination of income, gain, loss and expense of the VC fund on an annual basis on my tax return. Because my economic arrangement is determined over the life of the VC fund, but I have to report and pay taxes annually, I can *lose* money that I've paid in taxes simply because of my status as a partner. For example, if there are early gains and later losses in the VC fund, I might have to pay tax on my carried interest share of the early gains, but if later losses offset those gains, I might never be entitled to the economic benefit of that carried interest upon which I paid tax. Since later,

offsetting losses, generally can only be deducted against future capital gains, if I do not earn any capital gains in the future, I will lose the tax benefit associated with those losses. With an option there is only an upside. With carried interest there are two sides – up and down.

You might also ask why my carried interest is different from compensation received by other service providers. As mentioned, my carried interest is *contingent* upon value being built in the entire portfolio of companies that I work with. Other service providers such as consultants receive *guaranteed* payments – similar to my management fees. Even if a portion of their compensation is performance-based, that compensation typically is based on *annual* performance whereas my carried interest (in order to get the tax benefits of long-term capital gain) is attributable to value built up in my portfolio companies over many years. Furthermore, when performance-based compensation is paid to other service providers, it depletes the assets of the business, thereby depleting its value. When I receive carried interest, that means that the business was sold and a third party has paid me, leaving the assets and value inside the business. Other performance-based compensation, whether paid by a company to its executives or paid to a lawyer as a contingency fee upon winning a case, does not involve the sale of a capital asset – a condition currently and historically required to receive capital gain treatment. My carried interest, on the other hand, is only afforded long-term capital gain treatment if my VC fund sells a business, a capital asset, in which value has been created.

My carried interest is very similar to founder's stock or a sole proprietor's interest in his business. When founders start a company, they typically receive common stock in the company in exchange for their ideas and labor. At some time, the company may issue preferred stock to a financial investor in exchange for what is presumably far more financial capital than the founder invested. If the company is successful and is sold or goes public, the founder will be permitted to sell the founder's stock and receive long-term capital gains tax treatment. Even company executives or employees who receive "restricted stock" after the start-up has received venture financing can receive long-term capital gains treatment when they later sell their stock. The only distinction is that if the executives pay less than fair market value for the stock upon receipt, they will recognize ordinary income for the difference upon receipt. But all of the later "upside" is eligible for long-term capital gains treatment.

Carried interest is like the stock received by the founder of a start-up company because we both receive equity interests in our businesses that are disproportionate to the financial capital invested

in those businesses. The same might exist for a sole proprietor who borrows financial capital from a lender. Each of us, however, invests time, energy and money in the hopes of building value in our businesses. As a result, we all should (and currently do) receive capital gain tax treatment when we sell our businesses and that value is realized.

Consider the scenario in which two friends come together to form a business. One friend has the time and passion to run the enterprise on a daily basis; the other has the financial capital to allow the business to set up shop and open its doors. Historically, if that business is successful at the end of the day, the partners determine how to share the profits, even if they determine to do so in a manner that is not pro-rata to the financial capital each committed at the outset. The ecosystem of the entrepreneur, venture capitalist and limited partners is analogous: all contribute different components in hopes of making the start-up profitable but the limited partners have decided to split their part of that potential profit in a non-pro-rata manner in order to reward both the entrepreneur and the VCs. At the VC fund level, the limited partners have essentially made the decision that if the fund is cumulatively profitable, balancing all the portfolio company investments, then they are willing to give an extra profit incentive to the venture capital partner in exchange for the value they have created from actively working with portfolio companies.

If sweat equity or intangibles are not recognized as having long term value associated with them, then venture capitalists may as well be passive investors. This scenario would be potentially devastating to the entrepreneurial community that actively seeks venture capital for the intangible value of expertise and networks they receive alongside the financial investment. They are not in the market for high risk credit – which is what venture capital would become without the sweat equity. For the entrepreneur's sake, we don't believe that Congress wishes to change the venture capital value proposition – our investment and sweat equity create value long term together. This is the spirit in which capital gains tax policy was enacted – and it has fostered the environment needed for a thriving entrepreneurial community here in the United States.

Venture Capital Needs Consistent Policy Conducive to Investment

The National Venture Capital Association represents over 480 venture capital firms, investing in multiple industries and multiple regions across the United States. Across this diversity lies one commonality for innovation and entrepreneurship to succeed: a consistent alignment of critical investment drivers including robust capital markets, access to talent, and a regulatory and tax

environment that supports risk-taking and allows failure. Despite the value and economic strength created by venture capital investment, we are still a small and fragile industry. Our investing dynamics are highly susceptible to changes in our ecosystem. In 1979, the creation of the prudent man rule by the Department of Labor which permitted pension funds to invest in venture capital fundamentally changed our asset class for the better. Changing the tax law around carried interest and capital gains could have the same size impact – but for the worse.

My peers and I are regularly asked by state economic development leaders from across the country what they can do to increase venture investment in their region. Our answer is consistent. You must foster an environment that 1) feeds the innovation pipeline with basic R&D funding, 2) attracts and retains entrepreneurs through opportunities to grow their businesses and 3) encourages venture capital investment and long term risk taking through favorable tax and capital formation policies. The same advice holds true at the national level. The United States is home to the world's most innovative and entrepreneurial minds. But these minds need venture capital investment and expertise to bring their innovations to market. Otherwise, the ideas are stuck in the labs, garages, and computers, awaiting funding and know how.

Since the 1970s, the US entrepreneurial system has been the envy of the world. Uniquely, our system not only leveraged the attributes listed above, but also consistently fostered an environment that allowed entrepreneurs to take a risk, start a company, access capital and to succeed *or* fail. Just as we have seen the emergence of a global economy in almost every sector of society, in the last several years we have begun to see the US venture capital model exported to other developing countries such as India, Israel and China. Not only are US venture capitalists investing in foreign companies but some are actually leaving the United States to set up funds domiciled in these regions.

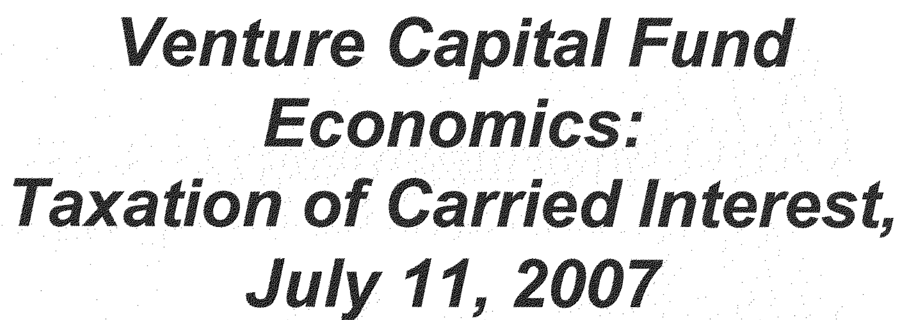
Perhaps more significant, those countries, which now have expanding internal markets and participate in the global economy in a more comprehensive manner, are also fostering indigenous venture capital markets. Foreign born nationals who have been educated in the US, and perhaps have started companies here, now have a viable option to return home and become part of the local venture base, whether in Israel, India or China. This was not the case just five years ago. Also many foreign countries have witnessed how venture capital has benefited the US economy and are becoming very aggressive in attracting these talents to their shores. We have seen this with the burgeoning semiconductor business in China, with the biotech industry in Singapore, and

in the large and growing software market in India, all of which are being led by foreign nationals who began their careers in the US. Even in Europe where considerable pressure is being placed on the private equity industry, government officials are simultaneously affirming support for venture investment in small start-ups. Given the opportunity, these foreign economies would be all too happy to grab the brass ring from the United States. The game is ours to lose.

To continue to foster an environment of venture investment and entrepreneurial success in the US, we need public policy makers to continue to embrace a consistent, long-term perspective as it relates to capital formation policies, including taxes. As an industry, we are eager to continue to invest in entrepreneurs with the same enthusiasm and commitment that we have put forth in the past, but we do require your support. Our limited partners (and their beneficiaries such as public pension fund holders, university endowment beneficiaries, and private charitable foundation grant recipients) must be assured that their costs of investing in venture funds will not increase because the balance of partnership income is suddenly thrown off kilter. And the next generation of talent – faced with the option of following in my path or choosing a less risky career with a shorter payout horizon– needs the incentive to become a venture capitalist in search of the next Google. We are already competing with more lucrative and more guaranteed career paths – we do not need additional hurdles to continue to attract the best and brightest minds to our asset class.

America has always rewarded risk takers from its earliest days until now. Through our capital markets, our tax laws and our regulatory structures, the government has made it possible for those with a promising idea to take the leap of faith and set out on a risky but potentially rewarding path. And while we have moved a long way from the early settlers betting their lives for a better way of life, this spirit lives on today in the entrepreneurs that are taking respective risks to make life better for all of us. We believe that Congress has understood well the venture capital value contribution to this process and has enacted and maintained tax policies that promote our activities. We are hopeful you will continue supporting this legacy of innovation so that the US can maintain its leadership for years to come.

Thank you for the opportunity to speak with you today.

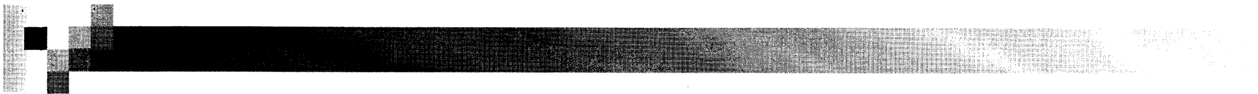


Venture Capital Fund Economics: Taxation of Carried Interest, July 11, 2007

Senate Finance Committee Hearing

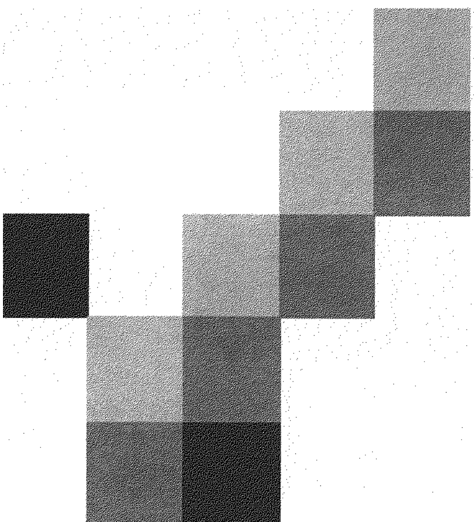
Attachment A to testimony of Kate D. Mitchell, Scale Venture Partners

IN ACCORDANCE WITH TREASURY REGULATIONS GOVERNING PRACTICE BEFORE THE IRS (CIRCULAR 230), WE HEREBY INFORM ANY TAXPAYER THAT (A) THE INFORMATION CONTAINED IN THIS DOCUMENT IS NOT INTENDED OR WRITTEN TO BE USED, AND CANNOT BE USED, BY ANY TAXPAYER FOR THE PURPOSE OF AVOIDING PENALTIES THAT THE INTERNAL REVENUE SERVICE MAY ATTEMPT TO IMPOSE ON AN INVESTOR, (B) THE INFORMATION WAS WRITTEN TO SUPPORT THE PROMOTION OR MARKETING OF MATTERS ADDRESSED BY THE WRITTEN INFROMATION AND (C) TAXPAYERS SHOUD SEEK ADVICE BASED ON THEIR PARTICULAR CIRCUMSTANCES FROM AN INDEPENDENT TAX ADVISOR.



Contents

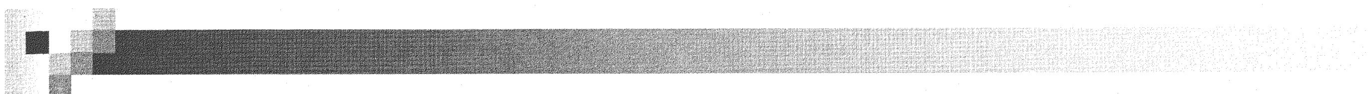
- Venture Capital Basics
- Venture Capital Fund Economic Arrangements
- Allocations: Current Taxation of Carried Interest
- Common Distribution Methodologies
- Clawback Provisions
- History of Tax Partnerships



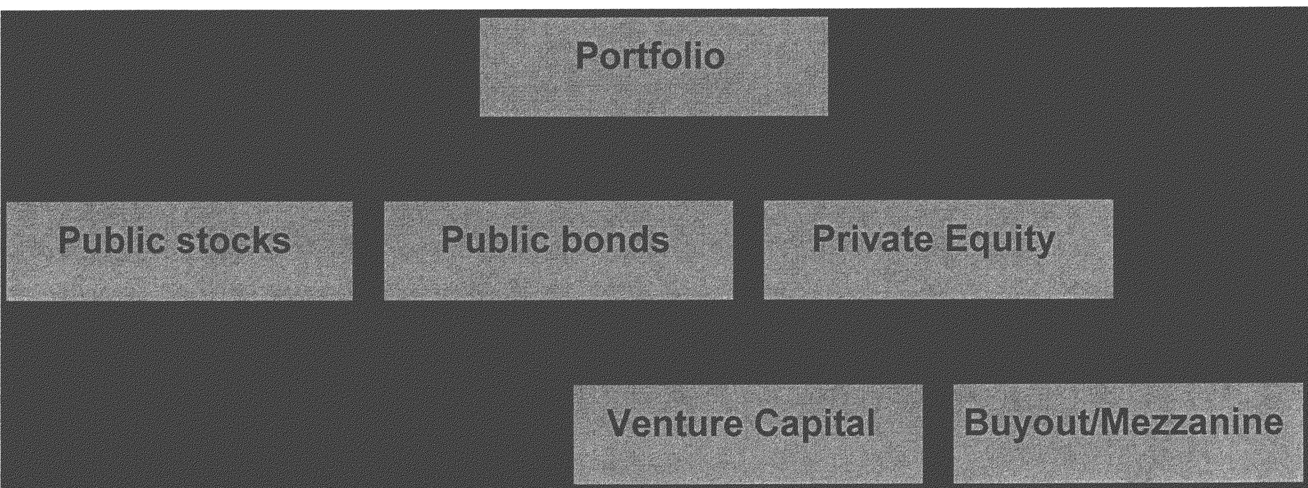
Venture Capital 101 Nuts & Bolts

For the Entrepreneur – Many Options to Choose From

- Personal Funds
- “Friends and Family”
- Personal credit card/other debt
- Angel investors
- Venture capital
- Corporate direct investment
- Venture leasing
- Mezzanine Financing
- Merger and Acquisition
- Initial Public Offering
- Secondary/Follow-on Public Offering
- Private Placements – Debt & Equity
- Buyout/Acquisition Financing
- Corporate Debt



Venture Capital as an Asset Class



Venture Capital Investment is Productive

- For VC every dollar invested in 1970-2005, there was $5.45 in US revenue during 2005
- For every $38,500 of venture capital invested in 1970-2005, there was one job in the year 2005
- Of the $385 billion invested in 1970-2005, over half of it has been invested in the last 6 years and is not yet a significant contributor – true impact likely much higher than portrayed above
- Provided 10.0 million US jobs; Sales of $2.1 trillion (16.6% of GDP)

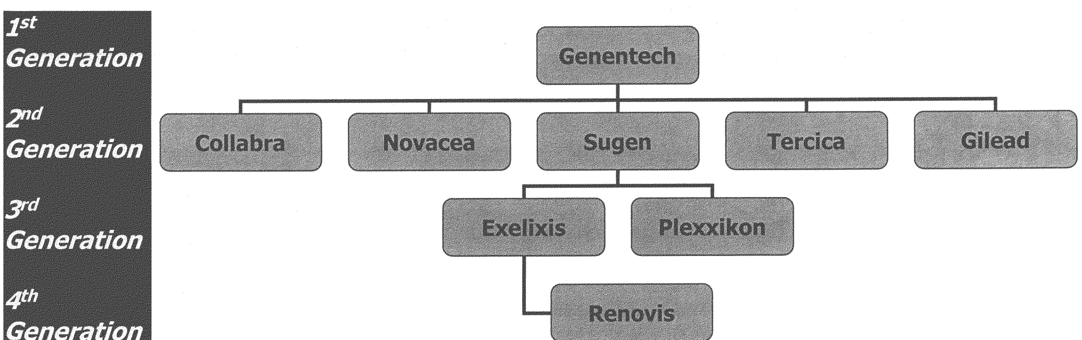
Source: Venture Impact 2007 by Global Insight

Whole New Sectors Have Been Created...And Will Be Created

- Biotechnology
- Network Security
- Package Delivery
- OnLine Retail
- Health Care Devices
- CRM
- Intelligent Merchandising
- ERP Software
- Medical Devices
- Auto ID/RFID
- WiFi Networks
- Genomics
- Wireless Messaging
- Security Technology
- Web Services
- ...

Venture Capital Investment Ripples Out to Other Companies

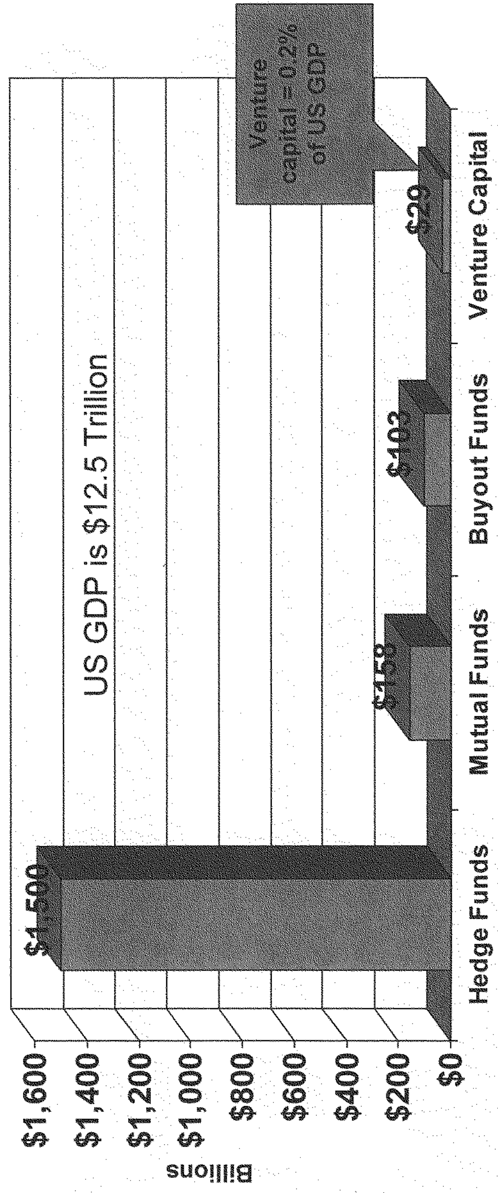
- Venture Capital leads to the spawning of new companies, often with groundbreaking technologies that occurs frequently with successful venture-backed companies…entrepreneurs regroup and continue to innovate…VC's continue to back these proven teams



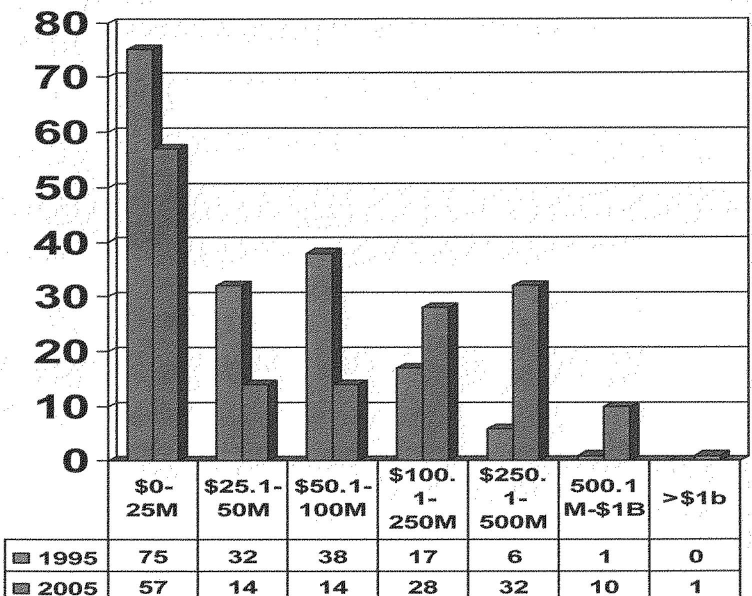
Typically Buyout Funds Out Raise Venture 2x-4x

Year	VC Raised $B	BO/Mezz Raised $B
1998	30	60
2000	105	77
2003	11	30
2004	17	52
2006	29	102

Source: Thomson Financial / National Venture Capital Association – News release 1/16/2007 and prior releases


US Venture Capital Investment in Perspective
Private Equity Annual Intake
US GDP is $12.5 Trillion
Billions
$1,600
$1,400
$1,200
$1,000
$800
$600
$400
$200
$0
$1,500
$158
$103
$29
Venture capital = 0.2% of US GDP
Hedge Funds
Mutual Funds
Buyout Funds
Venture Capital
Source: BLS website, Investment Company Institute, Thomson Financial, NVCA

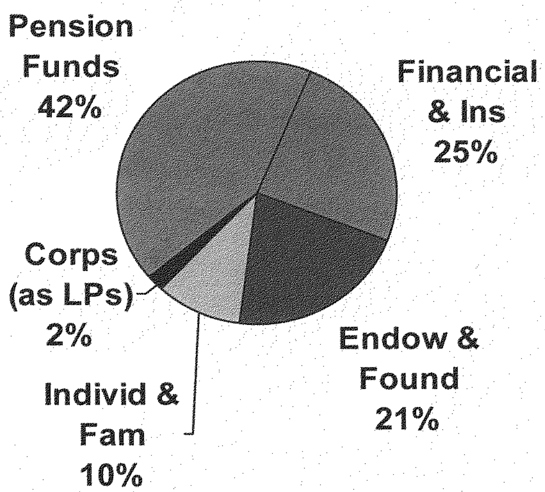
Number of Funds by Size: 1995 vs. 2005



	$0-25M	$25.1-50M	$50.1-100M	$100.1-250M	$250.1-500M	500.1M-$1B	>$1b
1995	75	32	38	17	6	1	0
2005	57	14	14	28	32	10	1

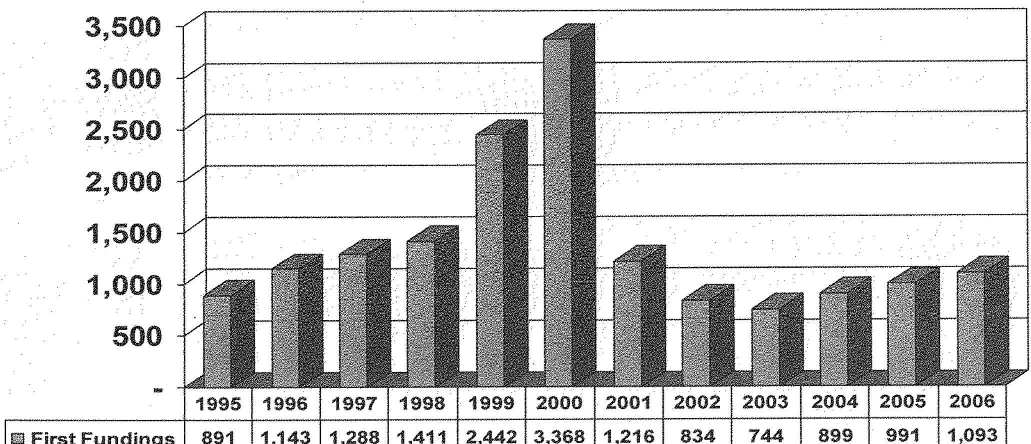
Source: VentureXpert™ Database by VE & NVCA

Sources of Venture Funds



Source: 2003 data from 2004 NVCA Yearbook, prepared by Thomson Financial, page 22

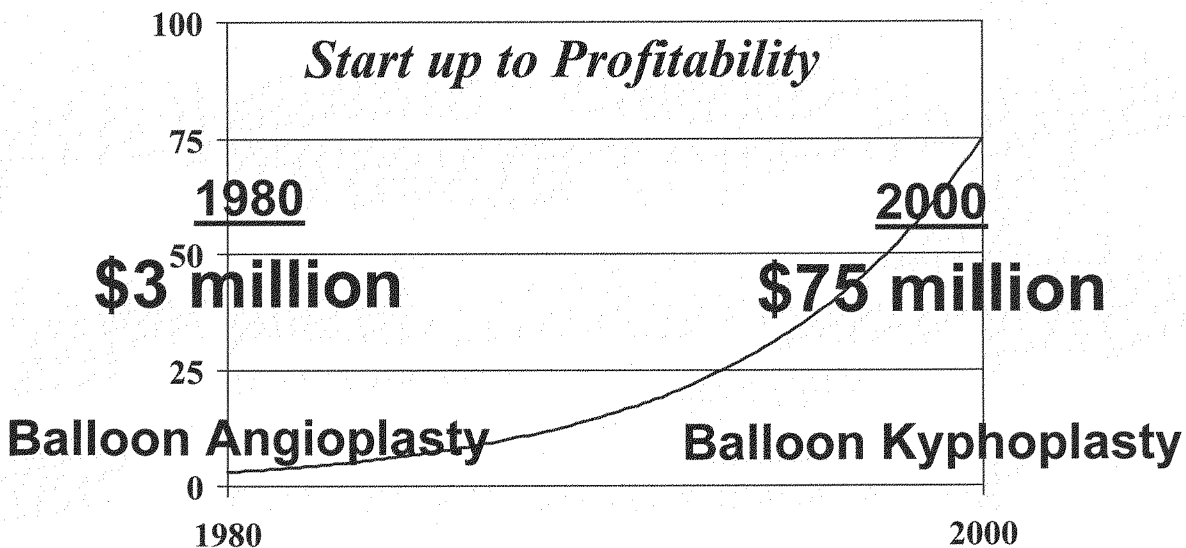
The Number of First Time Fundings (New Companies) is Up

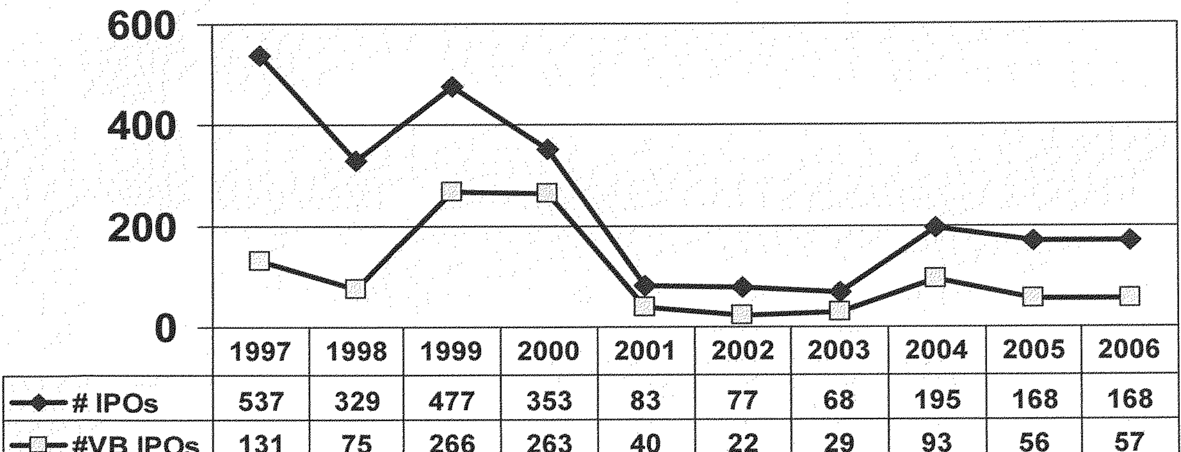


	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
First Fundings	891	1,143	1,288	1,411	2,442	3,368	1,216	834	744	899	991	1,093

Source: PricewaterhouseCoopers/National Venture Capital Association MoneyTree™ Report, Data: Thomson Financial

Funding Requirements for Medical Devices – One Example



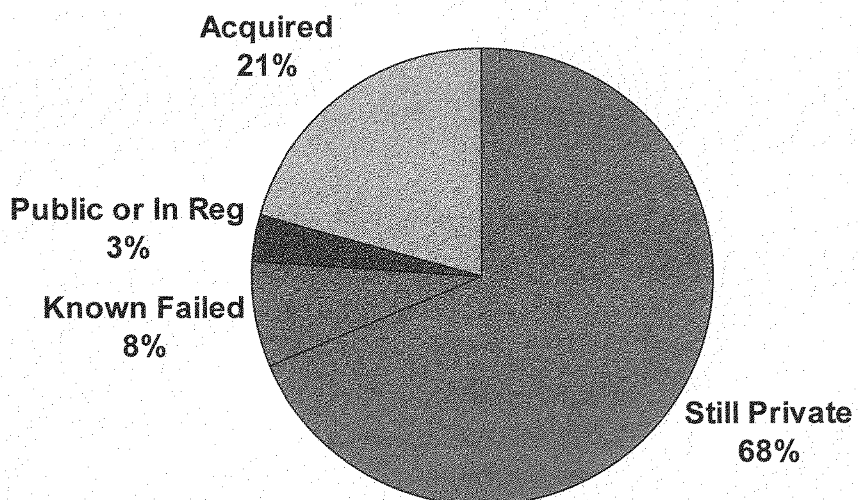


	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
# IPOs	537	329	477	353	83	77	68	195	168	168
#VB IPOs	131	75	266	263	40	22	29	93	56	57

Source: Thomson Financial/National Venture Capital Association

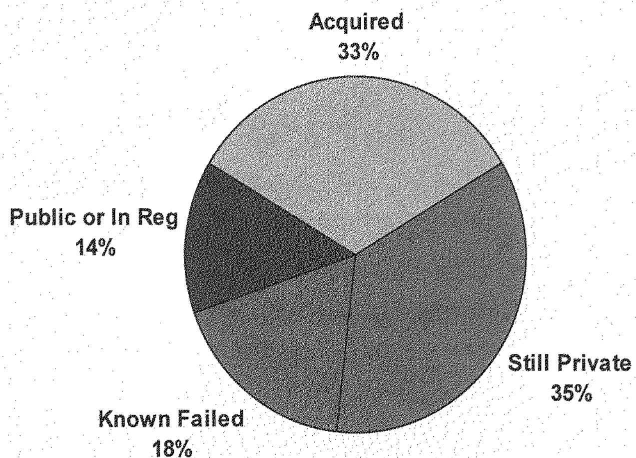
Of Companies Receiving First Funding in 2001 and 2002, There Are Few Exits

2040 Companies Total

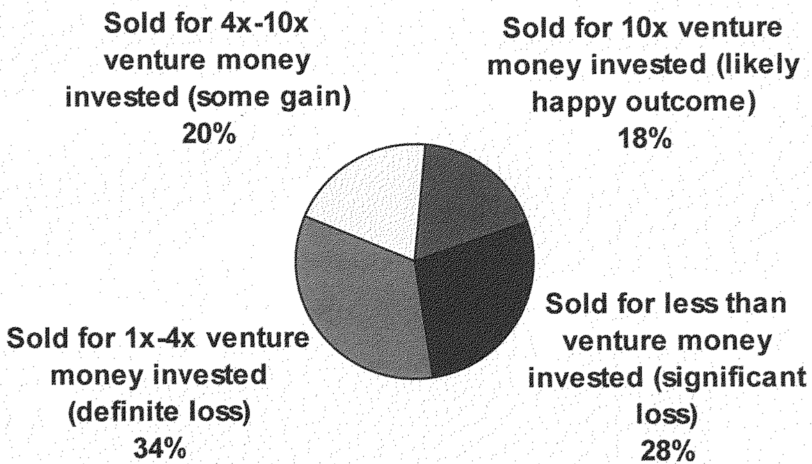


Source: PricewaterhouseCoopers/National Venture Capital Association MoneyTree™ Report, Data: Thomson Financial

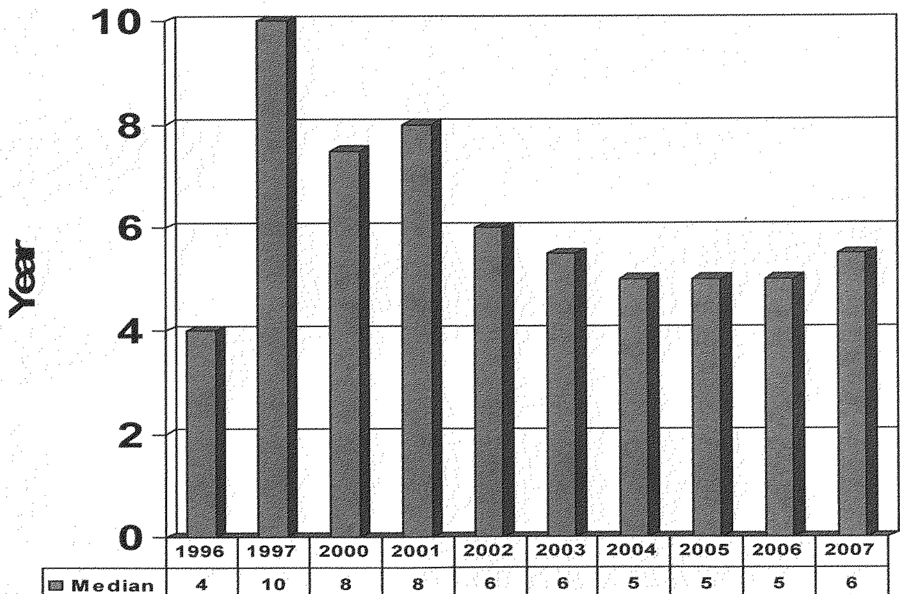
For First Fundings From 1991 to 2000, Approximately 33% Were Acquired and 14% Went Public



Source: PricewaterhouseCoopers/National Venture Capital Association MoneyTree™ Report, Data: Thomson Financial


Exit Through Company Sale Success Rates 2006
(Based on typical VC ownership percentage of 25%)
Sold for 4x-10x venture money invested (some gain) 20%
Sold for 10x venture money invested (likely happy outcome) 18%
Sold for 1x-4x venture money invested (definite loss) 34%
Sold for less than venture money invested (significant loss) 28%
Source: 2007 NVCA Yearbook prepared by Thomson Financial

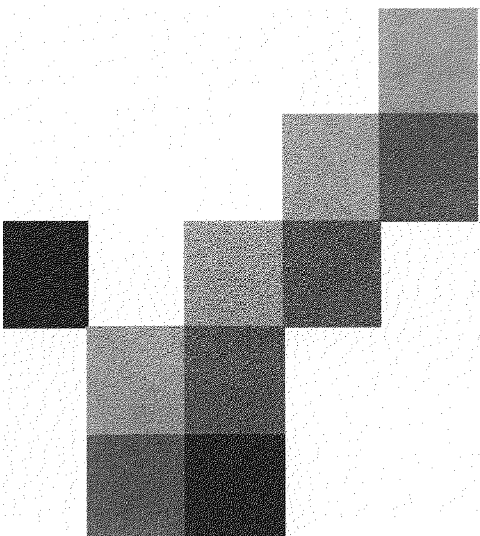
Actual or Projected Year of First Carried Interest Payout



	1996	1997	2000	2001	2002	2003	2004	2005	2006	2007
Median	4	10	8	8	6	6	5	5	5	6

Source: VentureXpert™ Database by Thomson Financial & NVCA

Venture Capital Fund Economic Arrangements



The Venture Capital Economic Deal - Basic 80/20 Split

- How do Venture Capital Funds operate? *Very simply*
  - Draw down capital from investors, both LPs and the GP
  - Use the capital to:
    - Invest in start-up companies
    - Pay expenses (management fees and other operational expenses)
  - Recognize income from the companies
    - Usually only when the companies are acquired/go public
    - Sometimes, but rarely, earn dividend income
  - Distribute cash proceeds from companies when sold or go public
    - Sometimes distribute stock of the companies instead
  - Recognize/distribute short-term income
    - Earned on drawndown capital before invested
    - Earned on proceeds before distributed

The Venture Capital Economic Deal - Basic 80/20 Split

- Fund Capital
  - GP Contributions ~ 1%; LPs contribute ~ 99%
  - The market generally requires that the GP contribution be a meaningful component of GP's net wealth, usually from 1-5% of Fund Capital
- Cumulative Net Profit
  - 80% per Capital; 20% carry to GP
    - Overall: 79.2% (LPs) and 20.8% (GP)
- Cumulative Net Loss
  - 100% per Capital
    - Overall: 99% (LPs) and 1% (GP)

The Venture Capital Economic Deal - Basic 80/20 Split

- An "Overall" Economic Arrangement:
  - Determined at inception of the VC Fund
  - Reflects an "overall" economic deal taking into account all VC Fund activity from inception to liquidation
  - Actual economic results will not be known until the end of the life of the VC Fund
  - Typical term of VC Fund is 10-year term with one or two 1-year extensions, plus a reasonable time to liquidate
  - Any interim distributions during the life of the Fund will be "trued up" if the GP is over-distributed through a "clawback" from the GP

The Venture Capital Economic Deal - Basic 80/20 Split

- GP Commitment is Significant
  - For an average VC Fund size of $100 million, GP entity typically contributes $1 million
  - This $1 million is shared by the individual VCs, often 2-5 individuals
- GP Commitment Subject to Actual Risk
  - Amount reflective of true economic/entrepreneurial risk
  - Many bubble-era VC Funds lost money overall, including GP's /individual VCs' money

The Venture Capital Economic Deal – Basic 80/20 Split

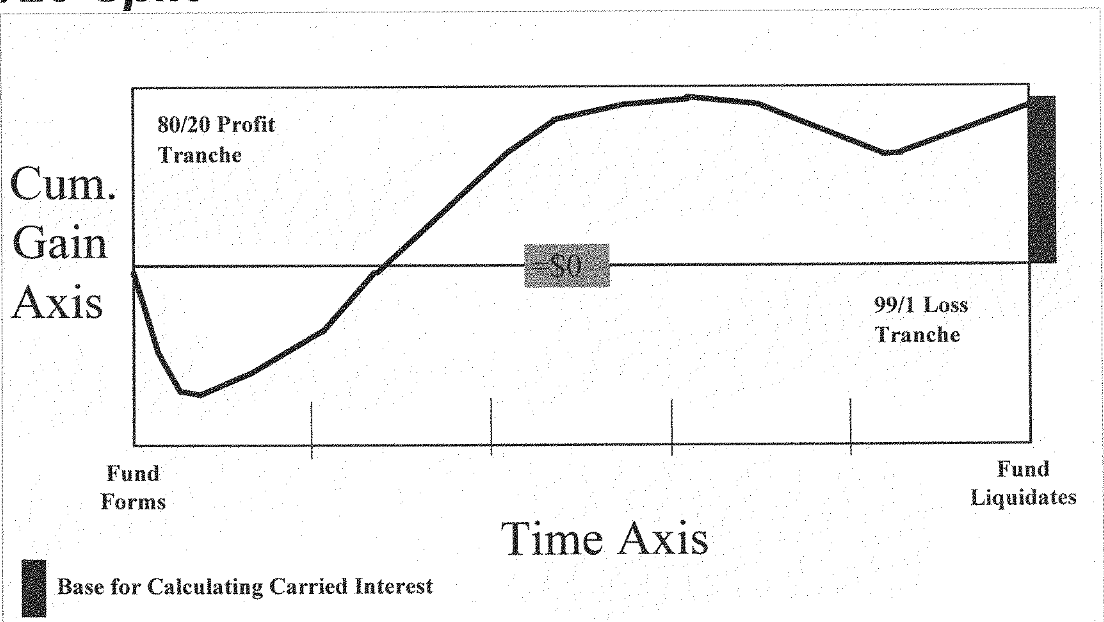
- A VC Fund itself, like any other partnership, is treated as the owner of property and earner of income/gains generated by the VC Fund
- Partners are subject to tax on their "distributive shares" or "allocations" on an annual basis
    - Tax reflects each partner's economic entitlement from the VC Fund

The Venture Capital Economic Deal – Basic 80/20 Split

- "Reverse deferral"
  - GP/Individual VCs are subject to tax on the 20% carried interest as soon as the VC Fund is cumulatively net profitable
  - Distributions of carried interest most often delayed until LP's capital contributions are first returned

The Venture Capital Economic Deal – Basic 80/20 Split

- The tax character of each item of income, gain, loss and expense is determined at the VC Fund level
  - Long-term capital gain results if companies that are sold have been held for more than one-year
  - Other types of income, less common, include short-term capital gain, dividends and interest – all subject to tax at ordinary income rates
  - Expenses are "Section 212" expenses, subject to limited deductibility under Sections 67 and 68 and not deductible under the AMT regime


The Venture Capital Economic Deal – Basic 80/20 Split
Cum. Gain Axis
80/20 Profit Tranche
=$0
99/1 Loss Tranche
Fund Forms
Fund Liquidates
Time Axis
Base for Calculating Carried Interest

The Venture Capital Economic Deal – Basic 80/20 Split

- What is Cumulative Net Profit?
- Gains from investments are netted against losses from investments over the life of the Fund
- What about other items?
  - Current Income, if any
  - Management Fees
  - Other Expenses
  - Short-term income

The Venture Capital Economic Deal – Basic 80/20 Split

- The basic 80/20 split can vary depending on how Management Fees are shared
- The GP's carried interest will be greater if Management Fees do not reduce cumulative net profit
  - Carry Percentage (20%) x Management Fees over Life of Fund (2% x Commitments x 10 years)
  - Example: 20% carry x 2% annual fee x $100 million commitments x 10 years = $4 million

The Venture Capital Economic Deal – Basic 80/20 Split

Example.

In Years 1 and 2, VC Fund draws down $100 -- $86 to invest in portfolio companies; $14 to pay expenses ($2/year)

- $99 from LP and $1 from GP

- VC Fund uses $46 to invest in Company A in Year 1, $40 to invest in Company B in Year 2, $14 to pay expenses in Years 1-7
- Company A acquired/goes public in Year 5 – VC Fund receives $100
- Company B goes under in Year 7 – VC Fund receives $0
- *Alternative*: Company B "goes sideways" – VC Fund recoups its money in an acquisition ($40)

The Venture Capital Economic Deal – Basic 80/20 Split

Example.

- Year 1-4: Net Loss in each year = $<2>
  - *Cumulative Net Loss at end of Year 4 = $<8>*
- Year 5: Net Gain = $52 ($54 gain from Company A; $<2> expense)
  - *Cumulative Net Gain at end of Year 5 = $44*
- Year 6: Net Loss = $<2>
  - *Cumulative Net Gain at end of Year 6 = $42*
- Year 7: Net Loss = $<42> ($40 loss from Company B; $<2> expense)
  - *Cumulative Net Gain at end of Year 7 = $0*
- Year 7 *Alternative*: Net Loss = $<2> ($<2> expense only)
  - *Cumulative Net Gain at end of Year 7 = $40*

The Venture Capital Economic Deal – Basic 80/20 Split

Year 5: $100 cash to distribute

- Distribute per capital contributions -- $99 to LPs and $1 to GP (No Carry Distributed)
  - Most common distribution methodology for VC Funds
- Net Gain = $52 ($54 gain from Company A; $<2> expense)
  - Cumulative Net Gain at end of Year 5 = $44
- ***GP pays tax in Year 5 on 20% carry or $8.80***
  - ***"Reverse Deferral" – GP pays tax on carry even though cannot take it until LP capital contributions are returned***
- GP also pays tax in Year 5 on its 1% interest like any other partner
  - 1% of $8 used to reverse out prior losses
  - 1% of remaining $44 less carry, or 1% of $35.20
- GP taxes consist of pro rata gain and expense items
  - *Expense items likely not deductible by GP so ultimate tax higher*

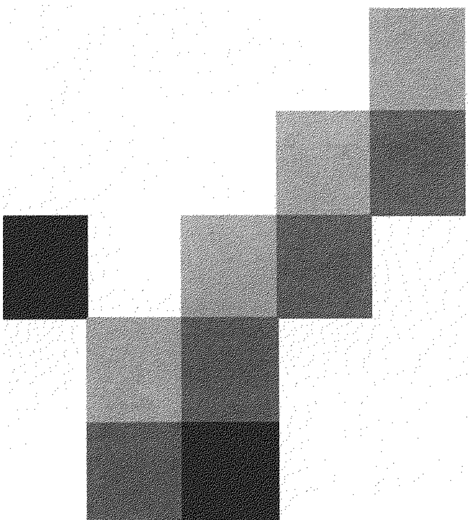
The Venture Capital Economic Deal – Basic 80/20 Split

Year 7: $0 to distribute

- Cumulative Net Gain at end of Year 7 = $0
- GP allocated Net Loss in amount to reverse out prior Net Gain allocations
- Net Loss = $<42> ($40 loss from Company B; $<2> expense)
- ***GP has been taxed in prior year on carry, even though ultimately not entitled to receive carry and, in fact, never received carry***

The Venture Capital Economic Deal – Basic 80/20 Split

- Year 7 *Alternative*: $40 to distribute
  - Net Loss = $<2> ($<2> expense only)
  - Cumulative Net Gain at end of Year 7 = $40
  - Distributions made so that GP receives 20% of Cumulative Net Gain ($8.00) plus 1% of remaining 80% ($0.32) over the life of the Fund
  - ***Distributions not subject to tax because they were already taxed in Year 5***



Allocations: Current Taxation of Carried Interest

Allocations: Taxation of Carried Interest

- **Allocation/Distribution Distinction**

- Allocations
  - Determine each partner's share of income and loss for tax purposes
- Distributions
  - Generally not taxable
  - Distributions are also taxed if cash is received in excess of basis
  - Distributions in kind take a carryover basis (for purposes of determining gain/loss on eventual sale)
  - Basis of distributions in kind is further reduced to the extent the carryover basis exceeds a partner's basis in its partnership interest

Allocations: Taxation of Carried Interest

- **Annual Accounting Concept**
- Every dollar of partnership income, gain, loss and expense must be allocated to the partners annually
  - ☐ No "warehousing" is permitted
  - ☐ More frequent allocation periods
- Taxes are assessed based on these allocations

Allocations: Taxation of Carried Interest

- **Allocation-Driven Agreements**

- Allocations of income or loss increase or decrease partners' capital accounts
- Liquidating distributions made in accordance with capital accounts
- Capital accounts control ultimate economics
- Interim distributions reduce capital accounts; negative capital accounts must be restored or additional income allocated so as to eliminate deficit

Allocations: Taxation of Carried Interest

- **Distribution-Driven Agreements**

- Allocations of income and loss are made to reflect each partner's right to distributions
- Liquidating distributions made in accordance with regular distribution provisions
- Capital accounts generally irrelevant
- Distributions control ultimate economics

Allocations: Taxation of Carried Interest

- **Tax Allocations**

- Allocation-Driven Agreements
  - Allocations made in accordance with "Section 704(b) safe harbor"
- Distribution-Driven Agreements
  - Allocations made in accordance with "partners' interests in the partnership"
- Either method should result in the same US federal income tax liability for the partners
- GP pays tax on its 20% share of cumulative net profits, when earned by the Venture Capital fund, regardless of whether that carried interest is distributed to the GP

Allocations: Taxation of Carried Interest

- **Section 704(b) Safe Harbor Requirements**

- Maintain capital accounts
- Liquidate in accordance with positive capital account balances
- Restore deficit capital account balance

or

- Provide for "qualified income offset"
  - Requires gross income allocations to eliminate any "unexpected" capital account deficit in excess of DRO

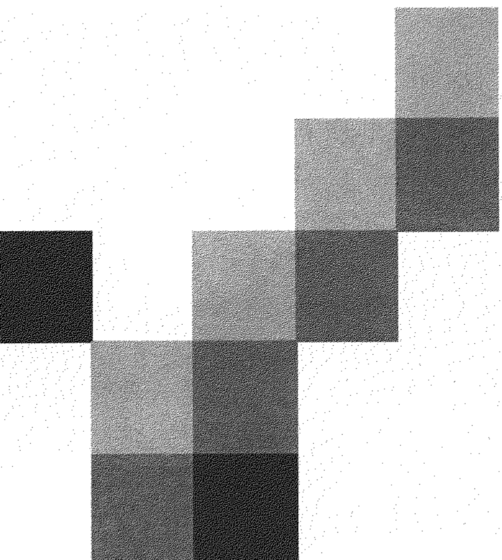
Allocations: Taxation of Carried Interest

- **Section 704(b) Capital Accounts**
- *Increased by:*
  - Money or FMV of property contributed
  - Allocations of taxable and tax-exempt income
  - Gain on distribution of appreciated securities
- *Decreased by:*
  - Money and FMV of property distributed
  - Allocations of tax losses and deductible/nondeductible tax expenses
  - Loss on distribution of depreciated securities

Allocations: Taxation of Carried Interest

- **Partner's Interest in the Partnership**

- Allocations are made to adjust capital accounts so that distributions will not cause capital accounts to be negative
- Not a safe harbor so tax results are less certain regarding timing and character
- Venture Capital funds use both methodologies (Safe Harbor and PIP), but we believe the majority fall within the Section 704(b) safe harbor



Common Distribution Methodologies

Distribution Methodologies

- Distribution methodologies are negotiated among the partners
- Distribution methodologies include the following (in order of predominance within the Venture Capital industry):
  - Return of Capital
  - FMV or NAV Tests
  - Preferred Returns
  - IRR/Multiple Hurdles

Distributions: Return of Capital

- GP does not receive its carry until Partners' Capital is returned
- What is "Capital"?
  - Commitments
  - Contributed Capital/Invested Capital
  - Cost of Disposed Investments and Expenses
  - Cost of Disposed Investments
  - ***Today, it is most common for Venture Capital funds to return Contributed Capital***
- "Catch-up" provisions

Distributions: Return of Capital

Example

- In Year 5, Security A had been disposed for $100.
- Commitments –
  - If Commitments = $1000, entire $100 distributed 99/1
- **Contributed Capital –**
  - **$100, entire $100 distributed 99/1**
- Cost of Disposed Investments and Expenses –
  - $56, so after $56 is returned 99/1, GP receives its $8 of carry
- Cost of Disposed Investments –
  - $46, so after $46 is returned 99/1, GP receives its $8 of carry

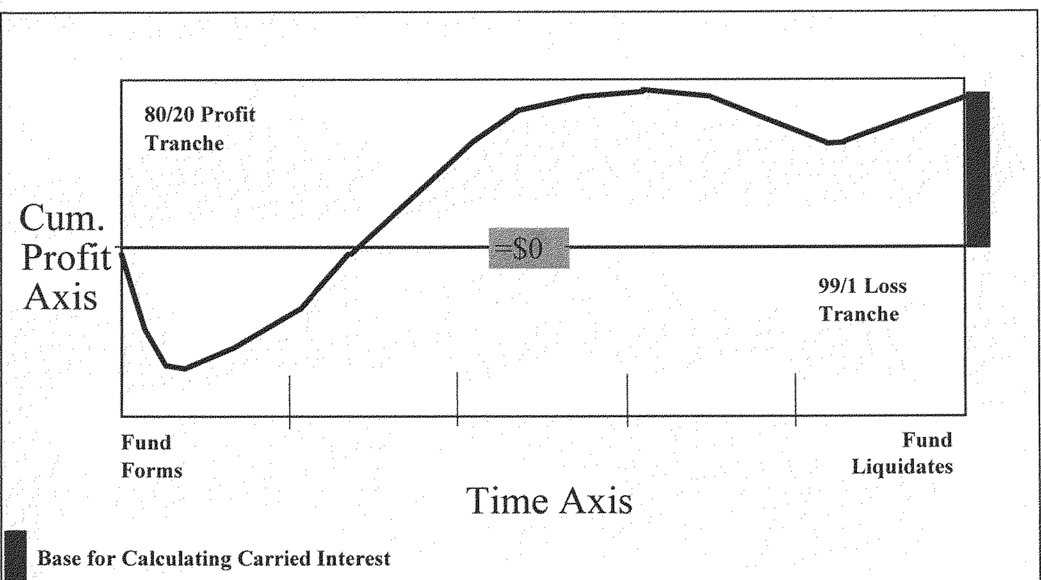
Interaction of Allocations and Distributions

- GP is entitled to 20% of cumulative net profit (allocations), but GP's 20% carry (distributions) might be delayed
- "Reverse Deferral" – GP is subject to tax currently without receiving current economic benefit
- Although most Venture Capital funds provide for the GP to receive distributions in order to pay tax, GP is not permitted to receive the remainder of its economic benefit until the distribution test is met

Interaction of Allocations and Distributions

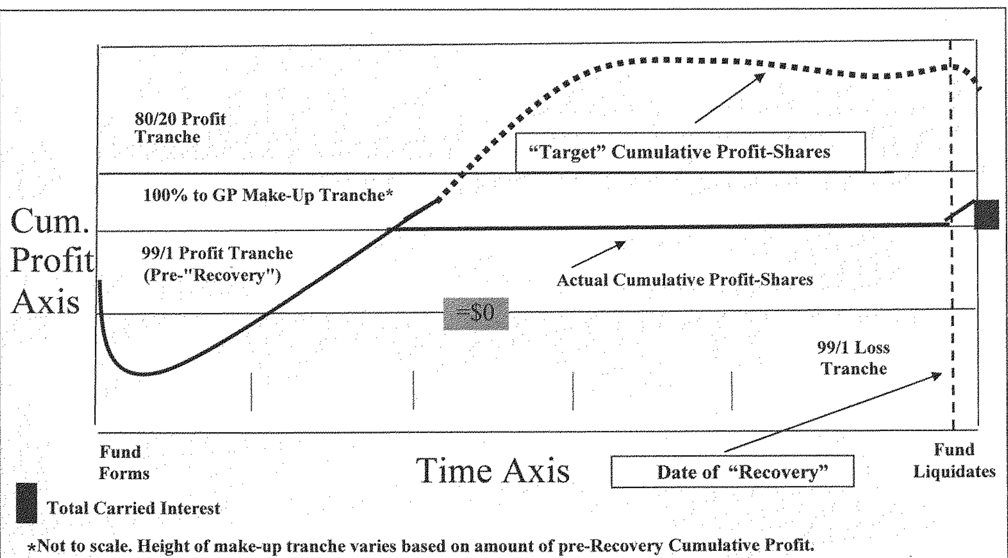
- *Alternative*: Some Venture Capital funds do not allocate 20% of cumulative net profit to GP until GP is entitled to carry distributions
- *Economic Risk*: If there are insufficient profits after the distribution test is met, the GP might not be entitled to its entire 20% carry distributions

Protect Economic Deal through Current 80/20 Allocations



Current carry allocations protect the GP ***unless*** the Fund distributes too much to LPs

Economic Risk if GP's 20% Carry Allocations are Delayed



In this example, a timing preference turns out to be a true preference

Clawback Provisions

- *Purpose*: Protect the basic 80/20 deal given that cumulative net profits is determined from inception of the Fund until liquidation
- If the Fund had early gains and later losses, then any distribution methodology (except one) could result in the GP being overdistributed
  - Exception: Return of Commitments, then 80/20
- Since the GP is obligated to restore this amount to achieve the basic 80/20 split, its capital account can be driven negative in the interim under the Section 704(b) safe harbor

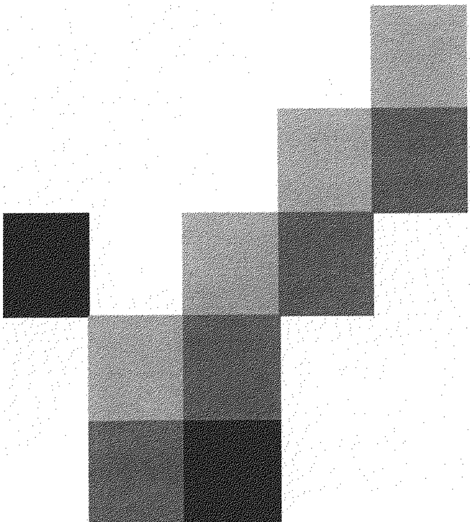
Clawback Provisions

- If the GP has received carried interest distributions in excess of 20% of cumulative net gain, then the GP must return this amount
  - GP has already been taxed on this amount
  - Only if GP is able to take a capital loss (as a result of the later return/contribution) will the GP avoid tax on this amount, even though GP not entitled to the economic benefit
- Preferred Return/IRR/Multiple version: Two-staged to ensure that the GP does not receive carry if the preferred return has not been received by LPs
  - GP gives back greater of (1) Preceding Bullet and (2) the amount by which LP's distributions are less than capital and preferred return

Clawback Provisions

- Tax Distribution Limitations
  - Flat percentage reduction of any clawback amount
  - More common: Limit so that the GP is not required to return an amount greater than carried interest distributions less tax distributions attributable to carry allocations

History of Tax Partnerships

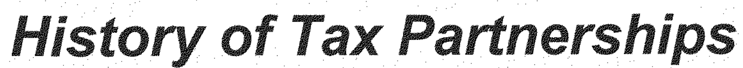


History of Tax Partnerships

- Congress originally defined a partnership as a "catch-all" category to ensure that no income went untaxed
  - 1916 Act provided for partners to include their shares of partnership income on their individual returns
  - No definition of "partner" or "partnership"
  - Until 1932, some taxpayers asserted that "syndicates" could avoid taxation because they were not state law partnerships, corporations or trusts
    - (1) no corporate taxation on entity because not a corporation
    - (2) no owner-level taxation because not a partnership

History of Tax Partnerships

- Today, the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation or a trust or estate



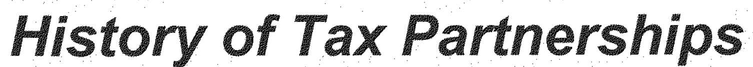
History of Tax Partnerships

- Under Subchapter K of the Code, partnerships function as the earner and owner of income produced by pooled capital and services of its members
- In lieu of assignment of income principles, Subchapter K provides for the allocation of partnership income, gain, loss and expense among members according to their “distributive shares” or “allocations”

History of Tax Partnerships

- A partner's allocation, for tax purposes, reflects that the portion of the partnership's income, gain, loss or expense that he is entitled to receive or incur economically
  - Tax follows economics

- The agreement of the partners – not assignment of income – determines how partnership items are apportioned among partners
  - No need to evaluate what each partners' contributed services of capital has produced



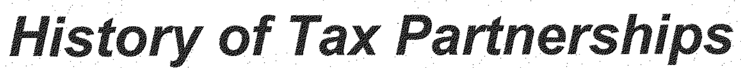
History of Tax Partnerships

- "Intent" has been an important element in ascertaining whether a partnership exists

- Courts look to "whether the parties really and truly intended to join together for the purpose of carrying on business and dividing the profits or losses or both"
  - Tower, 327 US 280; Culbertson, 337 US 733

History of Tax Partnerships

- "A person shall be recognized as a partner for income tax purposes if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person"
  - Section 704(e)(1)
- "however the owner of a partnership interest may have acquired such interest, the income is taxable to the owner, if he is the real owner. If the ownership is real, it does not matter what motivated the transfer to him or whether the business benefited from the entrance of the new partner"
  - Legislative History



History of Tax Partnerships

- Under Treasury regulations, a capital interest is “an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership”

History of Tax Partnerships

- Section 704(e)(1) may have priority over the intent test of Tower and Culbertson

- Section 704(e)(1) does not govern:
  - Persons who participate in service partnerships or other arrangements in which capital is not a material income-producing factor
  - The partner status of persons who own non-capital interests in capital-intensive businesses

- Culbertson/Tower Intent Test Factors:
  - Proprietary profit share, Share of venture losses, Capital interest
  - Right to participate in management, Substantial services
  - Held out as partners to third parties, form of agreements, partnership tax returns filed, etc.

History of Tax Partnerships

- Check the Box Regulations
  - Although an unincorporated domestic entity separate from its members that is not a trust (and certain foreign entities) can elect classification as a partnership or a corporation, the regulations do not provide specific guidance as to "partner" status
  - Partnership is the default (catch-all) category

History of Tax Partnerships

- Check the Box Regulations
  - Under 704(e)(1), any person who has a capital interest in a state law entity in which capital is a material income-producing factor should be a member under the check the box rules
  - Any persons who are owners of interests in legal entities (partnerships or LLCs) should also be members regardless of Section 704(e)(1)

History of Tax Partnerships

- The GP of a Venture Capital fund is a partner of the fund
  - Under Section 704(e)(1) if it has a capital interest
  - Under the check the box regulations if the fund is a state law partnership
- A Venture Capital fund is the earner and owner of all income and capital of the fund
- A Venture Capital fund's allocations, if in accordance with the Section 704(b) regs and reflective of economic reality, determine the taxation of the GP

History of Tax Partnerships

- Any change to the taxation of Venture Capital funds must consider the unintended consequences of any such change to operating businesses, such as start-up companies, organized in LLC form
  - Start-up LLCs often provide for disproportionate sharing as between management and investors
  - Exits often structured as asset sales giving rise to capital gain
- Changes could also affect family partnerships/LLCs

Venture Impact

The Economic Importance of Venture Capital Backed Companies to the U.S. Economy

Third Edition

GLOBAL INSIGHT

ABOUT GLOBAL INSIGHT

Global Insight is a privately held company formed from the two most respected economic and financial information companies in the world, Data Resources, Inc. (DRI) and Wharton Econometric Forecasting Associates (WEFA).

With the integration of the World Markets Research Centre (WMRC), Global Insight also provides the world's first same-day analysis and risk assessment service covering over 200 countries and four industries, providing insightful analysis of market conditions and key events around the world. With over 40 years of experience behind it, Global Insight provides the most comprehensive economic and financial coverage of countries, regions, industries, and markets available, using a unique combination of expertise, models, data, and software within a common analytical framework to support planning and decision making.

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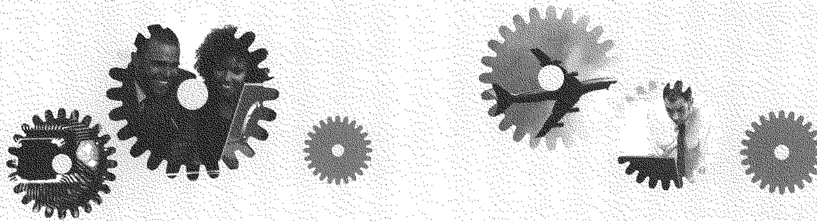

Venture Impact

The Economic Importance of Venture Capital Backed Companies to the U.S. Economy

Third Edition — Data Updated Through 2005

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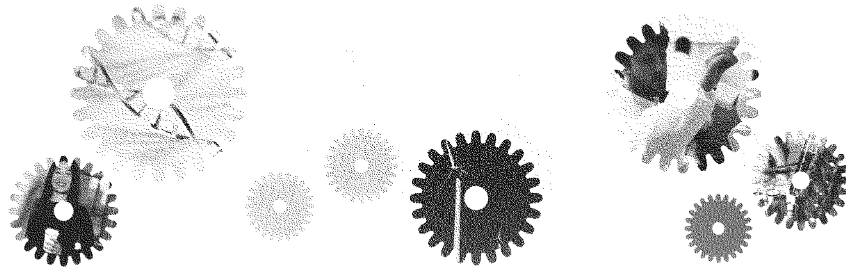
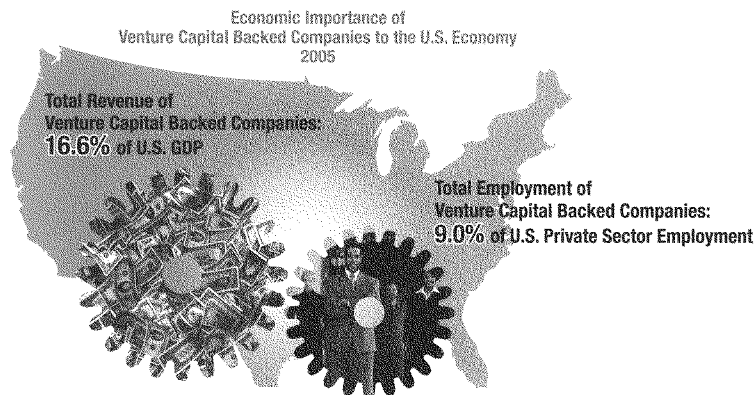


This report provides an overview of the key findings contained in the Global Insight study, *Venture Impact: The Economic Importance of Venture Capital Backed Companies to the U.S. Economy*, commissioned by the National Venture Capital Association (NVCA). The statistics presented here are based on a database of nearly 23,500 venture capital backed companies. The data demonstrates the enormous contribution of venture capital backed companies to U.S. jobs, sales, economic growth, and technological progress. The nation's venture capital industry plays a paramount role in nourishing the U.S. economy by bringing innovative concepts and business models to life.



Boosts America's Economic Strength by Creating Jobs and Revenue

Employment and sales data conclusively show the importance of venture capital backed companies to the U.S. economy. Venture capital financed companies are found in all sectors of the American economy. Innovative venture capital backed businesses such as Genentech, Medtronic, Microsoft, Home Depot, and Intel are among the prominent and diverse American companies that received venture capital early in their development.

The nation's venture capital industry plays a paramount role in nourishing the U.S. economy by bringing innovative concepts and business models to life.

Together, the nation's venture capital backed companies employed just over 10.0 million American workers in high-quality jobs and generated $2.1 trillion in revenue in 2005. The total revenue of venture capital financed companies comprised 16.6 percent of the nation's gross domestic product (GDP) and 9.0 percent of U.S. private sector employment in 2005.

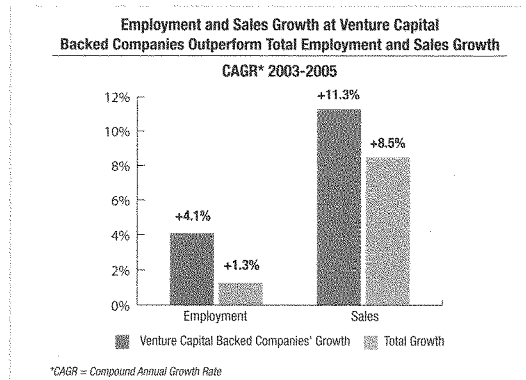
Economic Benefits of Venture Capital Backed Companies on the U.S. Economy 2000, 2003, and 2005

	2000	2003	2005
Jobs	8.7 million	9.2 million	10.0 million
Revenue	$1.5 trillion	$1.7 trillion	$2.1 trillion

The payoffs for venture capital investments are enormous. Similar to recent years, $23 billion was invested in 2005. This represented just 0.2 percent of U.S. GDP. Revenue generated by the universe of venture backed companies in 2005 corresponded to 16.6 percent of GDP.

Outperforms Other Companies

Venture capital backed companies outperformed their non-ventured counterparts in job creation and revenue growth. Employment in venture backed companies jumped by 4.1 percent, while national employment grew by just 1.3 percent, between 2003 and 2005. At the same time, venture capital backed company sales grew by more than 11.0 percent, compared to an overall rise in U.S. company sales of 8.5 percent during the same period.



Sustains Employment and Revenue Across Major U.S. Industry Sectors

The nation's innovative and cutting-edge venture capital backed companies sustain jobs and revenue across diverse industry sectors from computers and peripherals, media/entertainment/retail, semiconductors, software, and telecommunications to biotechnology, financial services, healthcare services, and medical devices.

Venture Capital Backed Companies by Top Five Industry Sectors
Employment and Revenue
2005
(ranked by employment)

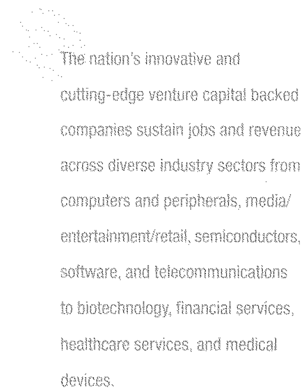
Industry	Employment at Venture Capital Backed Companies	Revenue at Venture Capital Backed Companies
Media/Entertainment/Retail	2,005,700	$299.0 billion
Computers and Peripherals	1,866,400	$466.0 billion
Industrial/Energy	1,180,100	$268.0 billion
Financial Services	896,900	$134.0 billion
Software	857,700	$211.0 billion

In 2005, venture capital financed companies in the media/entertainment/retail sector employed more than 2.0 million Americans, followed by the computers and peripherals industry with 1.9 million American jobs. The computers and peripherals industry was the leading industry in 2005 with revenue at $466.0 billion, followed by the media/entertainment/retail sector with $299.0 billion in 2005 revenue.

Additionally, the revolutionary products generated by the nation's venture capital backed biotechnology and medical devices and equipment sectors supported nearly 425,000 high-skilled, high-wage jobs in 2005.

Contributes to Economic Health of State Economies

California, Texas, Pennsylvania, Massachusetts, and Georgia were the top national job creators measured by venture capital backed companies headquartered in their state. In California alone, nearly 2.3 million jobs were supported by venture capital backed companies headquartered in the state.



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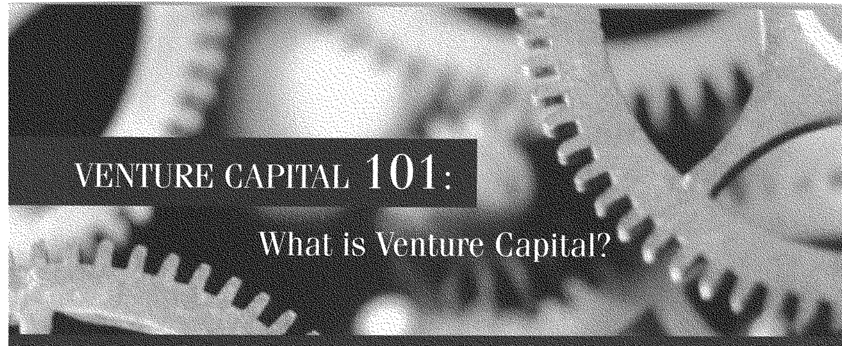
Top Five States by Employment at Venture Capital Backed Companies Headquartered in the State 2005

Rank	State	Employment at Venture Capital Backed Companies
1	California	2,285,200
2	Texas	1,089,100
3	Pennsylvania	697,600
4	Massachusetts	639,900
5	Georgia	604,300

California, Texas, Washington, Pennsylvania, and Massachusetts were the top five states by revenue at venture capital backed companies headquartered in their state. California was the nation's leader by this metric, with more than $500.0 billion in revenue tied to venture capital backed companies headquartered in the state.

Top Five States by Revenue at Venture Capital Backed Companies Headquartered in the State 2005

Rank	State	Revenue at Venture Capital Backed Companies
1	California	$507.0 billion
2	Texas	$274.0 billion
3	Washington	$127.0 billion
4	Pennsylvania	$113.0 billion
5	Massachusetts	$112.0 billion



Venture capital has enabled the United States to support its entrepreneurial talent and appetite by turning ideas and basic science into products and services that are the envy of the world. Venture capital funds and builds companies from the simplest form – perhaps just the entrepreneur and an idea expressed as a business plan – to freestanding, mature organizations.

Risk Capital for Business

Venture capital firms are professional, institutional managers of risk capital that enables and supports the most innovative and promising companies. This money funds new ideas that could not be financed with traditional bank financing, that threaten established products and services in a corporation, and that typically require five to eight years to be launched.

**Venture Capital Backed Companies
Known for Innovative Technology and Products
2000 and 2005 Employment**

Company	2000	2005	# Change
Intel Corporation	86,100	99,900	13,800
Microsoft	39,100	61,000	21,900
Medtronic, Inc.	21,490	33,000	11,510
Apple Inc.	8,568	16,820	8,252
Genentech	4,459	9,500	5,041
Google	--	5,680	n/a

Source: Hoover's

Venture capital is quite unique as an institutional investor asset class. When an investment is made in a company, it is an equity investment in a company whose stock is essentially illiquid and worthless until a company matures five to eight

years down the road. Follow-on investment provides additional funding as the company grows. These "rounds," typically occurring every year or two, are also equity investment, with the shares allocated among the investors and management team based on an agreed "valuation." But, unless a company is acquired or goes public, there is little actual value. Venture capital is a long-term investment.

Venture Capital Backed Companies Known for Innovative Business Models 2000 and 2005 Employment

Company	2000	2005	# Change
The Home Depot	201,000	325,000	124,000
Starbucks Corporation	47,000	115,000	68,000
Staples	49,993	65,078	15,085
Whole Foods Market, Inc.	18,500	38,000	19,500
PetSmart, Inc.	19,825	30,300	10,475
eBay	1,927	12,600	10,673

Source: Hoover's

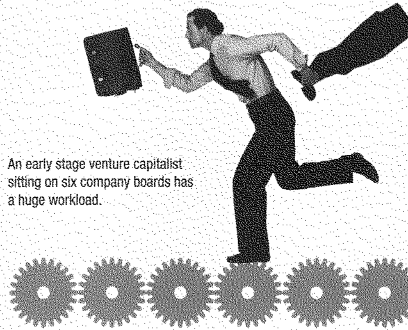
Venture capital firms are professional, institutional managers of risk capital that enables and supports the most innovative and promising companies.

More Than Money

The U.S. venture industry provides the capital to create some of the most innovative and successful companies. But venture capital is more than money. Venture capital partners become actively engaged with a company, typically taking a board seat. With a startup, daily interaction with the management team is common. This limits the number of startups in which any one fund can invest. Few entrepreneurs approaching venture capital firms for money are aware that they essentially are asking for 1/6 of a person!

Yet that active engagement is critical to the success of the fledgling company. Many one- and two-person companies have received funding but no one- or two-person company has ever gone public! Along the way, talent must be recruited

What Entrepreneurs Are Really Asking For!



An early stage venture capitalist sitting on six company boards has a huge workload.

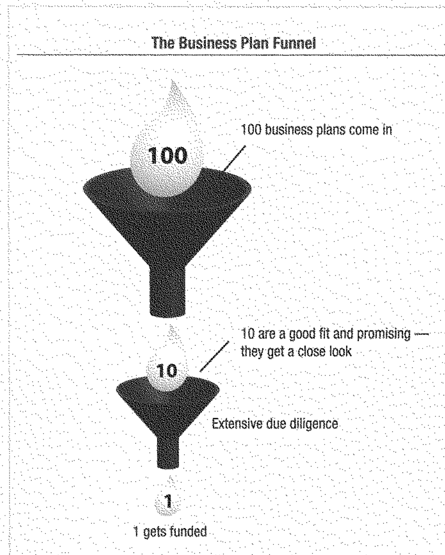
and the company scaled up. Ask any venture capitalist who has had an ultra-successful investment and he or she will tell you that the company that broke through the gravity evolved from the original business plan concept with the careful input of an experienced hand.

Deal Flows — Where The Buys Are

For every 100 business plans that come to a venture capital firm for funding, usually only 10 or so get a serious look, and only one ends up being funded. The venture capital firm looks at the management team, the concept, the marketplace, fit to the fund's objectives, the value-added potential for the firm, and the capital needed to build a successful business. A busy venture capital professional's most precious asset is time. These days, a business concept needs to address world markets, have superb scalability, be made successful in a reasonable timeframe, and be truly innovative. A concept that promises a 10 or 20 percent improvement on something that already exists is not likely to get a close look.

Many technologies currently under development by venture capital firms are truly disruptive technologies that do not lend themselves to being embraced by larger companies whose current products could be cannibalized by this. Also, with the increased emphasis on public company quarterly results, many larger organizations tend to reduce spending on research and development and product development when things get tight. Many talented teams have come to the venture capital process when their projects were turned down by their companies.

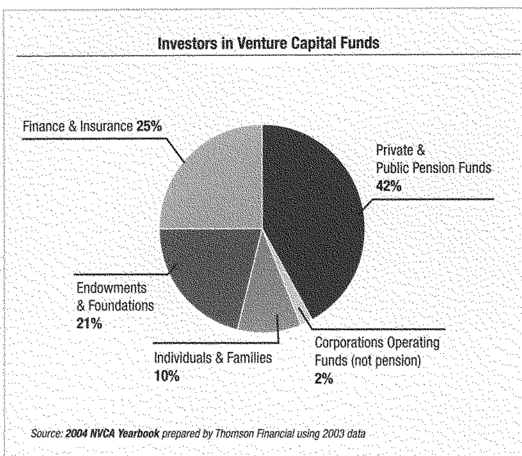
The Business Plan Funnel



Common Structure — Unique Results

While the legal and economic structures used to create a venture capital fund are similar to those used by other alternative investment asset classes, venture capital itself is unique. Typically, a venture capital firm will create a Limited Partnership with the investors as LPs and the firm itself as the General Partner. Each "fund," or portfolio, is a separate partnership. A new fund is established when the venture capital firm obtains necessary commitments from its investors, say $100 million. The money is taken from investors as the investments are made. Typically, an initial funding of a company will cause the venture fund to reserve three or four times that first investment for follow-on financing. Over the next three to eight or so years, the venture firm works with the founding entrepreneur to grow the company. The payoff comes after the company is acquired or goes public. Although the investor has high hopes for any company getting funded, only one in six ever goes public and one in three is acquired.

Investors in Venture Capital Funds

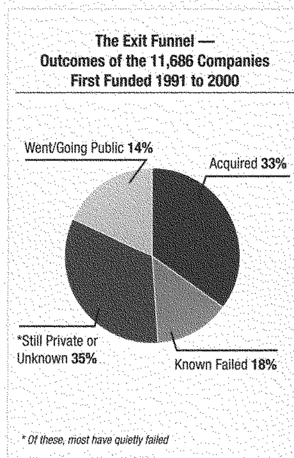


*Source: **2004 NVCA Yearbook** prepared by Thomson Financial using 2003 data*

Economic Alignment of all Stakeholders — An American Success Story

Venture capital is rare among asset classes in that success is truly shared. It is not driven by quick returns or transaction fees. Economic success occurs when the stock price increases above the purchase price. When a company is successful and has a strong public stock offering, or is acquired, the stock price of the company reflects its success. The entrepreneur benefits from appreciated stock and stock options. The rank and file employees throughout the organization historically also do well with their stock options. The venture capital fund and its investors split the capital gains per a pre-agreed formula. Many college endowments, pension funds, charities, individuals, and corporations have benefited far beyond the risk-adjusted returns of the public markets.

The Exit Funnel — Outcomes of the 11,686 Companies First Funded 1991 to 2000



** Of these, most have quietly failed*

What's Ahead

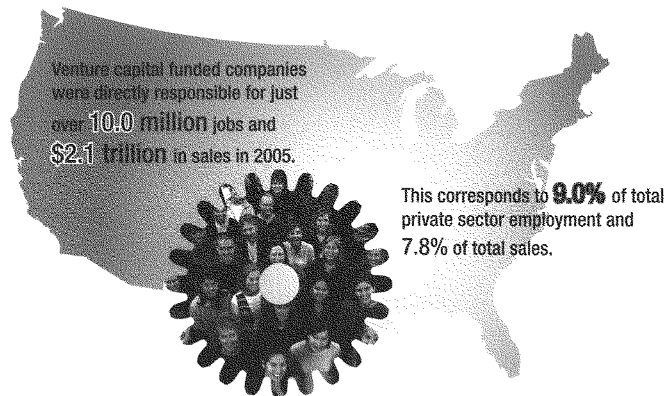
Much of venture capital's success has come from the entrepreneurial spirit pervasive in the American culture, financial recognition of success, access to good science, and fair and open capital markets. It is dependent upon a good flow of science, motivated entrepreneurs, protection of intellectual property, and a skilled workforce.

The nascent deployment of venture capital in other countries is gated by a country's or region's cultural fit, tolerance for failure, services infrastructure that supports developing companies, intellectual property protection, efficient capital markets, and the willingness of big business to purchase from small companies.

Venture Capital Backed Companies Boost America's Economic Strength

The Venture Capital Sector Has Grown To Become a Major Force in the U.S. Economy

Venture capital funded companies are an integral part of the American economy. Venture capitalists have provided the U.S. economy a reward far beyond their investment of money and time in these companies. Venture capital investment continually reinforces America's entrepreneurial spirit by producing innovative and cutting-edge technology and products. In doing so, the venture capital industry becomes a catalyst for change. Venture capitalists, many of whom are former successful entrepreneurs themselves, shepherd new business men and women to reach their full potential.



Venture Capital Backed Companies Create Jobs and Revenue

Venture capital backed companies known for their innovative technology and business models, such as Microsoft, Intel, Genentech, and Starbucks, added more than 1.3 million jobs to the U.S. economy between 2000 and 2005, resulting in annual growth of approximately 2.9 percent. Total venture capital backed company employment exceeded 10.0 million jobs in 2005. The data show that venture capital backed companies added 765,700 jobs to the U.S. economy in the last two years alone, posting a 4.1 percent annual growth rate.

Sales by venture capital financed companies jumped from $1.5 trillion in 2000 to $2.1 trillion in 2005. Venture capital backed companies posted a 6.8 percent annual growth rate over the last five years.

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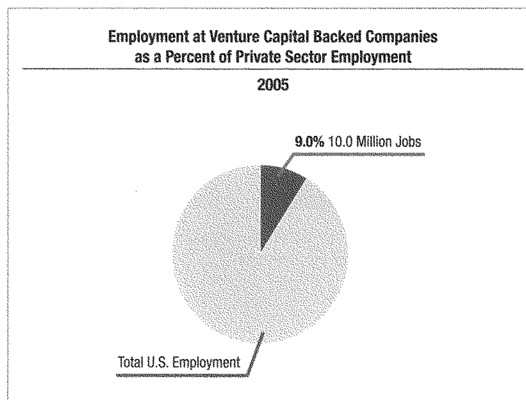
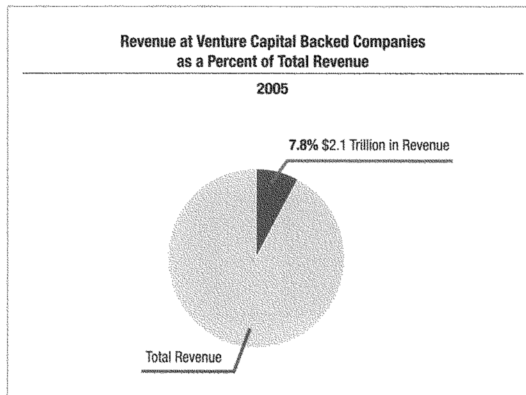
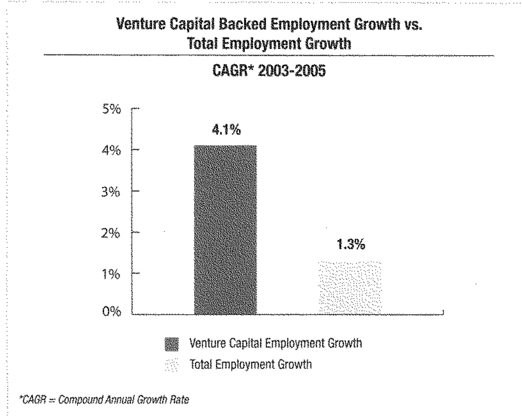
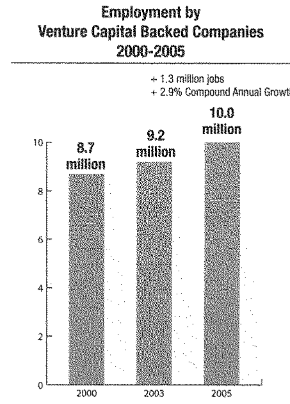




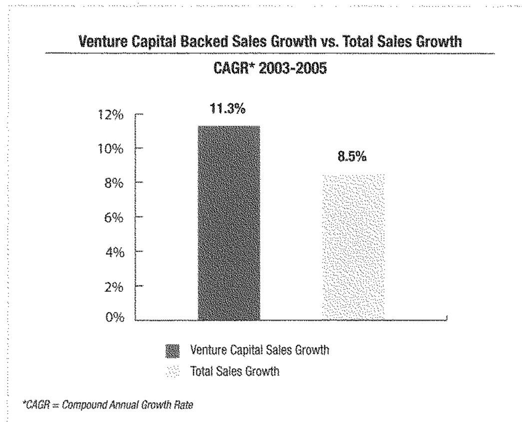
Venture Capital Backed Companies Create Jobs and Add Workers at a Faster Rate than Non-Ventured Companies

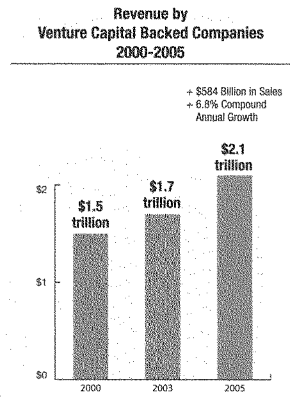
Companies financed by venture capital added jobs at a faster pace than their non-ventured counterparts. The most recent statistics show that the 4.1 percent annual growth rate of jobs among venture capital backed companies was more than three times faster than the 1.3 percent total private sector employment growth rate between 2003 and 2005.





Similarly, venture capital backed companies outperformed total U.S. sales growth at a compound annual rate of 11.3 percent for venture capital backed companies, compared to 8.5 percent for total U.S. sales between 2003 and 2005.





Venture Capital Backed Companies Create Jobs

The most recent statistics from Global Insight reveal that the venture capital job creating engine is not limited to one segment of the economy. It permeates the entire American economy from computers, software, and telecommunications to biotechnology, financial services, and medical devices.

Venture capital financed companies in the media/entertainment/retail sector produced the largest number of jobs, employing more than 2.0 million workers in 2005, and comprising over half of the industry's nearly 4.0 million jobs. Other large industries in employment by venture capital backed companies were the nearly 1.9 million jobs in computers and peripherals, accounting for 9 of every 10 jobs, and the 1.2 million jobs in the industrial and energy sector.

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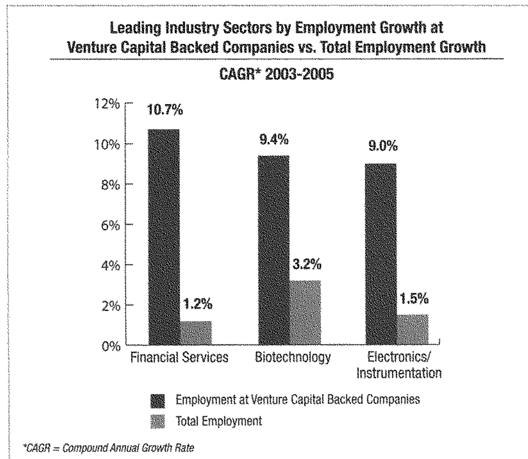
The employment statistics also show a heavy concentration of venture capital supported employment in the software industry, with nearly 860,000 jobs, representing almost 90 percent of the 960,000 total jobs in software, in 2005. The revolutionary products generated by the nation's venture capital backed biotechnology and medical devices and equipment sectors supported nearly 425,000 high-skilled, high-wage jobs in 2005.

Top Five Industry Sectors by Venture Capital Backed Employment and Share of Total Employment 2005

Industry	Employment at Venture Capital Backed Companies	Total Sector Employment	Venture Capital Backed Companies' Share of Total Employment
Media/Entertainment/Retail	2,005,700	3,991,300	50.3%
Computers and Peripherals	1,866,400	2,099,000	88.9%
Industrial/Energy	1,180,100	22,484,400	5.2%
Financial Services	896,900	10,464,900	8.6%
Software	857,700	959,600	89.4%

Global Insight also found that venture capital backed companies' employment growth outpaced total industry employment growth across all sectors between 2003 and 2005. The financial services sector recorded double digit compound annual gains of 10.7 percent, compared with an industry average of only 1.2 percent between 2003 and 2005. The biotechnology sector closely followed, with 9.4 percent annual growth in employment from 2003 to 2005. By contrast, the annual employment gain for the total biotechnology industry was only 3.2 percent during this same period. Venture capital backed companies in the electronics, healthcare, and computers and peripherals industries all expanded their employment at a significantly higher annual rate than the industry average.



Semiconductors, networking and equipment, and information technology services were the only three venture capital backed sectors that experienced net job losses between 2003 and 2005. However, declines in the overall industry were more severe than the aggregate downturn in venture capital supported companies.

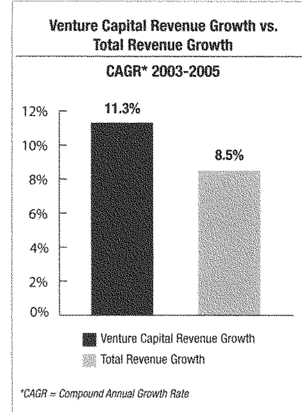
Global Insight also found that venture capital backed companies' employment growth outpaced total industry employment growth across all sectors between 2003 and 2005.

The almost 23,500 venture capital backed companies generated $2.1 trillion in sales for the American economy in 2005. Like employment, sales by venture capital financed companies are not limited to one segment of the economy. Computers and peripherals, media/entertainment/retail, industrial and energy, software, and telecommunications were the five leading industries by revenue. Computers and peripherals industry sales were $466.0 billion in 2005, followed by the nearly $300.0 billion in sales posted by the media/entertainment/retail sector. Sales by venture capital backed companies in the industrial and energy industry totaled nearly $270.0 billion, software services sales exceeded $210.0 billion, and telecommunications sales were $161.0 billion in 2005.

Venture Capital Backed Revenue by Industry Sector and Share of Total Revenue 2005

Industry	Revenue at Venture Capital Backed Companies	Total Sector Revenue	Venture Capital Backed Companies' Share of Total Revenue
Computers and Peripherals	$466.0 billion	$670.0 billion	69.5%
Media/Entertainment/Retail	$299.0 billion	$822.0 billion	36.4%
Industrial/Energy	$268.0 billion	$6.0 trillion	4.5%
Software	$211.0 billion	$584.0 billion	36.1%
Telecommunications	$161.0 billion	$426.0 billion	37.7%

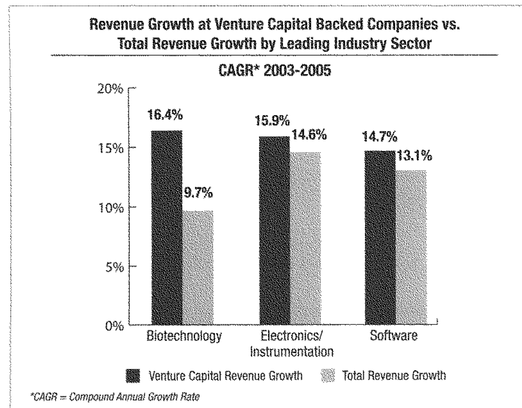
Sales by venture capital backed companies outpaced their non-ventured counterparts. The most recent statistics show that the 11.3 percent annual growth rate in sales among venture capital backed businesses exceeded the 8.5 percent annual growth rate in total sales between 2003 and 2005.

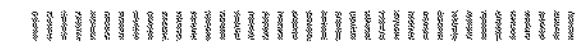


Venture Capital Backed Companies Outperform Their National Counterparts by Revenue

As with employment, venture capital backed companies outperformed their national counterparts in every industry sector when measured by revenue. The industry posting the greatest differential in revenue growth was biotechnology. Revenue at venture capital backed biotechnology companies totaled nearly $67.0 billion in 2005, posting a compound annual growth rate of 16.4 percent, compared to a 9.7 percent growth rate for the entire biotechnology industry between 2003 and 2005.

The electronics and instrumentation industry recorded the second largest annual growth rate at 15.9 percent between 2003 and 2005, reaching $70.0 billion in revenue. Software services revenue jumped by 14.7 percent on an annual basis between 2003 and 2005, compared to 13.1 percent for the total software industry for the same time period.





The industry posting the greatest differential in revenue growth was biotechnology. Revenue at venture capital backed biotechnology companies totaled nearly $67.0 billion in 2005, posting a compound annual growth rate of 16.4 percent, compared to a 9.7 percent growth rate for the entire biotechnology industry between 2003 and 2005.

Venture Capital Supports Employment Across the Country

Venture capital backed companies create jobs in every state. California, Texas, Pennsylvania, Massachusetts, and Georgia led the nation by venture capital backed employment in 2005. Even small states by population like Montana, South Dakota, and Wyoming benefit from jobs generated by venture capital investments in local companies headquartered in these states.

Employment at Companies Headquartered in the State 2003-2005

Rank	State	Employment at Venture Capital Backed Companies 2003	Employment at Venture Capital Backed Companies 2005	Growth Rate of Venture Capital Backed Companies' Employment CAGR* 2003 - 2005
1	**California**	2,173,800	2,285,200	2.5%
2	**Texas**	949,700	1,089,100	7.1%
3	**Pennsylvania**	530,600	697,600	14.7%
4	**Massachusetts**	616,800	639,900	1.9%
5	**Georgia**	525,200	604,300	7.3%
6	**Tennessee**	523,400	540,800	1.7%
7	**Washington**	377,700	444,500	8.5%
8	**New York**	398,200	415,700	2.2%
9	**Virginia**	345,200	348,900	0.5%
10	**Minnesota**	268,700	302,000	6.0%
11	**Florida**	292,700	301,900	1.6%
12	**New Jersey**	263,200	279,900	3.1%
13	**Illinois**	200,200	211,600	2.8%
14	**Ohio**	173,200	184,100	3.1%
15	**Connecticut**	168,900	173,400	1.3%

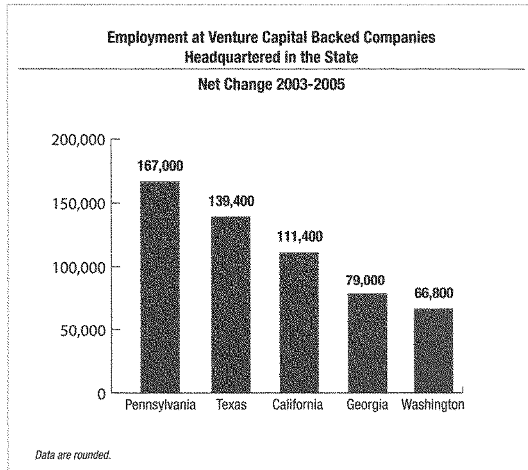
**CAGR = Compound Annual Growth Rate*

Venture backed companies headquartered in California provided the greatest number of jobs, totaling nearly 2.3 million in 2005. Texas was the second largest state by venture capital backed companies headquartered in the state, with almost 1.1 million jobs nationwide in 2005, and nearly 700,000 jobs were supported by venture capital backed companies headquartered in Pennsylvania. Massachusetts and Georgia completed the top five states for national job creation by venture capital backed companies headquartered there.

Although Pennsylvania ranked third in the nation by total venture capital backed employment, it posted an annual employment growth rate of 14.7 percent, the strongest in the nation. As a result, venture capital backed companies with headquarters in Pennsylvania generated more than 167,000 jobs between 2003 and 2005. During the same period, venture capital backed companies headquartered in Texas added nearly 140,000 jobs. While California was the nation's leading state by employment at venture backed companies, it ranked third nationwide in jobs added between 2003 and 2005 at 111,400 and posted a 2.5 percent annual growth rate in employment. Georgia and Washington also posted substantial job gains between 2003 and 2005, adding 79,000 jobs and 66,800 jobs, respectively, as a result of investments made by venture capital backed companies headquartered there.

Employment at Venture Capital Backed Companies Headquartered in the State

Net Change 2003-2005



Data are rounded.

Venture Capital Supports Sales Across the Country

Venture capital backed companies generate sales nationwide. California, Texas, Washington, Pennsylvania, and Massachusetts topped the list of states by revenue generated by venture capital backed companies headquartered in the state.

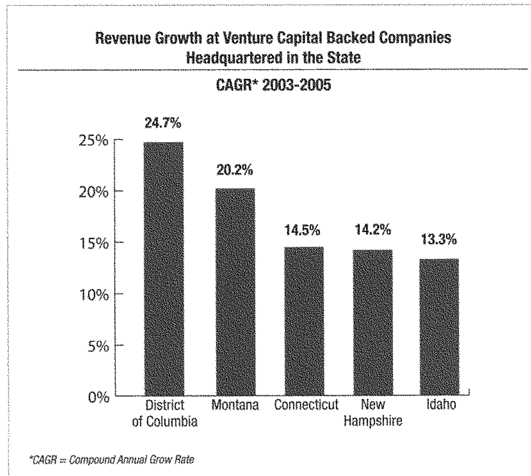
Revenue by Venture Capital Backed Companies Headquartered in the State 2003-2005

Rank	State	Revenue at Venture Capital Backed Companies 2003	Revenue at Venture Capital Backed Companies 2005	Growth Rate of Venture Capital Backed Companies' Revenue CAGR* 2003-2005
1	**California**	$397.3 billion	$506.8 billion	12.9%
2	**Texas**	$219.6 billion	$274.0 billion	11.7%
3	**Washington**	$100.4 billion	$127.4 billion	12.6%
4	**Pennsylvania**	$92.3 billion	$112.8 billion	10.6%
5	**Massachusetts**	$91.4 billion	$111.7 billion	10.6%
6	**Georgia**	$87.7 billion	$109.2 billion	11.6%
7	**New York**	$72.5 billion	$87.4 billion	9.8%
8	**Virginia**	$69.5 billion	$82.9 billion	9.2%
9	**Tennessee**	$59.4 billion	$71.6 billion	9.8%
10	**Florida**	$57.9 billion	$68.9 billion	9.1%
11	**Minnesota**	$52.6 billion	$65.0 billion	11.2%
12	**Connecticut**	$41.1 billion	$53.9 billion	14.5%
13	**New Jersey**	$39.2 billion	$48.1 billion	10.7%
14	**Illinois**	$29.2 billion	$36.8 billion	12.3%
15	**Maryland**	$28.0 billion	$30.6 billion	4.6%

**CAGR = Compound Annual Growth Rate*

Venture capital backed companies headquartered in California led the nation by sales from venture capital supported companies at $506.8 billion in 2005. Second ranked Texas posted venture backed sales of $274.0 billion, while Washington ranked third with $127.4 billion in sales in 2005. Pennsylvania and Massachusetts rounded out the list of the top five states by revenue at venture capital backed companies with totals of $112.8 billion and $111.7 billion, respectively, in 2005.

While every state benefited from expanding revenue, growth was not equal across all states. Although the District of Columbia posted venture capital backed revenue of only $2.2 billion in 2005, it posted the fastest growth rate in the nation, with a compound annual growth rate of 24.7 percent between 2003 and 2005. Based on the compound annual growth rate between 2003 and 2005, Montana was the second fastest growing state in the country at 20.2 percent, followed by Connecticut at 14.5 percent. New Hampshire and Idaho completed the list of the top five states by venture capital backed company revenue growth.



Methodology for the Global Insight Study

Global Insight constructed a database of 23,476 venture capital backed companies. This database measures venture backed employment and sales revenue across states and industries for the 2003 and 2005 periods. The Global Insight database is created from four unique databases.

The first database was the 2003 Venture Capital Database. Using this database, the top 200 companies in terms of 2003 revenue were identified. Current 2005 employment and revenue estimates were entered into the database as available for the top 200 companies. For the remainder of the companies in the database, 2005 employment and revenue figures were projected using industry growth rates. The industry data are based on the Venture Economics Industry Code (VEIC), which Global Insight maps to a specific North American Industry Classification System (NAICS) code. Note that the venture capital share of the media/entertainment/retail sector is only a rough approximation because some retail industry employment is included in the distribution industry.

The Global Insight Business Demographics Navigator[1] was used to estimate sales and employment growth figures for the 2003 and 2005 periods. These growth rates were applied to the 2003 revenue and employment observations to obtain estimated 2005 employment and revenue.

The second database consisted of 181 venture capital backed companies that offered IPOs during the January 1, 2003 to June 20, 2006 period. Sales and employment figures for all 181 companies were obtained and added to the database.

The third database was comprised of 306 companies that received venture capital backed investment funds over the March 1, 2003 to June 30, 2003 period. Employment and sales data for 2005 were obtained for 143 of the 306 firms.

The final database consists of mergers and acquisitions occurring over the January 1, 2003 to June 30, 2006 timeframe. This database was cross-checked with the other three databases. The database is adjusted when one venture capital backed company acquires another.

The list of venture backed companies used to establish, and subsequently update, the database used for this study comes from the MoneyTree™ Report by PricewaterhouseCoopers and the National Venture Capital Association based on data from Thomson Financial. Thomson Financial is the leading commercial provider of data on the venture capital industry. Thomson's VentureXpert database is the official database of the NVCA.

1 Global Insight's Business Demographics Navigator provides historical and forecast data projections for nominal sales, real sales, employment, and establishments at the national, state, and metro geographies for 6-digit NAICS codes.

Content First, LLC

This publication was prepared from the Global Insight study by Content First, LLC, a full-service public policy research services firm in Washington, DC that utilizes a unique process of melding solid research and analysis with presentation and communication. Content First brings advocacy data, industry statistics, and policy research to life for trade associations, businesses, law firms, consulting firms, and the public affairs community.

Content First produces economic and policy reports for prominent trade associations, including the U.S. Chamber of Commerce, the Organization for International Investment, the Representative of German Industry and Trade, and the Transatlantic Business Dialogue. In addition, Content First co-authored the NVCA report *American Made: The Impact of Immigrant Entrepreneurs and Professionals on U.S. Competitiveness*. For more information about Content First, visit www.contentfirst.com.

National Venture Capital Association

The National Venture Capital Association represents approximately 480 venture capital and private equity firms. NVCA's mission is to foster greater understanding of the importance of venture capital to the U.S. economy and support entrepreneurial activity and innovation. NVCA represents the public policy interests of the venture capital community, strives to maintain high professional standards, provides reliable industry data, sponsors professional development, and facilitates interaction among its members.

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National Venture Capital Association

Senate Finance Committee Hearing July 11, 2007
Carried Interest Part I
Questions & Answers for the Record
For Kate Mitchell
Submitted 7-26-07

Questions from Chairman Baucus

1. How much of your own money do you invest in the average venture capital fund? do you use leverage to fund your investment?

It is typical for venture firms to invest from ½ to 5% of the committed capital. The amount is determined in the negotiations with the LPs who want to ensure that the general partners have a significant amount of their net worth at stake. Scale Venture Partners has two active funds, with commitments of $500 million and $400 million, respectively. Our limited partners require that the general partner commit 1/2% of total commitments to the first fund and 1% of total commitments to the current so the general partner has committed $2.5 million and $4 million, respectively, to each fund. The portion of that general partner commitment that I am personally responsible for is $345,503 and $535,469, respectively, for each fund. As a result, I have total personal commitments to the Scale Venture Partner funds of $880,963.

Because venture capital funds are much smaller than other types of investment funds (typically under $500 million), the management fees that are necessary to run the business and pay salaries are much smaller than other investment funds. We still, however, need to make significant personal financial commitments to our funds per our agreements with our investors. This requirement alone can discourage talented professionals from entering the venture capital business, especially if they do not have any significant personal assets of their own.

I have not borrowed or used any type of leverage to satisfy this commitment. I write a check out of my personal savings. In addition, it is very rare for our venture capital funds' portfolio companies to borrow other than for working capital or equipment financing purposes. Any such borrowing that an underlying portfolio company may engage in would result in those loan proceeds staying in the company to help it grow and would not be used to redeem the interests of any owners.

2. How does carried interest affect the decisions you make to back certain companies? How would changing the tax rates on carried interest affect those decisions?

Scale Venture Partner's primary objective is to maximize returns for its investors through investments of financial and human capital and other intangibles into private start-up companies. Carried interest and the taxation of carried interest are not, in and of themselves, primary considerations in making individual investment decisions today.

Whether a change in tax rates will affect our current approach will depend on the nature of the change. For example, if the elimination of a tax rate differential only applied to activities conducted in a certain form (like our current form) but continued to be available in other

contexts (as the Levin bill proposes), then we might structure our investments differently if we could continue to take advantage of a lower capital gain rate. If a potential portfolio company would not be able to accommodate that structure, then we might not invest in that company.

As another example, if the tax rate were to change, the acceptable risk profile of our portfolio companies might change. Since we are owners of the venture fund, through our ownership in the general partner, we have to pay tax on an annual basis as a GP. This can cause us to lose money if the overall portfolio later has losses that we cannot use (as described below in # 3). In addition, taxation of the carried interest can impact us and our investors if there is a clawback obligation. Therefore, a significant change in the taxation of carried interest likely will be factored into our risk assessment with respect to any investment that could result in a loss. This means that companies that are currently within the range of acceptable risk may cease to be within that range and may cease to receive venture financing. The net result is that venture firms will tend to favor later stage companies in order to reduce the effort, the risk and the time required to exit. Early stage companies would be harder to form and fund, reducing the overall number of venture backed companies and depressing the returns for the sector.

More important, fewer new companies may receive venture capital funding if the ability to attract talented professionals to the venture capital industry diminishes. Venture capitalists possess a unique skill set – technological expertise and business acumen. As mentioned above, venture capitalists must make a significant personal financial outlay in deciding to make this their career. In addition, the career entails a high and real risk that carried interest will not even be earned. We saw, for instance, in the after-math of the internet bubble – which affected the venture capital industry almost exclusively – that many venture capitalists did not earn a dollar of carried interest. During that period, the invested capital in the venture sector shrank from $ 105 BN to $ 19.7 BN and the number of new funds more than halved. Finally, the long delay before any potential carried interest is ever paid requires significant confidence and foresight in any professional. This combination (significant financial outlay, high risk, long delay) has always been a hurdle in attracting the limited group of qualified professionals to the venture capital industry. In fact, the number of venture capital professionals and firms has been shrinking. Taxation as an owner of the businesses those professionals build (i.e., as capital gain) has been one mitigating factor in continuing to attract talent. If this factor is eliminated, it will be one more reason for these professionals to seek more consistently lucrative positions in less high-risk and less innovative industries. This will result in fewer companies receiving venture financing and fewer companies succeeding in developing innovative and creative technologies, industries and jobs.

Finally, under a more global view, the taxation of carried interest has an impact on the capital that is deployed by venture capital firms in the US, as young venture capitalists entering (or moving within) the industry might favor non-US firms if US tax laws are unfriendly. It is true that current US tax rules might prevent US citizens from such a behavioral response. There are, however, many non-US venture capitalists who currently operate in the US, but who could easily move their activities back to their home countries. Many of those countries, like Israel, India and China, are trying to lure entrepreneurial activity – venture capital activity – to their shores through tax- and regulatory-friendly environments in order to compete in the innovation- and

knowledge-based economy. Similarly, firms with multi-national teams and multi-national strategies could shift more capital to their non-US activities.

This global shift in venture investing is already happening. A significant number of successful, experienced American venture capitalists are shifting their focus to new funds in China and India where they are apprenticing new, local venture capitalists and forming companies and jobs. This movement overseas has happened over a very short period of time demonstrating that money and human capital does respond quickly to market incentives.

3. At the hearing, you stated that a venture capital general partner is subject to risk. Please provide a full list of these risks. What steps can a venture capital general partner take to limit these risks?

There are many types of risk undertaken by venture capitalists, some of which significantly differentiate them from other service providers.

A. Risk of Time and Effort (Opportunity Cost). *The primary risks that venture capital general partners take are identical to the risks taken by any entrepreneur. They invest their capital and their time in the development of new technology and new businesses, in the hopes that their investment will pay off. Often it does not. In exchange, they often give up lucrative careers that provide more stable, guaranteed compensation (like investment banking, consulting and law).*

There is also an important reputational risk to joining a venture capital firm. Given that the best returns are limited to the top 25% of the funds (and many LPs think it is only the top 10% of funds), there is, therefore, a high mortality rate for venture firms themselves. We may leave a stable job, spend our most productive years trying to "make a go" of a venture career, only to find that we are one of the 75% that may not get funded again in the future by our LPs. Our likelihood of easily stepping back on the stable job track is low given our failed time in venture.

B. Risk Associated with Invested Financial Capital. *Though most of the capital comes from outside investors (as is the case with most entrepreneurial ventures), venture capitalists also typically invest a significant amount of their personal net worth in these companies. The amount of capital that I have personally invested in Scale Venture Partners represents a significant portion of my personal net worth. I have not received carry in either of our funds yet since the first fund was formed in 2000. As a result, I am investing a portion of my retirement savings in the hope that our funds will create long term value in our companies, for our LPs and for my family and those of my partners.*

C. Financial Risk Associated with Clawback/Valuation. *This risk is related to the general partner's contractual arrangement with the fund's limited partners. Specifically, the carried interest is calculated as a percentage of cumulative profits. Therefore, if one investment is successful and the venture capitalists receive carried interest (after return of the investors' capital), the general partner (and, in turn, the venture capitalists) may have to return some or all of the carried interest in the future if other investments generate losses.*

If the carried interest has previously been received in the form of portfolio company stock, there is a risk that stock will decrease in value before it is or can be sold by the general partner or the venture capitalists. Under almost all agreements, the clawback cannot be satisfied with that depreciated stock. Instead, the venture capitalists have to make up the difference out of their own personal assets. Clawback provisions have become very actively discussed in our business since post 2000, there were a number of funds and general partners who found themselves in the position of owing a clawback. As time has moved forward, LPs have continued to insist on including these provisions in our fund documents as they serve to align us very strongly with their interests as the financial investors over the life of the fund.

This risk generally can be reduced by delaying the receipt of carried interest payments to minimize the likelihood of a clawback. This is the approach that Scale Venture Partners and most venture capital funds take. That is, most general partners do not receive any carried interest from their fund until the investors have received a 100% return of their capital contributions to the fund (or in the most conservative case the capital commitments to the fund). Though this reduces the risk of a "clawback" obligation, it does not eliminate the risk, and in addition, this pushing back of the carried interest to the GP is a further proof that a venture capital career is a "deferred gratification" business, where significant wealth can only be earned after not just one but a string of successful investments.

Furthermore, the delay of carried interest does not defer or otherwise reduce the tax liability – the venture capitalists still have to pay tax on their shares of profits even if, at such time, they receive no distributions of proceeds.

Finally, delaying receipt of carried interest for such a long time period makes it even more difficult to compete in the market with other types of businesses for talented professionals. The tax rate differential has been one incentive for young venture capitalists to view the delay in receipt of carried interest (often 7 years) as worthwhile.

D. Financial Risk Related to Annual Taxation of Cumulative Economic Arrangement.
Because the venture capitalists are partners – owners of the fund through the general partners – they have to pay tax on an annual basis reflecting their economic entitlements to a share of the profits of the fund, including carried interest. The general partner's carried interest, however, is calculated on a cumulative basis (over the entire 10-plus year life of the fund). As a result, the general partner's (and, in turn, the venture capitalists') actual economic entitlement will not be determinable until the end of the life of the fund.

This can result in tax anomalies resulting in the venture capitalists paying more in tax than they should have – a real economic risk of loss. For example, if the carried interest totals $20 million in the early years of the fund, the GP will pay tax on that amount in the years that they were realized by the fund but years before carried interest distribution would have been made. Later losses might result in the overall carried interest equaling only $5 million. (Losses often occur later in the life of the fund after all attempts to make a portfolio company profitable ultimately have failed.) This would result in the venture capitalists paying tax on $20 million even if the venture capitalists are only entitled, ultimately, to $5 million. Although they will receive $15

million in losses, those losses might not be deductible by the venture capitalists because they can only be carried forward to offset capital gains, and cannot be carried back.

There is a complex interplay between the timing of the venture capitalist's tax liability and the timing of overall returns to investors. If the fund delays carried interest distributions to the GP before the capital of the fund has been returned, then there frequently is a provision for tax distributions to be made by the fund to the GP (and, in turn, the venture capitalists). This provision has evolved because otherwise venture capitalists in a newer fund (which is most likely to have a "no distributions until full return of capital" provision) could otherwise be bankrupted by success, owing monies to the IRS for a success that, pursuant to the fund documents, they have not received any distribution from. Without this provision the industry would not be viable. If the tax rate is raised, these tax distributions will have to be adjusted upward with the result of lowering the LP return (IRR) on venture funds.

All of the above risks can only be reduced by pursuing the most promising ventures and working diligently to make them successful. They create real incentives to build value in the innovative companies in which we invest.

4. A general partner's profits interest is subject to a "clawback." A clawback means that the general partner will be required to return part or all of the income received on a profits interest if the fund fails to meet a specified return for the limited partners. How frequently are clawback provisions exercised in venture capital funds?

The clawback provision is not a provision that is "exercised" – it is an absolute obligation that applies if the general partner receives distributions in respect of its carried interest in amounts that exceed 20% (or other carried interest percentage) of cumulative net profits. It usually applies only at the end of the life of the fund, although some agreements provide for "interim" clawback obligations.

It arises as follows. If the fund sells securities for a profit, the fund may make a distribution to the general partner based on that profit (assuming that the required amount of capital is returned to the other investors, and assuming that any other hurdle is satisfied). However, if such profits are reduced or eliminated by subsequent losses, the general partner will be required to return the prior distributions to ensure that, cumulatively, the general partner has not received more than 20% (or other carried interest percentage) of profits net of losses.

It is not uncommon for general partners (and, in turn, the venture capitalists) to face a clawback situation. General partners often try to anticipate a potential clawback obligation during the life of the fund and this can incent them to work even harder with their remaining portfolio companies. Although the risk of clawback is minimized if all capital contributions are returned prior to distribution of carried interest, it is not eliminated. For example, contributed capital can be returned and carried interest distributed, and then more capital can be drawn down and lost on investments and expenses.

A great number of venture capital general partners found themselves in this situation several years ago when the dot-com/internet bubble burst. Although these companies were very risky and many failed, this bubble was also a part of advancing technology in our economy today.

Questions from Ranking Member Grassley

1. If carried interests were taxed at ordinary income rates, would you seek to change the carried interest terms of your business, or otherwise renegotiate your management partnerships for the future, to make up for your extra tax costs? Are there other alternative structures you might use to reduce the tax costs?

Taxes (especially those resulting from taxation at ordinary income rates) are an important factor in establishing the terms for any financial arrangement. Venture capital is not an exception. In the market for talented managers and other professionals, venture capital funds compete with investment banks, buyout funds and other financial institutions. Venture capital funds already have a competitive disadvantage in that the remuneration that they offer (i.e., carried interest) is highly risky and often subject to long delay, compared to the bonuses offered by investment banks, for instance. An increased tax on these managers will make it much more difficult to attract them to the venture capital industry.

It is very likely, therefore, that the economic burden of that tax will be shifted to or shared with the investors. This might happen through an in increase in carried interest percentages. If enacted in the form of the Levin bill – which would result in early taxation and an ordinary income rate – it is likely that any carried interest taxed at ordinary income rates would be restructured so that it would not be taxable prior to distribution (as it currently would be).

It is more likely, however, that guaranteed compensation – management fees – would increase. If carried interest is taxed at ordinary income rates like other service income that is not contingent, then venture capitalists would be incented to negotiate for a higher guaranteed form of return. They would likely take less in the contingent, carried interest, form. This, of course, would reduce the alignment of interests that currently exists for the limited partners, general partner and entrepreneurs to build value in companies. These fees would come out of the pockets of the investors.

Like any other business, in order to maximize returns to our owners, we will use any alternative structure that is legally available to reduce taxes (assuming that the taxes are not outweighed by the other costs of using such structures). Whether any alternative structures are available would depend on the form of final legislation. For example, nonrecourse borrowing or options might be possible alternatives as Professor Gergen raised in his testimony. This would require more documentation and introduce waste and inefficiencies into what is now a simple partnership structure.

It also might be possible to provide venture capitalists with "founders stock" in the underlying portfolio companies instead of with carried interest at the fund level. This would preserve capital gain treatment and might be able to mimic the current economic deals although the

cumulative aspect to the carried interest makes this complex and expensive to implement. (See the answer to question 8 below.)

The concern I have with these structures is that either they leave us less aligned with our LPs or the venture fund incurs more expense – the net result of which is to make venture a less attractive asset class for our financial investors. As I mentioned in front of the Committee, the long term and high risk nature of venture already has some LP's wondering if this is the best place to put the amount of capital they are putting today The damage to the US economy would be that fewer new companies would be created and, therefore, fewer new jobs would be formed.

2. Is the general partner in a venture capital fund typically a limited liability company, or some other entity, with the individual venture capitalists as members or owners, or are the individual venture capitalists themselves the general partners?

Typically, the general partner of a US fund is a limited partnership or a limited liability company ("LLC"). If a limited partnership is used (a "GPLP"), the general partner of that GPLP is normally organized as an LLC. The venture capitalists (often referred to "general partners", which is a misnomer) typically would be the limited partners of the GPLP and would receive their shares of the carried interest in that capacity. They would also be the members of the LLC that served as the general partner of the GPLP.

If an LLC is used as the general partner of the fund, the "general partners" become members of the LLC and receive their shares of the carried interest in that capacity. Receipt of carried interest through an LLC structure is often avoided due to uncertainties in the non-US classification of LLCs for non-US tax purposes. For example, unless Canada changes their view of US LLCs to mirror their treatment of US limited partnerships (as is currently under review by the Canadian government), a US investor who invests through a US LLC likely would pay capital gains tax in <u>*both*</u> *Canada and the US, regardless of the fact that this type of double taxation is precisely what the treaty is intended to avoid.*

The formation of an LLC makes sense in that it makes a group of usually three to seven individual partners an "entity" that may have some change in membership (as allowed under the fund documents with the LP investors) during the 12 year life of the fund. The LLC "entity" structure allows for an orderly evolution of individual managers over that time.

3. In your testimony, you referred to preferred stock structures in financing portfolio start-up companies.

4. Is it common in the VC business model for VC funds to receive convertible preferred stock in exchange for the fund's investment, while giving the entrepreneur common stock?

Yes.

5. If so, what are the reasons for using this financing structure?

Typically, any start-up company that we encounter will have already issued common stock to its founders upon formation of the company. Frequently, the founders will have invested little or no capital at that point. As a result, they often will have received that "founders stock" with no or minimal tax effect because, at the point of formation of the company, that founders stock had little or no value.

Pursuant to the terms of our financing agreements, our funds generally receive preferred stock which is necessary to create the proper economic incentives for us and for the founders because it gives our funds "downside" protection in the event of a low value sale of the Company. In this situation, there would be no or minimal gain meaning there would be no or minimal gain flowing through to the general partner.

In most cases, the return on preferred stock has some form of cap such that, at a high value sale, the venture firm is far better off converting to common and participating alongside the founder and management team. In the case of an IPO, all preferred shares are required to convert to common prior to the IPO.

To provide an example, assume that we invest $5M in XYZ company in exchange for 40% of the stock (where such percentage is based on the assumption that we convert our preferred stock to common stock – i.e., on an "as converted" basis). Assume that the founders have invested little or none of their own capital. If the company were sold for $5M, 100% of the proceeds should be returned to us. If we had a simple liquidation preference, any sale over $12.5 million would incent us to convert to common alongside the entrepreneur (since 40% x $12.5 million = $5 million or the amount of our capital which would be a simple liquidation preference).

This preferred stock structure, of course, aligns us with our LP's who want to get their capital back first and want the venture capitalists and the entrepreneur to be rewarded out in the future only when they have <u>*exited*</u> *the company at a significant gain. Our hope in investing in an early stage start up is to create significant long term value; therefore, any other structure would create improper incentives among ourselves, the entrepreneur and our LPs. The founders get their upside when this single company is successful. The venture capitalists get their upside only after a portfolio of companies has been exited successfully.*

6. Into what percentage of the total common shares are the preferred shares typically convertible?

The percentage of the company that the preferred shares are convertible into varies deal by deal. The venture ownership will also likely vary over the life of the company as successive "rounds" of preferred investments are made if and when the company continues to meet its business milestones. Some successful companies have not required multiple rounds of capital so the founders have continued to own a majority of the company while the venture capitalists have owned as little as 25% or less as was the case with Google and EBay. In most companies which require multiple rounds of capital, the investors collectively might own as much as 75% on an as converted basis by the time of an exit. Given the risk and the work effort required in building these small companies, venture investors usually work in syndicates so that ownership is shared among a group of investors. It is worth pointing out that success for the venture

capitalist does not come from the preference or from owning a high percentage of the company but rather from owning a good percentage of great companies. The venture investor will make money where their founders make money.

7. What is viewed as the most valuable aspect of the convertible preferred stock – the right to convert (i.e., option value) or the distribution/liquidation preference?

By far the most important aspect of the preferred stock is the right to convert to common stock in the event the investment in the company is successful. That is the only way that the fund and the LPs make the level of return that makes the "venture model" work. As I described in my testimony, the loss rate on venture is high so the "winners" in a portfolio have to provide significant returns.

Though economic arrangements vary, typically the terms of convertible preferred provide that, upon a sale of the company, the preferred stock holders will receive the greater of (1) the amount that they invested plus a minimal return (typically an 8% annual return) and (2) the amount that they would have received if their preferred stock were common stock (so if we hold 40% of the shares, we get 40% of the proceeds). The intention would be simply to convert and participate with the common, as described in (2), but it is also necessary to ensure that founders and other common holders do not participate in any proceeds unless we receive a return of part or all of our capital plus a minimal return (as described in (1)). We would not make an investment if we thought that we would only receive the liquidation preference – in this sense, we do not value the liquidation preference at all.

Ultimately, the right to convert has a far higher potential value as the most significant returns in our business typically come when a company goes public or is sold at such a high value that the best return for the venture firm is to convert to common shares (as the return on preferred shares is usually limited). There is, however, no "option value" involved, despite the use of the term "convertible". Option value suggests that there is an opportunity to "wait and see" before we put our capital at risk. Our capital is put at risk up front. The conversion feature is merely a mechanism used to eliminate the liquidation preference and put us on par with all equity holders – the same result could be achieved without conversion by simply providing in the investment documents that all proceeds will be shared pro rata by all shareholders, without regard to the class of shares held.

8. Could the profits interest at the fund level be thought of as economically similar to the common stock at the portfolio company level, and the limited partner interests similar to the convertible preferred?

Yes. In the early stages of a portfolio company, the founders receive common stock. At that time, the company generally has no assets and therefore has no value or has very little value. Therefore, the receipt of this "founders stock" generally does not trigger any tax. Sometime later, the company will raise capital by selling preferred stock, entitling the holders to a return of their capital and a minimal return before the common stock holders are entitled to receive any proceeds on a sale of the company. This liquidation preference also has implications for the value of the common stock – that is, the common stock is very similar to a profits interest in that

a hypothetical liquidation at the time of financing would generally result in a zero return to the common stock holders.

The economics (and tax consequences) at the fund level are very similar. At the time that the venture capitalists form the fund, and receive the contractual right to a carried interest, the fund has no assets and, therefore, no value. As the fund draws down capital from investors and makes investments, all of the value of the fund is attributable to the investors (the "LPs") – that is, the investors basically have a preferred interest because they are entitled to a return of their capital (and sometimes a minimal return (8%)) before the general partner is entitled to receive any distributions with respect to its carried interest.

Economically, the venture capitalists are in the same position as the founders. The venture capitalists and the founders will only profit from the carried interest and the founders' stock, respectively, to the extent that the proceeds from a sale or public offering of the company exceed the capital provided by the investors (plus a minimal return, if applicable). The economic analogy (and tax analogy) is even closer in those situations where the portfolio company is structured as a partnership or limited liability company.

The only difference for the venture capitalist is that, even if an investment is profitable, there is an additional risk that such profits will be offset by losses on other investments, resulting in less carried interest or no carried interest at all. A typical venture fund holds 20-30 portfolio companies and the carried interest is determined by aggregating the gains and losses of those portfolio companies.

In short, for a founder to make a capital gain he or she has to create enough value in the company to more than return the investor's capital and for a GP to make a capital gain he or she has to help create enough value in multiple companies to return the LP's invested capital.

9. Limited partners in venture capital funds give up 20% of their upside to the general partner.

10. Why are the financial partners in a VC fund willing to give up 20% o the profits on their investments?

The reason that financial partners in a venture fund are willing to "give up" 20% of the profits is the same reason that venture funds are willing to allow founders to retain an equity interest in the company. The venture capitalists are instrumental in building value in their companies. In fact, in many cases, we are, effectively, the founders. The financial partners are looking for people with the right skills to create and work with these companies in the hopes of generating returns upon exit and they absolutely recognize in all their due diligence that the GP provides "more than money." There is no significant desire or trend for LPs to invest directly in start up companies as they do in other sectors because they recognize that while they might have the money, they do not have the expertise or the time to contribute. They are more than happy to share 20% of the profits. For the most successful funds, they even share more to incent the GP to make profits for both of them.

We serve operational functions that are similar to the functions that our founders and management provide. We serve on the board of directors, we provide strategic guidance for management (and sometimes we are "management"), and we provide technical/scientific guidance (as many of us have advanced science degrees).

We also contribute intangible assets to the portfolio companies that are critical to their success. For example, we provide access to our networks of customers, suppliers, distributors, potential employees, and prospective business partners. We open up our customer lists and databases. Our goodwill and reputation in the industry allow doors to be opened to the entrepreneurs. In one case in my own portfolio, our fund introduced what was then a small start-up to a Fortune 500 company who has now become its largest partner, driving a significant portion of its future growth and greatly improving its prospects for success.

We work side-by-side with the other founders, managers and employees of our portfolio companies, and share the direct responsibility for their success.

Because our talents are not fungible, financial partners are willing to allow us to keep equity (as owners of the enterprise) that is contingent on those talents and intangible contributions. The number of creative and innovative ideas is finite. The subset of those ideas that can be brought to market and succeed is limited and needs venture capital talent and contributions. Financial partners recognize that these risky endeavors require a high reward in order to continue to be available to them.

11. What factors enter into the negotiation of the carried interest percentage?

A twenty percent carried interest is relatively standard in the industry. Some funds that have established a reputation, or track record, for generating extraordinary returns demand and have received a higher rate – 25%, and in a few cases, 30%. For most direct funds (as opposed to "funds of funds" or "secondaries funds"), however, a 20% carried interest is considered necessary by LPs to incent GPs to enter this high-risk venture capital industry, where returns might be zero.

In our experience, the LPs do not begrudge the carried interest and spend far more time negotiating the level of management fees. Therefore, a taxation change that might drive more emphasis on fee income and less focus on capital gains (which is where the fund returns are made) will run counter to the incentives they were trying to put in place to begin with.

CBO TESTIMONY

Statement of
Peter R. Orszag
Director

The Taxation of Carried Interest

before the
Committee on Finance
United States Senate

July 11, 2007

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Chairman Baucus, Senator Grassley, and Members of the Committee, thank you for inviting me to testify on the taxation of carried interest.

My testimony makes the following main points:

- A growing amount of financial intermediation is occurring through private equity and hedge funds, which are typically organized as partnerships or limited liability companies and now have at least $2 trillion under management. Those organizational forms are growing rapidly for many reasons, including their tax advantages over traditional financial services corporations.

- A general partner of a private equity or hedge fund typically receives two types of compensation: a management fee tied to some percentage of assets under management and "carried interest" tied to some percentage of the profits generated by those assets. The management fee is taxed as ordinary income to the general partner. Taxation on the carried interest is deferred until profits are realized on the fund's underlying assets, and any resulting profits to the general partner are taxed at the capital gains tax rate to the extent the fund's profits reflect capital gains.

- Most economists, however, would view at least part and perhaps all of the carried interest as performance-based compensation for management services provided by the general partner rather than a return on financial capital invested by that partner. That perspective would suggest taxing at least some component of the carried interest as ordinary income, as most other performance-based compensation is currently treated, regardless of the nature of the underlying investments generating the profits of the fund.

- A variety of proposals have been put forward to alter the tax treatment of carried interest. Policymakers considering those changes need to evaluate many factors, including the potential distortions created by the current tax treatment of partnerships and carried interest relative to that of other organizational forms and types of income; the consequences for a broad range of industries, including real estate development, if a general solution is adopted, or the advisability of industry-specific rules, if a solution targeted to financial investment funds is pursued; the potential unintended effects, complexity, and perceived fairness of tax changes; and any net revenue effects. My testimony briefly reviews several recent proposals to change the tax treatment of carried interest in light of those considerations.

- Much of the complexity associated with the taxation of carried interest arises because of the differential between the capital gains tax rate and the ordinary income tax rate, which creates an incentive to shift income into a form classified as capital gains. Further widening of the differential between the taxation of ordinary income and of capital gains would create even stronger incentives to shift income into the tax-preferred capital form.

I would also emphasize that any revenue estimates associated with changing the tax treatment of carried interest would be undertaken by the Joint Committee on Taxation. My testimony therefore does not discuss specific revenue effects from proposed changes to that tax treatment.

Recent Innovations in Financial Services

Financial markets have experienced substantial innovation over the past several decades. Those innovations have affected the assessment and pricing of risk (including the development of credit derivatives and interest rate swaps) and the use of financial markets in supplying credit. The resultant changes in the allocation of capital and the pricing and dispersion of risk has probably contributed to continued economic growth. By increasing businesses' and households' access to capital, financial innovations probably also help explain the dampening of business cycles and the significant decrease in macroeconomic volatility over the past two decades.[1] The innovations also, however, have facilitated an ability by individual market participants to assume substantially greater degrees of risk and thus raised concerns about potential systemic risks to the financial system.

In addition to their effects on the allocation of capital and dispersion of risk, the financial innovations have been associated with substantial rewards to many people engaged in financial activities. The compensation of the top executives of investment banking firms are among the highest in the country. Recently, the pay of those top executives has, if anything, been surpassed by the compensation of people managing investments through alternative structures such as private equity and hedge funds. A recent study estimated that in 2004, almost nine times as many of those types of investors earned in excess of $100 million as did public company chief executive officers.[2] According to one press account, the top 25 hedge fund managers earned $14 billion in 2006, with one manager earning more than $1.5 billion. The substantial income accruing to managers of private equity and hedge funds is one facet of and a contributor to broader income trends.

Private equity and hedge funds in particular have played an increasingly important role as financial intermediaries:

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1. See Karen E. Dynan, Douglas W. Elmendorf, and Daniel E. Sichel, *Can Financial Innovation Help to Explain the Reduced Volatility of Economic Activity?* Finance and Economics Discussion Series, Working Paper No. 2005-54 (Washington, D.C.: Federal Reserve Board, November 2005). The decline in macroeconomic volatility, however, does not appear to have been associated with a reduction in the volatility of household earnings or income. See Statement of Peter R. Orszag, Director, Congressional Budget Office, *Economic Volatility*, before the Joint Economic Committee (February 28, 2007).

2. See Steven N. Kaplan and Joshua Rauh, *Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?* Working Paper No. 615 (Chicago, Ill.: University of Chicago, Graduate School of Business, Center for Research in Security Prices, September 13, 2006).

- **Private equity** funds raise capital to purchase or invest in new and existing businesses. They are private in the sense that their ownership interests are not publicly traded. Instead, they raise investment capital outside public financial markets from sources such as pension funds, endowments and foundations, and wealthy individuals. With those funds, they make various investments, including in publicly traded companies. Private equity firms may acquire mature public companies with the intent of converting them to private companies, restructuring or reorganizing their activities, and then later reselling them to the public or another firm. The initial purchase of a public firm by the private equity fund can be done through a leveraged buyout (LBO), in which the private equity firm relies heavily on debt raised from third-party investors to finance the necessary purchases of the public company's shares. Venture capital is a type of private equity that specializes in investing in small start-up businesses.

- **Hedge funds** trade in a variety of financial markets and typically adopt complicated investment strategies, often involving financial derivatives. Some funds buy and sell stocks of publicly traded companies or derivative instruments based on stocks, such as options. Some specialize in debt instruments based on corporate loans, mortgages, and credit card debt. Many derivatives of subprime mortgages are held in hedge funds. Other hedge funds specialize in trading currencies, commodities, and derivatives based on them. Despite their name, hedge funds are not necessarily "hedged" in the traditional sense of being insulated from risk; many hedge funds take significant risks either knowingly or unknowingly. As with private equity funds, hedge funds do not raise funds through public issuance of securities; instead, they typically raise capital from institutions and wealthy individuals. Hedge funds' investments are often intended to be shorter term and typically do not involve management control, in contrast to the investments made by private equity funds, although the distinction between hedge funds and private equity can become blurred in practice.

The role of private equity and hedge funds has expanded substantially in the past 20 years. From 1980 to 1995, the amount of capital under management in the private equity market increased from roughly $5 billion to over $175 billion.[3] In the past decade, the market has continued to experience rapid growth, and by some estimates, private equity funds now have more than $1 trillion under management. Estimates also suggest that roughly 8,000 to 9,000 hedge funds now exist, with more than $1 trillion in funds under management. In other words, private equity funds and hedge funds together have more than $2 trillion under management.

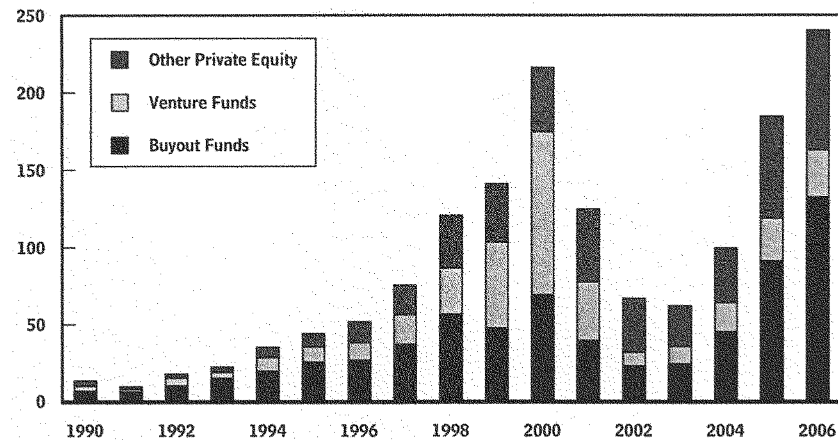
In 2006, private equity firms raised over $240 billion in capital, up from less than $25 billion a year in the early 1990s (see Figure 1). The private equity market is

3. See Stephen D. Prowse, "The Economics of the Private Equity Market," *Economic and Financial Policy Review*, Federal Reserve Bank of Dallas, Third Quarter (1998), pp. 21–34.

Figure 1.

Capital Raised by U.S. Private Equity Funds

(Billions of dollars)



Source: Congressional Budget Office based on data from Thomson Financial, Morgan Stanley Research.

dominated by a small number of major players. Over the past five years, the top five private equity firms have raised an average of $30 billion in capital. The average amount raised among the next five largest firms was $18 billion and among the next 40 largest firms, about $8 billion.

The volume of private equity deals more than doubled in 2006, with LBOs accounting for almost 20 percent of the $3.5 trillion in global mergers and acquisitions. This year, LBOs accounted for more than 17 percent of the $2.26 trillion in deals through June 2007 and are on pace to break last year's record volume.[4]

Tax data provide another indication of the significant income that flows through entities such as private equity and hedge funds, along with other partnerships and S corporations. In 2005, capital gains from partnerships and S corporations were 22 percent of total current-year long-term capital gains reported on individual income tax returns, and 27 percent of the gains received by the 1 percent of taxpayers with the highest income (those figures do not include losses carried over from previous years).

4. Thomson Financial, as cited in "Who's Who in Private Equity," *The Wall Street Journal Online*, available at www.wsj.com.

Structure and Tax Treatment of Private Equity and Hedge Funds

Most private equity and hedge funds are organized as partnerships or limited liability companies; in most of this testimony, they are referred to simply as partnerships, because the tax characteristics of partnerships and most limited liability companies are essentially identical.

The partnerships typically consist of one or more general partners, who manage the partnership and determine the investment strategy, and limited partners, who contribute capital to the partnership but do not participate in management. General partners may also invest their own financial capital in the partnership, but such investments usually represent a small share of the total funds invested. (The general partner is itself typically a partnership, with the individual managers of the fund as partners.)

Several factors may motivate private equity and hedge funds to be organized as partnerships. For example, a partnership structure is often attractive because its flexibility can accommodate complex financial arrangements among those managing the fund and those contributing capital to it. It is likely, however, that tax law plays an important role in explaining why so much financial management activity is now occurring through partnerships. In particular, private partnerships (and limited liability companies electing to be treated as a partnership for tax purposes) do not pay a separate corporate income tax. Instead, they pass all income and losses through to the partners, who are liable for any income tax. As described below, the partnership structure is also attractive to investment fund managers because of the manner in which part of their compensation (the so-called carried interest) is taxed.

In contrast to private partnerships, publicly traded partnerships are generally treated as corporations for tax purposes and are subject to the corporate income tax. (The primary exception to this rule is that certain partnerships that derive at least 90 percent of their income from passive investments such as dividends, interest, rents, and capital gains or from mining and natural resources and that are therefore not required to register as investment companies under the Investment Company Act of 1940 do not pay the corporate tax.)

The taxation of the partnership entity itself is not the primary focus of my testimony, although it is worth noting that corporate income tax revenues have declined over the past several decades relative to the size of the economy, partly because of the effects of financial innovation and global integration and possibly because of the increased use of noncorporate forms of conducting business (which were created in part to avoid the potential distortions associated with corporate

taxation).[5] Developments such as the growth of private equity and hedge funds may affect corporate income tax revenues in the future; a number of private equity firms, for example, are taking steps to go public without relinquishing their exemption from the corporate tax. Legislation introduced by Chairman Baucus and Ranking Member Grassley would tax as corporations publicly traded partnerships that derive income from asset management or as investment advisers.

Carried Interest

A general partner in a private equity or hedge fund is typically compensated in two ways: through a fixed management fee and a share of profits.

The fixed management fee, usually 1 to 2 percent of the assets under management, does not depend on the performance of the fund. For example, if the fund had $1 billion in assets under management and a 2 percent management fee, the management fee would amount to $20 million a year, and that amount would not depend on the return on the $1 billion in assets. The $20 million would be taxed as ordinary income to the general partner and would generate a deduction as an investment expense for the limited partners.

The second component of the general partner's compensation is a share of the profits on the assets under management. That component, which is often 20 percent of such profits, is usually referred to as carried interest, or, simply, carry.[6] For example, assume the fund with $1 billion in assets generated a 15 percent realized profit in a year. Of the $150 million in profits, the general partner earning 20 percent carried interest would receive $30 million. The other $120 million in profits would be split among the investors in the fund (including the general partner if he or she owned some of the capital in the fund in addition to managing it). In many cases, the general partner earns carried interest only when profits exceed some threshold.[7] For example, in many private equity funds, the general partner will

5. Corporate tax revenues declined from 3.6 percent of gross domestic product (GDP) in 1962 to 1.2 percent in 2003. A recent surge in corporate tax collections has temporarily reversed that longer-term trend—corporate tax revenues rose from 1.2 percent of GDP in 2003 to 2.7 percent in 2006, explaining the bulk of the overall increase in federal revenues over that time—but CBO projects a gradual decline in that share from current levels. See Congressional Budget Office, *Federal Tax Revenues from 2003 to 2006* (May 18, 2007) and *The Budget and Economic Outlook: Fiscal Years 2008 to 2017* (January 2007).

6. Managers of public mutual funds are not permitted to be paid in that fashion. Because private equity and hedge funds are exempt from the Investment Company Act of 1940, however, that form of compensation is permitted.

7. Such a preferred return for the limited partners is more common in private equity buyout firms than in venture capital firms. See Victor Fleischer, "The Missing Preferred Return," UCLA School of Law Research Paper No. 05-8 (February 2005).

receive carried interest only when profits exceed a "hurdle rate," often an 8 percent return.[8]

Tax Issues Surrounding Carried Interest

Carried interest arrangements for partnerships raise two significant tax issues: the timing and the character of the income earned by the general partner. Both of those issues involve the same underlying question, which is whether a general partner's carried interest should be treated as a quasi-investment in the partnership by the general partner, with the result that the carried interest would be subject to the same tax rules as apply to the limited partners' partnership interests, or whether the general partner's carried interest is more properly viewed as some form of contractual undertaking by the limited partners (or the partnership) to compensate the general partner for management services.

Deferral of Taxation

The first tax issue involves the timing of a general partner's tax liability for the carried interest that he or she receives for managing the fund. Under current law and regulations, carried interest is not taxed at the time the right to the future profits is granted (for example, when the partnership is created) but rather when the partnership realizes profits that are allocated to the general partner.

At one level, deferral is a specific example of a more pervasive phenomenon, which is the tax code's reliance on realization events—the sale of an investment, for example—to determine the timing of income from investments. Indeed, limited partners in a private equity fund also enjoy the benefits of deferral: They do not pay tax on unrealized gains but only on gains that have been recognized through a sale or similar event.

At another level, however, deferral as applied to a general partner's carried interest effectively assumes the conclusion of the underlying technical and policy issue: whether the general partner's carried interest should be treated as a simple investment by the general partner (albeit one that has no claim to the current capital of the fund but only to the future appreciation thereof), or whether, at least to some degree, the carried interest in substance is a form of compensation paid by the limited partners to the general partner for services in managing the fund. Most analysts believe that alternative characterization is more accurate.

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8. If that 8 percent hurdle rate applied to the example, the general partner would receive the 20 percent carried interest on $70 million (which is the $150 million in profits minus the threshold of $80 million that must be exceeded before carried interest applied), or $14 million.

More specifically, carried interest can be viewed as a call option on a limited partnership interest, with a value equal to 20 percent of the future capital in the fund and a strike price equal to 20 percent of the initial value of the fund.[9] Options pricing formulas, such as the Black-Scholes formula, can then be applied to valuing the carried interest. Although various complications arise in applying such options pricing techniques (including the requirement to estimate both the duration of the fund and the volatility of the underlying investments), it is clear that whatever the imperfections in the valuation process, an interest in future profits has some value greater than zero.

It is worth noting that deferral of taxation on carried interest generates a tax benefit to the general partner (who does not recognize income initially) but a tax cost to the limited partners (who do not enjoy a deduction or other reduction in taxable income at that point). Many limited partners are either tax-exempt entities in the United States or foreign institutions (see Table 1), however, so they may be largely unaffected by the lack of an immediate U.S. tax benefit. The net result is, therefore, the overall deferral of a net tax liability.

Treatment as Capital Gains or Ordinary Income

The second issue is the character of the income received as carried interest. Under current law and regulations, carried interest is treated in the same way as all other profits from the partnership for tax purposes. In particular, carried interest flows through to the general partner on the basis of the nature of the income from the underlying investments. Thus, if the carried interest arises from realizations of long-term capital gains on the investments held by the fund, the general partner is taxed on the carried interest at the long-term capital gains rate. In the paradigmatic private equity case, most profits arise from long-term capital gains, so the profit allocated to the general partner's carried interest will be taxed as long-term capital gains.[10] For simplicity, the remainder of this testimony assumes that case and also assumes that no hurdle rate is applied to the carried interest. Such a hurdle rate would affect the precise examples and calculations but not the underlying substance of the issue.

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9. A call option gives the holder the right to purchase an asset at the strike price. Consider a fund with $1 billion under management and 20 percent carried interest. If the fund then grows in the future to $1.5 billion, the general partner will be entitled to 20 percent of the $500 million increase, or $100 million. That outcome is equivalent to a right to receive 20 percent of the future value of the fund ($1.5 billion x 20 percent = $300 million) in exchange for paying 20 percent of the initial value of the fund ($1 billion x 20 percent = $200 million). This example assumes no hurdle rate is applied to the carried interest; the presence of such a hurdle rate would be reflected in the valuation of the option.

10. A hedge fund's income from securities trading, by comparison, usually constitutes a short-term capital gain or ordinary income, particularly if, as often is the case, the fund has elected to be taxed as a securities trader under section 475(f) of the Internal Revenue Code.

Table 1.

Percentage of Capital Investment in Private Equity by Type of Limited Partner

	2005[a]	2006[b]
Public Pension Funds	22	26.6
Corporate Pension Funds	10	12.3
Union Pension Funds	1	1.4
Banks and Financial Services	6	9.8
Insurance Companies	12	7.5
Endowments/Foundations	10	7.7
Family Offices	11	6.8
Wealthy Individuals	10	10.1
Funds of Funds	13	13.9
Other	5	3.9
Total	**100**	**100**

Source: Private Equity Council, *Public Value: A Primer on Private Equity* (Washington, D.C., 2007), p. 11.

a. Based on a sample of more than 75 global funds with total capital of over $32 billion.

b. Based on a sample of more than 110 global funds with total capital of over $44 billion.

To see how that system of taxation works, assume that a fund realized a profit of $150 million in long-term capital gains and that the carry was equal to 20 percent of that profit, or $30 million. The general partner would then pay capital gains tax on that $30 million; at a capital gains tax rate of 15 percent, the tax owed would be $4.5 million.

As an economic matter, the character of carried interest income should not depend on whether the compensation is performance-based. A wide range of performance-based compensation, including arrangements in which service providers accept the entirety of the risk of the success or failure of the enterprise, is effectively labor income and taxed as ordinary income for services. Contingent fees based on movie revenue for actors, for example, are taxed as ordinary income, as are performance bonuses, most stock options, and restricted stock grants.[11] So too are incentive fees paid to managers of other people's investment assets, when those fees are documented as such rather than as carried interest in a formal partnership. Instead, the key issue is whether the carried interest represents a fee for services provided or a

11. The tax treatment of nonqualified stock options, which are the most common type of options, is an example. Nonqualified stock options are generally taxed when they are exercised (although the tax can be delayed if the purchased shares are subject to a substantial risk of forfeiture), and the difference between the market price at the time of exercise and the strike price (multiplied by the number of shares) is taxed as ordinary income. The tax treatment of incentive stock options is more advantageous, but current law significantly limits the value of such options that can receive favorable tax treatment.

return of partnership long-term capital gains allocated to one partner (the general partner) under conditions that are not qualitatively different from the returns allocated to the other partners (the limited partners).

Most legal and economic analysis suggests that carried interest represents, at least in part, a form of performance-based compensation for services undertaken by the general partner. Although individual analyses differ slightly, there are two important themes with which most analysts concur. First, a general partner in a private equity or hedge fund undertakes a fundamentally different economic role from that of the limited partners, because the general partner is responsible (by virtue of his or her expertise, contacts and experience, and talent) for managing the fund's assets on a day-to-day basis. Second, the carried interest is not principally based on a return to the general partner's own financial assets at risk. If the purpose of the preferential rate on long-term capital gains is to encourage investors to put financial capital at risk, there is little reason for that preference to be made available to a general partner, whose risk involves his or her time and effort rather than financial capital.

Some observers view carried interest as a mixture of compensation for management services and capital returns. For example, one can think of carried interest as an interest-free nonrecourse loan from the limited partners to the general partner equal to 20 percent of the partnership assets, with the requirement that the loan proceeds be reinvested in the fund. (A borrower is not personally liable for a nonrecourse loan, beyond the pledged collateral, which in this case is the general partner's claim on future profits.) To see how this example works, imagine a fund worth $100 million. With no direct capital investment, the carried interest entitles the general partner to the profits on $20 million (20 percent of the profits on $100 million is equivalent to the full profits on $20 million). It is therefore as if the limited partners have contributed $80 million to the fund and then lent the general partner $20 million to invest in the fund too, but without charging the general partner interest on that loan.

This implicit loan perspective would result in treating carried interest somewhere between purely capital income and purely ordinary income. In particular, under current tax rules, the implicit interest on an interest-free loan would be taxed as ordinary income, with the interest rate set at the current rate on federal securities with the same duration as the loan. At the time the partnership sold its assets, any gain or loss to the general partner, after paying back the loan, would be treated as capital. In effect, then, this perspective would suggest that the component of carried interest attributable to implicit interest on the implied loan would be ordinary income and that the returns in excess of that implicit interest would be capital income.[12]

12. The presence of a hurdle rate on the carried interest would affect the calculation of the forgone interest on the implicit loan provided to the general partner.

The differential tax treatment of carried interest relative to the management fees earned by general partners has apparently led to efforts to transform management fees into carried interest. Consider the example of the $1 billion investment fund with a 2 percent management fee, 20 percent carried interest, and a 15 percent realized profit on long-term capital gains. The general partner would then receive $50 million in income: $20 million in management fees and $30 million in carried interest. With a 35 percent ordinary income tax rate and a 15 percent long-term capital gains tax rate, the general partner would pay $11.5 million in income taxes. If the general partner was able to reduce the management fee to 1 percent and increase the carried interest to 26.7 percent, the income flowing to the general partner would remain $50 million ($10 million in management fees and $40 million in carried interest). The taxes owed, however, would decline by $2 million, to $9.5 million. Such transformations of management fees into carried interest have apparently occurred, in some cases even after realized profits are known. Those types of transformations further highlight some of the similarities and, therefore, the interchangeability between management fees and carried interest. That those components of compensation are substituted for each other suggests, at least in part, that both types of income represent compensation to the general partner for management of the fund.

Finally, the issues of characterizing a flow of income as a return on capital or compensation for services provided are not unique to private equity or hedge fund partners and are not new developments. Many real estate development deals, for example, are structured as partnerships with essentially similar characteristics, in which an active manager or developer obtains a disproportionate share of partnership income or profits in return for his or her contributions of intangibles (contacts, know-how, and so forth) and management of the project. Nonetheless, the typical private equity firm presents the paradigmatic case for considering the appropriate tax treatment of carried interests.

Options for Modifying the Tax Treatment of Carried Interest

The tax issues described in the previous section have given rise to proposals to change the current tax treatment of carried interest. Policymakers considering such proposals may want to weigh the underlying substance of the tax issue at hand with various other considerations. For example, in general, changes in tax policy that have significant and potentially unexpected effects on particular industries should be approached with caution, because a broader policy objective may be served by stability and an associated perception of fairness. Furthermore, as noted above, carried interest arises not just within private equity and hedge funds; it is also a common feature of partnerships in other sectors. Many of the underlying tax issues that arise with regard to the taxation of carried interest in the financial services sector arise in those other sectors as well, and policymakers interested in changing the tax treatment of carried interest therefore need to evaluate the costs

and benefits of changing that treatment for all carried interest relative to restricting the change to the financial services industry.

Several proposals have been put forward to modify the tax treatment of carried interest. Under these proposals, some, if not all, carried interest would be treated as ordinary income regardless of the type of asset generating the fund's profits.[13]

Tax Carried Interest as Property When Granted. One alternative would be to tax the general partner on carried interest when granted. Under section 83 of the Internal Revenue Code, property (other than an option) transferred to a person in connection with the performance of services is generally taxed when that property is transferred. Under relatively unusual facts, the tax court held in *Diamond v. Commissioner* that the grant of a carried interest right "with determinable market value" constituted current ordinary income to the general partner.[14] Because carried interest may be difficult to value, though, most practitioners continued to view the granting of carried interest as a nontaxable event. The Internal Revenue Service later embodied that view in Revenue Procedure 93-27. One possibility would be to alter that revenue procedure and apply section 83 to the grant of a carried interest. The valuation could then be done by Black-Scholes or some other method.[15] The grant would be currently taxable as ordinary income to the general partner and generate a deduction for the limited partners.[16]

This approach would affect both the deferral component of carried interest and its character. For the reasons described above regarding the limited impact from a deduction granted to the limited partners, the result would be a net acceleration of revenues received by the federal government. Another result would be that the carried interest (its value determined at the time it was granted) would be treated as ordinary income. To the extent that the carried interest then appreciated or depreciated in value relative to the initial estimate, the changes would be taxed as capital gains or losses.

This approach would require some acceptable valuation methodology, however, which might be difficult to apply in the wide variety of circumstances in which carried interest arises. Furthermore, even with an accepted valuation methodology, modest changes in the assumptions applied may generate significant changes in

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13. To implement any of these options, policymakers would also need to decide whether to treat the resultant ordinary income as labor income; if so, the income would also generally be subject to payroll taxation. The arguments in favor of viewing carried interest as ordinary income would tend to suggest that tax treatment.

14. *Diamond v. Commissioner,* 56 T.C. 530, (1971), (*aff'd*), 492 F. 2d 286 (7th Cir. 1974).

15. See, for example, Lee A. Sheppard, "Blackstone Proves Carried Interests Can Be Valued," *Tax Notes*, vol. 115, no. 13 (June 25, 2007), pp. 1236–1243.

16. Although the valuation of the grant may be undertaken using options pricing methodologies, this tax treatment would differ from that applied to nonqualified stock options, which are typically not taxed when they are granted but when they are exercised.

valuation—creating opportunities to understate the value of the carried interest when granted. Finally, as noted above, deferral arises in a variety of settings across the tax code, and some observers believe eliminating deferral in this context but not others would not be justified.[17]

Tax Carried Interest as Ordinary Income When Realized. A second option would be to continue to allow deferral but to view carried interest as a fee for services provided and therefore tax the income distributed to the general partner as ordinary income. Carried interest would thus be taxable to the general partner as ordinary income and deductible as an expense incurred to earn investment income to the limited partners. As an example of this broad approach, consider the fund with $1 billion in assets and 20 percent carried interest. If the fund earned a realized profit of 50 percent, the carried interest of $100 million would be taxed to the general partner as ordinary income (rather than capital gains). At a 35 percent tax rate, the income tax owed would be $35 million, rather than the $15 million that would be due if the income were taxed at the 15 percent capital gains tax rate.[18]

H.R. 2834, introduced by Representative Levin and others, would implement this approach. Another approach proposed to accomplish the same objective is to modify section 707(a)(2)(A) of the Internal Revenue Code to require that carried interest be treated as a transaction between the partnership and a nonpartner; the result would be to treat the carried interest as ordinary income.[19]

This approach would most closely mirror the tax treatment of nonqualified corporate stock options, which share many characteristics with carried interest. As with the tax treatment of nonqualified options, this approach would not eliminate the deferral of taxation (because it would not impose the tax when the carried interest

17. For example, carried interest in the partnership context has much in common with employee stock options that a corporation might grant to valued employees. The tax code typically taxes those options as ordinary income only on exercise, in an amount equal to an employee's economic gain at that time (that is, the difference between the corporate stock's fair market value on the exercise date and the price paid by the employee under the terms of the option). Policymakers may want to consider whether it is appropriate to create a timing rule for carried interest that would vary significantly from the general rule adopted for somewhat analogous nonqualified employee stock options.

18. Again, the limited partners would receive an ordinary income tax deduction, but the net effect would probably be a revenue gain for the reasons described earlier in the text.

19. See Lee A. Sheppard, "The Unbearable Lightness of the Carried Interest Bill," *Tax Notes*, vol. 116, no. 2 (July 12, 2007), pp. 15–21.

was granted) but it would impose ordinary income taxation.[20] This approach would also most directly reflect the view that carried interest fully represents performance-based compensation for services provided.

The approach might, however, create various tax planning opportunities, including the use of nonrecourse loans from the limited partners to the general partner, to attenuate its impact. Finally, although there is widespread agreement among analysts that at least some component of carried interest represents compensation for services provided, there is somewhat less agreement that the full amount of carried interest represents such compensation. To the extent that at least some component of carried interest is viewed as a return on capital invested, this approach could be viewed as overtaxing carried interest.

Tax Imputed Interest on the Implied Loan.[21] A third option would be to explicitly treat the general partner's carried interest as a nonrecourse loan from the limited partners and tax the value of the implicit interest to the general partner as it accrued. As a result, that part of the carried interest would be treated as ordinary income, and part would be treated as a return on capital.

Consider again a private equity or hedge fund partnership that starts with $1 billion in assets. The underlying assets are sold after three years for $1.5 billion, generating a realized profit of $500 million. With 20 percent carried interest, the general partner would receive $100 million when the fund liquidated or sold the assets (20 percent of the $500 million profit). Under current law, the general partner would pay a tax of $15 million on his or her share of the profits (15 percent of $100 million), under an assumption that the distributions qualified as long-term capital gains. If the carried interest was treated as ordinary income, as in the option above, the general partner would pay a tax of $35 million (35 percent of $100 million).

If, instead, the 20 percent carried interest was treated as a nonrecourse interest-free loan with the loan proceeds invested in the fund, the general partner would generally pay a higher tax than under current law but generally less than under the ordinary income option. In particular, in the example, the general partner would be treated as if he or she had received a $200 million loan from the limited partners, which he or she then invested in the fund, obtaining a 20 percent interest in the fund. After three years, the general partner would be treated as if he or she

20. Apparently because of concerns about valuation, nonqualified stock options are generally not taxed when they are granted, but rather when they are exercised. Such valuation concerns are similar to those surrounding the value of a carried interest when granted, and the typical deferral of taxation on nonqualified stock options until they are exercised may suggest that the taxation of carried interests should also be deferred, as this option would entail.

21. One analyst describes this option as a cost-of-capital approach. See Victor Fleischer, "Two and Twenty: Taxing Partnership Profits in Private Equity Funds," University of Colorado Legal Studies Research Paper Series, Working Paper No. 06-27 (June 12, 2007).

received a 20 percent share of the $1.5 billion in assets held by the fund, or $300 million, and paid back the $200 million loan. The general partner would thus have a realized gain of $100 million (the underlying carried interest). The tax on that $100 million would be $15 million, again under the assumption that the fund's profits qualified as long-term capital gains. However, because the loan from the limited partners was interest-free, the general partner would be required by current law to count the forgone interest payments as ordinary income and pay tax on them each year.[22] With a 5 percent interest rate, the implied ordinary income would be $10 million per year, and the tax would be $3.5 million per year.[23] The time value of money aside, the total tax bill would be $25.5 million ($15 million plus $10.5 million). That tax liability, as expected, falls between the tax liability of $15 million under full capital gains tax treatment and the $35 million under full ordinary income tax treatment.

One advantage of this approach is that it may be more resistant to financial planning that does not change the underlying economics of the partnership arrangement. It also reflects the view that some analysts hold that carried interest is neither entirely a return on capital nor entirely labor compensation. However, the approach is clearly complex. The extent of the complexities involved may make this approach particularly difficult to implement in practice.

A Broader Issue: Differential Tax Rates on Capital and Labor Income

Much of the complexity associated with the taxation of carried interest arises because of the differential between the capital gains tax rate and the ordinary income tax rate. In particular, ordinary income for high-income taxpayers is typically subject to a 35 percent marginal income tax rate and, in the case of labor income, an additional 2.9 percent payroll tax for Medicare. Long-term capital gains for such taxpayers are typically subject to a 15 percent tax rate. The difference creates a strong incentive to shift income into forms classified as capital gains. Whether carried interest represented compensation for services provided or a return on capital invested would be largely irrelevant if the tax rates on labor and capital income were the same (although the issue of deferral would still remain).

22. This option assumes that the general partner would not receive a deduction for the imputed interest payments on the implicit loan. Under current law, imputed interest on actual loans may generate a deduction for the borrower. Advocates of this option, however, would not extend such a deduction to the general partner (the borrower of the implicit loan); they justify such a deduction in different ways.

23. The example follows the convention of using the federal interest rate on short-term securities. The choice of the proper interest rate is a significant issue in this approach, however. A 5 percent interest rate is arguably too low for a nonrecourse loan on a risky asset. The presence of a hurdle rate on the carried interest would also affect the calculation of implicit interest.

The Tax Reform Act of 1986 set the tax rate on capital gains at the same rate as the tax on ordinary income, but legislation since then has reintroduced differential tax treatment. A lower tax rate on capital gains and dividends than on other forms of income creates opportunities for tax avoidance and complicates the tax system. Income from sole proprietorships, S corporations, and other noncorporate entities is a mix of returns to capital and returns to labor, and a significant portion of the tax code is devoted to attempting to distinguish one type of income from another.

As the tax rate differential increases, the distinctions among different types of income assume greater importance. Proposals to reduce the tax on capital income (for example, by moving to a consumption tax) or to raise the tax on labor income (for example, by increasing the payroll tax) would increase the differential further and thereby create an even stronger incentive to shift income into a form classified as capital.

One motivation for differential tax treatment has been a desire to promote capital formation and economic activity. The empirical evidence suggests, however, that a low capital gains tax rate has only modest effects on such outcomes. Furthermore, the application of that broader motivation to carried interest in investment funds is unclear, because the financial capital that is gathered and invested in such funds is provided almost entirely by the limited partners, not the general partner.

Many considerations need to be taken into account in evaluating the appropriate tax rate on capital income. The income-shifting incentives and potential associated distortions created by differential rates on capital and income, which are highlighted by the debate over carried interest, represent one consideration.

Carried Interest Part I
Responses to Questions for the Record From Peter Orszag

Questions from Chairman Baucus

1. Many hedge funds conduct their funds offshore in a master feeder structure. Generally, the hedge fund is incorporated in a low tax jurisdiction, such as the Cayman Islands. The hedge fund managers receive incentive fees instead of carried interest. Economically, how is that different from a profits interest?

- An incentive allocation is economically equivalent to a profits interest. According to a recent Securities and Exchange Commission Staff Report,[1] "An investment adviser to a hedge fund generally receives compensation composed of an investment management fee and an incentive allocation. The investment management fee is an asset-based fee that is similar to the advisory fee charged by advisers to registered investment companies and is designed to provide the investment adviser with current cash flow to maintain operations. The investment management fee is generally one to two percent of net assets. The incentive allocation is not a fee paid to the investment adviser, but instead, is an allocation of partnership earnings and profits to the general partner of the partnership." It is worth noting, though, that the income of a partnership conducting typical hedge fund operations largely comprises ordinary income and short-term capital gains, in contrast to the long-term capital gains that often dominate the income of a private equity fund.

2. Mr. Solomon stated in his written testimony that a profits interest partner has an immediate ownership interest in the enterprise. What does a profits interest partner own? What can a profits interest partner receive upon liquidation of the partnership?

- A profits interest partner has a share of the partnership's future income and appreciation of the partnership's assets. A profits interest partner does not have a share in the liquidation proceeds of the existing partnership assets. A profits interest does not have a zero value at the time it is granted, however. As I discussed in my testimony, a profits or carried interest can be viewed as a call option on a limited partnership interest, with a value equal to 20 percent of the future capital in the fund, and a strike price equal to 20 percent of the initial value of the fund. Option pricing formulas, such as the Black-Scholes formula, can be used to value the carried interest, although various complications arise in practice in applying such option pricing techniques to private funds.

3. Mr. Solomon stated in his oral testimony that partners in a partnership have entrepreneurial risk. What risks does a profits interest partner have in a partnership?

[1] *Implications of the Growth in Hedge Funds*, Staff Report to the United States Securities and Exchange Commission, September 2003.

- A partner that holds only a profits interest does not have any traditional entrepreneurial investment in the partnership, because the partner does not put his or her own financial capital at risk. Instead, the profits interest partner risks only the value of his or her time and effort expended in managing the partnership. Thus, a profits interest partner's risk is limited to an opportunity cost – the risk that the profits interest partner's time and effort may yield only insubstantial cash returns, if future partnership profits are disappointing. In some cases – such as where profits have already been earned and distributed and the partnership has a clawback arrangement -- the profit interest partner could be required to pay back earnings if the partnership records a loss on subsequent investments. A profits interest partner who is a general partner in a limited partnership may have liability for losses that exceed the value of invested capital if the venture fails.

4. Mr. Donohue stated in his testimony that hedge fund managers and private equity fund managers that have gone or will go public are in the business of managing other people's money. What is the rationale for according capital gain treatment to these managers for their efforts in managing other people's money?

- The rationale given by supporters of the capital gains treatment accorded to hedge fund and private equity fund managers is that those managers are entrepreneurs who create and increase the value of a business, and thus should be taxed like other entrepreneurs. As I discussed in my testimony, however, most legal and economic analysis suggests that carried interest represents, at least in part, a form of performance-based compensation for services undertaken by the general partner. Although individual analyses differ slightly, there are two important themes with which most analysts concur. First, a general partner in a private equity or hedge fund undertakes a fundamentally different economic role from that of the limited partners, because the partnership charges the general partner with the responsibility (by virtue of his or her expertise, contacts and experience, and talent) for managing the fund's assets on a day-to-day basis. Second, the carried interest is not principally based on a return to the general partner's own financial assets at risk. If the purpose of the preferential rate on long-term capital gains is to encourage investors to put financial capital at risk, there is little reason for that preference to be made available to a general partner, whose risk involves his or her time and effort rather than financial capital.

- Mr. Donohue's testimony also suggests that the securities law analysis of the economic role of hedge fund and private equity fund management firms emphasizes the active nature of the services that they perform as the source of the income they earn, which is why such management firms are not themselves treated as "investment companies" for securities law purposes. Some tension thus appears to exist between the securities law analysis of these economic activities and the current tax law analysis.

Questions from Ranking Member Grassley

You explained one alternative for taxing carried interests as treating it as a nonrecourse loan from the investor partners to the manager partner, and treating the forgone interest, computed at the applicable federal rate, as ordinary income.

1. If the manager partner gives the investor partners a preferred return at least equal to the AFR before taking his carried interest, would it still be appropriate to impute an interest charge at the AFR?

- A preferred return, and the closely related concept of a hurdle rate, ensures that the investor partners receive a return at least equal to the return on an ordinary investment before the managing partner receives any share of the profits. A preferred return establishes a return floor for the limited partners, who could presumably earn that much in very low risk investments. Once the return floor is reached, the managing partner receives the full carried interest share of any remaining profits. A hurdle return also establishes a return floor, but after the return floor is reached the managing partner receives the full carried interest share of any remaining profits plus a catch-up return. The catch-up return continues until the managing partner has received the full carried interest share on all profits, not just profits in excess of the floor.

- A preferred return would affect the calculation of the foregone interest in the nonrecourse loan alternative. If the preferred return were set at the same rate as the interest rate on the implicit loan, it would not be appropriate to impute an additional interest charge on the implicit loan, although there would need to be some provision to account for the implicit below market rate if the private equity fund failed to achieve a return at least equal to the preferred rate.

- For example, consider a private equity fund that starts with $100 million in assets and grows at a 15 percent rate each year. If profits are realized after 7 years, the general partner earning a 20 percent carried interest would receive $33.2 million of the $166 million in total profits. With a preferred rate of 6 percent, the limited partners would receive the first $50.4 million in profits after 7 years, and the general partner would receive $23.1 million – 20 percent of the remaining $115.6 million in profits above the preferred return. Compare this with treating the 20 percent carried interest instead as a nonrecourse loan with an interest rate equal to the 6 percent preferred rate. In this case the general partner would be treated as if he or she had received a $20 million loan from the limited partners which he or she then invested in the fund, obtaining a 20 percent capital interest. After 7 years, the general partner would receive $53.2 million – 20 percent of the fund's $266 million in assets. After paying back the $20 million loan with interest compounded at 6 percent per year ($30.1 million), the general partner would be left with $23.1 million, the same as before.

2. Is AFR an appropriate rate, given that the "loan" is nonrecourse and secured only by the value of the carried interest, both as to principal and as to interest?

- Current tax rules specify the use of the Applicable Federal Rate (AFR) for loans with below market interest rates. Most legal analysts seem to agree that the existing rules for below market loans do not directly apply to profits interests in a partnership, and the interest rate required under those current rules therefore does not serve as a constraint here.

- As an economic matter, the AFR is below the proper rate for a nonrecourse loan on a risky asset such as the future profits of a private equity fund. As noted in the answer to the first question, a preferred or hurdle rate on the carried interest would also affect the determination of the proper interest rate.

Questions from Senator Schumer

In most of the testimony at the July 11th hearing, we focused on the financial industry. But let's look at a different situation that still uses a partnership structure, where part of the gain is based on what might be called "sweat equity."

1. Let's say that two individuals open a bagel or knish shop in Brooklyn. Let's call them "Bagel Buddies" or "Knish Capitalists." One of them provides all of the cash, and the other provides the know-how, and they each take a 50-50 interest in the partnership. At the hearing, those who oppose treating carried interest as capital gain seem to be arguing that if the partners sell the business in 10 years for a substantial gain, the financial partner should have his profit treated as capital gain, and the know-how partner should have his profit treated as ordinary income, since his investment in growing the partnership wasn't a financial one and he didn't have his own capital at risk. Isn't this what is being implied when people argue that those who are providing services or labor are not making a financial investment in the enterprise?

- It is important to distinguish two different levels of taxation: the taxation of Bagel Buddies' annual operations over the firm's 10 year life, and the taxation of gains realized by the Bagel Buddies partners when they sell the firm at the end of 10 years. When observers argue that those who are providing labor to a partnership should be taxed on the compensation for that labor at ordinary income rates, they are referring to the taxation of the current year's operations, not to the gain realized on the ultimate sale of the firm.

- In particular, assume that the 50-50 split that you describe is a split only of partnership profits, and that Ms. Brains does not obtain any current interest in the capital contributed by Mr. Money. (If Ms. Brains were given a capital interest in the partnership, which entitled her to a share of the proceeds if the partnership were immediately liquidated, the transaction would be treated as immediate taxable income to her.) Then consider what happens as Bagel Buddies sells its bagels to customers. The business will earn ordinary business income from its operations; that ordinary business income will be shared by, and taxed to, the two partners according to their partnership agreement. As a result, Ms. Brains will pay tax every year at ordinary income rates on her 50 percent share of the partnership's profits.

- After ten years of operations, Bagel Buddies has earned a loyal clientele, and a well-deserved reputation as the best bagel shop in Park Slope. The two partners now sell the partnership for a price that reflects not only machinery, leasehold improvements, and bagels in inventory, but also the operation's goodwill, tradename, and similar intangibles. The tax law provides that Ms. Brains' profit from the sale of the business (to the extent not attributable to certain ordinary income assets of the partnership) will constitute long-term capital gain. In effect, then, the tax law distinguishes between the current returns from Ms. Brains' "sweat equity" – Bagel Buddies' annual operating profits, which are taxed to her

as ordinary income – and her share (in particular) of the value that her hard work has helped to create, as to which she will obtain long-term capital gain treatment, when she sells those self-created intangible assets through the sale of her interest in the partnership.

- A similar outcome on final sale of the operation has occurred in the case of some recent Initial Public Offerings of private equity management companies that were organized as partnerships. The owners of the management company sold their interests for prices significantly above their tax basis in their partnership interests. At least in part, their sales price represented the goodwill, tradename, and going concern value of the management business that the partners had built up through years of hard work. Those partners appear to have treated the gain attributable to those sorts of intangible assets as long-term capital gain; those analysts who believe that carried interest represents performance-based compensation for services provided would nonetheless likely agree that such long-term capital gains treatment on the sale of the management company itself is indeed appropriate. In sum, the carried interests issue relates to the taxation of the private equity management company's operating profits, not to the taxation of the sale of the private equity management firm itself.

- In evaluating how the general partner's operating profits should be treated for tax purposes, it may also be worth considering a slight variation on your hypothetical. Suppose that Mr. Money opened Bagel Buddies on his own and simply hired Ms. Brains to run the business, rather than entering into a partnership. If Ms. Brains received a salary, the salary would be taxed as ordinary compensation. If Ms. Brains received stock options instead of a salary, the options would not be taxed at the time they were granted, but would be taxed as ordinary income when they were exercised. The taxable amount would Ms. Brains' economic gain on the stock (that is the difference between the fair market value of Bagel Buddies shares on the exercise date and the price of the stock when the options were granted).

- As Assistant Secretary Solomon noted in his testimony, there is a tension in the tax code between the partnership tax rules and the rules relating to the taxation of compensation. The questions at issue are whether the general partners in private equity firms are more like the Ms. Brains the partner or Ms. Brains the employee, whether simply organizing as a partnership without changing the basic economic relationship is sufficient to change the tax treatment of what is arguably compensation, and where Congress wants to draw the line for tax purposes between income from capital and income from labor.

1a. Now, some have argued that this is not the case, that in fact Section 751 prevents the conversion of ordinary income into capital gain income for the average partnership. But my understanding is that Section 751 applies only to unrealized receivables and inventory items of the partnership- not the appreciation of the value of the business as an ongoing enterprise, or the value of the building bought, or the assets used to produce income.

Could you clarify for me if my understanding is correct? Wouldn't most of the gain of the sale of the bagel business be considered capital gain under current law, even for the non-financial partner?

- Section 751 provides in effect that a partner's gain recognized from the sale of a partnership interest that is attributable to unrealized receivables and inventory items owned by the partnership is taxed at ordinary income rates. Any remaining gains from the sale of the bagel business would be considered a capital gain.

2. One of the issues that has come up in this debate over private equity and hedge fund taxation is whether U.S.-based general partners with ownership interests in offshore hedge funds should be allowed to defer their capital gains, and pay taxes years down the road after the earnings have grown substantially. I tend to think that this deferral is an abuse of the system and a way for the very richest people in the country to evade U.S. taxes. But this got me thinking about another aspect of fairness.

I understand that our system allows deferral, and I think it encourages U.S. corporations to keep earnings offshore in order to postpone paying taxes as long as possible. My question is this: Why would it be appropriate tax policy to end deferral for hedge fund partners, but keep deferral for U.S. corporations with foreign subsidiaries? Shouldn't the policy be consistent? What would be the policy rationale- other than raising taxes on very rich hedge fund partners- for making that distinction in the tax code?

- In principle, U.S. - owned foreign corporate subsidiaries that are engaged in active financial services businesses should all face similar tax environments. Active financial services firms are at least conceptually indistinguishable from other active businesses, and an argument could therefore be made that they should be subject to the same tax regime as are U.S.-owned subsidiaries engaged in other services.

- The deferral obtained by U.S. partners in offshore hedge funds is somewhat different, however, because it relates to the taxation of U.S. individuals who work for a foreign entity (as well as own interests in that entity). The United States taxes U.S. citizens on their worldwide income: that is, in general, U.S. citizens do not have the same deferral opportunities that are available to U.S.-owned foreign corporations.

3. Could you please give me your assessment of how changing the treatment of carried interest, or the rules regarding deferral on hedge fund income, might affect New York's position as the financial capital of the world? What are the most likely results of a change in policy, in terms of people or companies moving to the Cayman Islands or London or somewhere else?

- As noted in a recent media article,[2] a significant number of hedge funds are already registered offshore – some 3,500 in the Cayman Islands alone according to the article. Despite foreign registration, most hedge fund activities still take place in financial centers such as New York, Greenwich Connecticut, and London. It is unlikely that changes in the tax treatment of private equity firm carried interests would drive these activities away, since changing the taxation of carried interests would not generally affect the taxation of the limited partner investors in such funds. With regard to the general partner, the United States taxes the worldwide income of its citizens, wherever they may perform services. U.S. citizens who are managing partners in private equity funds or hedge funds will therefore generally be taxed by the United States wherever they may choose to live and operate their businesses.

- It is worth noting that British tax authorities are considering changes to similar laws governing the tax treatment of carried interest, and some effort to coordinate U.S. and British efforts in this area may be warranted.

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[2] *Offshore Tax Breaks Lure Money Mangers*, New York Times, July 1, 2007.

Questions from Senator Cantwell

1. Mr. Orszag, your testimony focused on the growing amount of financial intermediation occurring though private equity funds and hedge funds. Even though they are also structured as partnerships, should we look differently at the tax treatment of venture capital funds because of the assets in which they are investing?

- If Congress were to change the tax treatment of carried interest, an important issue would involve the scope of the change: whether it applies to all sectors or a subset of sectors. The underlying tax policy issues are often similar, but policy-makers for various reasons may nonetheless want to recognize differences between different types of partnerships.

2. You point out that whether carried interest represents compensation for services provided or a return on capital invested would be largely irrelevant if the tax rates on labor and capital income were the same. If this were the case, would there still be an incentive for capital formation and investments in high-risk entrepreneurship?

- It seems somewhat unlikely that a change in the tax treatment of capital gains would have a noticeable effect on investment in high-risk enterprises. First, many investors in venture capital funds are private and public pension funds, endowments and foundations, finance and insurance companies, and other corporations that do not pay taxes on capital gains at the individual level. Families and individuals account for only about 10 percent of venture capital investment through venture capital funds.[3]

- Second, even though the tax on capital gains tends to lower the after-tax return from investing in all capital assets, the ability to deduct capital losses is equivalent to government-provided insurance for investing in risky capital assets. Because of this insurance feature, taxes on capital gains may actually encourage some investments in risky enterprises relative to other, less-risky, investments. In effect the government becomes an investment partner, sharing in the gain if the investment pays off, but reducing some of the loss if the investment fails. This insurance feature is not completely symmetric, however, because current rules limit the amount of losses that investors can claim each year, although unused losses can be carried over to future years. The limit on annual losses is needed because taxpayers can control when they realize gains and losses. Taxpayers can postpone claiming capital gains (and paying tax) indefinitely, but can claim losses immediately as they occur.

- Even without a preferential tax rate for capital gains, other tax provisions would continue to provide specific benefits to start-up companies and other small businesses. These include, among others, Section 179 expensing which allows small businesses to immediate write-off up to $125,000 of the cost of assets

[3] Joint Committee on Taxation, *Present Law and analysis Relating to Tax Treatment of Partnership Carried Interests*, JCX-41-07, July 10, 2007. Figure 2, page 37.

placed in service each year rather than amortizing those cost over a number of years, a 50 percent tax exclusion for capital gains on the sale of small business stock, and the opportunity for small business to use much simpler cash basis accounting methods.

- Aggregate data do not show a relationship over time between capital gains tax rates and venture capital investment by individuals, although such evidence should be viewed with caution because there are many other influences occurring at the aggregate level.[4] There is no body of empirical economic research on the effects of capital gains taxes on investment in ventures capital, although a number of economic analyses have looked at the influence of taxes on the investment and hiring decisions of small businesses, and on the decision by individual workers to become self-employed rather than working for someone else.[5]

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[4] Jane G. Gravelle, *Capital Gains Taxes, Innovation and Growth*, CRS Report for Congress, RL30040, July 14, 1999,

[5] See: Bruce, Donald. "Effects of the United States Tax System on Transitions into Self-Employment." *Labour Economics* 7(2000):545-574; Carroll, Robert, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen. "Entrepreneurs, Income Taxes, and Investment." in Joel Slemrod, ed., *Does Atlas Shrug? The Economic Consequences of Taxing the Rich*. Cambridge: Harvard University Press, 2000a; Carroll, Robert, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen. "Income Taxes and Entrepreneurs' Use of Labor." *Journal of Labor Economics* 18(2000b):324-351; Carroll, Robert, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen. "Personal Income Taxes and the Growth of Small Firms." In James M. Poterba, ed., *Tax Policy and the Economy*, Volume 15. Cambridge: MIT Press, 2001; Cullen, Julie B., and Roger Gordon. "Taxes and Entrepreneurial Activity: Theory and Evidence from the U.S." Working Paper No. 9015, National Bureau of Economic Research, June 2002; and Gentry, William M., and R. Glenn Hubbard, "Success Taxes, Entrepreneurial Entry, and Innovation." Working Paper 10551, National Bureau of Economic research, June 2004. In a review of the effects of capital gains taxes on the economy, CBO concluded, "No research, however, has estimated the amount by which start-up investment responds to a change in the capital gains tax. Without such an estimate, CBO can do little more than recognize the possibility that a tax cut on gains might stimulate more enterprise and innovation. If innovation increased, growth would increase as well, but no empirical evidence indicates by how much." See: Congressional Budget Office, *An Analysis of the Potential Macroeconomic Effects of the Economic Growth Act of 1998*, August 1998.

Written Testimony
Prepared for the U.S. Senate Finance Committee

Sept. 6, 2007

By
Russell Read
Chief Investment Officer
California Public Employees' Retirement System

Chairman Baucus, Ranking Member Grassley and members of the Committee, I am pleased to provide the perspective of an institutional investor on the issue of private equity.

The California Public Employees' Retirement System, known as CalPERS, provides pension and health benefits to 1.5 million state, local public agency and school employees, retirees and their families.

A 13-member Board of Administration oversees the management of CalPERS assets, which total more than $240 billion. Our Fund began in 1932, initially investing only in bonds. Over the years, we diversified our assets into four major classes: global equity (public stocks), fixed income, real estate, and – beginning in 1990 – in private equity.

The goal of diversification has always been the same – to balance our portfolio against risk and to add value based on our ability to take advantage of market opportunities.

CalPERS Private Equity: Its Role, Performance History, and Promise

This long-term strategy has paid off over the years. Today, we are fully funded for retirement benefits and our investment returns pay 75 cents of every dollar disbursed in pensions. The remainder is split between the contributions of members and employers.

Our private equity allocation is managed by our Alternative Investment Management (AIM) Program. Over the past 17 years, we have increased our allocation to the AIM Program from 2 percent of total CalPERS assets to 6 percent, with a range of plus or minus 3 percent.

AIM investments had a market value of $17.4 billion as of July 31, 2007, accounting for 7.1 percent of total CalPERS assets. Since the Program began, we have made total commitments of $50 billion. Allocations may increase based on Board action at its scheduled November 2007 asset allocation workshop.

The role of the AIM Program is to maximize risk-adjusted returns, provide a hedge against the Fund's long-term liabilities, and diversify the overall CalPERS portfolio. This is consistent with California state law and our investment policy, which direct us to maximize returns and minimize the need for contributions from employees and employers who rely on taxpayers to make up the difference when investment returns fall short.

The record shows that private equity investments have significantly helped us to maximize our earnings and minimize contributions. As of July 31, 2007, the AIM portfolio had outperformed its public equity benchmark and the CalPERS actuarial rate in all periods.

The AIM portfolio's one-year return was 28 percent compared with its benchmark of 15 percent. Its three-year return was 22 percent against a benchmark of 17 percent. The 10-year return was 8 percent higher than the benchmark. The AIM Program's total return since inception was 14 percent compared with the CalPERS actuarial rate of 7.75 percent – the annualized gain on investment required to fund pension obligations.

More than 5,000 companies have received investment capital through our private equity program, generating more than $12 billion in cash profits to CalPERS since 1990.

Since the AIM Program began, the private equity industry has evolved and expanded. The asset class has become more global and institutional in nature. Private equity funds have increased dramatically. More experienced managers have emerged with differentiated strategies. This transformation has enabled CalPERS to build a diversified portfolio to meet our objectives. Our private equity fund managers invest across the spectrum of a company's life cycle – from its early stage, growth, and to maturity. This investment approach allows the AIM portfolio to be diversified by several parameters including vintage year, strategy, industry, and geography.

Generally, private equity is an attractive asset class to sophisticated investors like CalPERS because of the contribution it can make to an overall portfolio. This contribution is evident in historical quantitative performance and in the unique attributes of this asset class. Here are some examples:

- *High historical returns* – Private equity returns have historically outperformed those of public equities.
- *Portfolio diversification* – As an individual asset class, private equity has greater expected returns and corresponding higher expected risk when compared to other asset classes. However, adding private equity investments to a balanced portfolio can reduce total portfolio risk because their returns are not directly correlated with those of other asset classes. While each asset class carries its own risk, overall portfolio risk is

reduced. Private equity returns may be up while public equity and other asset class returns are down, or vice versa. In addition, sophisticated investors typically further reduce risk in their private equity portfolios by diversifying into different market segments (e.g., venture capital, buyouts, mezzanine debt, etc) and geographies (e.g., US, Europe, Asia, etc.).

- *Exposure to opportunities not appropriate for the public markets* – Investment opportunities such as early stage venture capital, buyouts of smaller-sized companies and purchases of distressed corporate assets are often better suited for the private equity market given their size and/or risk characteristics. These investments may offer superior risk-adjusted returns and may add additional portfolio diversification
- *Exposure to imperfect markets* – While private equity markets have become much more mature and competitive, they continue to be more opaque and difficult to understand than public markets. Yet skilled private equity managers can identify mis-priced assets and take advantage of other unique opportunities to create value.
- *Strong alignment of interests* – Private equity managers are compensated in large part through carried interest, which allocates a portion (typically 20 percent) of investment gains to the manager. This compensation structure aligns the interests of the investor directly with the manager, who in turn generally has the ability to directly influence the management of underlying portfolio companies. CalPERS seeks the same kind of interaction and agreement in its public equity program for the same reason: alignment of companies, boards, and shareowners leads to higher investment returns. The alignment process is more direct in the private than public equity sector, which involves many more shareowners voting at corporate meetings than a relatively much smaller number of decision-makers involved in private companies.
- *Structured securities and operational control* – Because private equity transactions are individually negotiated, private equity firms can optimally structure the terms of each investment to provide downside protection and/or enhance upside returns or liquidity. In the venture capital sector, examples include control rights, convertible preferred stock, liquidation preferences and anti-dilution provisions. In the buyout sector, a private equity firm may completely control management, operational strategy and capital structure strategy
- *Access to information* – Private equity investments are long-term and privately negotiated. Different than public market investments, private equity managers typically can conduct better, more comprehensive due diligence, including extensive interviews with management, review of internal books and records including budgets and projections, all prior to investing. This in-depth due diligence increases the likelihood of success and mitigates the risk of failure. In addition, after investing, private equity fund managers have contractual rights to access management reports and interim financial statements. As board members and owners, private equity fund managers preside over important board committees and

typically influence board meeting agendas, strategic reviews and other activities important to close, ongoing supervision of portfolio company activities.

CalPERS Private Equity: Process & Decision-Making

In building our private equity portfolio, CalPERS primarily commits capital alongside other institutional investors and acts as a Limited Partner or "LP" in a Limited Partnership structure, often called a "fund". One key aspect of the private equity market is that top-quartile performing investment managers dramatically outperform median performing managers. This creates a dynamic where a proven and successful General Partner or "GP" will receive demand for their fund in excess of the fund's targeted size.

Therefore, the AIM investment process focuses on identifying the highest potential opportunities while maintaining an "investor of choice" reputation in order to access the best funds. In each transaction, our objective is to negotiate a balanced Limited Partnership agreement that includes institutional governance and investor protections, transparency and consistency in investor communication and reporting, and a strong alignment of economic interests between the General Partner and the Limited Partners.

The overall set of partnership terms is designed to help ensure we maximize our returns and minimize our risk. Ultimately, our goal is to be a long-term investment partner with the best investment managers who will generate the best returns for our beneficiaries

In addition to our strong financial returns, we are proud of the fact that since the start of the CalPERS private equity program we have deployed approximately $23 billion in the U.S. economy and $28 billion into the overall global economy. This capital investment, alongside the investment of other Limited Partners in private equity funds, has helped create thousands of new companies and new jobs, making CalPERS and other major private equity investors major catalysts of economic growth at home and abroad. Many companies that proved to be successful investments within the AIM Program have become strong performers in our public markets group, thus creating additional value for CalPERS.

CalPERS has also developed and launched several private equity initiatives that have been designed to achieve our return objectives while also generating a variety of ancillary benefits.

For example, in 2001, CalPERS established the California Initiative Program with a $500 million initial allocation. The primary objective of the program was to earn attractive risk-adjusted returns with the ancillary benefit of having a meaningful

impact on California's underserved markets. Many of these markets have been historically overlooked by traditional sources of investment capital.

The California Initiative is a good illustration of the broader impact of private equity. To date, over $357 million has been invested in 144 companies through the program. These companies employ over 5,000 Californians and over 3,000 new jobs have been created across the country. Since inception of the program, its California company investments have experienced 12 percent employment growth compared to 1 percent for the state overall. In addition 90 percent of the companies with fewer than 100 employees offer health insurance (compared with 63 percent nationally) and 60 percent of the companies have women or minority owners and/or senior managers. These ancillary benefits have been obtained while generating a 19 percent total program return and a one-year rate of return of 53 percent. A subsequent $500 million commitment was made to the second phase of the California Initiative in 2006.

Another good example of the broader impact of private equity is the Environmental Technology Program, which was launched in 2004. This program was established to invest in companies that are developing and/or utilizing solutions that are more efficient and less polluting than existing or legacy products, services, or technologies. Examples of companies that have received investment as a result of this program include alternative energy companies, advanced and green building materials companies, and green agriculture companies. Although still early, these companies may evolve over the next few years to be the leading firms that help reduce society's impact on the environment.

The AIM Program's activities are governed by the AIM Program Statement of Investment Policy as adopted by the CalPERS Board of Administration. The CalPERS Investment Committee approves the AIM Annual Plan, oversees performance, delegates decision-making to the CalPERS Investment Staff as appropriate, and authorizes those investment and other decisions which have not been delegated to Staff.

CalPERS collaborates with its consultants to develop an overarching portfolio strategy and a framework for portfolio construction. CalPERS takes both a top-down and bottom-up approach to building its private equity portfolio. This requires a mix of quantitative and qualitative analysis.

We apply a highly disciplined investment process in implementing our investment strategy. Key elements of this process involve searching for and identifying investment opportunities, applying selection criteria, conducting due diligence, negotiating terms and conditions, obtaining necessary investment approvals, and monitoring funds post investment.

A due diligence review by CalPERS staff and consultants will include the following, as applicable:

- Discussions with principals of the proposed investment;
- Review and analysis of all pertinent offering documents including: offering memorandums, subscription agreements, private placement memorandums and operative investment agreements;
- Consideration of potential conflicts of interest, if any, posed by the proposed investment and prior investments and activities of the principals;
- Review and analysis of the investment concept, including entry and exit strategies and terms including fees, principal participation, and structure;
- Review and analysis of the fit within the AIM Program, including fit with the Strategy, Annual Plan, other constraints and guidelines, and compliance with applicable investment policies;
- Background and reference check of principals;
- Review and analysis of track record including performance of prior and current investments;
- Investigation of special terms and side letter agreements with past or present investors;
- Comparison of the opportunity to existing relationships or other alternatives, including cost comparisons;
- Analysis of the strategy; and
- Review of any lawsuits, litigation involving the General Partner, its principals, employees and prior funds.

We engage appropriate third-party resources to assist in the investment process as required including lawyers, management consultants, accountants, industry specialists, traditional pension fund consultants, and investment bankers.

We give primary due diligence emphasis to the quality and experience of the General Partners in a partnership investment. Additional factors may include, as appropriate:

- Integrity of the General Partner, its employees, and other investors;
- Quality of overall partnership governance, management of the partnership, including controls and reporting systems;
- Relationship with the relevant parts of the investment community;
- Relationship with Limited Partners;
- Nature of value-added involvement with portfolio companies, that is, their ability to generate returns based on their skills and beyond trends of the private equity market, including assisting management in building value in portfolio companies
- Potential for co-investments, where we directly invest in a portfolio as a Limited Partner alongside the General Partner;
- Strength of historical investment performance;
- Workload of General Partners and their availability to make new investments and monitor existing investments; and

- Appropriateness of terms and conditions and alignment of interests with Limited Partners. CalPERS focuses on having a strong alignment of interest between the General Partner and the Limited Partners, where the General Partner's financial interests are positively correlated with the success of the fund's investments. The more money CalPERS makes on its investment, the more money a General Partner makes. If CalPERS does not achieve a predetermined rate of return (typically 8% annually), then the General Partner does not receive carried interest. This philosophy is consistent with our view on the issue of Executive Compensation in the public markets.

CalPERS Private Equity: Fees

As a Limited Partner in several hundred private equity partnerships, CalPERS is very sensitive to the economic terms of private equity investment partnerships. High fees reduce the net returns to Limited Partners. The fees that are charged by General Partners generally include management fees, and carried interest, which is a pre-defined split of the net profits of the partnership. To help align interests of the GP and the LPs, we require the General Partner to make an investment in their funds alongside the Limited Partners.

Each private equity Limited Partnership agreement involves a business and legal negotiation between the General Partner and the Limited Partners. The end result is a unique legal document that reflects the management fee calculation, carried interest participation, General Partner cash commitment and all other economic and non-economic arrangements that have been negotiated for that particular transaction. Funds focused on a similar strategy will have different terms and conditions based on a myriad of factors including fees, historical track record, team composition, and fund size.

Private equity partnerships are long-term investment vehicles, typically with 10-15 year lives. This is a distinguishing factor from hedge funds, whose investment strategies are often much more short term focused. In a private equity fund, the fund manager will make investments in companies during the "investment period", typically the first 5 or 6 years of the fund's life. The fund manager then works to exit (or "harvest") the investments over the following 5 to 10 years.

CalPERS is very focused on actively negotiating all of the terms of a private equity partnership, including the economics to ensure that its interests are protected. In particular we focus on a strong alignment of interest.

Historical performance data shows a strong correlation between past and future top-quartile investment performance in the private equity asset class. As an investor seeking to maximize returns for its 1.5 million pension beneficiaries, CalPERS is focused on investing with the very best General Partners globally.

The very best General Partners often: charge the highest fees, are over-subscribed, and are well positioned to negotiate the legal documentation. The ability for top performing investment managers to structure "premium economics," which may include higher fees, is not unique to private equity. For example, carried interest for the very best General Partners can reach 30% of net profits compared to the typical 20%. To reiterate, fee structures are: currently variable across funds, heavily negotiated, based on a number of factors, and difficult to reduce for the very best General Partners.

A delicate balance exists for a Limited Partner like CalPERS to be successful: achieve access into the very best private equity investments, while at the same time negotiating appropriate economic incentives for the General Partner.

Due to the interrelated nature of the economics for a private equity fund, it is complicated to say generically how a change in one component will impact the total economics. As each fund is individually negotiated, an adjustment to one component will lead to offsetting negotiations on other components.

From our perspective, investment comparisons and decisions are based on net returns (after fees and expenses) to the investors. The level of fees charged by a General Partner is only one consideration in the analysis of a private equity investment opportunity. CalPERS' historical performance indicates that on a net basis, attractive returns can be generated compared to both its benchmark and the actuarial rate providing incremental benefit to its beneficiaries from investing in the <u>best</u> private equity funds, <u>not the cheapest</u>.

We have a fiduciary duty under the California Constitution to do all we can to ensure the stability of our public pension fund on behalf of its members and California taxpayers – and to maximize investment returns and minimize contributions.

We are grateful for this opportunity to represent the clerks, custodians, technicians, safety officers, and other public employees who depend on CalPERS for their retirement security. We also are pleased that this Committee is giving this important private equity issue the full consideration and deliberation that it deserves.

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Responses to Questions for the Record From Russell Read
Carried Interest, Part III: Pension Issues
September 6, 2007

Questions from Chairman Baucus

1. Your testimony noted that CALPERS is considering making private equity investments in infrastructure projects.

A. How do the private equity investments you are considering expect to profit from infrastructure improvement? Would it be through loans? Purchasing companies that do the work? Building toll roads or lanes?

Response: Infrastructure assets typically generate steady and predictable cash flows. We anticipate annualized returns of 5 percent to 7 percent above inflation (Consumer Price Index). They offer diversification and a lower-risk profile than private equity investments. They perform well during economic downturns, provide a hedge against inflation, and have a low correlation to traditional asset classes. We would consider projects on a case-by-case basis, including those large enough to require participation by other large investors and potentially involving direct investments involving private equity, real estate, and fixed income assets. Projects might be privately-owned assets or those owned and/or operated by government entities. For example, economic infrastructure includes transportation, energy utilities, and communications networks. Infrastructure projects might consist of bridges and tunnels, toll roads, airports and seaports, and rail systems; clean energy projects, pipelines, power distribution/transmission, and water treatment/distribution systems; broadcast and wireless towers, cable systems, and satellite networks.

B. Is there anything other than location that distinguishes foreign infrastructure opportunities from domestic ones?

Response: No. Infrastructure needs are global in scope. We naturally would be closely attuned to investment opportunities in California and the United States, which have huge infrastructure capital requirements. But we will explore opportunities outside the United States as warranted as long as such investments offer attractive risk adjusted return expectations.

2. Mr. Read, we have heard that many fund managers may elect to convert management fees into additional carried interest. This election is provided for in the partnership agreement. CALPERS is invested in several private equity funds and has broad access to many fund partnership agreements.

A. Have you seen conversion of management fees into additional carried interest in any of CALPERS' investments?

Response: No.

B. How do these elections work?

Response: We don't see elections, but it's fairly typical for a General Partner to elect to convert a portion of a management fee into the partner's capital commitment to the fund.

C. How prevalent are these elections?

Response: While we have not seen conversion of management fees into carried interest, we have seen management fees converted into General Partner contributions as capital commitments on the General Partner's behalf. Limited Partners and General Partners agree in advance on fees. For alignment of interest purposes, CalPERS requires partners to invest their own money into each investment, and the General Partner can use part of fee income for that purpose.

3. On August 24, 2007 (the "August 24 letter"), the National Conference on Public Employee Retirement Systems ("NCPERS") sent a letter to the Chairman and Senator Grassley. On September 4, 2007, NCPERS sent another letter to the Chairman and Senator Grassley, in which NCPERS asked that the August 24 letter be disregarded because it did not represent the views of the majority of the NCPERS members. The letters are attached to this document.

A. Who approached NCPERS and suggested that NCPERS author the August 24 letter?

Response: We don't know.

B. What role, if any, did the Private Equity Council play in drafting the August 24 letter?

Response: We don't know.

C. Who participated in drafting the August 24 letter?

Response: We don't know.

D. Who reviewed and edited the August 24 letter?

Response: We don't know.

E. When did CALPERS become aware of the August 24 letter?

Response: After it was mailed.

Questions from Ranking Member Grassley

1. Mr. Read, you have indicated in your written testimony that CalPERS' investments in private equity funds have increased over the past 17 years and that the Board will meet later in the fall to determine whether it is prudent to increase the percentage of the funds' investments in private equity. I have 3 questions for you:

(A) Leaving the complex negotiations process aside, based on the fiduciary standards Mr. Trone outlined, and taking into account the "economics" of investing in financial instruments, would an increase in fees payable by CalPERS to a private equity fund have an impact on the Board's upcoming decision?

Response: We can't say to what extent a fee increase might affect the CalPERS Board's upcoming decision on allocations to our private equity asset class as this decision is based on a combination of long-term expected returns, volatility and correlation to the other asset classes. It is reasonable to believe that private equity will continue to generate returns that exceed those of the public markets.

(B) Will the recent fluctuations in the market and the credit issues our economy is currently facing have an impact on the decision?

Response: As a long-term investor, CalPERS recognizes that there will be cycles and fluctuations in both equity and debt markets. The decisions we make in our asset allocation process are based on long-term assessments of the market's expected returns and risks. Moreover, our allocation ranges for asset classes give our investment officers discretion to respond to market developments while still following our long-term allocation strategies.

(C) To what extent would CalPERS' net return need to be reduced before the Board would decide to decrease investments in private equity funds?

Response: We need to earn a sufficient premium over public market returns for private equity to make sense, given the higher relative risk for this asset class. High relative net returns not only are an important justification for investment with private equity funds, but for the asset class as a whole.

2. You testified that more than $17 billion of CalPERS' assets (about 7.1% of CalPERS' portfolio) are invested in private equity. What other alternative investments does CalPERS hold? What percent of CalPERS assets are invested in these alternative investments? Please explain whether and why the following percentages would be considered prudent investments.

20% of the pension fund in alternative investments;
30% of the pension fund in alternative investments;
40% of the pension fund in alternative investments.

Response: Private equity investments are primarily made in our Alternative Investment Management (AIM) Program. Additional alternative investments are made in other parts of the CalPERS Investment Office. In our Global Equity asset class, which is mainly comprised of common stocks, we have invested in hedge funds in a program called Risk Management Absolute Returns Strategies or "RMARS"). Global Equities also has invested in a number of activist corporate governance funds that focus on underperforming public companies. In total, these programs account for more that $10 billion of market value or more than 4 percent of the pension system's total portfolio. In addition, our Real Estate asset class has approximately $20 billion of market value, or more than 8 percent of the total CalPERS portfolio. Combined, alternative investments account for around 20 percent of total CalPERS assets. We consider 20 percent prudent under our present asset allocation strategy. Allocations beyond that level are up to the CalPERS Board's asset allocation/liability decision-making process, which it updates every three years. Again, the Board considers each asset class's expected returns, cross-correlation and volatility when deciding on appropriate allocation targets, as well as the overall availability of opportunities in each respective asset class that have the potential to generate acceptable risk-adjusted rates of return.

3. On August 24th, the executive director of the National Conference on Public Employee Retirement Systems sent a letter to members of the Finance Committee contending that, among other things, pension beneficiaries will "bear the burden" of any change in the tax treatment of carried interest, and the impact of any such change "is real and potentially great." On September 4th, the president of the Conference sent a letter rescinding the August 24th letter. It appears that a majority of the Conference's members did not share the opinions expressed in the letter.

Do you know whether representatives of the private equity industry, including private equity managers, had any role in the August 24th letter?

Response: We don't know.

Do you share the opinions expressed in the August 24th letter, and if not, why not?

Response: CalPERS was not consulted. It is possible that fee increases could be passed along to CalPERS and other Limited Partners as a result of added taxes for General Partners. However, fees would be, as they are now, one component of the overall negotiation process. We cannot predict how that would play out. However, our approach to investing in private equity would continue to be through partnerships with the best General Partners who have demonstrated the ability to generate the most attractive long-term returns. Private equity is an important asset class for CalPERS. We would make decisions about fund managers within whatever tax policy might ultimately be adopted and track whether new tax policies negatively impact the investment returns of the asset class in a material way.

4. As you know, many hedge funds utilize the master feeder structure, in which U.S. taxable investors invest through a domestic partnership and tax exempt investors invest through a foreign corporation. The fund managers receive the performance-based portion of their fee through a carried interest on the domestic side, and an incentive fee (characterized as compensation) on the foreign side. However, I understand that tax-exempts generally invest in private equity funds through a domestic partnership. I have two questions:

A. Does CALPERS invest in hedge funds through foreign corporations and in private equity funds through domestic partnerships?

Response: CalPERS typically invests through domestic partnerships when both domestic partnerships and foreign partnerships exist for the same fund.

B. If so, do you view the carried interest any differently than the incentive fee?

Response: No. Master fee structures using domestic partnerships and foreign corporations are generally designed to be economically neutral as between the domestic and foreign investment entities. Therefore, investors usually do not differentiate between carried interest and incentive or performance fees that are calculated as a percentage of profits.

5. Mr. Read, in your testimony you mentioned that CalPERS "is considering the potential investment of many billions of private equity dollars in infrastructure projects that are seriously under-funded and long overdue – both here and abroad."

Please explain the nature and structure of these potential investments. Are they privatization transactions? Are there taxable investors involved in these transactions? What tax benefits do the taxable investors get from the investments? Are those tax benefits shared with tax-exempt investors and, if so, how? Do these transactions involve long-term leases?

Response: Infrastructure assets typically generate steady and predictable cash flows. They offer diversification and a lower-risk profile than private equity investments. They perform well during economic downturns, provide a hedge against inflation, and have a low correlation to traditional asset classes. We anticipate annualized returns of 5 percent to 7 percent above inflation (Consumer Price Index).

We would consider projects on a case-by-case basis, including those large enough to require participation by other large investors and potentially involving private equity and fixed income asset classes. Projects might be privately-owned assets or those owned and/or operated by government entities. For example, economic infrastructure includes transportation, energy utilities, and communications networks. Specifically, infrastructure projects might include bridges and tunnels, toll roads, airports and seaports, and rail systems; clean energy projects, pipelines, power distribution/transmission, and water

treatment/distribution systems; broadcast and wireless towers, cable systems, and satellite networks. Some privatization transactions may be a part of this portfolio..

As a tax-exempt investor, we can't comment about potential tax benefits for taxable investors and are unclear about any benefits that would be potentially passed along to tax-exempt investors. Our understanding is that there likely would be long-term leases involved in these investments.

Questions from Senator Hatch

Mr. Read, I am a little confused about something in your testimony that I would like clarified. You indicated that CalPERS Alternative Investment Management (AIM) program, from which you apparently fund investments in private equity, hedge, and venture capital funds, comprised only 7.1 percent of CalPERS total assets. I realize this is a tremendous amount of money, but not compared with the total. You also stated that the AIM portfolio enjoys a total return since inception of 14 percent, compared with less than 8 percent for CalPERS actuarial rate. However, it seems to me that even though the return from your AIM portfolio is very impressive, the fact that it represents less than 10 percent of your total assets means that its impact on your overall return is rather limited, and that changes in the taxation of carried interest could not have much of an overall effect on CalPERS. Is this a fair statement?

Response: It is true that the CalPERS AIM Program makes up over 7% of the overall assets of our System. However, for point of clarification, this 7% does not include our allocation to hedge funds, which are managed in our Global Equities group. Therefore, the impact of tax changes on private equity partnerships may initially be relatively small on the overall rate of return to CalPERS. However, the impact on value-added earnings would likely be much larger, assuming such tax changes apply to other alternative investment strategies. Value-added earnings are those collectively generated by "alpha" strategies not just in the private equity program, but also in CalPERS hedge fund program, corporate governance program, and real estate program. By "alpha," we mean incremental returns generated by investment staff, partners and managers that exceed "beta" or market returns, which are returns achieved mainly through passively managed public equity funds or index investments. We estimate that more than 60 percent of our total excess return above our benchmark has come from our value-added programs. Therefore, these are meaningful sources of investment returns for CalPERS.

There has been a suggestion here today and elsewhere that raising taxes on the managers of these funds - private equity, hedge funds, real estate and venture capital – will not affect the investment returns for pensions that are invested in those funds. Essentially, the question comes down to economics and whether the managers will have the pricing power to shift some of that new tax burden to the investors by raising their fees. Some people suggest that market forces alone set the rates and if managers could charge more,

they would currently be doing so. The fact that many charge the 2 and 20 percent formula, the argument goes, means that the market won't pay more.

Mr. Read, isn't it true that for a good fund with a good manager and history of good returns, there are far more investors interested and that these funds turn away many investors. I realize CalPERS may not be turned away as much, but for a smaller pension plan, aren't they competing with dozens of other investors to get in on the better funds, essentially lining up around the block?

Response: With regard to the first comment, it is unclear whether top performing managers will be able to pass along higher fees to investors should they be faced with a higher tax burden. However, it is safe to assume that with higher taxes imposed on the general partners, investors will be in a less advantageous position to negotiate lower fees in the future. At best, investors will be left with the existing economic packages they have agreed to in the current partnerships. On your second point and question, we do seek to obtain optimum returns by investing with the best private equity managers. Based on their track record, these managers are often able to command higher fee structures. Currently, there is a significant amount of global capital targeting the best private equity managers. Despite our size, CalPERS is not immune to being turned away from top managers or receiving less than our desired allocation to their funds. Given the current demand for premier fund managers, we will have to work very hard to try to maintain both our current allocation percentages and current economic structures should higher taxes be introduced to fund managers who, in turn, seek to increase their fees on investors.

Questions from Senator Smith

The Oregon Public Employees Retirement Fund has about $7 billion invested in private equity funds. These funds have performed well for the fund. For 2006, the fund's private equity investments had a 25.1 percent return. For 2005, it was 38.8 percent.

Some have argued that a change in the taxation of carried interest may have a negative impact on the returns of pension funds that invest in alternative asset funds, such as private equity. And I certainly don't want Congress to do anything that would negatively impact the investment returns of the Oregon Public Employees Retirement Fund.

What are your thoughts on whether a change in the taxation of carried interest would negatively impact the returns of pension funds that invest in private equity funds?

Response: Any reduction in net compensation to General Partners, including the impact of changes to tax legislation, could potentially be passed along to CalPERS and other Limited Partners and thereby negatively impact net returns. We cannot predict how future negotiations might unfold. These negotiations would be influenced by many other factors including market environment and attractiveness of the opportunity. Our approach would

be to continue to identify top performing managers and make investments where we believe we can generate net returns in excess of our benchmark.

When a business is hit with new fees, regulations or taxes, is it normal that these costs are ultimately passed on to the consumer – or in this case the investor?

Response: The economic terms of private equity funds are determined through negotiations between the Limited Partners and the General Partner, who may or may not be able to pass on fees to the Limited Partner. Currently, fee structures are variable across funds and heavily negotiated based on multiple factors. To be successful, a Limited Partner like CalPERS must obtain access to the very best private equity investments while at the same time negotiating appropriate incentives for the General Partner. Clearly, those managers with the best track records and most investor demand will have more leverage should they choose to pass along less favorable economic terms to investors.

Last month the Oregon Investment Council voted to raise their private equity allocation in the Oregon Public Employees Retirement Fund from 12 percent to 16 percent.

I have been told that over the past decade many pension funds, both public and private, have increased their percentage of holdings in various managed funds – both private equity and hedge funds. Why is this the case?

Response: We are increasing our investments in private equity and hedge funds because they have given us high historical returns, have helped reduce our overall portfolio risk through diversifying our assets, and because they give us opportunities to add value not afforded in traditional public market investments.

As the amount of assets under management in non-traditional investments continues to grow, is it fair to say that pension managers will continue to increase their positions in such funds?

Response: There's been a steady increase in assets under management in these non-traditional investment funds. Specifically, in private equity, the expanding opportunity is driven by a couple of factors including 1) the ability to execute transactions in much larger companies that view private equity as a viable source of financing and 2) the increasing maturity of private equity markets outside of North America and western Europe. We believe that this trend is likely to continue based on the attractive risk-return profile that these funds offer Limited Partners.

What is the anticipated burden to public pension funds over the next decade as baby boomers move into retirement?

Response: The projected baby boomer wave of retirements and its impact on our retirement liability already is part of our actuarial calculations. Our actuarial staff continues to take demographic profiles into account, among several other factors, as they

calculate what is needed to fund our retirement program. At this point, our actuarial rate is 7.75%. Of course, any reduction in investment returns below that rate of return would require increases in contributions by employers and, potentially, active workers.

Will pension funds be able to meet their obligations to current and future retirees by relying solely on traditional investment vehicles?

Response: We believe a diversified asset allocation, including private equity and other alternative asset classes, is required to provide the actuarial return and reduce the volatility of the Fund such that we can meet our current and future obligations to our Members. These non-traditional assets give us the opportunity for enhanced risk-adjusted rates of return and help diversify our portfolio to reduce overall risk, therefore meaningfully contributing to the funding our retirement obligations of our Members.

Senator Pat Roberts
Statement for the Record
Senate Finance Committee Hearing
Carried Interest, Part II
July 31, 2007

I appreciate the concerns expressed by several of the witnesses during the Senate Finance Committee's hearing on the tax treatment of carried interest and publicly traded partnerships on July 31, 2007. Right now we have an economy that is resilient and continues to grow despite a slowdown in certain sectors. We need to be careful that any changes to the tax code do not discourage capital investment here at home or encourage capital to move overseas.

That is why I am concerned that proposals to treat carried interest earned by a general partner as ordinary income rather than capital gain income could have the unintended consequence of doing just that. Treating carried interest as capital gain is understood to be an important incentive to encourage investment and acknowledge the risk that accompanies this long-term investment. At a time when other countries are lowering their tax rates to grow their economies and attract capital investment, the U.S. should not be pursuing tax policy that threatens our competitiveness and makes investment in our economy less attractive.

As we examine proposals to change the tax treatment of carried interest, we need to keep in mind that this is also an important issue to Main Street as well as Wall Street. Private equity investments do more than just provide financial benefits to investors - they help revitalize communities and create jobs. These Investments to rejuvenate and rebuild struggling communities carry an inherent risk. We cannot ignore the likelihood that some of these investments would not be made if we change the tax code to make these investments less attractive.

While I appreciate that the committee is taking a thoughtful and thorough approach in examining the tax treatment of carried interest, I urge my colleagues to proceed with caution about making changes to any tax policy that could impact the availability of capital and the willingness of investors to take risks and to make needed investments in the U.S.

Testimony of Bruce Rosenblum
Chairman of the Board, The Private Equity Council
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

[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.

The Taxation of Carried Interests In Private Equity Partnerships

*David A. Weisbach**

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Over the past several months, there has been a great deal of discussion about the taxation of so-called carried interests in private equity partnerships. Congressman Levin (D-MI) recently introduced a bill that would treat income from carried interests as ordinary income from the performance of services, and the Senate Finance Committee staff has recently held a hearing to discuss the issue.

Carried interests, often called profits interests, represent interests in the profits of a partnership separate from an interest in the liquidation value or capital of a partnership. Carried interests are commonly used in private equity partnerships as well as other economic contexts, including real estate, venture capital, oil and gas, and small business. Under current law, holders of carried interests are taxed as partners on their distributive shares of partnership income. If the partnership has long-term capital gain, holders of carried interests are taxed on their shares of the long-term capital gain. The argument that some have raised and the apparent premise of the Levin bill is that this "pass-through" treatment of capital gains income from carried interests creates an anomaly because the sponsors of private equity funds perform services for the partnership, and most service income is taxed as ordinary income.

This argument is not consistent with basic principles of the tax law, including how capital gains are defined and how partnerships are taxed. The argument is misplaced for two reasons. First, the labor involved in private equity investments is the same type of labor that is intrinsic to any investment activity. Sponsors select the investments, arrange the financing, exercise control rights inherent in ownership of the portfolio companies, and eventually decide when to dispose of the assets. If the performance of these tasks were sufficient to deprive sponsors of capital gains treatment, capital gains treatment would not be available to any investor. For example, purchasing stock through a margin account involves combining capital, some portion of which is provided by third parties, and labor effort to make an investment. Notwithstanding that much of the value may be created by the efforts of the investor to identify good stocks or other investments, the investor gets capital gains treatment. The activities of private equity sponsors are similar. The only difference is that private equity sponsors

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raise funds by issuing limited partnership interests instead of debt, but there is no good reason for changing the treatment of private equity sponsors based on how they finance their activities or because they use a partnership.

Second, even if there were good reasons for changing the tax treatment of carried interests, the change would be complex and avoidable, imposing costs on all involved without raising any significant revenue. Any rule treating payments on carried interests as service income would require taxpayers and the government to accurately separate labor and capital income, a task which has proven difficult in other contexts. Moreover, because any change in the treatment of the current private equity fund structure would be based on the partnership tax rules, using a non-partnership structure, such as debt financing, would avoid those rules. The result would be less efficient economic structures and little or no change in tax revenues.

I. Background and Scope

Basic Structure. Private equity funds are partnerships formed to acquire large stakes in underperforming businesses.[1] They create value by restructuring the business, aligning management and shareholder incentives, and providing better monitoring of managers. The goal is to sell the restructured and improved business at a profit in three to five years, though the holding period may vary depending on the circumstances. Although private equity funds have been profitable in the last few years, their investments are highly risky, and there have been long cycles where returns were low.

The funds are created by a sponsor or private equity firm, such as Blackstone, KKR, or Warburg Pincus. The sponsor firm has expertise, contacts, deal flow, valuation systems, methods of managing companies, and other intangibles that potentially allow it to profit from this activity. The sponsor retains a general partnership interest in the fund, which allows it to retain control of the venture, and raises capital from outside investors who receive limited partnership interests. The limited partners generally contribute between 90 and 97 percent of the initial capital and the sponsor contributes the remaining 3 to 10 percent. The sponsor determines which portfolio companies to invest in and then raises additional funds, typically through debt, on a company-by-company basis. After the investments are made, the sponsor helps to restructure the

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[1]Private equity structures are described in detail in many other sources. See, e.g., Jack Levin, Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions (May 2006).

businesses with the objective of maximizing value. A fund typically has a life of about 10 to 12 years and will invest in a number of portfolio companies during that time.

Under a typical arrangement, the limited partners are entitled to receive a return of their invested capital and expenses plus an additional return of up to a specified amount, usually 8 or 9 percent (the hurdle rate). If there are profits above this amount, the limited partners receive allocations so that they will get 80 percent of total profits. For example, if total profits are 15 percent, the limited partners get the first 8 percent, none of the next two percent and then 80 percent of everything thereafter.

The sponsor retains the right to all returns from the venture once the limited partners have been paid. This right to profits above the hurdle rate is known as the carried interest. In addition, the sponsor receives two types of fees. One is a management fee, typically around 2 percent of total partnership capital. The management fee is a payment for the day-to-day services performed by the sponsor on behalf of the fund. The second consists of fees for providing services to the portfolio companies, sometimes known as transaction fees.[2] (The 2 percent management fee and the transactions fees sometimes partially offset.) Recent research shows that industry-wide, roughly two-thirds of the payments to the sponsors are from management fees or transaction fees and, correspondingly, roughly one-third is from carried interests.[3]

There are important business reasons for the structure of private equity partnerships. The sponsors must have sufficient freedom to be able to negotiate deals when they arise but also must be able to raise large pools of capital that are committed for a long period. This creates an incentive problem. If sponsors are unduly constrained, they will not have the necessary freedom to negotiate or make decisions, but if they have too much freedom without the right incentives, investors will not trust them with their funds. Fund structure, including the use of the 20 percent profits interest calculated over a portfolio of companies, the hurdle rate, and the multiple rounds of financing, is thought to best solve these problems.[4] The structure of these

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[2]These services include sitting on the boards of the portfolio companies and providing consulting services to help restructure the companies.

[3]See Andrew Metrick and Ayako Yasuda, *The Economics of Private Equity Funds*, (July 1, 2007) Table VI, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=996334.

[4]See Ulf Axelson, Per Stromberg, and Michael Weisbach, *Why are Buyouts Levered? The Financial Structure of Private Equity Funds* (January 4, 2007) available at http://www.business.uiuc.edu/weisbach/lbo%20funds%20final%20version%20jan2007.pdf.

funds is no more tax driven than any typical investment: within a basic structure, one wants to minimize taxes but taxes are secondary to business considerations.

Use of Profits Interests. Although the current discussion has focused on private equity partnerships, profits interests are used in many different sectors, including oil and gas, real estate, small businesses, hedge funds, and venture capital. I have not been able to obtain data on their overall economic value because the relevant partnerships generally are privately held. One indication of their wide-spread use is that there are hundreds of articles relating to only one aspect of their tax treatment, the treatment of the receipt of a profits interest. An entire chapter in the leading partnership tax treatise, is devoted to the issue (and was written long before private equity funds became prominent).[5] There have been a number of court decisions and a series of guidance documents from the Treasury, culminating in recently issued proposed regulations. It is apparent from this that any change to the taxation of profits interests would affect a number of sectors in the economy.

Current Tax Treatment. Although there have been occasional suggestions otherwise, the overwhelming consensus (including three separate pieces of guidance from the Treasury Department) is that the typical receipt of a profits interest is not and should not be taxable. For example, admission to a law firm partnership (entitling the new partner to a share of partnership profits) is not a taxable event even if admission is valuable and highly sought after. In the private equity context, the carried interest holder receives a zero capital account. Any gain or loss allocated to the holder is then taxed to the holder exactly as it would be to any other partner. The normal capital account maintenance and substantiality requirements of section 704(b) apply. The two percent management fee and the transactions fees are taxed as ordinary income. Because, as discussed above, approximately two-thirds of the earnings of private equity sponsors are from management fees or transactions fees, approximately two-thirds of the profits earned by private equity sponsors are taxed as ordinary income under current law.

Proposals for Change. A number of potential changes to the treatment of carried interests have been proposed, and it is not possible to consider them all. We can break them into two categories, front-end proposals and back-end proposals. Front-end proposals are concerned with the taxation of the receipt of a profits interest, with some

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[5]McKee, Nelson, and Whitmire, Federal Taxation of Partnerships and Partners (1997), Chapter 5.

suggesting that the receipt of a profits interest should be taxable like the receipt of stock or stock options, possibly under rules similar to those in section 83.

Back-end proposals would change the treatment of a holder of a profits interest over the life of the partnership. One such proposal, advocated in separate articles by Professors Victor Fleischer and Leo Schmolka, would treat a carried interest as the temporary borrowing of capital from the limited partners.[6] If a partner has a 20 percent profits interest, he would be treated as if he borrowed 20 percent of the partnership capital for the life of the partnership. The holder would either be required to pay interest on the use of capital or be taxed on the forgiveness of such a payment much like we impute interest on loans under sections 7872 and 1274. In effect, under this proposal, the general partner is treated as receiving a payment for services equal to the interest-free use of capital. A second proposal, advocated by Professor Mark Gergen, would treat any payment on a profits interest as ordinary income (and grant the partnership a deduction for the same amount, which would then potentially be capitalized under the rules of section 263).[7] The Gergen approach would treat all payments on a carried interest as in return for services, which is a very different measure of the payment for services from the measurement of service income in the Fleischer/Schmolka proposal. The approach taken in the Levin bill introduced last month is similar to the Gergen approach. The various approaches can be mixed and matched, such as combining the Gergen approach with a section 83(b)-type election to include the value of the interest when received.

The treatment of the receipt of a profits interest has been subject to numerous articles and discussions over the last 36 years, since the *Diamond* case first raised the issue to prominence. The overwhelming consensus is that taxing profits interests on receipt is not desirable. Doing so would raise intractable valuation issues,[8] complex questions about how capital accounts are to be kept, and deep philosophical issues about taxing services to be performed in the future. To avoid these issues, long

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[6]Leo Schmolka, *Taxing Partnership Interests Exchanged for Services: Let* Diamond/Campbell *Quietly Die*, 47 Tax L. Rev. 287 (1991); Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds, Legal Studies Research Paper Series*, Working Paper No. 06-27, March 11, 2007, revised June 12, 2007.

[7]Mark Gergen, *Reforming Subchapter K: Compensating Service Partners*, 48 Tax L. Rev. 69 (1992).

[8]The valuation problem in this case is more difficult than the standard option valuation problem. In the standard option valuation problem, one can observe the volatility of the stock and use this to price the option. In a partnership, there is no way to observe the price or volatility of the partnership interest. In part because of valuation difficulties, the Treasury has proposed regulations that treat the value as zero in most circumstances.

standing IRS policy, embodied in revenue procedures and proposed regulations, is to treat the receipt of a profits interest as the receipt of property with a zero value. Given the huge literature addressing the front-end issue, as well as the basic consensus on the right approach, I will not address it here. Instead, I will assume that the receipt of a profits interest is a nontaxable event. Below I focus on the back-end issue: how a holder of a profits interest should be taxed when income allocations or distributions are made.

II. Analysis

There are two basic considerations. The first is whether taxing gains on profits interests on a pass-through basis is consistent with the underlying structure of the tax law. I will address this issue by asking how the sponsors would be taxed if they engaged in the activity directly, and then ask whether that treatment should change if the sponsors use a partnership structure. The second issue is, assuming that a change is otherwise desirable, whether the complexity and avoidance costs of a change are worth the benefits.

Direct Engagement in the Activity. If the sponsors engaged in private equity investing directly, there is little question that profits they receive from the sale of portfolio companies would be classified as capital gains. To illustrate, imagine that instead of raising funds by issuing limited partnership interests, they simply borrowed the funds from the investors. To keep things simple, we can imagine that the loan paid a fixed rate of interest, but it could also have interest based on the receipts from the sale of the portfolio companies and still likely be classified as debt.[9] The sponsor would then use the borrowed funds and its own equity contribution to make investments in portfolio companies. Gains from the sales of portfolio company investments, just like gains from any investment, would unquestionably be taxed as capital gain.

Value is created in this example by combining capital and labor. The underlying theoretical question is why this is treated as capital gain rather than a return to services. Unfortunately, there is little if any conceptual clarity governing the distinction between capital gains and ordinary income. Without a solid rationale for the distinction (and

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[9]The limited partnership interest could be restated as a nonrecourse loan that paid a fixed 8 percent interest rate plus a contingent return of 80 percent of all profits above 10 percent. Although further analysis of the details would be needed, this might possibly be treated as debt given the fixed minimum return, seniority, and limited term. If such a financial instrument were not treated as a loan, an instrument with similar features likely could be. See Example 2 in Treas. Reg. 1.1275-4(b)(4)(vi) (illustrating a debt instrument that has payment based on gross receipts).

one that roughly tracks current law), it is difficult to make principled arguments with respect to any given return. At best, we can try to observe where the tax law draws the lines.

There appears to be two key factors. First, the more entrepreneurial the activity, the more likely the treatment will be capital. Second, the more that labor and capital are combined into a single return, the more likely it will be treated as capital. The most closely related example is an investor who borrows money to purchase stock. This activity combines capital, some of which is supplied by third parties, and labor effort, in terms of arranging financing, identifying investment opportunities, and purchasing and selling the investments. Investors get capital gains and losses on their stock sales, and we make no effort to isolate the labor component of their gains. Similarly, entrepreneurs such as founders of companies get capital gains when they sell their shares even if the gains are attributable to labor income. For example, most or possibly all of Bill Gates's fortune comes from his performance of services for Microsoft, but the overwhelming majority of his earnings from Microsoft will be taxed as capital gain. Although one can come up with various rationales for this approach, such as subsidies for socially beneficial activities, to minimize lock-in, or because of the difficulty of separating labor and capital, perhaps the best thing we can say is that this approach is built deeply into the structure of current law. Any change in the treatment of a private equity sponsor engaged directly in their investment activity would require reexamination of these basic principles.

Engagement Through a Partnership. The sponsors do not engage in their investment activity directly, raising funds from the financing sources through loans. Instead, they use a partnership, raising funds from the financing sources by issuing limited partnership interests. The question is whether the tax treatment should change because of the use of limited partnership interests as a financing vehicle. From an economic perspective, the answer is straightforward: the tax result should not change when financing mechanisms change. The tax law, however, often makes uneconomic distinctions, and the question is whether there is some tax law reason for changing the treatment based on a change in financing mechanisms.

A central premise of partnership taxation is we should not get a fundamentally different result when using a partnership than when engaging in the activity directly. Partnerships generally determine the character and other attributes of income as if they were individuals, and pass through that treatment to the partners. The partners are then taxed on their individual shares of partnership income. Here, the partnership is

engaged in the entrepreneurial activity and determines its treatment just like any other taxpayer. It receives capital gain or loss when it sells a portfolio company.

There are a number of places where the partnership tax regime departs from this pure look-through approach, such as by giving partners a basis in their partnership interest separate from the partnership's basis in its assets. There are often conflicts between classification of an item at the partnership and partner levels. Thus, if a partnership holds a capital asset for more than 12 months, a partner gets long-term gain or loss even if the partner has been a partner for less than 12 months. This type of conflict is not at issue here: the partnership rules do not create a disparity between partner and partnership treatment in this case.

A second exception to the pure look-through approach is if the payments to the partner are sufficiently fixed that it is clear that the partner is effectively not engaged in the activity directly. The underlying premise is that if the partner had engaged in the activity directly, his payments would depend on the success of the partnership business. If the payments instead are fixed, it is not appropriate to treat him as if he engaged in the partnership business directly. Instead, he looks more like a service provider. Therefore, we carve out these cases and treat them as transactions between the partnership and third parties.

There are two relevant code sections. First, section 707(c) provides that "guaranteed payments" for services – payments which are determined without regard to the income of the partnership – are treated as ordinary income to the recipient and generate a deduction or capital expenditure to the partnership. Second, section 707(a)(2)(A) re-characterizes certain distributions to partners as payments for services if the facts indicate that the partner was not acting in his capacity as a partner. The purpose of this rule, enacted in 1984, was to prevent avoidance of the capitalization rules through allocations of income. If section 707(a)(2)(A) applies, partner-level activity (provision of services) controls the treatment of the distribution. According to the legislative history, there are six factors to be used in making the determination of whether a partner is acting in his capacity as a partner. The most important factor is whether the payment is subject to appreciable risk as to amount, reflecting the notion discussed above that we use entrepreneurial risk as a method of determining whether the partner should be treated as engaging in the activity directly and therefore get partner treatment. The Joint Committee on Taxation explained that "partners extract

the profits of the partnership with reference to the business success of the venture, while third parties generally receive payments which are not subject to this risk."[10]

A typical carried interest easily passes all six factors – they have none of the factors that indicate that they are to be re-characterized as received for services. It is not even a close question, at least under current law, that the private equity sponsor is acting in its capacity as a partner with respect to a carried interest because the private equity sponsor really is the entrepreneur, using the limited partnership interests as a financing mechanism. Therefore, the section 707(a)(2)(A) rules sensibly do not recast the sponsor as someone not engaging in the partnership activity.

Proposals to abandon the pass-through treatment of carried interests are necessarily based on the theory that it is not appropriate to give a holder of a carried interest the same treatment he would have if he engaged in the partnership activity directly. The current lines are not written in stone and there is no reason to believe that they cannot be improved. Nevertheless, a typical private equity carried interest is so directly in the sphere of partnership activity, that it is hard to imagine a justification for changing current law unless the fundamental distinction between capital gain and ordinary income is revisited. This conclusion does not at all depend on a claim about whether the activities engaged in by the sponsor are more in the nature of labor or provision of capital. If the sponsor engaged in the activity directly, we would not make this distinction. Gains and losses would be capital, not ordinary even if the value were created primarily through labor. The only question then is whether there is some reason, because of the use of a partnership structure, that we would want to change this result.

Those seeking to change the result often analogize a carried interest to stock options, stock compensation, or payment for performance of services. The argument runs as follows: The traditional line drawn between partner and non-partner activity found in section 707 has eroded. It was previously based on the idea that service providers get fixed amounts. This is no longer true, as many employees now take risks associated with the success of the business through the receipt of stock, stock options or

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[10]The other factors relating to service income are whether the interest is transitory, whether the distribution and allocation to the partner are close in time to the performance of services, whether the goal is to get tax benefits, and whether the value of the recipient's interest is small in relation to the allocation. There is a six factor relating to the capital account maintenance rules which is focused on property transactions. See Senate Comm. on Finance, 98th Cong., 2d Sess., Deficit Reduction Act of 1984, S. Prt. No. 169 at 227-228 (Comm. Print 1984).

performance-based pay. These forms of service payments are, to some extent, taxed as ordinary income. To create parity with these employees, they argue, partners who have carried interests should be treated as non-partners and get ordinary income on their returns to a similar extent.

The analogy to an employee performing services, however, 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 general partner, the sponsor bears all of the fund's residual risk. Limited partnership interests are merely a financing method.[11] Although taxing carried interest on a pass-through basis creates a distinction between employees and holders of carried interests, changing the treatment of a carried interest to be like employee compensation would create an even more inappropriate distinction between financing methods for entrepreneurial activity.[12]

One way to think of the problem is one of drawing a line. Regardless of which way the analogy is resolved, there will remain a tax difference between similar items. Thus, if one believed that carried interests were like employee stock options, taxing them that way would not eliminate the problem: there would still be a distinction between carried interest and direct engagement in the activity. The core distinction created by the capital gains regime cannot be eliminated.

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[11]Both Gergen and Fleischer recognize that their proposals are inconsistent with the treatment of self-created assets but neither has an answer to why this is appropriate. Gergen argues that looking to the profits-interest partner is inappropriate because the real issue is whether the other partners can avoid capitalization of payments for services by making a partnership allocation instead of a salary payment. While this issue may be important where other partners are the entrepreneurs giving a service partner a profits interest, it is not relevant for the taxation of private equity funds. Fleischer considers this issue only with respect to the treatment of the receipt of a partnership interest and does not mention how it affects the back-end taxation of a profits interest.

[12]Moreover, if we follow the stock option analogy, any entrepreneur who uses nonrecourse financing, even one who works for himself, would get ordinary income on all of their gains. The reason that any time nonrecourse financing is used, the entrepreneur has an option-like payout. For example, if an entrepreneur borrows $95 on a nonrecourse basis and invests $5 of his own money, he will get the upside of the project after the interest on the loan is paid off but not bear any of the downside beyond his $5 contribution. The option analogy would treat this case the same as an employee getting options in his company, a result that is inconsistent with the basic structure of the capital gains preference.

Given that there will inevitably be a line between similar items, the question is how we should draw the line. I have argued elsewhere that we should do so by examining the efficiency effects of different lines, a process that is similar to but not exactly the same as reasoning by analogy.[13] To illustrate, suppose there are three items under consideration. Item A is high-taxed (ordinary compensation), Item C is low-taxed (self-created assets and founders shares), and we are trying to decide the treatment of B (carried interests). Suppose that under some theory of correctness in measuring income, we prefer to tax B like A. If, however, attempting to do so merely causes individuals to choose C, we should not tax B like A. We get little revenue or other benefits from treating B like A and we create enormous distortions because of this shifting. Economically, we want to examine whether B is a closer substitute for A or for C. We can show mathematically that the right way to measure this is to compare the ratio of amount of shifting to the revenue. If this is high – a lot of shifting to the low-taxed category and little revenue raised – the line is not desirable.

On these criteria, the choice is clear. As argued below, straightforward attempts to tax carried interests as ordinary income would simply lead to a change in the transaction structure, making them less efficient and raising little revenue. The reason is that a sponsor's carried interest is not like an employee stock option. It is like a return on an investment.

Complexity and Avoidance. The analysis above alluded to but did not directly address perhaps the most important problem in considering whether a change to the treatment of carried interests is desirable, which is the problem of complexity and avoidance. Changing the treatment of carried interests would be very complex because of the problems of defining carried interests. Moreover the complexity would be for naught because the change could be easily circumvented. Even if one were persuaded that the correct treatment of carried interests was as ordinary income, any benefits from changing the law would be swamped by the costs of complexity and avoidance.

The Gergen proposal would treat some distributions to partners as payments for services. The central problem is identifying which payments are for services. To do so, he would treat any payment to a service partner that is not pro rata with respect to capital accounts as entirely for services. This approach is vastly overbroad. Imagine a two person partnership where both partners provide an equivalent amount of services

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[13]David Weisbach, *An Efficiency Analysis of Line Drawing in Tax Law*, 29 Journal of Legal Studies 71 (2000).

and capital but have different appetites for risk and return on their capital. An allocation that reflected these different risk profiles might, say, give one partner all or most of the returns up to some fixed amount and the other partner everything beyond that. Gergen would treat all distributions in this case as for services even if the partners were each paid an arm's length salary.

The Gergen approach would also be easy to avoid. Using debt rather than limited partnership interests would make any such rules entirely inapplicable because there would be no partnership. If a partnership must be used, the transaction could be documented as the Fleischer/Schmolka structure. That is, if the profits interest were documented as a loan from the limited partners to the general partner (and a contribution of the loaned money), the general partner would unquestionably be receiving a return on contributed capital. The two-percent management fee would be their compensation for services. Thus, the significant complexity that the Gergen approach would introduce would be for naught, or at least very little.

The Levin approach is similar to the Gergen approach but rather than adopting a straight-up allocation rule, it would merely require a reasonable allocation between labor and capital. Similar avoidance mechanisms, such as the use of debt, would be similarly easy to use. Moreover, simply rearranging the labels on the current partnership structure would get around the Levin bill. For example, if the various returns paid to private equity sponsors are combined into a single return, the sponsors could allocate two-thirds of their returns as service income without changing their tax results at all. Auditors would have little basis to challenge such an allocation. More complex restructurings, such as loans from the limited partners to the sponsor who would then contribute the capital to the partnership would make a challenge to the allocations even more difficult. The result would be less efficient and transparent capital structures, an increase in tax controversies, and little or no additional revenue. More subtle rules that attempt to distinguish more accurately would be complex and yet remain inaccurate. This was the very problem faced by Congress when enacting section 707(a)(2)(A). Twenty-three years after passage of this rule, the Treasury has yet to issue regulations because there is no easy way to make the distinction between labor income and capital income. The Levin bill simply glosses over this central problem, hiding its complexities behind a rule that allocations must be reasonable.

The Fleischer/Schmolka approach suffers from similar problems. The underlying rationale is that uneven sharing of returns to capital represents implicit loans that should be recognized. This is a more accurate measure of the return to services than the

Gergen approach, but would likely be impossible to implement. It would be necessary to identify when one partner has implicitly loaned funds to another partner and then impute an appropriate cost of capital. If allocations are not straight-up, it would be impossible to identify implicit loans. At a deeper level, the capital accounts system required by the 704(b) regulations does not incorporate time value concepts (except to a limited extent in the substantiality test). Without time value concepts incorporated into capital accounts, there can be all kinds of internal loans among the partners. Attempting to revise the capital accounts rules to incorporate time value concepts, however, is a daunting prospect and would likely make the partnership tax rules entirely unworkable.

To illustrate, a typical private equity partnership uses a hurdle rate. The limited partners get the first 8 or 9 percent of the return. Once that return is achieved, the general partners get an allocation so that the overall return is split 80/20. This could be restated as a nonrecourse loan with a fixed return of eight percent and a contingent return of 80 percent of all profits above 10 percent. With a fixed return of eight percent, it would easily exceed any requirement of paying minimal interest as required by the Fleischer/Schmolka approach. Indeed, if we view the limited partnership interests as financial instrument issued to sophisticated third-party investors, there is no question that they are compensated for the use of capital. Tax rules that treat this return as inadequate would be ignoring the economic realities.

The Appendix includes some relatively simple examples of how partners might split up returns to both labor and capital. Any legislation should be able to address these simple examples. No proposal yet put forward can do so.

III. Conclusion

Study of the tax treatment of carried interests remains important. In recent years, the returns in the private equity context have been significant, and a thorough understanding of whether current law is correct is worthwhile. Although many have analogized carried interests to fees earned for managing money, an understanding of the structure of the industry reveals that they are more like the returns that any investor or owner of a business receives, returns that are taxed as capital gains on their sale. The only difference between carried interest and direct investments is the use of limited partnerships instead of debt as a means of financing. It does not make sense to change

the tax treatment significantly based on this difference. Moreover, proposals to date would merely impose economic costs in the form of complexity and restructuring of the business without collecting any significant revenue. On this ground alone, the proposals would be undesirable.

Appendix: The problem of distinguishing capital from services in a partnership

Any proposal to tax carried interest as ordinary income must be able to define when this treatment should apply. The problem is that capital and labor can be mixed in a partnership in ways that are virtually impossible to disentangle. The following examples illustrate some of the issues any such rule would have to face.

A and B form a partnership, each putting in $100.

1. A and B each work for the partnership and their services are worth the same amount. They are paid a zero or minimal salary. The partnership produces long term capital gain, allocated equally to A and B.

2. A gets 60% of the profits and losses for the first 5 years and 40% thereafter. The parties anticipate that the present value of A's and B's return on capital are the same but have different risk profiles.

   a.. The partnership hires a manager and pays an arm's length salary. Neither A nor B works for the partnership.

   b. Same except that A and B each work for the partnership. Their services are worth the same amount.

   c. Same except that the capital flows do not have equal present value. A's and B's services are worth differing amounts, offsetting the different in the present value of the capital flows.

   d. Same except that losses are shared equally even as profit allocations shift, with each of the above three possibilities for services.

3. A gets the first six percent of profits and B gets everything beyond that. Losses are shared equally, or alternatively, B bears the first losses until his capital account is zero, then A bears any further losses. (Similar to A getting preferred stock and B getting common in a corporation.)

   a. They hire a manager.

b. They work for the partnership and the value of A's and B's services are the same.

c. They work for the partnership and the value of their services are different.

4. A gets 70 percent of the profits from stores in Illinois and 30 percent of the profits from stores in California while B gets the reverse.

a. Neither A nor B work for the partnership. They hire managers at arm's length salaries.

b. A works in IL and B works in CA and each get paid a nominal salary. Their services are worth the same.

c. They both work for the partnership but their services are worth different amounts.

5. A has an idea but needs financing. B has $100.

a. B lends the $100 to A at a 10 percent rate of interest (recourse or, alternatively, nonrecourse). A develops the idea and sells the resulting patent for $200 the following year. He pays B $110 and keeps $90.

b. B lends the money to A in an "equity kicker" loan which entitles him to 10 percent interest plus five percent of any returns above 10 percent.

c A and B instead form a partnership. B gets a limited partnership interest which pays a preferred return of five percent and 10 percent of gains beyond that. B bears all losses. A receives all remaining returns and works for the partnership. A works for the partnership and gets a minimal salary.

d. A gets a patent on his idea. A contributes the patent and B contributes $100. They claim equal $100 capital accounts. B gets a preferred return of five percent and 10 percent of gains beyond that. A works for the partnership and gets a minimal salary.

6. Fleischer/Schmolka:

   a. A has an idea and B has $100. B lends A $20 at a 10 percent rate of interest. A contributes the $20 to the partnership and B contributes the remaining $80. They share profits straight up. A works for the partnership and pays gets paid a minimal salary.

   b. Same except that A agrees to pay B a contingent rate of interest on the loan based on a market-place contingency.

   c. Same except that A agrees to pay B a contingent rate of interest on the loan based on the performance of the partnership.

One response to these examples is that the pure profits interest case, where there is a service partner and a capital provider, is easier than most of these examples. We can simply treat all of the allocations to the service provider as compensation for services. We can get this easy case right and worry about the harder cases later in regulations, perhaps with some guidance in the legislative history.

Even in the most straightforward case, where the carried interest contributes no capital, it is not easy to identify the service elements. As Examples 5 and 6 show, it is not correct to treat the entire payment on a carried interest as for services but identifying the service element is not straightforward. Moreover, unless a clear boundary can be drawn around the easy cases, this strategy would introduce substantial complexity and uncertainty into many other cases. Drawing a clear boundary, however, would likely mean easy avoidance and little revenue.

PRIVATE
EQUITY
COUNCIL

Private Equity Council Case Studies

AutoZone

On June 26, 2007, the executives of Memphis-based AutoZone celebrated the opening of the company's 4,000th store in Houston, Texas. That achievement was the culmination of years of diligent effort initiated by private equity owners.

Between 1984 and 1996, private equity firm KKR helped to expand AutoZone from a small subsidiary of a food and drug wholesaler into the nation's leading auto parts retailer. Fully a decade after KKR exited, the company is still flourishing, with millions of Americans in 48 states benefiting from the high quality parts and service that AutoZone provides at highly competitive prices.

The story began in 1979, when J.R. Hyde founded Auto Shack and made it part of Malone & Hyde, the wholesale grocery business that his grandfather created in 1907. By 1984, he believed M&H was undervalued and approached KKR about the prospect of a management-led buyout. Noting Hyde's talent (he had spent seven years on Wal-Mart's board), KKR agreed to invest $115 million in equity, alongside the $35 million that J.R. Hyde and other managers were providing, and helped to arrange roughly $550 million in debt for the $700 million acquisition.

New Products, More Locations

The primary business of M&H remained wholesale groceries, but Hyde wanted to concentrate on the auto parts company, noting that most competitors in that space were mom-and-pop operations, many of which were not well run. Realizing the potential of AutoShack, KKR and management quickly set out to add innovative new products and expand the number of locations. Their strategy was clear: They intended to "offer high quality, low-cost parts to the car or truck owner who has to repair his own vehicle out of economic necessity."

In 1985, the company introduced Express Parts Service, a direct marketing program that offered customers the ability to have parts shipped to them. The following year, the company introduced the first quality control program in the industry and became the first to offer a lifetime warranty on virtually all parts sold. According to Hyde, the company "made a religion out of putting the customer first" and sought to create "a culture of excellence." The company also invested in an electronic catalog for all of its stores, which helped managers better manage their inventory. The investment proved prescient,

as the company more than doubled in size from about 160 stores in 10 states in mid-1984 to 339 stores in 15 states by the end of 1986.

Increasingly, it became clear that the auto division offered the best growth prospects for M&H. In 1987, KKR and the management team carved-out the auto division and sold the remainder of M&H. Doing so allowed them to spend all of their time and resources on finding new and better ways to serve customers.

Innovation From Within

During the next four years, KKR continued to invest in expansion efforts, improved systems and operations, and innovation from within. Recognizing and supporting the talent of its employees was instrumental to launching the ADuralast line of tools, a private line designed entirely by internal product managers. Renamed AutoZone, the company also invested in electronic management systems that helped to reduce wait times for customers and ease the accounting burden on local stores.

Seven years after going private, AutoZone returned to the public market. During its years as a private company, AutoZone's revenue had grown seven fold to $818 million, up from $120 million when KKR acquired it in 1984. In spite of the apparent success, not all were confident that AutoZone would be able to continue to grow. Analyst Norman Fosback was wary, saying that AutoZone was "a vastly overpriced stock that's worth only about half its present price. . . you're betting on too many good things happening over too many years in an unknowable future. . . it's a stupid bet."

After AutoZone went public, KKR maintained a significant ownership stake in the company and did not slow down AutoZone's expansion. Over the next five years, KKR continued to leverage economies of scale to increase the competitiveness of the business and lead AutoZone into new markets. The company entered the commercial auto parts market, lowering the cost of parts and diagnostic software provided to mechanics and technicians across the country. It also introduced multiple store designs, which enabled the company to provide low-cost, high-quality parts to small towns and rural areas in a cost-effective manner.

From 1,000 to 27,000 Employees, 160 to 1,400 Stores

KKR finally exited AutoZone in 1996. From a base of 1,000 employees and 160 stores when KKR took over, AutoZone had grown to be the third largest auto parts store in the country, with more than 1,400 stores and nearly 27,000 employees. More importantly, during its period of ownership, KKR had helped build a company that would carry its success into the future.

In the decade since KKR exited, AutoZone has become the largest auto parts chain in the country, with 53,000 employees and more U.S. locations in than Wal-Mart. It also has entered the heavy truck parts market and become a member of the Fortune 500. Revenues have soared from $818 million in 1991 to a projected $6.1 billion in 2007. This top-line growth and operational efficiency of AutoZone have helped to drive the stock price up at an annualized rate of 20 percent annually since going public. Apparently, Fosback got it wrong.

Private Equity Council Case Studies

SunGard

Based in Wayne, Pennsylvania, SunGard is a global leader in developing and marketing business software. Its annual revenue exceeds $4 billion. The company processes some 70 percent of all NASDAQ trades. SunGard has been growing rapidly. Today it has offices and employees (including subsidiaries) in 28 states[1] and in 30 other countries around the world. But in 2004, SunGard was having a tough time with Wall Street.

Apart from the need to tightly manage earnings volatility to keep Wall Street reassured, SunGard faced another problem: It seemed to management that analysts did not fully understand how to value the company's businesses: data protection and recovery, software for the financial services industry, and software for higher education and the public sector. According to SunGard CEO Cristóbal Conde: "You have institutional investors and analysts who cover way too many stocks and don't have the time or bandwidth to understand our businesses."

Faced with this reality, CEO Conde considered a plan he thought might improve the stock price. By spinning off Availability Services, SunGard's data protection and recovery business unit, he thought he could create two simpler, easier-to-understand companies that could be more easily valued. Still, Conde was reluctant to follow through. He believed that the company's long-term value would be greater if it were kept intact. But he continued to face difficulty persuading the public markets.

Growth Opportunity

Enter SilverLake Partners, a leading private equity firm focused on the high-tech sector. Beginning in May 2004, the PE firm met with SunGard's management team, spent significant time researching the company and became persuaded not only of the company's inherent value, but also of the opportunity to grow it more quickly and improve its core operations.

By 2004 standards, the SunGard transaction was huge. If completed, it would be the second largest ever done. SilverLake began assembling what would become the biggest ever consortium of PE firms, each with special expertise, to come together to undertake

[1] Alabama, Arizona, California, Colorado, Connecticut, Florida, Georgia, Hawaii, Illinois, Indiana, Kansas, Maryland, Massachusetts, Michigan, Minnesota, Missouri, New Hampshire, New Jersey, New York, North Carolina, Ohio, Oregon, Pennsylvania, Tennessee, Texas, Utah, Virginia and Washington.

the transaction. In March 2005, Silver Lake Partners, KKR, Bain Capital, Blackstone Group, Goldman Sachs Capital Partners, Providence Equity Partners, and TPG acquired SunGard in a transaction valued at $11.4 billion.

Freedom From Volatility Concerns

The acquisition by the private equity investors made a huge difference to the company. Says Conde: "When you're running a public company, so much of your personal credibility is tied to whether you can predict your [stock price] volatility from one quarter to the next." Today, he said, "I spend zero time thinking about the volatility of the business," and more time thinking about growth. "Volatility of the last quarter is not necessarily a predictor of the future," Conde said.

Refocusing CEO time is an important benefit of private equity, but hardly the only one. The new PE owners recognized that the company was very good at making new acquisitions and integrating these new companies into its own business. So, they set aside an additional $1 billion line of credit as dry powder to finance future acquisitions. Sure enough, the company has been busy on this front: Since going private two years ago, SunGard has acquired 21 companies for more than $350 million.

New Investments in R&D

Freedom from quarterly earnings pressure and a longer term focus also have allowed the company to upgrade its R&D pipeline. Conde notes: "in any given year we'd do eight to twelve R&D projects… This year [2006], we funded 53." In the first six months of 2007, the company funded 30 new projects.

The new owners also focused on improving the company's service to its customers by streamlining the organization and driving coordination across businesses. Business units within SunGard were consolidated and reorganized, reducing the number of P&L centers in the financial services software business from 65 to 14. In addition, the company established a centralized global account management system. Today, large financial services customers that once had to deal separately with each of SunGard's business units benefit from a single point of contact.

In the end, PE owners earn their return if they can drive growth. In SunGard's case, some of the private equity firms involved in the transaction are using the company's products and services themselves, some have recommended SunGard to their portfolio companies and some are using their network within various industries (financial services, for example) to recommend the company.

New Owners: "They've Done Everything They Said They'd Do."

Speaking of SunGard's new owners, CEO Conde says: "They've done everything they said they'd do." SunGard has been adding workers. The payroll is 3,000 employees larger

– now up to 16,000 – than it was pre-buyout. And while the Asia-Pacific region has grown by leaps for SunGard (as it has with other large tech firms) Conde said many of his new hires have been in the United States.

Operating results also have improved. Between 2004 and 2006, revenue and EBITDA (earnings before interest, taxes, depreciation and amortization) both rose by 10 percent. Organic revenue growth increased from five percent in the quarter in which the acquisition announcement was made to ten percent in the first quarter of 2007.

All these improvements have made the company bigger and stronger. Where Conde was contemplating a breakup, he now leads a company with its business units intact. The plan is on track, delivering the performance on which the investment case was based and creating the value for which the public markets were unwilling to give credit.

Private Equity Council Case Studies

Burger King

In 2002, as TPG (formerly Texas Pacific Group) reflected on the possibility of acquiring Miami-based Burger King from its corporate parent, it saw a company that had lost $37 million the year before and had closed more restaurants than it had opened. One in four franchisees was nearly bankrupt. The Burger King menu had not kept pace with healthy innovations being rolled out by McDonald's, Wendy's and most other fast food venues. A Business Week headline asked: "Will Burger King Drop to Number Three?" Meanwhile, industry sources told TPG that Burger King management was burned out and demoralized.

It wasn't easy being a small subsidiary of Diageo, the world's largest beverage company – especially when Burger King was not in the beverage business. Investment in stores and marketing had been starved. Burger King's advertising had not captured the public's imagination since the "Have It Your Way" campaign decades earlier. Everything about the enterprise felt stale.

Yet the number two burger chain in America still had things going for it: Ninety-nine percent brand awareness – and a perceived edge in quality. Burger King seemed to be an asset that was under-achieving despite its potential. Realizing this potential would require a massive operational turnaround, but for patient owners and managers with a shared vision, the opportunity to create a much more valuable company was clear. With this potential in mind, TPG partnered with Bain Capital (which had experience in a similar space from its prior acquisition of Domino's Pizza) and Goldman Sachs' PE arm to purchase Burger King in December 2002.

<u>New Owners Moved Quickly</u>

The new PE owners quickly overhauled senior management, ultimately replacing 15 of the top 20 positions, including the CEO, with new blood ready to bring new ideas and energy to the business. The new intensity was palpable from the start. The senior executives who stayed recall cursory business reviews with the former parent company, which rarely confronted escalating performance problems. Under private equity ownership, they reported, regular board meetings became the central strategic and operational forum for the business.

The new owners asked fundamental questions that nobody had asked in years about every aspect of the business. Why had drive-through waits skyrocketed and how could Burger

King shrink them? Why was Burger King discounting prices on premium products like the Whopper? For many who knew what had to be done and who believed in the company, the turnaround was an exhilarating experience, managers later recalled. Soon, things began to change. The new PE-installed Burger King team worked with creditors to restore franchisees' financial footing. The PE firms poured in their own capital and also used their financial savvy and relationships with lenders to help franchisees obtain new loans to renovate restaurants, pay rent and bridge advertising contribution shortfalls. In total, the PE consortium invested more than $150 million over and above what it had paid for the business to boost advertising and shore up weak franchises. These efforts paid off handsomely. From 2003 to 2005, the number of franchisees in financial distress fell 98 percent, from 2,540 to 60.

Strategy for Continued Growth

Stabilizing Burger King was job one. Growing it was next on the agenda. Supported by its PE owners, Burger King management designed a new, smaller and more economical restaurant model that was 25 percent less expensive and allowed for faster expansion within the U.S. and abroad. Where the company had closed 123 stores in fiscal 2005, it is on track to open 300 new ones in 2007. It now operates 11,100 outlets in all 50 states and more than 65 countries.

Driving sales was the ultimate challenge. Armed with newly-developed analytics, the company identified its most valuable customer segment, dubbed the "super-fan," and focused on better serving this customer, typically an 18-to-34-year-old-male. The company introduced new products – the Enormous Omelet Sandwich was a huge hit – and made pricing more competitive with the launch of a 99-cent menu. The changes worked. Average sales at North American stores – around $900,000 per store per year at their nadir – grew 33 percent, to roughly $1.2 million in 2007. The company's revenues in 2006 stood at $2.1 billion, up from $1.7 billion at the time of the acquisition. Income went from a loss of $37 million in 2002 to a profit of $27 million in 2006.

In 2006, Burger King went public, and the value created by this four-year turnaround process became apparent. The company was valued at $2.2 billion on the open market, up $700 million from the original $1.5 billion purchase price paid by the PE group.

Carried Interest Part II
Questions for the Record
Bruce Rosenblum
July 31, 2007

Questions from Sen. Baucus

1. In your oral testimony, you said that incentives will be reduced for venture capital and private equity if carried interest is taxed as ordinary income.

A. Please explain how incentives will be reduced.

I think incentives would be reduced in at least the following ways. First, I would expect generally that a sharp increase in tax rates on gains from long term investing would reduce the incentives to engage in such activity, which is inherently speculative. Given that venture capital and private equity activity is now being driven primarily by firm sponsors (as opposed to their limited partners, who are typically more passive participants in such investing activity), I would expect that a substantial change in the taxation of those sponsors would affect the extent of venture capital and private equity investing activity even if taxation of limited partners does not change. Moreover, there would be reduced incentives for private equity and venture capital sponsors to continue investing under the types of ownership structures typically associated with private equity and venture capital investing (where limited partners participate fully in the substantial majority of profits), and increased incentives for those sponsors to invest in the future through other types of vehicles, where third party capital is provided in a different form (e.g., debt, limited return preferred equity, and the like), since that would likely result in more favorable taxation of the sponsor's ownership interests.

B. Was the incentive lower when the tax rate on capital gains was the same as the tax rate for ordinary income?

Over the last ten years since capital gains rates were lowered, there has been a marked increase in private equity and venture capital investing activity as compared to the prior period when the tax rate on capital gains was the same as the tax rate for ordinary income (i.e., 1987 to 1996). The reductions in capital gains rates could be a factor underlying this increase, as could several other factors. I do not have an analytical basis for correlating potential factors with actual results.

2. In your oral testimony, you stated that any change in tax on a manager of a fund would be passed on to pension funds.

A. Please explain how a pension fund will be required to pick up any change in the effective tax rate of a fund manager.

In my testimony, I said that I could not predict with certainty any particular outcome of a tax change, but that one possibility is that, over time, some of the "tax pain" would be borne economically by limited partners. In saying this, I had in mind that this would occur through a shift in terms agreed to as between limited partners and general partners of funds. While it is conceivable that this could be done directly, with provisions entitling the general partner to a specific formula amount meant to represent all or a portion of increased taxes, I think it is more likely to occur through a less direct shift in other economic terms and/or fund structures. I also noted that the leading trade journal for pensions and certain major limited partners of private equity funds have expressed their view that this result would likely occur.

Finally, I acknowledged that the setting of terms as between limited and general partners was a "market driven" process, and that it would be the more successful private equity firms with established track records that would be in the best position to seek changes that would help balance out increased tax costs.

I did not say or imply that every fund sponsor could or would "pass through" this increased cost of doing business or that any such economic pass-through would represent a complete "make whole" of the general partner. Indeed, I believe my responses suggested that this would not likely be the case.

B. When the tax rate on capital gains decreased in 2003, did any members of the Private Equity Council pass the tax savings to the pension funds?

I believe that the overall trend among Carlyle and other large PE firms since 2003 has been a meaningful reduction in fees as a percentage of capital contributed to funds, and some reduction in effective carried interest percentages, but I do not have an analytical basis for correlating this trend with the reduction in capital gains rates (and, indeed, I am aware that there are other relevant factors at work as well).

C. In 1986, the capital gains and ordinary income tax rates for individuals were the same. For each member of the Private Equity Council that was in existence in 1986, please state the profits interest of the general partner in each fund. Did the profits interest decrease when the tax rate for capital gains decreased?

Carlyle was not in existence in 1986, and I do not know the terms of the funds of other PEC members then in existence. I believe that the PEC members which were in existence at that date looked very different than they do today (i.e., were recently formed "start ups" or had a relatively small amount of funds under management) so there may have been many factors involved in the evolution of their fund terms since that date. (Please also see my response to Senator Grassley's question 2(I).)

D. Congress could statutorily limit the amount of fees that a private equity fund may charge a pension fund. What is your response to this statement?

I believe Congress would be ill-advised to impose such a restriction. In general, I believe that our economy benefits when the market is allowed to determine commercial terms between contracting parties, at least in the absence of specific abuses or special market environments (e.g., "natural monopolies"). Pension funds are sophisticated investors which routinely negotiate with private equity firms over terms, and they have no "compulsion" to deal with private equity firms. However, pension funds have benefited immensely from their investments with top-tier private equity firms, through investment returns that have far exceeded other investment alternatives. Pension funds value their relationships with these private equity firms, and I do not think that most of them would view it as an advantage for Congress to prescribe the terms on which they are permitted to contract with private equity firms. If such terms are prescribed by Congress, some private equity firms may choose not to accept pension fund investments on such terms--if there are other sources of capital available to them—which would not benefit the pension funds, their beneficiaries or the US economy.

3. Many private equity fund managers have a one-time or periodic election to convert management fees into additional profits interest. This technique is described in the BNA Tax Management Portfolio on Private Equity and various Practicing Law Institute articles.

A. Please provide a list of the members of the Private Equity Council that convert management fees into carried interest, and please state the frequency of these conversions.

B. Please explain the various techniques that members of the Private Equity Council use to convert management fees into carried interest.

I can only speak to my own experience and understanding and not for all PEC members on their individual business practices. As noted at the hearing, Carlyle does not "convert management fees into carried interest". For each of our private equity funds, we set management fee levels, and related provisions, at the inception of the fund, and there is no relationship between changes in management fee levels and profits allocations. Please note, however, that this does not necessarily mean that there is a single management fee percentage that is static for the life of the fund. For example, in some funds, the management fee may be expressed as a certain percentage of commitments and invested capital up to a specified level, and a lower percentage of commitments/invested capital in excess of that level. In addition, after the "investment phase" of the fund, management fee percentages may be reduced and/or the percentage may apply to a different base—e.g., only invested capital that has not yet been returned to investors. There may also be reductions in management fees to reflect all or part of certain other fees received by affiliates of the general partner, such as transaction fees or portfolio company monitoring fees.

I am not aware of the specific fund provisions used by other PEC members. However, as I noted at the hearing, I am aware (in general terms) of "fee offset" provisions that have been used in some private equity funds. As I understand these arrangements, I would not describe them as "converting fees into carried interest", in that they are in essence formulae for defining the amount of the management fees payable at various points of the fund's life, and the amount of the general partner's profits allocation under various scenarios. Under my understanding of the most common form of these arrangements, the management fee is set at a certain percentage of commitments/invested assets, but is reduced in each period by a fixed percentage (e.g., 1%) or a fixed dollar amount of capital called for investment during the preceding period (the "offset amount"). The general partner has a profits interest in an amount equal to the offset amount and the return on the offset amount, but only to the extent cumulative profits are sufficient to support this allocation.

4. In your written testimony you refer to the residual risk that you bear as a fund manager. What is this residual risk?

Residual risks include the following: The general partner of a limited partnership has liability for the obligations of the partnership to the extent the partnership is not able to meet such obligations. The general partner also has fiduciary obligations to partners of the partnership, and is sometimes asserted to have such obligations to third parties (whether or not there is legal merit in such assertions). In addition, a firm such as ours puts its reputation, business relationships and goodwill on the line with each fund we sponsor, and that may require us as a practical matter to assume liabilities that may not legally be our obligation (some examples are included in my next response below).

5. You state in your written testimony that private equity firms assume liabilities. You also state that there are instances where general partners in private equity funds have gone out of pocket to ameliorate partnership losses.

A. Please provide examples where general partners in private equity funds have gone out of pocket to ameliorate partnership losses.

I will give two examples from my firm's history. (I have omitted exact names and certain other details from these descriptions for confidentiality reasons.)

1. Carlyle formed Fund X in early 2000 to pursue a specified subcategory of private equity investments, and at the time the fund had a high level of demand from limited partners. About two years later, however, there had been a major shift in the prospects for these types of investments, and many of the early investments in the fund were in fact performing badly. At the low point, we valued the capital in these initial investments at less than 40 cents on the dollar. As a gesture of goodwill to limited partners, Carlyle reduced the level of management fees; refocused the investment objectives of the fund; gave limited partners a one time option to reduce their unfunded commitments (some actually chose to increase commitments based on the refocused strategy); and, at additional cost to the firm, brought on additional investment professionals to help execute the strategy for prospective fund investments. Carlyle continued to devote considerable attention and expense to this fund, with the objective of at least returning limited partner capital, even though it was highly unlikely that there would ever be sufficient profits in the fund to support any allocation of carried interest profits. In fact, after several years of effort, it is now clear that the limited partners will receive all of their capital back with a modest profit; there will be no profits allocated to "carried interest" in this fund (since the minimum profitability hurdles will not be cleared); and the fund will be an out of pocket loss to Carlyle (i.e., expenses will exceed fees).

2. Carlyle formed Fund Y in 1999 to invest primarily in marketable debt securities through a leveraged partnership. Due to dislocations in the debt markets in the early 2000's, many of the partnership's assets lost value, and the value of the limited partner equity in the partnership fell below 50 cents on the dollar. In response, Carlyle waived management fees for 2.5 years (forgoing approximately $20 million in revenue that has never been reimbursed); invested an additional $10 million in below-market junior securities of the partnership, to ensure that the partnership would meet its debt covenants (this capital was ultimately returned due to the turnaround of the fund, but was at high risk when invested); and employed additional investment professionals, with incentive bonuses tied to a fund turnaround (at the expense of the general partner, not the fund). Over many ensuing years, Carlyle was in fact able to turn around the performance of the fund, so that upon the final liquidation of the fund in 2007 the limited partners will have received a respectable investment return on their invested capital (in excess of the "hurdle rate") and the general partner will have received carried interest distributions. However, as of 2002, the firm had placed itself in a position to suffer out of pocket losses had the turnaround not been successful.

B. In these instances, were the general partners legally obligated to pay such losses?

No

C. Did the obligation to pay arise from the clawback provision?

Not in these cases. (Please see the answer to question 12 for information regarding clawbacks.)

6. It has been argued that private equity and hedge funds will move offshore if S.1624 became law. However, some private equity funds like KKR are already offshore. KKR uses a Guernsey partnership for its permanent source of capital. The partnership is traded on a foreign stock exchange, and the Guernsey partnership invests as a limited partner in some of KKR's funds.

A. Which members of the Private Equity Council have a foreign permanent source of capital structure?

B. Are these foreign permanent sources of capital traded on a foreign or domestic stock exchange?

I am aware of the following publicly traded "permanent capital" vehicles formed by PEC members, which may not be comprehensive. Listings (US or foreign) are indicated in the descriptions. I believe that, in each case, the activities of the "offshore" vehicles are quite limited (in scope and size) in relation to the sponsoring private equity firm.

1. KKR Private Equity Investors is listed on the Euronext exchange (in Amsterdam). Its stated objective is to invest 75% of its assets in private equity investments identified by KKR, including limited partner interests in KKR's private equity funds, co-investments in portfolio companies of such funds and negotiated investments in equity or equity-linked securities.

2. AP Alternative Assets Ltd. is listed on the Euronext exchange. Its stated objective is to invest in, and co-invest with, private equity and capital market investments sponsored by Apollo.

3. KKR Financial Holdings LLC is a New York Stock Exchange listed specialty finance company formed in 2004 and affiliated with KKR. Its stated investment objectives include investments in corporate loans and debt securities, asset-backed securities, equity securities, and mortgage-backed securities, and commercial real estate loans.

4. Apollo Investment Corporation is a NASDAQ-listed "business development company" formed in 2004 and managed by Apollo. Its investment portfolio is comprised primarily of subordinated loans and senior secured loans of private middle-market companies with equity interests such as warrants or equity co-investments.

5. Carlyle Capital Corporation is an investment fund recently listed on the Euronext exchange. Its objective is to invest in a diversified portfolio of fixed income assets consisting of mortgage products and leveraged finance assets.

7. Please provide a redacted copy of a partnership agreement between the general partner and the limited partners.

Carlyle's partnership agreements are confidential and proprietary documents (the agreements themselves restrict disclosure) and it would not be appropriate to place them in a public record.

8. For each member of the Private Equity Council, how long does it take to return the capital invested by the limited partners?

I do not have data regarding the experience of other PEC members. For Carlyle funds, there are variances depending on the type of fund, the year that capital is raised and other factors. Our two most recent U.S. buyout funds that have returned all capital invested by limited partners (including fees) did so in the 27th and 31st quarters (respectively) after inception of the fund. Two subsequently

raised U.S. buyout funds (formed in 2005 and 2007, respectively) have not yet reached the point where they have returned all of the limited partners' invested capital.

9. Do any of the partnership agreements of members of the Private Equity Council require binding arbitration between the general partner and the limited partners?

I do not have data regarding the agreements of other PEC members. Carlyle's partnership agreements do not typically provide for binding arbitration of disputes.

10. At the July 11, 2007 hearing on carried interest, Mr. Solomon stated in his written testimony that a profits interest partner has an immediate ownership interest in the enterprise.

A. What does a profits interest partner own?

B. What can a profits interest partner receive upon liquidation of the partnership?

A profits interest partner has an ownership interest in the partnership with the economic and other rights as defined in the partnership agreement. Upon liquidation of the partnership, the receipts of that partner will depend on the value of the partnership's assets and the extent of the partner's defined rights. In general terms, the partner would participate in the profits of the partnership on liquidation if all conditions to that participation were satisfied (i.e., typically, the limited partners' capital has been returned and a hurdle rate has been met), and then to the extent of the partner's defined interest.

11. Some panelists stated that the general partner in a hedge fund, real estate, venture capital, or private equity partnership has entrepreneurial risk. What risks does a profits interest partner have in a partnership?

Private equity general partners bear the following types of entrepreneurial risks:

1. General partners (and their individual partners) contribute substantial capital to their private equity funds. At Carlyle, this can represent hundreds of millions of dollars invested in a single fund. Whatever percentage of total partnership capital this investment represents, it typically represents a very high percentage of the private equity partners' capital available for investment. This capital is subject to risk of loss, in whole or in part.

2. Like other entrepreneurs, private equity general partners (and their individual partners) contribute ideas, expertise, and years of effort to the private equity partnerships they form and own. Like other entrepreneurs, these general partners (and their individual partners) bear the risk that this investment will not result in any significant value in their ownership interests. The general partners bear a significant risk in forgoing other opportunities that provide greater security and guaranteed returns in exchange for the greater upside potential provided by ownership of their interest in the private equity partnerships.

3. Private equity general partners have liability for the obligations of the partnership to the extent the partnership is not able to meet such obligations, and they may be asserted to have liability to third parties for certain actions of the partnership.

4. Private equity general partners contribute their goodwill, business relationships and reputations to their funds, and these assets are subject to impairment.

5. As noted above, private equity general partners may feel obligated as a business matter (even if not legally obligated) to suffer out of pocket losses on the operations of a sponsored partnership.

12. A general partner's profits interest is subject to a "clawback." A clawback means that the general partner will be required to return part or all of the income received on a profits interest if the fund fails to meet a specified return for the limited partners. How frequently are clawback provisions exercised?

In funds (like most of those formed by Carlyle) where the general partner is entitled to distributions on an interim basis based on net profits realized to date, a potential "clawback" obligation arises each time a subsequently realized investment (not already written off or marked down at the time of the earlier distribution) fails to achieve the minimum return hurdle. We attempt to minimize this, to the extent possible, by proactively creating "reserves" for any investment that we believe may not meet minimum return hurdles on realization (the effect of which is to depress interim distributions with respect to investments realized as of an earlier date). In addition, we are usually entitled to offset potential clawbacks against future expected profit distributions that will (on a cumulative basis) cause the minimum return hurdle to be exceeded, or to defer settlement to the end of a partnership's life. I believe there has only been one case where Carlyle was in a net "clawback" position at the end of a fund's life. In this case, Carlyle and its partners were required to repay interim distributions made early in the fund's life when it became apparent years later that the minimum return hurdles would not be exceeded on a cumulative basis.

13. What percentage of capital does a general partner invest in a fund?

The percentage may vary according to the type and size of fund and the fund sponsor. In Carlyle funds, Carlyle and its partners are typically required to invest at least 3% to 5% of the total capital, and frequently invest in excess of this amount. (Please see also my response to Senator Grassley's question 7.A.)

14. Does the partnership agreement for a fund contain a clause that provides for binding arbitration between the general partner and the limited partners?

Partnership agreements may vary from sponsor to sponsor—or even among funds formed by a single sponsor—as to this and other terms. As noted above, I do not have data regarding the agreements of other PEC members. Carlyle's partnership agreements do not typically provide for binding arbitration of disputes.

Questions from Sen. Grassley

1. At the hearing, I asked you for a yes or no answer to the following question:

> I have read reports in the press that, rather than change the tax treatment of carried interest, some think it would be more fair and equitable to raise the top marginal rate to 40% and the capital gains rate back up to 20%. That would leave the fund managers with their 20% rate preference while raising taxes on everyone' else, including small business owners, households with two wage earners, investors who actually put their capital at risk, and retirees who depend on investment income. Would this make the tax system more fair and equitable than changing the treatment of carried interest?

If you wish, please elaborate on the answer you gave at the hearing.

I answered "no" at the hearing, but would like to elaborate briefly.

I believe the revenue impact of the significant change in tax rates outlined above would dwarf the revenue impact of a narrowly targeted change in "carried interest" taxation, so they are not directly comparable alternatives.

There are inherent difficulties in projecting increased revenues from a change in carried interest taxation, since the change in rate may be offset at least in part by changes in levels of investing activity, conversion of investment vehicles to structures that do not utilize carried interests, and other factors. In addition, some economists have concluded generally that lower tax rates on capital gains may in fact produce greater actual tax revenues than higher capital gains rates, for various reasons.

I also believe there are many good policy reasons for not raising long term capital gains rates at all, either as a narrow 130% tax increase on the capital gains allocated to general partners' carried interests or as a broader, across the board increase in rates. Of the two alternatives, I believe that a small increase that applies broadly would be more "equitable" than a massive increase which narrowly targets a subcategory of capital gains recipients. But that does not mean that either course is one that Congress should pursue.

2. A concern that you highlight in your testimony is that pension funds, endowments, and foundations would bear the cost of increased taxes on fund managers. Others have expressed similar concerns with respect to other types of alternative asset managers. I have the following questions regarding this concern:

Note: Please answer for each member of the Private Equity Council, where applicable.

I am not able to supply answers for other members of the Private Equity Council.

A. If all income from carried interests was taxed at ordinary income rates, how much do you expect your tax costs to increase?

It is difficult to estimate specific tax costs, for several reasons. First, we do not know in advance the long term capital gains that will be generated by our funds, whether those gains will exceed the minimum return hurdle on a cumulative basis over the life of a fund, or whether interim gain allocations will be "clawed back" in the future. (I would note that Private Equity Intelligence reports that 30% of the 578 private equity, venture, and similar funds formed between 1991-97 have either failed to meet their hurdle rate or did not deliver any carried interest proceeds to their GPs.) Second, for the most part, capital gains allocated to "carried interests" flow through to individual partners, and taxes are paid at that level. The calculation of such taxes may be affected by unrelated income, losses and tax attributes of that partner, whether the partner is subject to AMT, and other factors not necessarily known to Carlyle. As a gross simplifying assumption, our discussions of this issue have centered around a potential 20% rate differential (i.e., 35% versus 15%) on the tax costs of capital gains allocated to U.S. individuals with respect to "carried interests" (i.e., increased tax costs on each $1 million of such allocated capital gains would be $200,000).

B. Would your firm seek to change the fee structure of its business, or otherwise renegotiate its partnerships agreements, to make up for its extra tax costs?

C. Are there other alternative structures your firm might use to reduce tax costs, and how would those structures affect the returns of the limited partners?

I cannot predict what actions Carlyle would take in response to a tax change, and, as I indicated at the hearing, the reactions of Carlyle and others are likely to unfold and evolve over an extended period of time. This is not something the firm has studied to date and I am not aware of all of the alternatives that might be available.

My thinking on this subject has mostly been on a conceptual level, as follows: The underlying economic activity pursued by private equity and venture capital firms is at its core about the creation of capital gain—i.e., ownership and growth in the value of businesses. A change in carried interest taxation targets a particular form of ownership and financing (i.e., third party equity financing through a partnership with differential profit allocations as between founder-partners and third-party limited partners) rather than a fundamental change in how the underlying economic activity is taxed. Thus, there would likely be alternative structures and/or alternative types of financing that would produce better tax treatment for those driving this economic activity (i.e., sponsors). I have mentioned in response to Senator Baucus's question 1.A a few very basic thoughts about possibilities (e.g., greater reliance on debt financing; utilization of different types of securities, perhaps more akin to preferred stock or convertible preferred stock, for at least a portion of third-party equity capital), but I am sure that other possibilities would be considered as well. As discussed in my testimony, our firm and other private equity firms might also consider changes to fee structures or other terms, but it is too early to speculate on what decisions would be taken in this regard.

D. What factors enter into the negotiation of the carried interest percentage with your firm's limited partners?

As with other partnership terms, a carried interest percentage is proposed by the firm prior to the inception of a fund and is subject to acceptance, rejection or negotiation by prospective limited partners of that fund. In general, the firm tries to propose a package of partnership terms that it believes will be attractive (or at least acceptable) to the majority of prospective limited partners and will also make the fund an attractive (or at least worthwhile) venture for the firm.

The 20% carried interest percentage that has been used in most (although not all) of Carlyle's funds is largely based upon precedent. Preexisting practice (particularly with "follow on" funds) provides a useful starting point for negotiation of the terms of the next partnership. Also, 20% is the most prevalent percentage used by private equity firms generally (although, again, there is variation among sponsors and among different funds of the same sponsor). Consequently, a limited partner may resist a proposed percentage higher than 20% and the firm may resist a requested percentage lower than 20% as being "off market".

In the end, however, both general partners and limited partners are looking to their bottom line economic returns and the specific circumstances regarding the fund's prospects. Major

changes to expected economic returns on either side, whether caused by tax changes or other factors, might be sufficient to break from the established norms as regards future negotiation of terms.

E. How much do you think the fiduciaries of private and public pension funds would be willing to pay your firm to make up for the taxation of managers' income at ordinary rates?

As indicated above, I do not know what changes in terms the firm would propose, or what changes limited partners would accept, following a major change in the sponsors' basis of taxation.

F. At what point do you think the pension funds' fiduciary obligations to beneficiaries will preclude them from paying higher fees to your firm?

I believe fiduciaries of pension funds assess prospective private equity investments on a total risk and reward basis, and are justified (both legally and as a business matter) in doing so. Thus, a pension fund would be justified in paying higher fees to a fund if it believes that the total returns from such fund are likely to equal or exceed other investments of a similar risk profile, on a net basis after fees. The net returns to pension funds from top-quartile private equity funds (including Carlyle funds) have far exceeded returns from the general equity markets over an extended period of time.

G. How much of your firm's tax costs do you currently pass on to the investors in your funds?

We do not currently have provisions in our private equity funds that seek to measure tax costs and pass these on to limited partners. The totality of the economic relationship between the sponsor and limited partners is encompassed in other terms (e.g., fees and expenses payable by limited partners, sharing rights of limited partners with respect to fees paid or expenses reimbursed by others, relative profit allocation provisions, and the like).

H. If tax costs to fund managers were reduced, how much of those savings would your firm pass on to the investors in your funds?

I cannot predict what changes in economic terms the firm would propose, or what changes limited partners would seek, following a reduction in tax costs to the sponsor.

I. After the Tax Reform Act of 1986, ordinary income and capital gains rates were equal at 28%. Since then, capital gains rates have dropped to 20%, and then 15%, while the top marginal ordinary rate increased to 39.6%, and is now 35%. Did your firm's fee structures change at all in response to these changes in rate differentials?

Our firm was founded in 1987, but did not raise its first private equity fund until 1990. By 1997 when long term capital gains rates were reduced to 20%, Carlyle had raised only a few private equity funds, as compared to 29 currently active private equity funds (not including real estate or debt funds).

The evolution of partnership terms over the firm's history has been influenced by many factors, including the development of our reputation and track record, which has made our funds more attractive to prospective limited partners, and the growth in the size of our funds, which has required us to access a broader base of limited partners for capital. In general, there has been a trend since 1997 of reduced fees paid by limited partners in our funds (as a percentage of capital), and greater sharing with limited partners of fees paid by other parties. This has also been the trend from 2003 (when long term capital gains rates were further reduced to 15%) to date. However--as I indicated above in response to question 2. B from Senator Baucus, with regard to what I believe to be a similar overall trend for private equity firms generally--I do not have an analytical basis for directly correlating this trend with the reduction in capital gains rates (and, as noted above, there are other relevant factors at work as well).

3. Carried interest is said to align the interests of the fund manager with the limited partners. Another way to achieve that alignment is through an incentive or performance fee, which is actually used by managers of offshore hedge funds. Other than carried interest, does your firm use other incentive arrangements to achieve alignment of interest? If so, under what circumstances and why?

Carlyle does not use other forms of incentive arrangements in our private equity funds. Carlyle also sponsors and manages "high yield debt" and other "leveraged finance" funds, which are structured differently (and engage in investing activities that are quite different) from our private equity funds. In many of these funds, the manager receives an incentive fee.

4. Some take the view that carried interest should be treated exactly the same as nonqualified stock options that corporate employees receive.

A. What are your views? What are the similarities between carried interest and non qualified stock options? What are the differences?

I believe the analogy of a carried interest to a stock option provided to an employee is flawed. While carried interests and stock options are similar in the general sense that they increase in value based on increases in the value of underlying businesses, they differ in many fundamental respects.

First, options arise out of an employer-employee relationship. A stock option is a right *granted* by a corporation as *compensation* to an *employee*. By contrast, the general partner who has a carried interest is not an employee of the limited partners, but rather is an owner of the venture from the outset who maintains control over the management and affairs of the venture. In most cases, the venture would not even exist without the sponsor's ideas, driving force, and skill.

Thus, a "carried interest" profits interest is an *ownership interest* in a business enterprise (a fund), that is predominantly held by the *founders* of that business enterprise from the inception, and as a result of their creation, of the venture. In contrast to an option, the general partner need not exercise anything to be considered an owner of the venture and receives allocations and distributions in accordance with the partnership terms from the outset. In these respects, I think a carried interest has more in common with "founders stock" in a corporation than a corporate stock option.

Partnership interests with carried interest allocations are also typically subject to terms and restrictions (e.g., minimum return hurdles, clawback provisions) not typically associated with stock options. Moreover, while stock options are used in private companies (including portfolio companies owned by private equity firms), they are most prevalent in public companies, where (once exercisable) they entitle to the holder, at any time of his or her choosing, to acquire a liquid security that can almost immediately be converted into cash. If, subsequently, the value of the corporation decreases and its stockholders suffer losses, there are no consequences for the option holder who has exercised and taken this cash. In contrast, the holder of a carried interest typically remains at risk for the investment returns delivered to limited partners over the entire life of the business enterprise (the fund), has residual risk if the venture fails (as discussed in other responses above), and receives cash with respect to the carried interest only concurrent with the limited partners' receipt of cash profits. Thus, the "alignment of interests" between limited partners and holders of carried interests is more complete than that of stockholders and option holders.

B. Mr. Rosenblum, do private equity firms have similar incentive compensation arrangements for their employees?

Mr. Rosenblum, please explain how a "carry plan" works and how the tax consequences compare to a corporation's non-qualified stock option plan.

We do not use the term "carry plan" with respect to any arrangements at Carlyle, and I am not familiar with how that term may be used by others. At Carlyle, ownership of the carried interests in our funds is held predominantly by the global partners of the firm (who have an ownership interest in every Carlyle fund and, in most cases, a more heavily weighted interest in the fund(s) in which they take a particular leadership role), and to a lesser extent by other key personnel associated with the particular fund.

As indicated in my written testimony, most of the individuals at Carlyle who own carried interest rights (through their ownership interests in the general partner or its funds) are also employees of the general partner or one of its affiliates. In that capacity, these individuals also receive compensation taxed as ordinary income. That compensation is typically in the form of a salary and a discretionary annual bonus (both for persons owning carried interest rights and other employees). Bonuses are generally determined on the basis of individual performance (although the aggregate "bonus pool" allocated to employees working principally for a specific fund group may be related in a general sense to the performance of that fund group).

The firm also maintains a bonus arrangement, called the "employee equity pool," under which a broad-based group of employees receives annual bonuses calculated to equal a small portion (less than 2% in the aggregate) of the carried interest proceeds realized by all affiliates of the firm during the preceding year. These bonuses are treated as ordinary income for tax purposes.

5. You each raised concerns about the competitiveness of U.S. capital markets if the Baucus-Grassley bill became law.

A. Please explain the structures being used by PE firms who are now tapping foreign public markets through arrangements such as permanent capital vehicles. Why aren't similar vehicles being established and listed on U.S. exchanges? If they were, what would be the tax and securities law treatment?

In response to Senator Baucus's question 6, I have briefly described the "permanent capital vehicles" of which I am aware (two of which are listed on U.S. exchanges and three of which are listed on the Euronext exchange in Amsterdam). I am not an expert in either the securities law or tax issues related to these vehicles, nor am I aware of all of the factors that may have made a Euronext listing desirable in the cases in which it was chosen. However, I am generally aware that U.S. securities laws (the Investment Company Act in particular) might require changes in the structure of these foreign listed funds (e.g., constraints on investment objectives, limitations on debt, limitations on number of holders and/or restructuring of fees/terms) if they were listed in the United States. I am not aware of any significant tax differences that would arise from a U.S. listing.

B. London is often cited as the chief competitor of New York in terms of attracting capital and financial management. However, a U.K. private equity firm would not be able to go public on the FTSE as a partnership - it would be required to be a public limited company (plc), and thus be subject to U.K. corporate tax. For example, a large U.K. private equity firm, Man Group plc, is subject to the U.K. corporate tax.

(1) What fund managers are currently publicly traded in the U.S. and how are they treated for U.S. tax purposes?

I am aware of two New York Stock Exchange-listed firms whose core business involves the sponsorship of private equity funds—The Blackstone Group, L.P. and Fortress Investment Group, LLC. A third firm, Apollo Global Management, LLC, recently sold interests in a private placement, with the announced intent of registering the interests with the SEC and listing them on the New York Stock Exchange. I believe all of these firms are publicly-traded partnerships currently treated as partnerships for U.S. tax purposes.

(2) In what other jurisdictions have fund managers actually gone public, and how are they treated for local and U.S. tax purposes?

I am not aware of U.S. headquartered private equity firms that have gone public outside the United States (although, as discussed above, some have sponsored discrete "permanent capital vehicles" organized and listed outside the U.S.) I am generally aware of a few publicly traded private equity firms headquartered outside the United States—e.g., 3i (headquartered in the U.K.), Onex Corporation (headquartered in Canada)—but I do not know how they are taxed.

(3) In what other jurisdictions would fund managers seek to go public?

(4) How would those entities be classified for local tax purposes?

(5) How would those entities be treated for U.S. tax purposes?

Regarding (3), (4) and (5), I have no particular knowledge or expertise on these subjects and do not want to speculate.

C. What considerations would be implicated if rules similar to those that apply to regulated investment companies or real estate investment trusts were to be applied to publicly traded fund managers?

I am not familiar at any detailed level with the rules that apply to regulated investment companies or real estate investment trusts, and therefore I am not in a position to offer a view on all the considerations that might be implicated if they were sought to be applied to private equity firms. To the extent that the REIT rules require the preponderance of a firm's investments to be in real estate assets, I assume they would not be compatible with the operations of a firm that is not principally engaged in real estate investment. I also believe that the regulated investment company rules are not compatible with the structure and operations of most private equity firms.

6. In your testimony, you state that we should consider the consequences of changing the taxation of carried interest in the context of private equity. One of those consequences you warn about is that the PE managers will move offshore. You stated that one of the relevant questions is this: "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?" On this point, I have the following questions:

Note: Please answer these questions for each member of the Private Equity Council, where applicable.

I am not able to supply answers for other members of the Private Equity Council.

A. When your refer to "the next generation of PE entrepreneurs," are you referring to US persons, or foreign persons?

I am referring to U.S. and foreign persons (and, in particular, to whether there will be greater incentives for foreign persons, as opposed to U.S. persons, to undertake such roles).

B. When you refer to "wherever the climate is most favorable," are you referring to the source of investment capital, the location of potential portfolio company targets, where the fund manager may organize its funds, where the fund manager may organize the entity that conducts its business, or the where the fund manager may actually operate its business?

I am referring in particular to the climate most favorable for the formation of private equity firms, and especially the locus of the sponsor's operations (which might have a bearing on the choice of fund entity jurisdiction, and could influence the location of potential portfolio targets of that sponsor, but is not necessarily determinative in these areas).

C. Would your firm move the actual conduct of its private equity management business offshore if the U.S. were to tax carried interest as ordinary income?

As stated in my written testimony, I think it is unlikely that Carlyle would relocate its U.S. operations offshore.

D. Would your firm's partners give up their U.S. citizenship and move to another country?

As stated in my testimony at the hearing, I do not think my U.S. partners would give up their citizenship and move to another country. (I would not.)

E. Please provide the location of your non-U.S. offices. What is the function of your foreign offices, what revenue streams are attributed to those offices, where are they in your organizational structure, and how is their income generally taxed in the U.S.?

Carlyle currently has non-U.S. offices in Barcelona, Beijing, Dubai, Frankfurt, Hong Kong, Istanbul, London, Luxembourg, Mexico City, Milan, Mumbai, Munich, Paris, Sao Paolo, Seoul, Shanghai, Singapore, Stockholm, Sydney, and Tokyo. For the most part, these foreign offices house personnel who seek out investment opportunities and work with portfolio companies in their region. Persons in some of these offices also work on investor relations, financial reporting, legal and administrative matters.

We do not typically associate revenue streams with offices, as opposed to funds (although I believe that we are often required to allocate certain types of revenues and expenses to particular countries for local tax purposes). The fund revenues are those referenced above (e.g., fees and a return on ownership interests in the funds). The personnel working on investments for specific funds or fund groups are often spread out among multiple offices (for example, we have personnel in London, Paris, Barcelona, Milan, and Munich associated with our European buyout funds); and we may have different personnel in a single office associated with different fund groups (for example, a person in the Paris office might be working primarily with the European buyout funds, or with our European technology fund, or with our European real estate fund). Similarly, our organizational structure does not center around offices, but rather funds and the general partners or advisors serving those funds.

Most of the entities in our ownership structures are "pass through" entities for U.S. tax purposes (i.e., partnerships, LLCs or "disregarded entities"), so income from foreign operations that is ultimately attributable to U.S persons, by virtue of their direct or indirect ownership interests in the funds, general partners or affiliates providing advisory services to funds, is taxable in the U.S. at the individual partner level and at the applicable U.S. rates. These U.S. persons may have foreign tax credits available with respect to taxes paid in foreign jurisdictions on this income.

7. You state in your testimony that carried interest should receive capital gains treatment because it is "unambiguous" that you "buy and own companies and there can be no doubt that the companies [you] own are capital assets held for investment." Please answer the following questions for each member of the Private Equity Council, where applicable:

I am not able to supply answers for other members of the Private Equity Council.

A. What percentage of the total capital of each private equity fund that your firm manages does your firm (or partners in your firm) contribute and what percentage of the profits is your firm's (or partners') carried interest?

As discussed in response to Senator Baucus's question 13, we are required to commit a minimum portion of each fund's capital (typically 3% to 5%) and are usually permitted by our limited partners to commit/invest a greater amount, up to a cap (typically 5% to 10%). We have investment commitments of approximately $2.6 billion to our currently active private equity funds (29 in total, not including our real estate and debt funds), representing 5.3% of their total investment commitments (of which approximately $1.4 billion had been funded as of August 20, 2007.)

Our carried interest percentage is typically 20%, but since this is conditional on return of limited partner capital and a minimum return requirement, the actual profits percentage attributable to this interest varies from 0% (as noted in examples given in response to prior questions) to 20%.

B. Does your firm (or partners) receive a capital interest for contributing any intangible assets?

We are not assigned a capital account value for contributed intangible assets.

C. To what extent does your firm's (or partners') carried interest represent an ownership interest in these capital assets?

Please see the response to Senator Baucus's question 10. B.

D. Does the carried interest ownership share reduce the ownership interest of the limited partners (and your firm) below the extent to which they (and you) have contributed capital?

Since the terms of the carried interest require the return of all limited partner capital plus a hurdle rate return prior to profit allocations/distributions with respect to the carried interest, I do not think the carried interest causes any reduction in limited partner capital. Also, as noted above, the respective ownership rights and interests of the general partner and the limited partners are established at the inception of the venture. Thus, it would not be accurate or appropriate to say that the limited partners' ownership interest is reduced as a result of a carried interest.

E. Why do you contribute capital to the funds you manage? Is there a concern that otherwise, you would not be considered a partner for Federal tax purposes and that the character of the income from your share of the carry would not pass through the partnership to you?

We include minimum contributed capital requirements in our funds because this is important to limited partners, who want to ensure that the general partner and its partners are "at risk," not only with respect to their time and effort, but also with respect to their capital. As noted above, a Carlyle partner's investment in our funds often represents a very substantial portion of his or her available capital, and many limited partners appreciate this as a sign of confidence and commitment.

On the other side of the equation, the firm and its partners perceive investment in our funds to be an attractive opportunity, and there is thus motivation on our part to make such investments to the extent of our capacity to do so. Thus, our actual investment in a fund typically exceeds the minimum requirement.

I am generally aware that, for tax purposes, there used to be minimum contribution requirements for general partners in partnerships, but my perception is that our levels of investment are far above those old minimums. I certainly am not aware of any instance where tax considerations (as opposed to the factors outlined above) were brought to bear in setting investment levels.

8. Recent research estimates that, on average, the revenue of private equity firms, on a present value basis, is split approximately two-thirds fixed management fees and one-third from incentive fees, including carried interests, but that the amount of carried interest is concentrated in a small group of larger fund managers. Please answer the following questions for each of the firms represented by the Private Equity Council, where applicable:

I am not able to supply answers for other members of the Private Equity Council.

A. If the management fee were deferred until the time the carried interest is paid out, how would this two-thirds/one-third ratio change?

I do not know the methodology used to calculate the 2:1 ratio and therefore do not know the answer to the question.

B. What percentage of your firm's revenue is from incentive fees, and how much of that is carried interest and how much is from other incentive arrangements?

We do not use incentive fees or other incentive arrangements in our private equity funds. As noted above, we do use incentive fee structures in certain debt funds we have organized. These incentive fees were a de minimis percentage (less than 1%) of 2006 revenues. In 2006, revenues attributable to carried interest comprised 62% of gross revenues, with the remainder attributable to fees and earnings on invested capital.

C. What do the S- 1's of publicly offered alternative asset managers suggest this ratio is?

I have not reviewed the S-1's of other firms to ascertain this data.

D. In reference to the two-thirds/one-third split, how does providing such a high portion of earnings in the form of management fees - which are not performance based - serve to align managers' economic interests with those of the limited partners who invest in the fund?

As a private equity sponsor organizing a fund, it would not be our intention (nor do I think it would be the intention of other private equity firms) to end up with a 2 to 1 split of fees to carried interest proceeds over the life of the fund. This certainly would not be our limited partners' objective. Given the structure of these funds—with defined fixed fees and a highly variable amount potentially allocable to the carried interest—the ratio of carried interest proceeds to fees will be high if the fund is highly profitable and low if the performance of the fund is mediocre or poor. However, there is still an alignment of interests in each case, regardless of the actual end result, since everyone's incentives run in the same direction—if the fund is highly profitable, both limited partners and general partners will be happy. Both our own capital investment and our rights to potential carried interest allocations provide us with a powerful incentive to generate strong returns for our limited partners.

We do not always succeed as we intend—for example, in two funds described above (the first example provided in response to Senator Baucus's question 5.A, and the fund referred to in response to Senator Baucus's question 12) we received no carried interest allocation at all (although in both these cases the limited partners realized a profit). In addition, it should be the case that the best performing private equity firms produce a greater carried interest proceeds to fees ratio than the average private equity firm.

These questions concern the use of leverage in making PE acquisitions.

A. How much leverage is used in a typical buyout transaction, and who is usually liable for the acquisition debt - the portfolio company or the PE fund?

Our private equity funds do not incur debt at the fund level, so the answers below refer to debt incurred at the level of the portfolio company or acquisition vehicle. (On occasion, our private equity funds have undertaken limited obligations with respect to portfolio company debt—such as an obligation to contribute additional equity to the portfolio company if certain financial ratios are not maintained, or an obligation to pay lender expenses incurred during a pre-acquisition period. In addition, we sometimes use short term loans at the fund level to "bridge" the period between the required funding of a transaction and the receipt of capital called from investors.)

Portfolio company leverage levels (measured as a multiple of EBITDA) can vary widely, depending on the growth prospects of the business, the industry in which it operates, the cyclicality of its business, the terms of available indebtedness (for example, in a low interest rate environment, a portfolio company may be able to service higher levels of debt), the company's other cash needs (for example, whether it has high capital expenditure

requirements), and many other factors. Our buyout funds have made investments in and acquisitions of companies with no debt at all, and we have invested in companies with debt levels as high as 8.5x EBITDA. I would not say that there is a "typical" level of debt in a buyout transaction, and to some degree the debt levels can vary based on market conditions, liquidity, and lending practices. However, in the last five years, the majority of our U.S buyout transactions have involved leverage in the 4x to 7x EBITDA range at closing.

B. What is the source of credit in these transactions? Do related or unrelated hedge funds acquire this debt? If so, how?

Typically, one or more banks or financial institutions (unrelated to Carlyle) commit to provide debt for a transaction and then (either concurrently with closing or, in some cases, thereafter) syndicate or sell that debt to many holders. After the syndication or sale, there continues to be secondary trading of the debt, so the holders of that debt change over time.

Carlyle sponsors multiple debt funds whose portfolios include the debt of Carlyle-owned companies (and also include the debt of many unrelated issuers). This debt may be purchased at the closing of the syndication/sale, or purchased in secondary trading. In addition, Carlyle is the minority owner of a multi-strategy hedge fund which may acquire debt of Carlyle-owned companies. A number of unrelated hedge funds also acquire the debt of Carlyle-owned companies (again, either at the syndication/sale, or in secondary trading).

10. In your testimony, you refer to the impact of a tax increase on behavior and that the result will be that "[t]here will be deals that won't get done, entrepreneurs that won't get funded, and turnarounds that won't be undertaken."

A. Are you referring to the behavioral response of the fund managers, or the investors, or both?

I am referring primarily to what I expect would be a diminishment of U.S. private equity activities over time as a result of the tax change. Since private equity activity is driven by sponsor activity in the first instance (i.e., a sponsor makes the determination to form a fund, develops its strategy and profile, and then seeks limited partner capital), the response of sponsors and potential sponsors would probably be the most significant factor in this reevaluation, although limited partner behavior may play a role as well (e.g., a limited partner may decline to invest under a structure or terms which the sponsor believes are necessary, after the tax change, to justify a certain type of private equity venture).

B. Other than the tax cost of the fund managers, what factors are taken into account in determining whether or not to do a buyout deal?

I do not think that the tax costs of a private equity sponsor (or its partners) are a significant consideration today in evaluating potential buyout transactions on a deal by deal basis. Even in the wake of a significant tax increase, these costs will likely be more of a factor in determinations about whether to form a private equity firm at all (for potential private equity entrepreneurs), whether to form funds to pursue transactions of certain profiles (for existing sponsors), and whether certain types of private equity ventures (either funds or

deals) can be pursued on terms that make them sufficiently attractive, on a risk/reward basis, for both general and limited partners.

Significant considerations in evaluating a potential buyout deal include the quality (or potential quality) of the underlying business and the industry sector in which it operates, the ability of the sponsor to drive improvements in the business, the quality of the management team (either existing or available externally), the ability of cash flows to service debt (if debt is an anticipated part of the capital structure), the overall potential for increased value, and the risks involved in achieving that potential value.

E. How much of the debt issued for a buyout is repackaged in collateralized debt obligations? How have the recent developments in the CDO market impacted the buyout market?

In my experience, debt is not typically repackaged in collateralized debt obligations, but existing CDOs are among the buyers of debt issued in buyouts. I think that the current uncertainty in the debt markets (created in part by developments at some CDOs, but also by many other factors) impacts the buyout market in the short term by causing lenders to be less willing to make debt commitments. Longer term impacts could include higher pricing of debt, lower availability of debt on a given deal, and lower price expectations for sellers of businesses.

Questions from Sen. Kyl

During the hearing, you noted that if carried interest is taxed entirely at ordinary income tax rates, we would not likely see changes in our economy or in existing deals immediately, but that changes would come over time. I am concerned that such a dramatic tax increase (of 133%) could hurt economic growth and job creation by taxing corporate profits multiple times, discouraging risk-taking, and encouraging capital to finance investments overseas, rather than in the U.S. If you agree, can you explain in greater detail how capital formation, economic growth, and job creation might be affected? Please include specific examples of companies and jobs that have been reformed through the efforts of private equity investors, where appropriate.

As noted in response to the questions of Senators Baucus and Grassley above, I believe a tax change of this magnitude is likely to diminish private equity investing activity, and the economic impact of this could be significant. To the extent private equity firms opt not to proceed with certain transactions, the benefits that flow from private equity ownership will be lost to those specific businesses, and to the economy at large.

You asked for specific examples and they are too numerous to cover in this answer alone. But let me share a few examples from Carlyle's experience. In 2005, we acquired a company called AxleTech International Holdings, Inc., which designs and manufactures drivetrain components for growing end markets in the military, construction, material handling, agriculture and other commercial sectors. AxleTech was a solid business but it was focused on the low margin, low growth commercial segment of the market. Under Carlyle's strategic direction, Axletech developed a concerted business development initiative to offer its axle and suspension solutions to military

vehicle manufacturers in need of heavier drivetrain equipment to support the heavy armored vehicles required to protect American soldiers in Iraq and Afghanistan. At the same time, AxleTech expanded its product and service offerings in its high margin replacement parts business while continuing to grow its traditional commercial business. The result is that since Carlyle's acquisition, Axletech sales have increased 16% annually and employment has increased by 34% from 425 to 568, with new jobs created in Axletech's facilities in Troy, MI, Oshkosh, WI, and overseas. Indeed, it is one of the very few US automotive related companies that is growing in this challenging environment for the industry. And Axletech's job growth does not take into account the ripple effects on AxelTech's suppliers which are experiencing new hiring and capital investments.

In 2002, we acquired Rexnord Corporation, a Milwaukee-based provider of power transmission, bearing, aerospace, and specialty components. While healthy, it was a neglected division of a large British conglomerate. After being acquired by Carlyle and its partners, the company refocused its business on lines with the strongest growth prospects, took steps to improve product quality, inventory management procurement, and customer delivery, made key strategic acquisitions, and developed a plan to expand business in the growing China market. Under Carlyle, total revenues rose from $722 million in 2003 to $1.08 billion in 2006 and enterprise value doubled from $913 million to $1.8 billion.

Attached to my written testimony are three additional private equity case studies prepared by the Private Equity Council involving Burger King, Auto Zone, and Sungard, and I understand additional case studies will be distributed and posted on the PEC website (www.privateequitycouncil.org) in the weeks ahead.

Questions from Sen. Roberts

1. Mr. Ifshin noted in his testimony that because of his company's investments, hundreds of jobs have been created and communities have been revitalized. I'm concerned that during this debate, some have characterized this as a "Wall Street issue". Mr. Ifshin, I thank you for pointing out that this is also a "Main Street" issue that affects communities, pensioners, and individuals across this country. Would anyone else care to comment on the impact that these types of entrepreneurial investments have on Main Street? What's the benefit to communities in terms of job creation and investments in local economies? Would these investments continue to be made at the level they're being made now if taxes on carried interest were to increase?

In answers to Senator Kyl's question, I cited a few examples showing how private equity investment has strengthened companies, increased employment, and enhanced competitiveness. There are similar stories affecting people and communities throughout the country. For example, Dunkin' Brands, the holding company for Dunkin' Donuts and Baskin & Robbins, was purchased by a group of private equity firms including Carlyle in 2006 from a European conglomerate which had under-invested in it. The private equity owners' strategy, now being executed, is to pour talent and capital into the business to expand Dunkin' Donuts west of the Mississippi and to relocate many Baskin-Robbins stores to areas that are more likely to be visited by customers who want to buy ice cream. This change in strategy requires significant expenditures that reduce short-term earnings. Here is a case where the private equity investment provides the resources to help Dunkin' Brands achieve its goal of establishing new franchises that will create 250,000 new jobs—jobs with good career paths in

restaurant management as new stores are opened across the western United States and sales at the company's ice cream shops rise. Its success also is creating a new class of small business entrepreneurs in communities across America who find owning multiple Dunkin' Donuts franchises a way to achieve personal financial security and success.

But community impact goes beyond the economic benefits flowing from specific private equity investments. As you indicate, public pension funds, university endowments, and leading foundations together represent the single largest group of investors in private equity and collectively accounted for one-third of all capital allocated to private equity in 2006. In fact, the 20 largest public pension funds for which data is available have some $111 billion invested in private equity, delivering strong investment returns to their 10.5 million beneficiaries across the country in hundreds of communities.

Let me give you a concrete example of what these numbers mean to real people. The Washington State Investment Board, which is responsible for more than $75 billion in assets in 16 separate retirement funds that benefit more than 440,000 public employees, teachers, school employees, law enforcement officers, firefighters and judges, has been a major private equity investor for 25 years. In that time, the WSIB has realized profits on its private equity investments of $9 71 billion. Annual returns on private equity investments made by the board since 1981 have averaged 15 percent, compared to 10.1 percent for the S&P 500. Put another way, the excess returns generated by private equity investments during that period are worth $26,000 per retiree; or expressed another way: these returns have fully funded retirement plans for 10,000 WSIB retirees.

Beyond the obvious benefit to retirees, local communities benefit from strengthened university endowments better able to extend financial aid and create greater educational opportunities for students in virtually every state in the country, and strengthened foundations better able to carry out their social and scientific missions.

2. Several witnesses have touched on the fact that the investors in private equity funds often include university endowments and pension funds who receive substantial financial benefits when their investments are successful. These returns are key to helping manage tuition costs, and to securing the pensions of millions of retirees. If the tax treatment of carried interest is changed, would it jeopardize these strong returns that have benefited college students and pension recipients?

As I said in my testimony, while some have dismissed concerns that returns for LP investors will decline, this unfortunately is a possibility. First, if private equity activities diminish, there may be fewer attractive investment opportunities for pension funds, endowments and other limited partners. Moreover, as discussed above, it is possible that private equity 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. As noted in my testimony, this is exactly why Pensions and Investments Magazine, a leading trade journal, said 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."

3. Many partnerships are structured with a carried interest - oil and gas, real estate, venture capital, and health care. Isn't it a matter of fundamental fairness that the tax code not single out certain industries for different tax treatment?

Carried interest is just another name for the way partnerships divide the rewards of a joint venture between the founding general partners and partners who provide capital as limited partners. Carried interests are found throughout many industries and market segments. For example, real estate developers typically receive carried interests when they develop office buildings or other properties. Family businesses are often structured as partnerships, with profit sharing arrangements that are the equivalent of "carried interest." Venture capital firms and small business investment companies receive carried interest when they invest in new start up businesses. In sum, carried interests are common practice across the full spectrum of businesses and, indeed, are a core part of the entrepreneurial risk-taking so central to the American economic system. I believe all these activities are important and I do not believe there is any basis for treating carried interest in partnerships used in one sector less favorably than in another sector.

Questions from Sen. Salazar

1. What would be the real consequences to your respective industries of an increase in the tax on carried interest? Can you say with any degree of certainty that the amount of activity in private equity, hedge funds, and/or venture capital would decline significantly?

No one can predict with certainty the consequences of a change in the tax treatment of carried interest. Tax costs are but one of many variables factored into private equity activity. Other factors, including interest rates, access to capital, market liquidity, investment returns, and sector and macro economic trends are all relevant. But the underlying economic activity pursued by private equity and venture capital firms is at its core about the creation of capital gain, i.e., ownership and growth in the value of businesses. A change in carried interest taxation is clearly a relevant variable in the extent to which such activity is pursued. I think it is reasonable to believe that a dramatic tax increase will indeed have a negative impact on private equity activity.

2. Is it possible to tax carried interest as regular income for large private equity firms and hedge funds without it trickling down to smaller firms who make riskier investments?

I believe it would be difficult—and would represent unwise policy—to draw distinctions between "large" and "small" firms that use the same ownership structure and engage in similar activities.

First, today's large private equity firms were small not that many years ago; and many of today's small firms may aspire to be larger, since that could be the natural outcome of success. A policy that taxes the same entity one way when it is "small", but imposes a tax penalty on it when it becomes "big," would create unnatural impediments to the growth and success of firms, and might create distorted incentives for firms to break up into pieces to avoid becoming large.

Second, small firms do not necessarily make riskier investments than large firms, as the question implies. The purchase of Chrysler or a bankrupt steel company may be a large transaction and a very risky proposition; conversely, a small firm might acquire a regional business of a modest size, but in a secure and not particularly risky sector. In general, size is a poor surrogate for any qualitative characterization of a firm's activities.

Finally, it is difficult to understand what policy objectives would be served by size distinctions here, or how such distinctions could be justified in the context of a system that does not otherwise distinguish between the size of investments or investors in determining capital gains taxation. An individual or a trust making investments does not have a different basis of taxation calibrated to the size of the aggregate investment pool. Bill Gates did not have one method of taxation applicable to his stock holdings when Microsoft was small, and another when Microsoft became big. The complexity and economic distortions of such rules would far outweigh any perceived benefits.

3. What are the principal distinctions between carried interest and regular income? In each of your viewpoints, do those distinctions get at the heart of how our tax code intended to distinguish between capital gains income and regular income?

Carried interest is a feature of a sponsor's ownership interest in the private equity funds formed by that sponsor. Similar to other ownership interests, its value is contingent upon the growth in value of capital assets (in this case, primarily operating businesses, most of which are themselves taxed as corporations), and its value is realized only on disposition of the capital assets. It differs from "compensation income" in many ways, including the fact that it is not "granted" in the context of an employer/employee relationship or pursuant to a services contract, and is not even in part fixed in nature.

There are a number of policy reasons for taxing long term capital gains at a differential rate, including encouraging long-term investment and risk-taking, avoiding "lock-in" (i.e., significant disincentives to selling a capital asset), and minimizing the tax on "inflationary" returns. In each case, these reasons apply equally well to carried interests as they do to other forms of ownership interests.

4. On the issue of whether to tax publicly traded partnerships, what makes the difference between generating passive income for investors and actively providing financial services? In your view, are today's large hedge funds and private equity firms actively providing financial services?

Generally, private equity firms provide services only to the private equity investment funds they form, own and control. They do not provide "financial services" to third parties, like an investment bank does. Rather, their core business is to operate their own investment partnerships, which they co-own with their limited partners. (There are a few private equity firms that also have ancillary services businesses, providing advisory services to unaffiliated third parties, but these ancillary services businesses operate and are taxed like any other services firm.)

The current PTP law does not require that the party operating a qualifying business be "passive". Indeed, it would be difficult for any business to qualify as a PTP if this were the case—someone has to manage the oil and gas, real estate, or other assets owned by the PTP. Rather the test is whether the requisite portion of PTP income is "qualifying" (e.g., interest, dividends, capital gains). If this is the case, it should by no means be "disqualifying" for a private equity general partner to provide "services" to the affiliated partnerships owning the capital assets that produce this qualifying income.

5. In your view, how does this issue relate to the broader issue of ensuring that our tax burden is distributed fairly? Should we feel confident in explaining to middle-class families who dutifully pay their taxes year in and year out that the way we tax carried interest is consistent with the promise of a fair distribution of our tax burden?

The taxation of capital gains attributable to carried interest ownership is certainly fair in the context of a tax system which, for many good policy reasons, taxes long term capital gains at a lower rate than the highest marginal rates applicable to ordinary income. By definition, this means that ordinary income earned by many Americans will be taxed at a higher rate than long term capital gains. (According to IRS data I have seen, the average effective tax rate paid by Americans on their "modified taxable income" was about 18% in 2004 and 2005, as compared with the 15% rate on long-term capital gains.) However, if in the minds of some, this is a "fairness issue" with respect to carried interest taxation, it puzzles me why there is not a similar "fairness issue" in their minds with respect to other capital gains. For example, do they think it is "more fair" to tax the realized investments of inherited trust fund wealth at long term capital gains rates?

In fact, many of the commentators who have raised "fairness" issues about carried interest taxation have also expressed the view that the "bigger problem" is the differential long-term capital gains rate itself, which such commentators say should be abolished altogether. While I strenuously disagree with this conclusion, I believe the position is at least more "conceptually coherent" than that reflected by the Levin bill in the House, since I believe there is no justification for carving out capital gains allocated to private equity sponsors and taxing them differently than other capital gains.

6. What percentage of your ventures would not be sufficiently profitable if not for the reduced tax rate on carried interest? Why should the government encourage you to make those kinds of investments?

As stated in response to questions of Senators Baucus and Grassley, I do not think it is possible to quantify a precise percentage of private equity activity that would not be pursued because of tax changes. However, private equity firms are not seeking special government incentives or tax rates to encourage their activities, but rather the same basis of taxation applicable to capital gains generally. To the extent the current long-term capital gains rate encourages investment by private equity firms (and others), it is serving an important economic purpose — and, indeed, validating one of the policies underlying the rate differential. (Please also see my response to question 3 above.)

Questions from Sen. Schumer

Under current law, PTPs are taxed as partnerships if they are engaged in different types of real estate, oil and gas activities, or if 90 percent of their income is from dividend, interest, or capital gains. Is there any justification for denying partnership tax status for investment partnerships and continuing to allow partnership tax status for oil and gas and real estate activities?

Under current law, PTPs are taxed as partnerships if 90% of their income is "qualifying". Qualifying income is generally defined as dividends, interest and capital gains, but also includes certain types of income (e.g., income from exploration, development, production, refining or distribution) specifically associated with oil and gas operations, as well as rents associated with real estate properties.

In general, I believe that the PTP rules should be "industry neutral." However—particularly in light of the long history of reliance on the PTP rules by real estate and oil and gas firms—I am not suggesting that the specific references to oil and gas and real estate revenue types be excised. Nor is the private equity industry asking that special types of revenue associated with private equity operations (e.g., fund management fees) be specifically included as qualifying income. But to the

extent that an entity engaged in private equity or other investment complies with the general standard—with 90%+ of income derived from interest, dividends and capital gains— no justification exists for treating the entity differently.

Questions from Sen. Smith

Question 1- Private Equity Firms

LEAD IN:

A couple of recent studies show that private equity firms and the companies they own have a proven track record of strong financial performance and job creation. For example, a recent study by professors from Harvard University and Boston University concluded that companies that went public again after being held by private equity firms for at least a year consistently outperformed the stock market. A recent analysis by A.T. Kearney identified more than 600,000 jobs in the United States between 2000 and 2003 that were created as a result of private equity investments.

QUESTION:

- Given this track record of success, why would we want to increase taxes on private equity firms?
- What are your thoughts on whether increasing taxes on this industry will likely result in the loss of jobs?

It is important to understand one central fact about private equity: private equity firms seek to improve the performance and increase the value of the companies in which they invest. Any other approach would defy common sense, because the entire business model rests on selling investments at a gain. Our goal is to make companies more competitive and stronger over the long term and that often translates into more employment, though it may also mean that an enterprise that would otherwise have gone out of business continues to operate, thus preserving jobs which might otherwise have been lost. The Private Equity Council has compiled numerous case studies showing the positive impact of private equity investment on competitiveness. It is highly likely that some of these benefits would not be realized in the event of a fundamental change in the economic model underlying private equity investments.

Question 2 - Baucus-Grassley bill

LEAD IN:

Chairman Baucus and Ranking Member Grassley have introduced a bill that would tax as corporations all *publicly traded* partnerships that directly or indirectly derive income from investment adviser or asset management services. Because this tax change could discourage private equity firms and hedge funds from going public, some have argued that it would frustrate advocates of greater transparency among these firms. Publicly traded companies are legally required to disclose more information about their business than privately held firms.

QUESTION:

What are your thoughts on this argument?

This argument indeed has merit. One of the criticisms of private equity and hedge funds has been their lack of transparency. Going public would bring more transparency to a private equity or hedge fund, but this benefit could be diminished should the Baucus-Grassley bill be enacted. A privately owned private equity or hedge fund firm need not provide any information about itself to outsiders, though disclosure to our limited partner investors is indeed extremely detailed and robust. (Moreover, many of our portfolio companies issue publicly traded debt and must file the same public reports with the SEC as a publicly traded company does.) By going public, a private equity or hedge fund would be required to provide comprehensive ongoing disclosures about its business operations, its financial performance, its equity owners, its management, its governing instruments and extensive additional information. The Form S-1 registration statements filed by Fortress, Blackstone, KKR and Och-Ziff in connection with their initial public offerings each contained over 300 pages of detailed information about those firms. By imposing disincentives to public offerings by private equity and hedge fund firms, the proposed legislation would likely reduce public access to the type of information contained in such filings.

OPENING STATEMENT
SENATOR KEN SALAZAR
SENATE FINANCE COMMITTEE HEARING
CARRIED INTEREST, PART II
JULY 31, 2007

Thank you, Chairman Baucus and Senator Grassley, for holding today's hearing on the taxation of so-called "carried interest."

Thank you also to our panelists for being here today. I would like to extend a special welcome to Bill Stanfill, whose business, Trailhead Ventures, is headquartered in Denver, Colorado. I appreciate what you do for Colorado's economy, and appreciate your coming to Washington to share your views with this Committee.

As I mentioned at the first hearing on this issue earlier this month, I am committed to working to restore fairness to our tax code by ensuring that corporations and wealthy Americans paid their share of our nation's tax burden. I have also long supported tax policies that encourage investment and foster the entrepreneurial spirit that has driven our nation's economy for the past 230 years.

Our tax rate on long-term capital gains income, currently 15 percent, has implications with respect to both of these goals. While this rate clearly makes investment more attractive, it can make our tax structure more regressive in some ways. According to data cited in yesterday's Washington Post, in 2005, the wealthiest ten percent of households received over 90 percent of the benefit from reduced rate on capital gains and dividends.

That's why it's so important that we get it right on this question.

When we discuss how to tax the income of general partners of private equity firms, hedge funds, and venture capital funds, we need to ask whether the proposals in question advance the cause of fairness by ensuring that income is taxed properly, or whether these proposals have the potential to put a damper on the American entrepreneurial spirit by making investment in some ventures less attractive.

I understand that part of the reason we are here today is because private equity firms and many of their counterparts have had a pretty good run – according to the Congressional Research Service, private equity firms raised between $200 billion and $250 billion in 2006 alone.

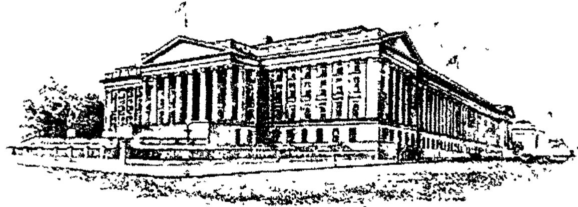
I support tax policies that encourage people to take the risks associated with starting or investing in a business because I believe investment and entrepreneurship foster an economic vitality from which all Americans benefit. But that benefit is spread evenly

only when income is taxed appropriately – regular income as regular income, and capital gains income as capital gains income.

This Committee has already heard from government witnesses on the policy merits of the tax treatment of carried interest. Today we will hear from the investors and businessmen and women who are directly impacted by our tax policies in this area.

I look forward to hearing the views of our panelists on the real consequences of changing the way we tax carried interest. Considering these consequences will be critical as we seek to ensure that our tax code is both fair and economically dynamic.

Thank you.



U.S. TREASURY DEPARTMENT
OFFICE OF PUBLIC AFFAIRS

TESTIMONY OF TREASURY ASSISTANT SECRETARY FOR TAX POLICY ERIC SOLOMON BEFORE THE SENATE FINANCE COMMITTEE ON THE TAXATION OF CARRIED INTEREST

Washington D.C. --Mr. Chairman, Senator Grassley, and distinguished Members of the Finance Committee:

Thank you for the opportunity to testify regarding the federal income tax treatment of carried interests. Carried interests have received increased public attention recently. However, they are not a new phenomenon. They have been used successfully for many decades by small and large partnerships, across many industries, to pool the capital of investors with the ideas and skills of other entrepreneurs in joint profit-making enterprises.

My testimony will discuss the current taxation of carried interests, the use of carried interests by both small and large partnerships in industries as diverse as real estate and natural resources, and the similarity of the current tax treatment for carried interests and other analogous areas. I will discuss alternatives that have been suggested for the taxation of carried interests. While it is important to review our tax laws and policies, we must fully assess the costs and benefits of changes that may have adverse consequences on entrepreneurial activity.

The 2 and 20 for Private Equity and Hedge Funds

Hedge and private equity funds are typically structured as partnerships for federal tax purposes. Managers of these funds often receive an asset-based management fee paid annually of 2 percent of the fund's committed capital and an interest of 20 percent in the profits of the fund. The 20 percent profits interest is referred to as the "carried interest." For managers of private equity

funds and in certain cases for managers of hedge funds, the carried interest represents a substantial portion of their total return from the funds.

Upon receipt of the carried interest, the fund manager becomes a partner in the fund and pays tax in the same manner as other partners on his distributive share of the fund's taxable income. The character of the income included in the manager's distributive share is the same as the character of the income recognized by the fund. Thus, if the fund earns ordinary income or short-term or long-term capital gain, each partner's distributive share includes a portion of that income. For example, if the fund sells stock of a portfolio company that it has held for more than a year, the manager's share of the long-term capital gain is taxed at the 15-percent federal long-term capital gain rate. Fund managers receive a benefit from owning the carried interest only if the fund is successful. In this manner, the fund managers' interests are aligned with those of the capital investors.

Background

A. Business Structures

There are many ways for U.S. business activity to be organized for tax purposes, including as corporations, sole proprietorships, or partnerships. Each of these business models contributes to the competitiveness of the U.S. capital markets and economy.

A partnership is a flexible business arrangement among co-venturers. The partnership format gives the partners substantial choice in how they will share the economics of their joint undertaking. The partners decide what each will contribute in capital, ideas and skills and how they will share in profits and losses. This flexibility of the partnership structure enables entrepreneurs more easily to establish and grow their businesses.

For tax purposes, a partnership is broadly defined to include any two or more persons that join together in a business activity for the purpose of making a profit. An attractive feature of a partnership is that income is not taxed at the partnership level. Instead, income flows through to the partners and is taxed to them based on the income's underlying character (e.g., ordinary income or capital gain). In contrast to this pass-through treatment for partnerships, income earned by a corporation is subject to two layers of federal income tax -- once at the corporate level and again at the shareholder level when dividends are paid.

The partnership tax rules are intended to permit taxpayers to conduct joint business or investment activities through a flexible economic arrangement without incurring an entity level tax. The tax rules allow partnerships to make special allocations of income and loss among partners to accommodate the myriad economic arrangements seen in the market today. Consequently, the partnership structure is an attractive business model for business enterprises of all types and sizes.

In 2005, nearly 2.8 million businesses of all sizes and in a broad range of industries filed a partnership information return.[1] The number of partnership returns filed by industry was as follows:

- Real estate, rental, and leasing -1,295,948
- Services - 520,726
- Finance and insurance - 87,958
- Wholesale and retail trade - 189,976
- Construction - 182,153
- Agriculture, forestry, etc. - 127,605
- Manufacturing - 44,828
- Information - 37,438
- Mining - 28,205
- All other - 48,788

The U.S. economy by any measure is among the strongest and most resilient in the world, and the flexibility offered by partnerships plays an important role in that success.

B. Taxation of Compensation for Services

The Internal Revenue Code has historically taxed compensation differently from income generated from investment. Compensation is taxed at ordinary income rates and is subject to employment tax. Income or gain derived from the return on investment is taxed at a variety of rates, which are generally lower than the ordinary income rates and are designed to encourage entrepreneurship, investment, and risk taking. Lower tax rates have been an important factor in promoting long-term economic growth. The best examples of the difference in rates are the federal individual long-term capital gain rate of 15 percent, and the federal individual dividends rate of 15 percent, compared to the maximum federal individual ordinary income tax rate of 35 percent.

Compensation income is typically a fixed and determinable amount payable to either an employee or independent contractor. The employee receives a salary (wages) that is reported on Form W-2, while an independent contractor receives payments normally reportable on a Form 1099. The employee's or independent contractor's right to payment of compensation, other than certain incentive bonus payments or performance fees, is not subject to entrepreneurial or business risks.

Unlike employees and independent contractors, a partner has a stake in the business with rights and obligations that vary depending upon the terms of the partnership agreement. While compensation of employees and independent contractors is typically fixed and payable regardless of the success of the business, a partner's distributive share of partnership income is subject to the entrepreneurial risks of the partnership's business. The partners are rewarded only

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[1] Although income, gain and losses flow through to the partners, the partnership is required to file an information tax return on Form 1065. Partnerships are also required to provide the partners with a declaration of their share of the partnership items on a Schedule K-1.

if the partnership succeeds. In some instances, however, a partner may have a right to receive from the partnership guaranteed payments for services. Guaranteed payments under section 707(c) of the Code are determined without regard to income of the partnership and are taxed as ordinary income. The key difference between a guaranteed payment to a partner and a partner's distributive share is that the guaranteed payment is not subject to business risks while the distributive share is subject to such risks.

Additionally, the partnership rules in section 707(a) provide that if a partner engages in a transaction with a partnership other than in his capacity as a partner, the transaction will be viewed as one between the partnership and a person who is not a partner. Generally, payments falling in this category are not contingent in amount and not subject to any appreciable risk of nonpayment. In that regard, payments under section 707(a) are similar to guaranteed payments under section 707(c), with the principal difference being that the section 707(a) payments are made to a member other than in his capacity as a partner, while guaranteed payments under section 707(c) are made to a partner in his capacity as a partner. In any event, section 707(a) payments and section 707(c) payments are not subject to business risk.

Taxation of Partnership Profits Interests (Carried Interests)

A. General Rules

A consistent principle in the development of the federal income taxation of compensatory transfers of partnership interests is that after the partnership interest is issued, the service provider is taxed as a partner in the same manner as a person making an investment of capital in the partnership. As a partner, the service provider reports his distributive share of the partnership's taxable income. The character of the taxable income as either ordinary income (or loss) or capital gain (or loss) is normally determined for all partners at the partnership level.

Under current guidance, whether a service provider is taxed on the receipt of a partnership interest depends on whether the interest is a capital interest or a profits interest. A capital interest provides the service provider with a share of the partnership's liquidation proceeds if, immediately after the interest was transferred, all of the partnership's assets were sold at their fair market value, all liabilities were paid in full, and the remaining amount was distributed to the partners. A profits interest, by contrast, does not provide the service provider with a share in the liquidation proceeds. Rather, a profits interest allows the service provider to share only in the partnership's future income or appreciation in the partnership's assets.

Current guidance provides that a service provider is taxed on the receipt of a capital interest, but generally is not taxed on the receipt of a profits interest. This treatment of a profits interest represents a reconciliation of the tension between the partnership tax rules and provisions related to the taxation of compensation. Section 83 of the Code requires a service provider to recognize compensation income when vested property is transferred in connection with the performance of services. The amount of income that is recognized is equal to the excess of the fair market value of the vested transferred property over the amount paid for the property, if any. However, under the partnership tax rules, which are designed to tax income only once, if a partner were taxed upon the transfer of a profits interest, he would be taxed twice on the same income. First, he

would be taxed at ordinary income tax rates on the value of the profits interest at the time of transfer, which is generally determined by reference to the anticipated future stream of partnership income. Second, he would be taxed again when the income is recognized by the partnership. Also, determining the fair market value of a profits interest is difficult because of the speculative nature of the interest.

The taxation of the receipt of a profits interest has been the subject of substantial litigation dating from *Diamond v. Commissioner* (7th Cir. 1974) to *Campbell v. Commissioner* (8th Cir. 1991). In the most recent case, *Campbell*, the Eighth Circuit Court of Appeals held that the profits interest transferred to the service provider had no fair market value because of its speculative and contingent nature.

Rather than continue to expend resources in asserting that the receipt of a profits interest is taxable and challenging the valuation of profits interests, the Treasury Department and IRS in 1993 adopted an administrative rule that the receipt of a profits interest by a service provider generally is not a taxable event. In 2005, the Treasury Department and IRS published proposed regulations that would continue in most instances the approach adopted in 1993. The proposed guidance departs from the current administrative rules in one significant respect by requiring that the partnership and its partners make an affirmative election to determine the fair market value of the partnership interest transferred to service providers by reference to its liquidation value. This election is intended to ensure that neither the partnership nor any partner will take a deduction in connection with the transfer of the interest that is different from the amount (if any) included in income by the service provider. This symmetry in the context of a profits interest means that, while the service provider reports no income in connection with the transfer of a profits interest, neither the partnership nor any partner may take a deduction.

> The following simple example illustrates the application of these tax rules:
>
> Entrepreneur and Investor form a partnership to acquire a corner lot and build a clothing store. Investor has the money to back the venture and contributes $1,000,000 . Entrepreneur has the idea for the store, knowledge of the fashion and retail business, and managerial experience. In exchange for a 20 percent profits interest, Entrepreneur contributes his skills and know how. Entrepreneur and Investor are fortunate and through their combination of capital and efforts, the clothing store is successful. At the end of 5 years, the partnership sells the store for $1,600,000 reflecting an increase in the going concern value and goodwill of the business. Entrepreneur has $120,000 of capital gain and Investor has $480,000 of capital gain. (Some of the gain may be treated as ordinary income due to recapture of previously claimed depreciation deductions.)

Under current tax law, Entrepreneur does not have compensation income at the time of receipt of the 20 percent profits interest. He is treated as a partner from the date he receives the interest and is subject to tax at capital gains rates on his portion of the gain from the sale of the business. To the extent the partnership generates ordinary income from operations prior to the sale of the business, Entrepreneur is subject to tax at ordinary income tax rates on his distributive share of the operating income.

B. The Taxation of Carried Interests Parallels Taxation of Services in Analogous Areas

The development of the tax law regarding partnership interests transferred in connection with the performance of services generally has been consistent with the tax treatment of compensatory transfers in other areas. These areas include the taxation of services provided by a sole proprietor in his business, the taxation of a stock grant to a service provider, and the taxation of a service provider under various forms of sharing arrangements, such as for oil and gas exploration and development.

A sole proprietor who through his labor turns an idea into a valuable business generally will be taxed at capital gains rates when the business is sold. Our federal income tax system does not attempt to tax the gain from the sale of the business at ordinary income tax rates under the theory that the proprietor's labor enhanced the value of the business. Furthermore, the federal income tax law does not attempt to distinguish between the enhanced value of the business due to the proprietor's services and the enhanced value due to market conditions.

When a corporate employer makes a vested stock grant to an employee, the employee recognizes compensation income under section 83 of the Code in an amount equal to the fair market value of the shares, and the employer is entitled to a tax deduction in an equal amount. Thereafter, the employee is treated as holding the stock as an investor and is subject to tax at capital gains rates on any gain from the sale of the stock.[2] The employee may continue to be employed and his labor may contribute to the enhancement of the value of the shares, but he is still taxed at capital gains rates on the gain from the sale of the shares.

Stock options awarded to an employee are taxed somewhat differently than a stock award. Under section 83 of the Code and Regulation §1.83-7, the employee is not subject to tax upon the grant of a nonqualified stock option that has no readily ascertainable value. Instead, at the time of exercise of the nonqualified stock option, the employee recognizes compensation income on the spread between the fair market value on the date of exercise and the exercise price, and the employer is entitled to a tax deduction in an equal amount. Following exercise of the option and receipt of the shares, the employee is treated as an owner and is taxed in the same manner as an investor at capital gain rates on the gain from the sale of the shares. A special statutory rule applies for the taxation of incentive stock options (ISOs) under section 422 of the Code. In this case, the employee is not subject to tax at ordinary income rates when the ISO is exercised and is subject only to tax at long-term capital gain rates when the shares are sold, provided that the employee holds the shares for at least one year from the date of exercise or two years from the date of grant, whichever is longer.

Some have argued that the transfer of a carried interest is similar to the transfer of a stock option to an employee and should be taxed similarly. Both the stock option and profits interest provide

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[2] A stock grant is similar economically to a profits interest in certain circumstances. For example, assume an executive of a new corporation receives a grant of Class A shares, which by their terms provide the executive with an economic return only after payment to the capital investors in Class B preferred shares. In this case, the value of the Class A shares is speculative and contingent on performance of the business. Consequently, the Class A shares may have only nominal value. Under the rules for taxing a stock grant, the executive is subject to tax upon the receipt of the Class A shares, but the amount taken into income may be nominal.

the service provider with the right to receive a fixed interest -- 20 percent for example -- in the appreciation of the enterprise's equity over a stated amount. However, important differences between stock options and carried interests lead to different tax treatment.

Upon receipt of a stock option, the employee has no ownership rights until the option is exercised and he receives the underlying shares. The employee has no voting rights and no economic rights to dividend payments with respect to the stock until the option is exercised. Upon receipt of a carried interest, the service partner has an immediate ownership interest in the enterprise with all of the attendant rights and responsibilities. The service provider is taxable on his distributive share of partnership taxable income and has the rights and responsibilities with respect to ownership of the partnership interest provided in the applicable partnership agreement and state law.

Another analogy may be made to oil and gas contractual arrangements. It is common in connection with the development of oil and gas properties for the owner of a property to enter into a contractual sharing arrangement with a service provider in which the service provider provides exploration, development and completion services on the property. For example, the owner may assign an interest in the oil and gas property to the service provider in exchange for the service provider's agreement to drill and complete a well on the property. The tax law dating back to the early 20th Century has been that the service provider is not taxed upon receipt of the property interest, but rather that the service provider is taxed only on the production from or sale of the property. As such, except for recapture of intangible drilling costs, depletion and accelerated depreciation, gain from the sale of the oil and gas property is treated as section 1231 gain taxable at long-term capital gains rates.

In all of the situations described above, services have unquestionably contributed to an increase in the value of the business or assets. Nevertheless, following the service provider's receipt of an ownership interest in the enterprise, if capital assets (or assets described in section 1231 of the Code) are sold, the gain is taxed at capital gain rates. The common theme in all these instances is that a person who contributes skill and knowledge to the success of the enterprise and receives an ownership interest that is subject to entrepreneurial risk will succeed only if the enterprise succeeds. The service provider in each instance has acquired an ownership interest in the enterprise betting that his upside will provide an ample economic reward. The incentives provided by this structure contribute to innovation and risk-taking.

Alternatives to the Current Taxation of Carried Interests

Several alternatives to the current system of taxing carried interests have been suggested. This section briefly summarizes the alternatives and some of the potential issues.

A. Value the Carried Interest as of the Date of Transfer and Tax the Service Partner on That Value

This alternative requires that a value be determined for the carried interest at the time of receipt by the service partner and that the service partner include the amount in income as ordinary

income. The partnership (and thus the partners) would be entitled to a deduction equal to the income recognized by the service partner subject, however, to existing limitations on deductions.

Concerns and complexities raised by this alternative include:

- The service partner would be taxed twice on the same income. First, the service partner would be taxed at ordinary income rates on the fair market value of the profits interest, which is generally the present value of the future stream of income. Thus, he would pay that tax at the beginning of the business venture, whether or not it succeeds. Next, the service provider would be taxed on his share of the income generated by the partnership, which flows through to the partners.

- As discussed above, this approach requires the valuation of speculative partnership interests. Requiring a valuation of such partnership interests, including private equity and hedge fund interests, would lead to litigation between the service partner and the IRS. In the past, the IRS has attempted to enforce a fair market value valuation on transfers of profits interests, which led to protracted litigation.

- This proposal would add substantial uncertainty to the taxation of carried interests for partnerships, small and large, in many industries. This rule is likely to affect the economic deal between the service partners and the investors.

B. Tax the Service Partner's Distributive Share of Income From the Carried Interest as Ordinary Income

This alternative requires treating the service partner's distributive share of taxable income from the carried interest as ordinary income taxed at ordinary income tax rates.

Concerns and complexities raised by this alternative include:

- The proposal reverses longstanding tax rules that determine the character of a partner's distributive share of partnership income by reference to the character of the partnership's income. These rules have operated successfully for many decades.

- Unlike the simple example of the Entrepreneur and Investor earlier in this testimony, in many instances, the service partner will make an investment of contributed capital or undistributed profits in the partnership or may be responsible for a portion of the partnership's debts. Under this alternative, the tax rules would have to provide for an allocation of the partnership's taxable income between the carried interest and invested capital and distinguish between the enhancement of value due to services and the enhancement of value due to market conditions.

- This would add significant complexity to the tax law and increased administrative difficulties for the IRS.

- The proposal leads to tax results that are at odds with other analogous instances, such as sole proprietorships.

- This proposal would add substantial uncertainty to the taxation of carried interests for partnerships, small and large, in many industries. This rule is likely to affect the economic deal between the service partner and the investors.

C. Impose Annual Income Realization on the Service Partner

This alternative retains present-law treatment of the transfer of a carried interest, with the result that the service partner recognizes no income upon receipt of the carried interest and is immediately treated as a partner. Unlike current law, however, this alternative would require that the service partner recognize ordinary income each year in an amount intended to approximate the cost of the service partner's use of the investors' capital. For example, if the investors contributed a total of $1,000,000 to the partnership and the service partner had a 20-percent carried interest, the service partner would be treated as having the use of 20 percent of the investors' capital of $1,000,000, or $200,000, and would recognize annually ordinary income at a predetermined cost of capital rate.

Concerns and complexities raised by this alternative include:

- It is unclear what the cost of capital rate should be for the service partner and whether different rates would be necessary based upon each particular partnership.

- It is unclear how best to determine the amount of investor capital available for use by the service partner.

- This proposal would affect all types of partnerships, small and large, in many industries and would add substantial complexity to the tax law. This rule is also likely to affect the economic deal between the service partner and investors.

Concerns Regarding Changes in the Taxation of Carried Interests

The current tax treatment of carried interests provides certainty for taxpayers in planning their transactions and, at the same time, is administrable for the IRS. The current taxation of carried interests also encourages the pooling of capital, ideas and skills in a manner that promotes entrepreneurship and risk-taking.

Partnerships of every size and every industry have established and operated their businesses in reliance on the existing tax rules. While it is important to review our tax laws and policies, we must be cautious about making significant changes to partnership tax rules that have worked successfully to promote and support entrepreneurship for many decades.

Thank you for the opportunity to testify before the Committee today. I would be pleased to answer any of your questions.

RESPONSES TO QUESTIONS FOLLOWING THE TESTIMONY OF ASSISTANT SECRETARY ERIC SOLOMON BEFORE THE SENATE FINANCE COMMITTEE ON CARRIED INTEREST, PART I

Department of the Treasury
September 20, 2007

Baucus Question 1 (for Mr. Solomon, Mr. Gergen and Mr. Orzag)

Many hedge funds conduct their funds offshore in a master feeder structure. Generally, the hedge fund is incorporated in a low tax jurisdiction, such as the Cayman Islands. The hedge fund managers receive incentive fees instead of carried interests. Economically, how is that different from a profits interest?

Answer

We understand that in certain situations managers provide services to a foreign hedge fund under a contractual arrangement. In determining whether a particular arrangement should be characterized as a contractual arrangement or a partnership for tax purposes, it is necessary to examine all of the respective rights and obligations of the parties, including their particular economic arrangements. The contractual relationship will be treated as a partnership for tax purposes if it is determined that based on objective factors the parties acting in good faith and with a business purpose have joined together as co-proprietors in the present conduct of an enterprise. Under this legal standard, it is possible that a performance fee based on a percentage of profits from the business may be structured as a fee for services arrangement if the objective factors indicate that the underlying legal relationship is strictly a contractual arrangement. Objective factors indicating that a contract is a fee for services arrangement include those in which the service provider typically has no governance rights and the contract can be terminated by the service recipient pursuant to the terms of the contract.

In contrast, a share of the profits from a business may be treated as a partner's distributive share of partnership income when the parties intend to join together as co-proprietors in the joint undertaking of an enterprise and the agreements and documentation describing this relationship evidence their intent. Under this arrangement, the investors of capital are typically limited partners and the individuals who contribute know-how and expertise typically are the general partners (although general partners can also contribute capital). The general partners have control over, and legal responsibility and liability for, operation of the partnership. The parties expect and intend that the general partners will remain with and retain responsibility for the venture until it is sold or otherwise terminated.

Baucus Question 2 (for Mr. Solomon, Mr. Gergen and Mr. Orzag)

Mr. Solomon stated in his written testimony that a profits interest partner has an immediate ownership interest in the enterprise. What does a profits interest partner own? What can a profits interest partner receive upon liquidation of the partnership?

Answer

The partners' respective rights and obligations are typically set forth in a partnership agreement. This agreement provides what each partner will contribute to the partnership

in capital, skills, and know-how and the manner in which each partner will share in the economic success or failure of the enterprise. One partner, for example, may contribute money to the joint undertaking, while another partner may contribute expertise and knowledge. The tax law provides the partners with substantial flexibility in determining their respective ownership interests and participation in the economic success and failure of the undertaking.

The federal income tax laws applicable to partnerships are intended to permit the conduct of a joint undertaking through a flexible economic arrangement without incurring a second, entity-level tax. To that end, the income of a partnership is not taxed at the partnership level. Instead, income from the partnership flows through to the partners and is taxed to them based on the underlying character of the income to the partnership as either capital gain or ordinary income. The partnership format allows the partners to share income and loss from operations in a manner consistent with their sharing of the economic benefits and burdens from operations.

A profits interest is a partnership interest that has all of the attendant rights and obligations specified in the partnership agreement and under applicable state law. A profits interest represents a present right to share in partnership income, whether from operations or from the sale of assets in liquidation of the partnership. The partnership format permits an allocation and distribution of annual income from operations to the partners. This operating income may be distributed to the partners periodically as it is earned by the partnership, or may be retained for use in the partnership's business. Each partner is subject to tax on his distributive share of partnership income. If income is retained by the partnership for use in its business, each partner's capital account is increased by his or her distributive share of such income. Any increase in the partner's capital account for undistributed profits may be reduced by future losses allocated to the partners. A partner's capital account is paid to the partner in the future (through distribution of previously taxed undistributed income) or upon liquidation of the partnership.

Baucus Question 3 (for Mr. Solomon, Mr. Gergen and Mr. Orzag)

Mr. Solomon stated in his oral testimony that partners in a partnership have entrepreneurial risk. What risks does a profits interest partner have in a partnership?

Answer

As described in response to Baucus Question 1, the intent of the parties is the principal determinant of what constitutes a partnership and who are the partners in the enterprise. Based on the intent of the parties, the owner of a profits interest is a partner with the attendant rights and obligations stated in the partnership agreement and under applicable state law.

The profits partner is often a general partner and, under state law, has significant risk associated with assuming responsibility for the liabilities of the partnership. For example, in many real estate development partnerships, the profits partner is personally liable for an outstanding construction loan obtained to build partnership property. As a general partner, the profits partner is also exposed to environmental, tort, contract, and other liabilities that arise from operation of the partnership. Additionally, to the extent the profits partner's share of operating income is retained for use in the business (after being subject to tax at the partner level), such amounts are subject to the risk of future partnership losses and to the claims of creditors of the partnership.

In some instances, in advance of the formation of the partnership, a profits partner spends substantial amounts of his own money and time undertaking preparatory work, such as feasibility studies and financing evaluations. This time and money represents an investment by the profits partner in the enterprise, which is also placed at risk if the venture were to fail.

Finally, a profits partner who has contributed skills and know-how to the partnership risks damage to his reputation if the undertaking is not successful. Any such damage may adversely affect the perceived value of his skills and know-how for future transactions.

Baucus Question 4 (for Mr. Solomon, Mr. Gergen and Mr. Orzag)

Mr. Donohue stated in his testimony that hedge fund managers and private equity fund managers that have gone or will go public are in the business of managing other people's money. What is the rationale for according capital gain treatment to these managers for their efforts in managing other people's money?

Answer

It is common in many partnerships, small and large, and in industries as diverse as real estate, oil and gas, and venture capital, to pool investors' capital with the skills and knowledge of individuals that are necessary to operate the enterprise successfully. Most often, a carried interest is issued by the partnership to the service partner contributing the skills and know-how. A consistent principle in the development of the federal income taxation of carried interest is that when the interest is issued, the holder is thereafter taxed as a partner. As a partner, the service partner reports his distributive share of the partnership's taxable income. The character of the taxable income as either ordinary income (or loss) or capital gain (or loss) is normally determined for all partners at the partnership level.

Partnerships of every size and in every industry have for decades established, organized and operated businesses in reliance on these tax rules. The historical tax treatment of compensatory partnership interests encourages the pooling of capital, ideas, and skills in a manner that promotes entrepreneurship, risk-taking, and economic growth.

Baucus Question 5 (for Mr. Solomon)

Many hedge funds use a structure in which part or all of the hedge fund is located in a low or no tax jurisdiction. These hedge funds are able to defer recognition of income from incentive fees. How are these hedge funds able to achieve deferral?

Answer

U.S. managers of offshore hedge funds (usually organized as foreign corporations for U.S. tax purposes) typically operate under a contract for their services and structure their compensation arrangements as incentive fees rather than receiving a profits interest in the fund. In this situation, the U.S. manager acts under a contractual fee arrangement and the fee is taxed as compensation at ordinary income rates.

U.S. hedge fund managers may elect to defer payment of their incentive fees in the same manner that any employee of a domestic U.S. business may elect to defer payment of his or her compensation. The deferral of the hedge fund manager's fee is considered nonqualified deferred compensation and must satisfy the election, payment, written documentation, and reporting requirements of section 409A of the Internal Revenue Code. Failure to comply with the requirements of section 409A will result in immediate income inclusion and an additional 20 percent tax on includible amounts. Under the section 409A timing-of-payment limitations, the U.S. hedge fund manager is permitted to defer payment of the fees to a specified date in the future. When the fees are paid, the manager recognizes compensation income and is taxed at ordinary income tax rates.

Section 409A(b) includes a provision that subjects nonqualified deferred compensation that is "set aside" in an offshore trust or similar arrangement to automatic income inclusion. Section 409A(b) is generally not applicable to a U.S. hedge fund manager's election to defer the fees owed by the offshore hedge fund because the deferred fees are commingled with the assets of the offshore fund and are subject to the claims of the fund's creditors.

Baucus Question 6 (for Mr. Solomon)

Does Internal Revenue Code § 409A apply to hedge fund managers that manage funds located offshore? Please provide an explanation.

Answer

The application of section 409A to hedge fund managers that manage funds located offshore is described in the response to Baucus Questions 5 and 7.

Baucus Question 7 (for Mr. Solomon)

Treasury recently issued proposed regulations under Internal Revenue Code § 409A. Do these regulations apply to hedge fund managers that manage funds located offshore? Please provide an explanation.

<u>Answer</u>

As explained above, section 409A does apply to U.S. hedge fund managers who elect to defer fees that are owed to them by hedge funds with which they have a contractual relationship. In April 2007, the Treasury Department and the IRS issued final regulations under section 409A, which established the requirements that must be followed by service recipients and service providers to be in compliance with the statute. These final regulations apply to U.S. hedge fund managers who elect to defer fees owed by either a U.S. hedge fund or an offshore hedge fund. Consequently, U.S. hedge fund managers who elect to defer their asset-based or performance fees are subject to the election, payment, written documentation, and reporting requirements of section 409A.

Baucus Question 8 (for Mr. Solomon)

It has been argued that private equity and hedge funds will move offshore if Congress changed the taxation of the managers of these funds. How many U.S. managed hedge funds are already offshore?

<u>Answer</u>

Although the Treasury Department and the IRS do not have specific numbers, we understand that a significant number of U.S.-managed hedge funds have a dual domestic/offshore structure. A domestic partnership is established for investments by taxable U.S. investors and an offshore fund, usually organized as a foreign corporation, is established for other investors. Because the managers of these offshore funds are U.S. taxpayers, the fees they earn from managing the offshore funds are subject to U.S. tax.

Baucus Question 9 (for Mr. Solomon)

It has been argued that private equity and hedge funds will move offshore if S. 1624 became law. However, many private equity funds like KKR are already offshore. KKR uses a Guernsey entity for its permanent source of capital. How many private equity funds use a foreign structure to obtain permanent funding?

<u>Answer</u>

Pursuant to Code section 6103, the Treasury Department cannot comment on specific taxpayer matters. In general terms, however, it is important to distinguish between the issuance of interests in an investment company (the fund itself) and the issuance of interests in an investment management company, which S. 1624 addresses. Published

reports indicate that at least six private equity and hedge fund companies (the investment funds) that are affiliated with U.S. investment management companies, have issued interests on foreign exchanges since 2004. Although these companies have obtained one source of "permanent funding" offshore, the U.S. partners of their affiliated investment management companies remain subject to U.S. tax.

Baucus Question 10 (for Mr. Solomon)

On July 13, 2007, the New York Times published an article by David Cay Johnston regarding Blackstone's tax receivable agreement, which is described in Blackstone's SEC filings. Under the tax receivable agreement, the Blackstone managers sell tangible and intangible assets to a corporation. The corporation pays 85% of the amount of the cash savings or tax benefits to the transferring managers. Does Internal Revenue Code § 1239 apply to affect the character of the transaction? Please provide an explanation.

Answer

Pursuant to Code section 6103, the Treasury Department cannot comment on specific taxpayer matters. In general, and without addressing any specific transaction, section 1239 characterizes gain from the sale or exchange of depreciable property between related parties as ordinary income. Related parties for this purpose include a person and a corporation in which the person owns (directly or indirectly) more than 50 percent of the value of the corporation's stock, and a person and a partnership in which the person owns (directly or indirectly) more than 50 percent of the partnership's profits or capital interests. Property is treated as depreciable for this purpose if the property, in the hands of the transferee, is of a character which is subject to the allowance for depreciation provided in section 167. Section 197, which generally governs the amortization of goodwill and certain other intangibles, provides that for purposes of Chapter 1 of the Code, any amortizable section 197 intangible shall be treated as property that is of a character subject to the allowance for depreciation provided in section 167. Therefore, section 1239 could apply to a sale or exchange of intangible assets between related parties.

Baucus Question 11 (for Mr. Solomon)

Many private equity fund managers have a one-time or periodic election to convert management fees into additional profits interest. How prevalent are these elections? Please explain how private equity fund managers convert management fees into carried interests.

Answer

In private equity and hedge funds, it is common for the manager to receive both an annual management fee of 2 percent of the fund's committed capital and an interest of 20 percent in the profits of the fund. The annual management fee is taxed to the manager as

a guaranteed payment under the rules of section 707(c). A guaranteed payment for services is treated as a payment to a person who is not a partner to the extent the payment is determined without regard to the income of the partnership. The manager must include the guaranteed payment as ordinary income for his taxable year within which ends the partnership taxable year in which the partnership deducts such payment.

The profits interest (or carried interest) provides the manager with a distributive share of partnership income, if any. Unlike the guaranteed payment, which is fixed and payable without regard to the success of the partnership, the manager's distributive share is subject to the entrepreneurial risks of the partnership.

Replacing the manager's annual management fee of 2 percent with an increase in the manager's distributive share of partnership profits presents a number of substantive tax questions. The answers to these questions in large part turn on the surrounding facts and circumstances.

The nature of a manager's compensation arrangement is not specifically reported on the income tax returns filed by private equity funds, and the IRS does not have specific information from audits of these entities that could be used to provide an accurate estimate of the prevalence of elections to convert management fees into profits interests. The Treasury Department and the IRS are continuing to consider and develop information on this issue.

Baucus Question 12 (for Mr. Solomon)

How many hedge funds are audited per year?

Answer

In its annual workload-planning processes, the IRS has historically not set a specific goal for the number of hedge funds or private equity funds to be examined. In part, this is because there is no uniform definition of a hedge fund, although the IRS does track some information on partnerships by relevant industry codes. Accordingly, although the IRS has audited approximately 30 large financial services partnerships each year, statistical information for these audits has not been tracked separately from other large flow-through entities.

The IRS's ability to identify participants in complex pass-through enterprises such as hedge funds and private equity funds has improved significantly in the past year. Using research and technological advances to capture information from return filings, the IRS can link and identify many of the enterprise participants and the relationships between these participants. Moreover, the IRS can now select a fund, identify most of the participants in the fund, follow the flow of gains, losses, credits, deductions, and other items, and thus improve its risk assessment and focus examination resources. Once these new capabilities are fully implemented, the IRS will have a more detailed picture of the

operations of complex financial services partnerships, including hedge funds and private equity funds.

In addition to the work being done by the IRS to target examination resources on hedge funds and private equity funds, a working group was formed in March of this year involving the IRS Office of Chief Counsel, the IRS Large & Mid-Size Business Division, and the Treasury Department to consider a broad range of issues relating to private pools of capital. The work being done by this group includes consideration of legal questions raised, such as deferred compensation, dealer/trader/investor status, partnership profits interests and unrelated business taxable income, and considering additional published guidance in these areas.

Baucus Question 13 (for Mr. Solomon)

How many hedge fund managing partnerships, limited liability companies, and S-Corporations are audited per year?

Answer

See response to Baucus Question 12.

Baucus Question 14 (for Mr. Solomon)

How many private equity firms are audited per year?

Answer

See response to Baucus Question 12.

Baucus Question 15 (for Mr. Solomon)

How many private equity fund managing partnerships, limited liability companies, and S-Corporations are audited per year?

Answer

See response to Baucus Question 12.

Baucus Question 16 (for Mr. Solomon)

Many offshore hedge funds are engaged in lending in the United States. Does Treasury intend to provide guidance in this area?

Answer

The Treasury Department and the IRS have been evaluating the need for, and the possible scope of, guidance that would provide greater clarity regarding the lending activities of foreign residents, including offshore hedge funds. This year's Treasury/IRS Priority Guidance Plan, released on August 13, 2007, includes a project to provide "guidance on financing activities, including lending activities under section 864."

Grassley Question 1

You suggested there are means by which US manager partners could move their activities offshore and avoid US tax on their share of profits.

- **Could you provide specific examples of methods to achieve such a result and the steps that would have to be taken?**
- **Even if managers moved their own business offshore, why would they not still seek to provide capital and investment advice to promising US businesses and seek to benefit from future appreciation of such businesses?**

Answer

Given the significant consequences associated with expatriation and corporate inversion, as well as established private capital managers' professional and personal ties with the United States, we believe that it is unlikely that existing U.S. private capital management firms would move offshore as a result of changes in the tax treatment of carried interests. However, higher taxes on the industry could make it more difficult for existing firms to attract new talent from foreign countries because talented individuals may choose to work in lower tax jurisdictions. Moreover, new firms entering the field would have an increased incentive to establish themselves offshore.

Grassley Question 2

This question concerns the PTP bill that Senator Baucus and I introduced last month. Some critics of that bill have pointed to the Real Estate Investment Trusts (REITs) and Regulated Investment Companies (RICs) as examples of structures that avoid a corporate level tax and are publicly traded. However, both RICs and REITs are subject to significant restrictions under the tax rules regarding assets, structure, and activities of the entity. Given the restrictions on RICs and REITs do you think these are the relevant baseline with which to compare private equity and hedge fund managers that go public?

Answer

In enacting the special tax rules governing real estate investment trusts (REITs) and regulated investment companies (RICs), Congress considered some of the same issues that are raised in connection with the tax-preferred status of publicly traded partnerships (PTPs) that are taxed as partnerships.

REITs are corporations for tax purposes. A REIT's taxable income is computed in a manner similar to other domestic corporations except that the REIT is entitled to a deduction for dividends paid to shareholders. Thus, while a REIT is not a flow-through entity like a partnership or S corporation, it pays no corporate-level tax to the extent its

otherwise taxable income is distributed as a dividend. Similar tax treatment is afforded to RICs, which can avoid an entity-level tax if they meet certain asset and income tests and distribute most of their earnings to their shareholders.

Qualification as a REIT under the Internal Revenue Code is limited to a corporation that owns real estate (or real estate mortgages), engages primarily in passive activities with only limited active business, and regularly distributes its income to its shareholders. To maintain status as a REIT, the corporation must satisfy specific tests regarding its income and assets.

A REIT is permitted to own stock of a taxable REIT subsidiary (TRS). The TRS may engage in active business activities that the REIT itself is not permitted to conduct. The TRS, however, is not entitled to a deduction for dividends paid to its shareholder (i.e., the REIT) and is therefore subject to an entity-level corporate tax. Congress intended to limit the ability of the REIT to derive income from the TRS without a corporate-level tax, and to that end, provided specific rules that limit the amount by which the TRS' income can be reduced through transactions between the REIT and the TRS. Interest paid by a TRS to the REIT is subject to the earnings-stripping rules of section 163(j). Additionally, the REIT is subject to an excise tax of 100 percent on excess interest, rents, or other deductions of the TRS in transactions with the related REIT.

A PTP is treated for tax purposes as a corporation unless 90 percent or more of its gross income is qualifying income. Also, any PTP that would be described as a RIC if it were a domestic corporation is taxed as a corporation. Qualifying income is generally limited to passive income and certain other types of income, including income from natural-resources activities. Based on a review of public filings, it appears to be a common practice for PTPs to organize wholly owned C corporations to conduct activities that produce non-qualifying income. The subsidiary C corporations are subject to an entity-level corporate tax and the partners of the PTP pay a second level of tax on any dividends paid by the C corporations to the PTP.

A comparison between REITs and PTPs taxed as partnerships can be made in that the statutory regimes governing both types of entities were designed, in part, to prevent an erosion of the corporate-tax base by conferring special tax status on such entities only if they engage in passive activities. Similarly, both types of entities can earn, indirectly, active income through the use of a TRS by REITs and C corporation subsidiaries by PTPs taxed as partnerships. While the particular rules applicable to each type of organization may be different, the rules share a common result—they limit the activities of the entity to certain prescribed passive activities and provide a means to earn active income within the enterprise by means of subsidiary C corporations that are subject to an entity-level corporate tax.

Schumer Question 1 (for Mr. Solomon, Dr. Orszag, and Mr. Gergen)

In most of the testimony at the July 11th hearing, we focused on the financial industry. But let's look at a different situation that still uses a partnership structure, where part of the gain is based on what might be called "sweat equity."

Let's say that two individuals open a bagel or knish shop in Brooklyn. Let's call them "Bagel Buddies" or "Knish Capitalists." One of them provides all of the cash, and the other provides the know-how, and they each take a 50-50 interest in the partnership. At the hearing, those who oppose treating carried interest as capital gain seem to be arguing that if the partners sell the business in 10 years for a substantial gain, the financial partner should have his profit treated as capital gain, and the know-how partner should have his profit treated as ordinary income, since his investment in growing the partnership wasn't a financial one and he didn't have his own capital at risk. Isn't this what is being implied when people argue that those who are providing services or labor are not making a financial investment in the enterprise?

Answer

In your example, the person with the know-how and skill necessary to run the business and the person with the capital necessary to finance the business join together as co-proprietors in an entrepreneurial venture. As partners, they share in the success of the business. For tax purposes, each partner reports and pays tax annually on his distributive share of partnership income. The character of each partner's distributive share as ordinary income or capital gain is determined at the partnership level. Thus, each partner will report each year his distributive share of ordinary income from operations. When the business is sold at a gain, each partner will report his distributive share of any portion of the gain, including any long-term capital gain.

Arguments have been advanced that, because one partner's contribution in your example is of know-how and skill (which some say look like "services"), rather than of money or other property, the distributive share of the gain from the sale of the business for the partner contributing the know-how and skill should be taxed at ordinary income rates. Under this argument, the type of contribution made by a partner to the partnership affects the character of his distributive share of partnership income. Thus, if the investment by a partner is solely in money or other financial assets, the capital-gain character of the partnership's income would flow through to the partner, but if the contribution is of skill, know-how, or past or present services, the partner's distributive share of the partnership's income would be ordinary income. In essence, the argument is made that the partner contributing know-how and skill is providing "services" by managing the investor's money, and as such, he or she should be taxed at ordinary income rates on any payments received for such services. The argument advanced for treating the distributive share of the partner contributing the know-how and skill as ordinary income applies to your example. The argument would also apply to partners who contribute know-how and skill to partnerships in other industries such as real estate and oil and gas.

The argument that the partner contributing know-how and skill, rather than money or other property, should receive different tax treatment is contrary to long-standing and well developed tax laws applicable to partners in small and large partnerships across many different industries.

Schumer Question 2 (Follow-Up for Mr. Solomon, Dr. Orszag and Mr. Gergen)

Now, some have argued that this is not the case, that in fact Section 751 prevents the conversion of ordinary income into capital gain income from the average partnership. But my understanding is that Section 751 applies only to unrealized receivables and inventory items of the partnership – not the appreciation of the value of the business as an ongoing enterprise, or the value of the building bought, or the assets used to produce income. Could you clarify for me if my understanding is correct? Wouldn't most of the gain of the sale of the business be considered capital gain under the current law, even for the non-financial partner?

<u>Answer</u>

Generally, gain or loss from the sale of a partnership interest is treated as the sale or exchange of a capital asset and is taxed at capital gain rates under section 741 of the Code. An exception to this general rule applies to the sale of certain types of assets. Section 751 provides that a partner who sells his partnership interest will recognize ordinary income or loss to the extent that the amount realized from the sale or exchange is attributable to partnership unrealized receivables or inventory items (collectively referred to as "hot assets"). The income or loss realized by a partner upon the sale of an interest in hot assets is the amount of income or loss that would have been allocated to the partner if the partnership had sold the hot assets in a fully taxable sale at their then-fair-market value.

Unrealized receivables are defined as rights to payments for goods delivered or to be delivered (to the extent the proceeds from the sale of such goods would be treated as an amount realized from the sale of an asset other than a capital asset) or services rendered or to be rendered. The term "unrealized receivables" also includes other items such as depreciation recapture and recapture with respect to oil and gas or mineral properties.

"Inventory items" include, (i) stock-in-trade of the partnership or property held by the partnership primarily for sale to customers in the ordinary course of the partnership's business, (ii) any other property held by the partnership that upon its sale would be considered property other than a capital asset and other than property described in section 1231, and (iii) any other property that if held by the selling partner directly would be considered property described in (i) and (ii).

In the example provided, whether most of the gain recognized by the non-financial partner from the sale of his partnership interest to an unrelated third party is taxed as capital gain under section 741 or as ordinary income under section 751 depends upon the

fair market value of the partnership's hot assets at the time of the sale of the partnership interest. Goodwill or going concern value, or other capital assets (or section 1231 property) of the partnership generally are not hot assets and, accordingly, to the extent substantial value is properly allocated to such assets, they would not create ordinary income for either the financial partner or the non-financial partner under section 751.

Schumer Question 3 (for Mr. Solomon and Dr. Orzag)

One of the issues that has come up in this debate over private equity and hedge fund taxation is whether U.S.-based general partners with ownership interests in offshore hedge funds should be allowed to defer their capital gains, and pay taxes years down the road after the earnings have grown substantially. I tend to think that this deferral is an abuse of the system and a way for the very richest people in the country to evade U.S. taxes. But this got me thinking about another aspect of fairness.

I understand that our system allows deferral, and think it encourages U.S. corporations to keep earnings offshore in order to postpone paying taxes as long as possible. My question is this: Why would it be appropriate tax policy to end deferral for hedge fund partners, but keep deferral for U.S. corporations with foreign subsidiaries? Shouldn't the policy be consistent? What would be the policy rationale – other than raising taxes on very rich hedge fund partners – for making that distinction in the tax code?

<u>Answer</u>

Your question refers to two types of deferrals. The first is the election that U.S. hedge fund managers may make to defer the fees owed by an offshore hedge fund under the terms of a service contract. The second is the deferral of foreign income earned by foreign subsidiaries of U.S. corporations.

With respect to the deferral of a hedge fund manager's fee, under section 409A, the managers are subject to the same deferral election and payment restrictions that apply generally. In this context, section 409A applies the nonqualified deferred compensation requirements equally to all industry groups.

With respect to the deferral of foreign income earned by U.S. corporations, the United States has a hybrid system for taxing international income with elements of both a worldwide and a territorial system. Generally, domestic corporations are taxed on their income whether earned in the United States or abroad; that is, corporations are taxed on their income on a worldwide basis. However, U.S. parent corporations with foreign subsidiaries are generally not taxed in the United States on the active business income of their foreign subsidiaries until such income is repatriated and distributed as a dividend to the U.S. parent. Until that income is repatriated, U.S. tax is generally deferred. The purpose of permitting this deferral of active business income of foreign subsidiaries is to help U.S. multinational corporations compete in foreign countries.

Schumer Question 4 (for Mr. Solomon and Dr. Orszag)

Could you please give me your assessment of how changing the treatment of carried interest, or the rules regarding deferral on hedge fund income, might affect New York's position as the financial capital of the world? What are the most likely results of a change in policy, in terms of people or companies moving to the Cayman Islands or London or somewhere else?

Answer

Higher taxes in the U.S. for managers of hedge funds and private equity funds could make it significantly more difficult for existing firms to attract new talent from foreign countries because talented individuals may choose to work in lower tax jurisdictions. Moreover, new firms entering the field would have an increased incentive to establish themselves offshore. The magnitude of this effect depends on numerous factors, including not only the tax rates on income of private capital managers in foreign jurisdictions, but also the relative benefits and burdens of national financial regulatory regimes and operational constraints on investment-manager location.

Question from Senator Crapo

Mr. Solomon, in response to an earlier question, you said there were ways in which one could structure a fund's operations so that it could be relocated to another country, at least for future investments. My concern is that, if that kind of restructuring is possible, and if we make these kinds of changes in fundamental tax law rules, there is a risk that in the future funds and management companies that might be headquartered in the US would begin to look elsewhere, and not only to London, but also to Asia. Do you share that concern?

Answer

Higher taxes in the U.S. for managers of hedge funds and private equity funds could make it significantly more difficult for existing firms to attract new talent from foreign countries because talented individual may choose to work in lower tax jurisdictions. Moreover, new firms entering the field would have an increased incentive to establish themselves offshore. The magnitude of this effect depends on numerous factors, including not only the tax rates on income of private capital managers in foreign jurisdictions, but also the relative benefits and burdens of national financial regulatory regimes and operational constraints on investment-manager location.

Cantwell Question 1

Mr. Solomon, the Joint Committee on Taxation defines "carried interest" generally as a "right to receive a percentage of fund profits without an obligation to contribute to the capital of the funds" conditioned upon the underlying performance of the fund. Presumably what the general partner is "contributing" instead of capital is sweat equity—his management capabilities—and he has an incentive to help the fund succeed. This carried interest is taxed when received as a capital gain. How does this differ in substance from the performance-based compensation that is awarded to the CEO of a public company, who also provides management capabilities, as an incentive to help the company succeed but is generally taxed as ordinary income?

Answer

A carried interest represents an interest as a partner in a partnership. The carried interest owner typically makes a contribution to the partnership of know-how and skills that are critical to the success of the partnership. The partnership pools the skills and know-how of the carried interest owner with capital from other investors.

The partners have the rights and obligations specified in the partnership agreement and under applicable state law. In many cases, the partnership is organized under state law as a limited partnership in which the carried interest owner is the general partner. As the general partner, the carried interest owner is vested with management responsibility for the partnership's operations and is liable for the contractual and tort obligations of the partnership. It is generally anticipated that the general partner will act as the general partner throughout the life of the partnership.

In contrast, an employment relationship does not make the employee an owner in the employer's business. The employee is not a co-proprietor in a joint undertaking with the employer. Instead, the employee is in a subservient relationship to the employer, and as such, the employee is subject to the direction and control of the employer. The employee is not liable for the obligations of the employer. Also, the employee may be terminated under the terms of his or her employment agreements.

An employee may receive a performance fee as compensation that is similar in amount to the carried interest partner's distributive share of the partnership profits. However, compensation for an employee calculated in an amount similar to the partner's distributive share of partnership profits does not make the employee a partner. Partner status is based on a number of objective factors (including the sharing of profits) that demonstrate that the parties have come together as co-proprietors in a joint enterprise.

Cantwell Question 2a

Another issue that arises here is the different way the tax code treats different types of business activities. Corporations, for example, are subject to two layers of tax—an entity level tax on income and then an individual level tax on the amounts distributed to shareholders as dividends. Partnerships and other passthrough entities are subject only to one layer of tax–at the individual level. The President's Advisory Panel on Federal Tax Reform, in its November 2005 report, highlighted the economic distortions created by the double taxation of corporate earnings and the complexity of the business tax system, and proposed several recommendations to improve the tax treatment of business entities, one of which was to level the playing field among different types of entities.

a. **What is the Treasury's position on the Panel's recommendations for reform of the business tax system?**

Answer

Since release of the report by the President's Advisory Panel on Federal Tax Reform, the Treasury Department has studied the Panel's recommendations carefully. The Treasury Department is, however, focusing more broadly on the impact that our business tax system has on global competitiveness.

Cantwell Question 2b

b. **Given that Secretary Paulson cautioned against a piecemeal approach with regard to the issues we are contemplating today, does Treasury have broad proposals for the Congress to consider that would address some of these more fundamental tax policy concerns?**

Answer

Many of the issues surrounding private equity arise from distortions in the current system of business taxation, and in particular the tax disadvantage of corporations relative to flow-through business. The recent Treasury Conference on Business Taxation and Global Competitiveness was conceived to initiate a dialogue about how U.S. business taxation should be reformed to make U.S. businesses more globally competitive. The Treasury Department is currently evaluating the ideas raised at the conference to determine its next steps.

Cantwell Question 3

What is the Treasury's position on S. 1624, the legislation dealing with publicly traded partnerships that Chairman Baucus and Senator Grassley have introduced?

__Answer__

The proposed legislation presents difficult issues involving the intersection of our double-tax system for corporations and the single-tax system for partnerships and the special tax rules for entities such as real estate investment trusts (REITs).

Two themes emerge from the existing publicly traded partnership (PTP) statute (section 7704) and its legislative history. One theme is that publicly traded, active businesses should be subject to corporate-level tax. Another theme is that passive income should not be taxed twice because it could have been earned directly by the owners of the PTP or, in the case of dividends, the underlying income has already been subject to a corporate-level tax. Consequently, section 7704 provides only one level of tax for PTPs that have mostly passive income, and provides for a second, corporate-level tax for PTPs with too much active income.

In evaluating application of section 7704 to private equity and hedge funds, it is important to bear in mind the original concern of Congress in permitting pass-through treatment for items of passive income as well as special treatment provided for real estate and natural resources. If a PTP with dividend income were subject to tax at the entity level, that income would be subject to an additional level of tax. Moreover, to impose an entity level tax on PTPs operating only in a particular industry would be create new instances of disparate tax treatment.

Cantwell Question 4

Did the Treasury Department issue any type of ruling or official opinion on the specific tax status of Fortress or Blackstone as a publicly traded partnership exempt from corporate tax treatment?

__Answer__

Pursuant to section 6103 of the Internal Revenue Code, the Treasury Department cannot comment on specific taxpayer matters.

Cantwell Question 5

What is Treasury's position, generally, with respect to the question of whether, as a matter of policy, a business that derives income from asset management and investment advisory services and that takes the form of a publicly traded partnership should be subject to tax as a corporation?

Answer

The current tax treatment of PTPs reflects a decision to protect the corporate tax base by limiting the circumstances in which partnerships can raise capital in the public markets without paying an entity-level tax. Under the current regime, a PTP can generally avoid entity-level tax if its income falls into certain prescribed categories such as passive investment income. Any proposal to change this regime that could result in higher taxes on particular segments of the economy must take into consideration the significant benefits that come from lower tax rates on investment income. In addition, it is important that the tax laws be applied uniformly across all sectors of the economy, and any proposal to single out a particular industry would raise important policy concerns.

Senate Committee on Finance

Carried Interest II

Hearing July 31, 2007

Testimony of:

William D. Stanfill

Founding Partner, Trailhead Ventures, L.P.

Denver, Colorado

Introduction

Chairman Baucus, Ranking Member Grassley, and Members of the Committee, my name is William Deming Stanfill, founding partner and head of the Denver office of Trailhead Ventures, a private venture capital partnership whose investment focus is information technology. At the outset, I would like to make clear that I speak not on behalf of my firm and certainly not on behalf of the industry. Rather I speak as a private citizen who has been involved in the venture capital industry for 25 years.

I joined the Centennial Funds of Denver in 1982 and was responsible for a fund of funds activity wherein we invested in thirty venture partnerships around the United States. The venture partnerships collectively invested in 600-700 portfolio companies including telecommunications, medical, and information technology. Those portfolio companies were scattered across the U.S., from Massachusetts to California, Florida to Oregon, Colorado and Utah, Arizona, Texas, and New Mexico, Alabama and Georgia, Idaho and New Hampshire.

What We Do

In 1995, I left the Centennial Funds, purchased the fund-of-fund activity and formed Trailhead Ventures to invest directly in early stage information technology enterprises. By industry standards we are a small fund. Our advantage is our ability to provide seed and early-stage capital of $2-4 million to start-up companies. A $500

million partnership, by contrast, cannot manage 125 to 250 investments of $2-4 million each. Our limited partners include state and corporate retirement funds, university endowments, and the occasional high net worth individual.

Basically we back entrepreneurs who have good ideas and an obsession to bring them to market. We help surround the entrepreneur with a world-class management team. If the team performs well, we have the good sense to stay out of their way. The last thing most venture capitalists want is for the management team to hand them the keys to the enterprise. That said, we serve on boards, assist with business strategy, help interview and select members of the senior leadership team, and introduce the entrepreneurs to professional and other service providers who can bring value to the enterprise.

How We Are Compensated

We receive a management fee, based on a percentage of committed capital, to cover salaries and expenses. After payback, when limited partners have recouped their investment, we then share in the profits on an 80/20 split. This is the "carried interest." Both the management fee and the carried interest represent compensation for the work that we do. The general partners also invest at least 1% of the fund's capital. The earnings on that 1% are, of course, not compensation, but qualify for capital gains treatment along with our investors' earnings.

How Our Compensation is Taxed

Our management fee is taxed as ordinary income. However, the carried interest, even though it is compensation, is primarily taxed at capital gains rates. I can understand why many in my industry want to preserve this special tax advantage. Clearly, it has served US and ME well. The tax subsidy each year to private equity fund, hedge fund, and venture capital fund managers is in the *billions* of dollars. But I think this special tax break is neither fair nor equitable. After all, a gifted teacher who is training and inspiring and challenging our children and enriching *human* capital gets no such special treatment.

All workers add value—to a greater or lesser extent. Greg Alvarado, the landscaping artist who maintains my yard, brings beauty and order to my home and the

neighborhood. But the tax rate on my carried interest is less than the tax rate on his earnings. Or how about the veterans of the Iraq war, in particular the 26,000 casualties? Do I deserve a tax break more than they do? Ben Stein doesn't think so. Nor do I.

Many Americans invest sweat equity in their jobs and their businesses, take risks, contribute to the economy, and may have to wait a long time before their hard works pays off. But they still pay ordinary income tax rates on their compensation. To the extent we take risk, we take it with other people's money. As Bill Gross, the managing director of PIMCO Bond Fund noted, "[w]ealth has always gravitated towards those that take risk with other people's money but especially so when taxes are low."

Consequences of Changing the Tax Treatment

I don't think that changing the tax law to require me and other managers of venture capital firms, private equity firms, and hedge funds to pay tax on our compensation like other working taxpayers would have the dire consequences that some are predicting.

Many predict that firms will locate overseas, taking jobs and tax revenue out of the country. My firm is too small to play in the international field—the learning curve is too steep and the expenses are too high. And if you are doing seed investing, we've always found sufficient deals in our own backyard. And my accountant advises me that, even if we did move our fund offshore, as a U.S. citizen I would still be subject to U.S. tax on my income.

I don't see why my limited partners would stop investing in our fund just because my tax treatment changes. It doesn't affect their taxes—most of them are non-taxable entities anyway. If my investors ask me what this tax change means to them, I'm going to tell them "nothing." And I'd still have a strong incentive to do the best for my investors. After all, I don't earn profits until they do.

What limited partners should expect from a venture capital investment is a 500 basis point (5%) premium over a portfolio of publicly-traded securities. And that premium is not a risk premium, but a premium for illiquidity. Why? Because we are a 10-year partnership. But in addition to that premium, the investor gets a lottery ticket and the results can be substantial. In the first Trailhead Fund, we have produced a 54%

internal rate of return net to the investor and if we liquidated the remaining public securities today, we would return 10 to 11 times our partners' capital.

I have read Kate Mitchell's testimony from the first hearing about the wonderful things we venture capitalists do. I think this is an idealized view of our industry—a vision of the Wizard of Oz comes to mind. Am I the only one who found her remarks just a bit self-serving? But we don't lead every deal in which we invest. Occasionally we are followers, along for the ride. Ms. Mitchell and I do the same kind of work—we just come to different conclusions about the tax treatment of our earnings.

What is interesting about early-stage venture investing is the rewarding collaboration between the limited partners who bring dollars and trust, the venture capitalist who brings judgment and experience, and the entrepreneur who brings an idea and a fire in his or her belly. That combination can create wonderful, profitable results. But there is a first among equals here that we should never forget, and is the key to the equation, and that is the entrepreneur.

I have loved my work over the last 25 years and I would not stop doing it because my tax rate was adjusted to the level of other citizens'. And I don't think losing the carried interest tax break would drive other venture capitalists out of the field. We like the excitement and satisfaction of assisting management in transforming good ideas into successful businesses. We get ample compensation, financial and psychic, for the work we do and the risks we take, in the form of a share of the profits. There is more than a hint of Chicken Little here. But our industry won't end or be significantly disrupted if this legislation is enacted any more than the auto industry's dire predictions of doom came to pass after mileage standards, seatbelts, and air bags were mandated.

Does Venture Capital Deserve Special Tax Breaks?

I could make a public policy case for excluding venture capital from this legislation. For unlike private equity and hedge funds, the venture capital industry does create jobs. We fund small start-ups rather than restructure huge companies. And we don't use leverage to pay ourselves back and leave the portfolio companies saddled with debt. But I won't. I still think our earnings are compensation and should be taxed the same as the compensation of everyone else in this country—from teachers and

firefighters to athletes and movie stars. I don't think it is fair for those teachers and firefighters to subsidize special tax breaks for me and other venture capitalists. Or for private equity and hedge fund managers.

Wealth Inequality

How long will we tolerate the ever-widening gap between rich and poor? Though my preference is for major tax reform—increased standard deductions, a base rate for all income: wages, salaries, dividends, royalties, and capital gains with some progressivity built in – major tax reform is not on your agenda. However, I do believe it is fair, equitable, and appropriate to attack the issue of tax equity at the margins. We should not do nothing because we can't do everything. I am especially disturbed by suggestions that we can't afford to provide health insurance for low income children, first rate medical care for our injured soldiers or fund – at the federal level – the mandates of No Child Left Behind. I am disturbed that these and other human priorities are unaddressed while we pretend we can afford to continue these tax breaks.

Conclusion

I'm delighted to be part of the venture capital business—it's been a wonderful 25 years. We funded a lot of companies—many of them successful. We've worked hard and I think we've earned our compensation. My point simply is that fairness and equity dictate that we pay ordinary tax rates on that compensation.

Was Ben Franklin prescient when he warned us that our republic would fail because of corruption, greed, and, dare I say it, special interests? Doesn't gross inequity in our tax code, maintained by the very people who benefit from it, come close to the same thing? We and our representatives have a choice. We can change the tax code in favor of equity and fairness. Or we can come to the same conclusion reached by Walt Kelly and his mouthpiece, Pogo, "we have met the enemy and he is us."

Thank you and I would be pleased to answer any questions.

TESTIMONY OF DONALD B. TRONE
PRESIDENT OF THE FOUNDATION FOR FIDUCIARY STUDIES
AND THE FOUNDER OF FIDUCIARY360

SUBMITTED TO THE U.S. SENATE FINANCE COMMITTEE

"THE IMPACT A PROPOSED TAX ON HEDGE FUNDS AND PRIVATE EQUITY INVESTMENTS MAY HAVE ON THE FIDUCIARY PRACTICES OF RETIREMENT PLAN SPONSORS"

September 6, 2007

Mr. Chairman and members of the Senate Finance Committee: There are more than five million men and women who serve as investment fiduciaries; and who serve as trustees and investment committee members of retirement plans, foundations, endowments, and personal trusts. In turn, these stewards are responsible for managing the vast majority of our nation's liquid investable wealth. As critical as their function is to the fiscal health of our country, we still do not have a single federal or state agency that is providing education and training to these five million investment fiduciaries. Nowhere is this problem more pronounced than when we begin to examine the absence of sound fiduciary practices by many retirement plan sponsors when they make investments in hedge funds and private equity.

Good morning, my name is Donald Trone, and I am the president of the Foundation for Fiduciary Studies and the founder of Fiduciary360. I have been involved with writing, teaching, and preaching about investment fiduciary responsibility for more than twenty years.

I appreciate the opportunity to appear before you today and, as requested, my testimony will address the investment fiduciary issues associated with the use of hedge funds and private equity, including the likely impact a proposed change in the tax treatment of carried interest received by hedge and private equity fund managers may have on the decision-making process of an investment fiduciary.

To address the latter issue first, and to cut to the chase: A tax on hedge and private equity fund managers likely will have no more impact on the inappropriate use of these investment strategies than a hike in the capital gains tax would have had on investors during the dot-com bubble. Unfortunately, in many cases where investment fiduciaries have invested in hedge funds and private equity, speculative hubris has supplanted procedural prudence.

Most investment fiduciary legislation is based on a flexible doctrine that gives consideration to incorporating changes in the types of asset classes, asset strategies, and financial products made available to investors. At the root of this doctrine is the concept of a process standard and the requirement that the investment fiduciary demonstrate their procedural prudence.

No asset class is ever inherently imprudent: it is the way it is built and how it is used that determines whether the prudence standard has been met. While even the most aggressive and unconventional investment strategies, such as those employed by hedge funds and private equity, can meet the standard if arrived at through a sound process; the most conservative and traditional asset classes may be inadequate if a sound process is not implemented.

The Foundation for Fiduciary Studies has identified twenty-two practices that provide the details of a fiduciary's prudent investment process. A listing of these practices, which have been modified for the purposes of this hearing to specifically address the special fiduciary issues associated with hedge funds and private equity, is provided under Enclosure 1.

Three of the more significant practices are the requirements that the fiduciary demonstrate the due diligence process that was followed in the evaluation, selection, and monitoring of each investment option. There are numerous factors that should be considered, which are determined by facts and circumstances:

- Size of the portfolio
- The ability of the fiduciary to give investment direction to the portfolio manager
- Investment expertise of the fiduciaries
- Ability of the fiduciary to properly monitor the strategies and/or investment options
- The liquidity of the investment option
- The ability of the fiduciary to fund a strategy with assets-in-kind
- Minimum required investment
- The degree to which the investment is diversified
- The ability for the investment option to meet asset allocation and rebalancing guidelines
- The ability of the fiduciary to negotiate lower fees for growing or larger portfolios
- The degree of portfolio transparency
- Whether portfolio and performance information is audited
- The degree of regulatory oversight
- The ability of the fiduciary to perform appropriate due diligence.

Now compare the due diligence process just outlined to the process described in a recent *Wall Street Journal* article entitled, "Venture Firms vs. Investors." (A full copy of the article is attached as Enclosure 2.) The reporter, Rebecca Buckman, describes how some investment fiduciaries are strong-armed by venture firms into investing in unproven funds in order to remain within the good graces of the venture firms:

> *"These investors—including big university endowments, foundations and pension funds—worry that, if they don't comply, they could damage their relations with the venture-capital firms and possibly lose out on the chance to get into the firms' more typical funds, which invest in small start-ups."*

The investment fiduciary also has a duty to control and account for all investment-related fees and expenses; including the duty to identify all parties that have been compensated from these fees, and the duty to demonstrate that an assessment was made as to whether each party is receiving compensation that is fair and reasonable for the level of services being rendered.

The well-publicized, exorbitant fees that investment fiduciaries are willing to pay for access to hedge funds and private equity also provides convincing evidence that we're witnessing yet another "investment bubble." All bubbles have the same characteristics; best summarized as the "toos"—**too** much product is brought to market **too** soon (not being properly vetted), and it's **too** expensive. As in all previous bubbles, many fiduciaries have joined in the chorus line, singing: "*This time it's different.*"

Specific to the impact a proposed tax on hedge and private equity fund managers would have on the fiduciary's decision-making process: A tax hike would have the impact of reducing the investment's return, as well as reducing the attractiveness of the investment's expected risk/return profile. Unfortunately, even knowledgeable and responsible investment fiduciaries often are not capable of accurately modeling a hedge fund's risk/return profile because of the lack of portfolio transparency and the absence of audited track records.

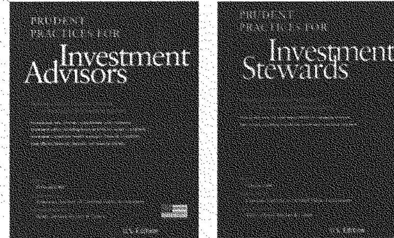
In theory, a tax hike would have the effect of making hedge funds and private equity investments less attractive in a prudently diversified portfolio. In reality, the current, unbridled exuberance for these investment strategies means that a tax increase will have little-to-no-effect on their use.

Thank you.

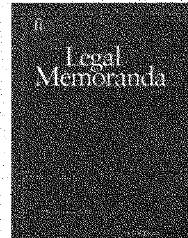
Enclosure 1:

Fiduciary Practices Associated with the Use of Hedge Funds and Private Equity

The fiduciary practices which follow are based on the handbooks ***Prudent Practices for Investment Stewards*** and ***Prudent Practices for Investment Advisors***. Both handbooks were written by Fiduciary360 and edited by the AICPA (American Institute of Certified Public Accountants).



Each of the practices is substantiated by legislation, case law, and regulatory opinion letters. The legal memoranda were prepared by the law firm of Reish Luftman Reicher & Cohen.



1. The hedge fund/ private equity manager demonstrates an awareness of their fiduciary duties and responsibilities.
2. Investments are managed in accordance with applicable laws, trust documents, and the fiduciary's investment policy statement (IPS).
3. The roles and responsibilities of all involved parties (fiduciaries and nonfiduciaries) are defined, documented, and acknowledged.
4. The hedge fund/private equity manager is not involved in self-dealing.
5. Service agreements and contracts are in writing, and do not contain provisions that conflict with fiduciary standards of care.

6. Assets are with a custodian that can provide an independent and objective valuation of the portfolio's holdings.

7. The hedge fund/private equity strategy is consistent with the portfolio's investment time horizon.

8. The hedge fund/private equity strategy is consistent with the portfolio's risk level, and the fiduciary can demonstrate an understanding of the portfolio's risk exposure.

9. The hedge fund/private equity strategy is consistent with the portfolio's expected, modeled return.

10. The selected hedge fund/private equity strategy is consistent with the portfolio's identified risk, return, and time horizon.

11. The selected hedge fund/private equity strategy is consistent with implementation and monitoring constraints of the fiduciary.

12. The fiduciary's investment policy statement contains the detail to define, implement, and monitor an investment in a hedge fund/ private equity strategy.

13. The fiduciary can demonstrate that a due diligence process was followed in selecting the hedge fund/private equity strategy.

14. The fiduciary considers the impact an implementation in hedge funds/private equity may have on "safe harbor" procedures available to the fiduciary.

15. The investment in hedge funds/private equity is appropriate for the portfolio size.

16. The fiduciary can demonstrate that a process was followed in vetting the hedge fund/private equity manager's custodian.

17. The fiduciary receives periodic reports which compare the investment performance of the hedge fund/private equity strategy to an appropriate index, peer group, and objectives outlined in the fiduciary's investment policy statement.

18. Periodic reviews are made of qualitative and/or organizational changes of the hedge fund/ private equity manager.

19. The fiduciary has control procedures in place to periodically review the hedge fund/private equity manager's policies for best execution, "soft dollars," and proxy voting.

20. Fees for investment management are deemed reasonable, and are consistent with agreements and with all applicable laws.

21. “Finder’s fees” and other forms of compensation that may have been paid for asset placement are appropriately applied, utilized, and documented by the hedge fund/private equity manager.

22. The fiduciary has a process to periodically review its effectiveness in managing its fiduciary responsibilities.

Enclosure 2:

Venture Firms vs. Investors

Yale and the Like Quietly Cite Pressure to Back Offbeat Funds

By Rebecca Buckman
The Wall Street Journal, August 28, 2007, Page C1

Some top venture-capital firms eager to expand into new markets are twisting their investors' arms to get them to go along—or so say the investors.

Investors said big-name firms such as Sequoia Capital and North Bridge Venture Partners have been exerting subtle—and not-so-subtle—pressure on some of their limited partners, as these investors are called, to put money into unproven investment vehicles, including funds that invest in China, India and so-called later-stage U.S. companies.

These investors—including big university endowments, foundations and pension funds—worry that, if they don't comply, they could damage their relations with the venture-capital firms and possibly lose out on the chance to get into the firms' more typical funds, which invest in small start-ups.

One limited partner feeling the heat is Yale University and its $18 billion endowment fund. Yale declined to invest in some funds launched in the past few years by Sequoia, including a 2005 fund focused on Chinese companies. Sequoia later decided to "oust Yale from its partner group" because the university passed on the new funds, which targeted "later-stage deals, China and Israel," according to a September 2006 internal Yale review of the endowment's private-equity portfolio.

Sequoia told Yale it preferred investors that would give the Menlo Park, Calif., venture-capital firm a "blank check" to invest as it saw fit, according to the 39-page Yale memo, parts of which were reviewed by *The Wall Street Journal*. A Yale spokesman declined to comment.

Sequoia partner Doug Leone declined to comment on the Yale situation, citing privacy agreements with the firm's investors. He said Sequoia doesn't pressure its investors and has "multiple" investors who have declined to put money into the firm's many overseas funds "without repercussions of any kind .... We encourage our limited partners to invest only in the funds they believe in."

Some Sequoia investors said they felt no pressure to invest in the firm's overseas funds. One Sequoia investor, Massachusetts Institute of Technology, provided a statement at Sequoia's request saying the university has "on more than one occasion declined to invest in name brand venture capital firms' affiliated products that did not match our portfolio requirements," and "we continue to maintain excellent relationships with those firms."

The discord offers a look inside the culture of the venture-capital world, highlighting the increasing power of the industry's top firms. With median industry returns lackluster lately, spots in venture funds that are performing well are more highly prized than ever—and new spots seldom open up, except when firms launch new investment vehicles.

So, even large investors like universities and foundations generally are loath to publicly criticize the firms, partly for fear of getting kicked out of their funds. Many investors also pony up for new types of funds because they don't feel they really have a choice of not investing—even though some venture firms tell them they won't be punished for passing. Still, some investors are skeptical about the ability of even the best-performing firms to succeed in such areas as investing overseas and in larger companies at home.

In some cases, investors "have really felt like there's been a gun held to their heads," says Josh Lerner, a Harvard Business School professor who has studied the venture-capital industry. Some venture-capital firms tell investors that "if you want to continue to be able to invest in the mother ship, you've got to play ball and invest in the secondary funds," he says.

Apart from Sequoia, investors said North Bridge pressured some existing investors to put money into a new growth fund of roughly $500 million the Waltham, Mass. firm raised last year. At least one institution said it was told that how much it put into the growth fund would help determine how much the institution could invest in a coming early-stage fund. The other criterion was how much money it had invested in North Bridge's previous early-stage fund, these investors said.

North Bridge declined to comment. Three investors with the firm who were asked by North Bridge to comment on the issue said they weren't pressured to put money into the growth fund.

Some investors said they don't mind any subtle arm-twisting over secondary funds because they are happy to put money into any product offered by such top-ranked firms as Sequoia and North Bridge.

Many investors said they don't begrudge the best venture-capital firms using their increasing influence to expand into new markets. Sequoia, which has funds targeting China, India and Israel, said in June regulatory filings that it was raising two additional China funds of about $225 million and $450 million.

Kleiner Perkins Caufield & Byers, which famously backed such companies as Amazon.com Inc. and Google Inc., started a $360 million China-focused fund this year and last year launched a $200 million fund focusing on companies that make drugs or disease-detection products used in health pandemics. And Silicon Valley's Accel Partners this summer said it had teamed up with IDG Ventures to launch a $510 million fund focusing on China, two years after the firms raised their first joint China fund.

"All the first-tier funds are sort of rolling into this new model of multisector venture funds, which is a way of having your finger in a lot of pies," said Paul Kedrosky, executive director of the William J. von Liebig Center for Entrepreneurism and Technology Advancement at the University of California at San Diego. It also means funds can collect more fees from investors, because fees generally are based on assets under management. Most venture-capital firms expanding overseas said they are simply responding to increasing globalization in the industries in which they invest.

Still, limited partners who don't want to go along worry they may get cut out of future funds if they don't invest in the new offerings. Sometimes the pressure is subtle, with firms saying that declining to participate in new funds is "fine" but may "change the relationship" between the firm and the investor, according to one university endowment official.

What makes Yale's falling out with Sequoia so unusual is that big investors known for their long-term outlooks, such as Ivy League endowments and well-known charitable foundations, often have more clout and receive better treatment from venture firms.

"With our relationships, we're close enough with the [fund] managers that we're part of the dialogue when they're thinking about doing something with a new fund" and are rarely "approached after all is said and done," says Dan Feder, who helps manage the endowment at Princeton University in New Jersey. "But I understand that our experience is probably not typical."

Responses to Questions for the Record From Donald B. Trone
U.S. Senate Committee on Finance Hearing
Carried Interest, Part III: Pension Issues
September 6, 2007

Questions from Ranking Member Grassley

1. **Plan fiduciaries are required to, among other things, defray reasonable expenses in administering the plan and are under a duty to control and account for all investment-related fees and expenses. Mr. Trone, you stated that you believe that investment fiduciaries are currently paying "exorbitant" fees for access to hedge and private equity funds. Do you think these fees are fair and reasonable for the level of services that are being rendered and the nature of the risk associated with private equity funds?**

No, I do not think the fees that many investment fiduciaries are paying for access to hedge and private equity funds are fair and reasonable because many fiduciaries are investing in inferior funds. A knowledgeable fiduciary who has performed the requisite level of due diligence on an investment option would be able to demonstrate that the following information was appropriately taken into consideration:

a. That the hedge or private equity manager demonstrated an awareness of their fiduciary duties and responsibilities to the plan sponsor.

b. That the investment into a hedge or private equity fund was made in accordance with applicable laws, trust documents, and the plan sponsor's investment policy statement (IPS).

c. That the hedge or private equity manager is not involved in self-dealing.

d. That the hedge or private equity assets are with a custodian that can provide an independent and objective valuation of the portfolio's holdings.

e. That the hedge or private equity strategy is consistent with the portfolio's investment time horizon.

f. That the hedge or private equity strategy is consistent with the portfolio's risk level, and the plan sponsor can demonstrate an understanding of the portfolio's risk exposure.

g. That the hedge or private equity strategy is consistent with the portfolio's expected, modeled return.

h. That the selected hedge or private equity strategy is consistent with implementation and monitoring constraints of the plan sponsor.

i. That the plan sponsor's investment policy statement contains the detail to define, implement, and monitor an investment in a hedge or private equity strategy.

j. That the plan sponsor can demonstrate that a due diligence process was followed in selecting the hedge or private equity strategy.

k. That the plan sponsor considered the impact an implementation in hedge or private equity may have on "safe harbor" procedures available to the fiduciary.

l. That the investment in hedge or private equity is appropriate for the portfolio size.

m. That the fiduciary will receive periodic reports which compare the investment performance of the hedge or private equity strategy to an appropriate index, peer group, and objectives outlined in the fiduciary's investment policy statement.

n. That the plan sponsor has made periodic reviews of qualitative and/or organizational changes of the hedge or private equity manager.

o. That the plan sponsor has the ability to periodically review the hedge or private equity manager's policies for best execution, "soft dollars," and proxy voting.

p. That the fees for the hedge or private equity fund are reasonable, and are consistent with agreements and with all applicable laws.

q. That "finder's fees" and other forms of compensation that may have been paid for asset placement are appropriately applied, utilized, and documented by the hedge or private equity manager.

Unfortunately, a majority of investment fiduciaries would not be able to demonstrate this level of procedural prudence.

Evidence also has begun to surface that many hedge fund strategies are converging to resemble long, buy-and-hold strategies utilized by traditional mutual fund managers. In other words, the investment fiduciary could pursue a substantially similar risk/return profile to what is offered by a hedge fund by selecting a mutual fund with substantially lower fees.

To what extent do net returns need to be reduced by higher fees before an investment fiduciary would determine that a particular investment was no longer prudent?

I don't know. The irrational exuberance exhibited by many plan sponsors makes it difficult to calculate a net return that would cause plan sponsors to give more careful consideration to their investment decisions in hedge and private equity strategies.

2. Mr. Trone, you stated in your testimony that investment fiduciaries are not capable of modeling a hedge fund's risk and return due to the lack of transparency. Mr. Trone, do you believe hedge funds should be registered with the SEC, and if so, why?

I believe there should be a central depository of information on hedge and private equity managers, and the information should be readily accessible to the public. Unfortunately, if the SEC is the designated depository, I believe the public will mistakenly think that the SEC has vetted the services of those hedge and private equity managers that are registered, and the public may be led to believe that the services of the registered managers are "suitable." This may be case where a private contractor hired by the Government to maintain the database may be a better alternative.

To what extent is the transparency of the funds themselves improved by a fund manager going public?

I don't believe transparency is improved since the details of the investment strategies being employed by the private equity manager do not need to be revealed in the public disclosure documents. On a related issue

Question from Senator Hatch

Mr. Trone, the main message I understood from your testimony is that the current level of taxation of carried interest is not the major issue here, but rather the inappropriate use of private equity and hedge funds as investments for retirement funds, and that because these investments are in a speculative bubble, any increase in the tax on carried interest will have little, if any, impact. Is this correct?

That's correct. A tax on hedge funds and private equity likely will have no more impact on the inappropriate use of these investment strategies than a hike in the capital gains tax would have had on investors during the dot-com bubble. Unfortunately, in many cases where investment fiduciaries have invested in hedge funds and private equity, speculative hubris has supplanted procedural prudence.

Questions from Senator Smith

The Oregon Public Employees Retirement Fund has about $7 billion invested in private equity funds. These funds have performed well for the fund. For 2006, the fund's private equity investments had a 25.1 percent return. For 2005, it was 38.8 percent.

Some have argued that a change in the taxation of carried interest may have a negative impact on the returns of pension funds that invest in alternative asset funds, such as private equity. And I certainly don't want Congress to do anything that would negatively impact the investment returns of the Oregon Public Employees Retirement Fund.

What are your thoughts on whether a change in the taxation of carried interest would negatively impact the returns of pension funds that invest in private equity funds?

Yes, I do believe a tax would have the effect of reducing returns. However, I am not an economist and would not be able to even venture a guess as to the net effect.

When a business is hit with new fees, regulations or taxes, is it normal that these costs are ultimately passed on to the consumer – or in this case the investor?

Again, not being an economist, I can only provide an unqualified opinion: It's subject to free market operations. When there is stiff competition in a services sector, the new fees are probably absorbed by the vendor so that the vendor's fees remain competitive. In the case of hedge and private equity managers, money is being thrown at these funds and managers don't seem compelled to offer competitive pricing. In other words, I suspect most hedge and private equity managers would pass the tax on to investors.

Communication

Statement for the Record
of the
American Federation of Labor and Congress of Industrial Organizations
815 16th Street, NW
Washington, DC 20006

Hearing on Carried Interest, Part III: Pension Issues
United States Senate Committee on Finance
September 6, 2007

The AFL-CIO appreciates the opportunity to present our views as to whether ending the preferential tax treatment enjoyed by a select group of investment managers may impact pension fund returns. As the representative of 10 million working Americans who rely on pension funds and 401(k) plans for their future retirements, the AFL-CIO is engaged in an ongoing effort to promote public policy and corporate governance practices that protect our members' retirement security. The AFL-CIO strongly supports the current efforts in Congress to restore some measure of equity to the tax code by requiring hedge fund and private equity real estate and hedge fund managers to pay their fair share in taxes. We believe that both the Levin-Rangel bill, H.R. 2834, and the Grassley-Baucus bill, S.1624, would provide badly needed correctives to a tax system that has become grossly unfair.

Union members participate in benefit plans with more than $5 trillion in assets; union-sponsored pension plans hold approximately $400 billion in assets. In our view, the tax legislation being considered in both the Senate and the House of Representatives poses no threat to pension funds' returns on investments in private equity, real estate, and hedge funds.

The Levin-Rangel bill requires investment managers to pay ordinary income tax rates on their wages like all other Americans, while the Grassley-Baucus bill requires private equity firms and hedge funds that go public to either provide investors with the protections they are entitled to under the Investment Company Act or pay corporate taxes on their earnings.

Those opposed to taxing carried interest as ordinary income have advanced a variety of arguments, including arguments against further complicating the tax code and arguments about international competitiveness and capital formation. The real estate industry has gone so far as to link tax breaks for the wealthy with urban renewal programs. Each of these arguments has proved to be ill-founded and self-serving.

As to the focus of this hearing, i.e. whether changing the tax code would have a deleterious effect on pension fund returns, the AFL-CIO strongly agrees with the assessment of Orin Kramer, Hedge-Fund Manager and Chairman of the New Jersey State

Investment Council: "The argument that this is about the interests of retired public employees is ludicrous."[1]

The Levin-Rangel bill would require managers of certain private partnerships to pay ordinary income-tax rates of as much as 35% on "carried interest" which currently is taxed at the 15% long-term capital-gains rate. Carried interest, like performance bonuses, stock options, and restricted stock grants is a form of compensation intended to create an alignment of interest between investment managers and their clients. Carried interest, however, is the only form of incentive compensation that receives long-term capital gains tax treatment without limitations.[2] Changing the law so as to tax carried interest as ordinary income would simply remove an illogical and unjustified tax subsidy enjoyed by some of the wealthiest Americans.

The argument that requiring investment managers to pay their fair share in taxes would lower returns to pension funds and other investors because managers would, consequently, charge higher fees is not credible. Investment managers are prohibited from raising fees for current investors, as the fees are contractually established between the investor and the manager when the investor agrees to invest in a fund.

As to future investment, the firms will continue to charge what the market will bear. Current fees are already substantially higher than those charged by a wide range of money management alternatives—including bank trusts, insurance company separate accounts, and mutual funds. It is hard to imagine that alternative investment managers could command higher fees than they charge now – at some point the costs would outweigh the opportunity to earn higher-than-average returns and pension funds would simply invest their money elsewhere. The likelihood that pension funds would agree to pay higher fees becomes even more remote as interest rates rise and the credit markets tighten because these market factors make it more difficult to generate high returns using investment strategies that rely on borrowing, as private equity, real estate, and hedge funds do.

Opponents have also argued that, if carried interest is taxed as ordinary income, alternative investment managers will have less incentive to work hard and maximize returns for their investors. This argument is an insult to the working Americans who do their best each day despite having to pay ordinary income tax rates. It is hard to imagine that individuals who have the opportunity to earn tens, if not hundreds, of millions of pre-tax dollars would forego that opportunity because they might have to pay ordinary income tax rates rather than a subsidized capital gains rate.

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[1] See "Buyout Firms' Tax Rise Wouldn't Hurt Workers, Pension Funds Say," Bloomberg News, July 11, 2007. http://www.bloomberg.com/apps/news?pid=20601103&sid=aqyXkfhsNZmY&refer=us.

[2] §83 of the Internal Revenue Code requires employees who receive property, including stock, in exchange for services to either pay ordinary income taxes on the value of the property at the time they receive it and recognize any appreciation thereafter as capital gains or wait until they liquidate the property and then recognize the full amount they receive as ordinary income.
Under §422(d) of the Internal Revenue Code, employees who receive incentive stock options may recognize $100,00 worth of these options as capital gains each year.

Furthermore, the Grassley-Baucus bill would have no impact on the taxes paid by pension funds on returns from investments in private equity, hedge funds or similar alternative investment strategies. It would affect only those pension funds that buy units of publicly-traded asset management firms because these firms would have to pay entity-level taxes before making distributions to their investors. This tax treatment is no different than that required of traditional public companies that are required to pay taxes on their profits before paying out dividends. It is also unlikely that pension funds would invest in publicly-traded partnerships because, as institutional investors, they may invest directly in the private equity, real estate and hedge funds managed by these firms. Direct investors are entitled to preferred returns, are owed fiduciary duties by the investment managers, and have greater access to their individual money managers.

In sum, the AFL-CIO sees no valid justification for the individuals who manage private equity, real estate, and hedge funds to receive tax subsidies that leave the burden of paying ordinary tax rates to working people. The status quo imposes a real cost on working Americans—effectively using the tax system to redistribute wealth from working people to the wealthiest Americans.