Carried Interest Taxation and Pensions

Testimony before the Committee on Finance, U.S. Senate

by

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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

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[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.