Testimony Concerning The Tax Treatment of Compensation Paid to Hedge, Private Equity and Venture Capital Fund Managers

Darryll K. Jones
Professor of Law
Stetson University School of Law
1401 61st Street South
Gulfport, Florida 33707

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

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[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

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[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.