


The Impact of Increasing Carried Interest Tax Rates of the U.S. Economy

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In today's polarized political climate leading up to the 2008 elections, a number of presidential candidates and members of Congress have singled out private equity sponsors, venture capital funds, hedge funds, and other businesses organized using limited partnership structures for punitive attention. They are proposing more than doubling income tax rates on the general partner's contractual share of profits, known as "carried interest," from long-term capital gains rates to ordinary income levels.

On October 25, 2007, Chairman Rangel of the House Committee on Ways and Means proposed a tax bill that the *New York Times* described as "a massive overhaul of the American tax system with serious implications for the private equity and hedge funds industries."¹ Then, on November 1, 2007, the House Ways and Means Committee passed H.R. 3996, an \$81 billion tax package billed as the "Temporary Tax Relief Act of 2007," on a 22–13 party-line vote.² This bill contained a provision to tax all general partner income, including the long-term capital gains component, as ordinary income—which, according to their calculus, would raise \$25.6 billion in tax revenues over 10 years. Treasury Secretary Henry M. Paulson, Jr., has said that the White House opposes the plan, asserting in a statement that it "would dramatically raise taxes in ways that in my

judgment would hinder America's ability to compete in the global economy."³

It may not be a coincidence that the Dow Jones Industrial Average Index fell 360 points the same day. Or that the same week, reflecting the climate of rising tax rates, Cisco announced a strategic initiative with state-owned China Development Bank to invest in innovative high-growth Chinese companies; Morgan Stanley announced that it raised a \$1.5 billion Asia private equity fund; the China Investment Corporation announced it was in discussions to buy stakes in three more large U.S. private equity funds; Carlyle laid out its China strategy; CITIC, China's largest securities firm, said that it would buy a stake in Bear Stearns; General Motors announced it would build a major R&D operation in China; and Ford announced R&D alliances with two Chinese Universities. And all this is taking place at a time when the U.S. capital markets are caught in the grip of the sub-prime mortgage crisis, banks are trying to deal with \$300 in illiquid leveraged loan commitments, and analysts are worried about the possibility of recession.

The U.S. Chamber of Commerce, in an effort to better understand how carried interest affects the U.S. economy as a whole and how different sectors and industries may be affected by the proposed tax increase, commissioned Rutledge Capital to conduct

a study of these issues. In early September, the Chamber released Part 1 of the study,⁴ which presented a preliminary macro-level survey of the impacts of proposed changes in the treatment of carried interest. This article summarizes the key issues and presents the results.

WHAT IS CARRIED INTEREST?

Carried interest arises when two or more investors who bring different skills and assets to the venture come together to form a new business venture or investment project. A real estate developer, for example, may have an idea for a project, project plans, ability to get zoning approvals, know-how, an organization, a network of trusted people, and a reputation for quality—but not adequate funds to develop the project. A pension fund, university endowment, insurance company, or other investor may have the money to finance the project but lack the entrepreneurial assets brought by the developer.

The Limited Partnership Structure

A half-century ago, in order to encourage entrepreneurship and capital formation, Congress created a flexible investment vehicle that these parties could use to work together. That vehicle is the partnership, to which each partner contributes unique assets; the partners have great flexibility to divide up the gains from their investment in any way they deem appropriate, and all income to the partnership flows through the partnership to be taxed to the individual partners, based solely on the character of the income—ordinary income, dividends, interest, fees, short-term capital gains or long-term capital gains—that the partnership receives in the course of its business.

Since its inception, the partnership structure has been a resounding success, giving American investors and entrepreneurs the tools to create and grow businesses; build housing developments, shopping centers, and hospitals; develop oil and gas fields; start new technology companies; and finance mergers and acquisitions.

In 2005, based on the most recent publicly available data on partnership tax returns from the Internal Revenue Service, 16.2 million American investors were partners in 2.8 million partnerships holding \$13.7 trillion in assets to engage in business and investment ventures in every sector of the American economy.

Rutledge Capital estimates, based upon the most recent Federal Reserve Board flow of funds data,⁵ put total assets invested in American partnerships at \$15.3 trillion in Q3 2007. These \$15.3 trillion dollars of assets underpin the market values of the \$69.2 trillion of stocks, bonds, mortgages, mutual funds, real estate and other assets owned by American households and nonprofit organizations.⁶

When creating and structuring investment partnerships that have a life of 5–10 years or more, investors work hard to make sure that the interests of the various partners are aligned to avoid later potential conflicts. Limited partners, like the financial investor in the above property development example, may put up 90–99% of the financial capital but lack the intangible entrepreneurial assets to carry out a successful project. Because of this, they typically agree to carve out a portion—usually 20%—of the ultimate gains of a project for the general partner, who may contribute only 1–10% of the financial capital. This is done in recognition of the fact that the reputation, network, know-how and other intangible assets of the general partner are extremely valuable. General partners typically have more information about the operating details of an investment than the limited partners. To protect limited partners from conflicts due to this asymmetry of information, the partners often agree that the general partner must wait until the end of the partnership—after all of the limited partner's capital, partnership expenses and fees, and usually a preferred return have been paid—before the general partner receives their portion of the gain. These delayed payments, which are carried on the partnership's capital accounts until the end of the partnership, are referred to as the general partner's "carried interest."

In addition to carried interest, the general partner collects an annual management fee from the partnership—usually 2% of total committed capital per year—as compensation for the work of managing the partnership's activities and maintenance and may collect additional fees for investment banking activities and advisory services to portfolio companies. Such management fees are, and always have been, treated as ordinary income and taxed at ordinary income tax rates.

Under well-established tax principles, all partnership income is passed through to the individuals making up the partnerships based solely on the character of the income received. To the degree the partnership receives fees or interest payments all partners—general

and limited—will be taxed at ordinary income rates. To the degree the partnership receives long-term capital gains or short-term capital gains, the partners will pay taxes on that income in the appropriate way.

According to University of Chicago's David Weisbach, this is in accord with the long-accepted principle of partnership taxation that the existence of the partnership structure should matter as little as possible to its tax treatment; i.e., the tax results from operating the partnership "should vary as little as possible from the results that the partners would get if they engaged directly in partnership activity."⁷ A recent study by Andrew Metrick and Ayako Yasuda of the Wharton School showed that management fees for a typical private equity fund make up about 2/3 of the total value received by general partners over the life of the partnership, with the remaining 1/3 comprised of carried interest.⁸

To the extent that carried interest is composed of income from dividends, interest, fees for services, or short-term capital gains, it is taxed at ordinary income tax rates of up to 35%. The remaining portion of carried interest, arising from the partnership's long-term capital gains—less than 1/3 of total general partner earnings—is taxed at the long-term capital gains tax rate, which is currently 15%.

Economics of a Limited Partnership

General and limited partners do not have identical interests, assets, or abilities. Instead, they share a conviction that, together, they can successfully pursue an opportunity that no single partner or class of partners can achieve alone. In order to better align their interests, general and limited partners create a partnership agreement to govern their behavior and relationship during the period of the venture.

Partnership agreements are negotiated at arms length, sometimes over many months, between the general partner and one or more lead representatives of the limited partners, often the largest initial investor with many years of experience. In addition to the annual management fee (often 2% per year during the initial investment period and less for the remainder of the fund) and the size of the carried interest allocation to the general partner (often 20% of net profits), there are a myriad of other parameters and conditions that must be negotiated in a partnership agreement including 1) the term of the partnership, 2) the length of the investment period,

3) whether capital commitments are funded initially or called when investments are made, 4) the hurdle rate, often 8–10%, 5) the allocation of partnership expenses, 6) and the disposition of fees from portfolio companies and investment banking activities, 7) the method of calculating capital accounts, 8) rates of return and carried interest, 9) provisions regarding key partners, and 10) procedures for winding up the activities of the fund.

While each partnership agreement is unique, Exhibit 1 illustrates the economics of a representative limited partnership, depicting the order in which partners receive distributions. In this example, we assume that a partnership makes only one investment at the beginning of the fund, holds the investment for three years, then sells the investment and distributes the proceeds according to the partnership agreement.

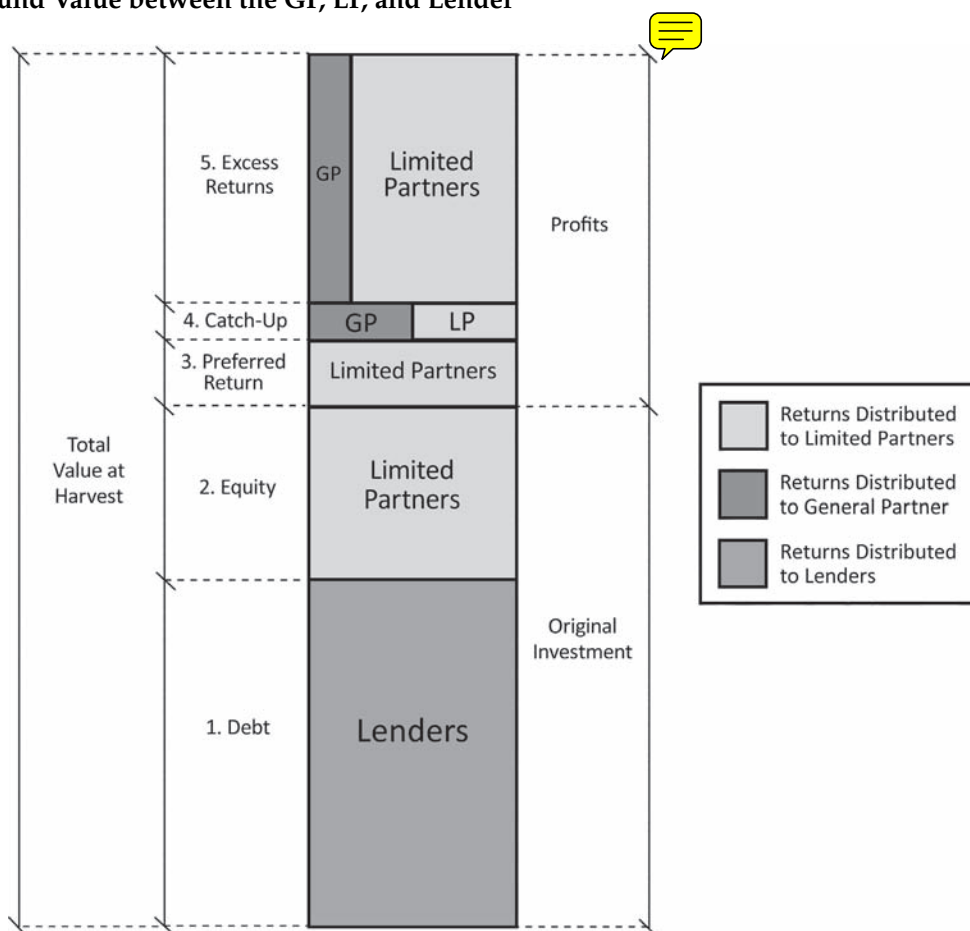
As shown in Exhibit 1, when the general partner sells the investment for "Total Value at Harvest," represented by the entire amount, they first pay the Lenders, representing principal and interest on any money borrowed to fund the original investment. Then the limited partners receive an amount equal to their original investment plus the management fees paid by the fund to the general partner over the course of the fund, represented. Next the limited partners receive their Preferred Return, calculated by compounding the hurdle rate as an interest charge on all capital and fees over the life of the investment. If the hurdle rate is 10%, for example, and the capital was invested for three years, the preferred return would be 33% of the total equity investment. At this point, the general partner has not received any carried interest.

After limited partners have received their initial investment and preferred return, the general partner enjoys a Catch-Up return period, in which the GP collects more than 20% of the incremental gains (in this example, 50%) until they have collected sufficient carried interest to make total carried interest equal to 20% of total profits. Above that, further gains are split 80/20 between the limited partner and general partner.

Note where the general partner appears in the capital structure—last in line. This means their share of gains is more risky than the return of the limited partners. This gives the general partner powerful incentives to maximize the value of the investment. Generally, companies owned and governed by private equity investors enjoy a significant performance advantage over other companies.

EXHIBIT 1

Allocation of Fund Value between the GP, LP, and Lender



Metrick and Yasuda [2007] analyzed confidential data from one of the largest pension fund investors to estimate distributions of the parameters of partnership agreements for 238 venture and buyout funds raised between 1992 and 2006. They used these estimates to report statistics about the compensation of private equity partners and professionals, including present values of management fees, revenue, and carried interest per \$100 of committed capital in the fund. Their results, shown in Exhibit 2 and shown as summarized in a 2007 paper by the Joint Committee on Taxation in Exhibit 3, are that carried interest payments make up 37.7% of venture revenues and 31.1% of buyout revenues. This constitutes an upper bound on the amount of income that could be taxed at long-term capital gains rates, because some portion of the gains reported as carried interest was received by the partnership in the form of interest, dividends, or fees, all of which are taxed at ordinary income tax rates.

Recent Trends

As seen in Exhibit 4, American investors organize partnerships for all kinds of business and investment ventures. For example, in 2005, the most recent year available, the Internal Revenue Service reports that there were 2.8 million partnerships doing business across all industries, made up of 16.2 people acting as partners; the total assets held by these partnerships added up to \$13.7 trillion. These same partnerships reported \$42.6 billion in short-term capital gains and \$277.7 billion in long-term capital gains—86.7% of their total capital gains were long-term capital gains.

Examining the partnerships separated into various sectors, one can see that the largest category of partnerships, by assets, is security and financial partnerships. There, 2.9 million people were partners in 219,171 partnerships, which held \$6.5 trillion of financial assets

EXHIBIT 2

Revenue Estimates

Venture Capital Fund Characteristics (94 funds)				
Present Value of	Mean	25%	Median	75%
Carry per \$100	\$8.98	\$8.40	\$8.86	\$9.32
Management fees per \$100	\$14.80	\$12.04	\$14.61	\$26.69
Total revenue per \$100	\$23.78	\$20.92	\$23.50	\$17.61
Carry per partner	\$7.04	\$2.14	\$4.45	\$7.68
Management fees per partner	\$10.57	\$3.69	\$7.13	\$12.67
Total revenue per partner	\$17.61	\$5.74	\$11.21	\$19.99
Carry per professional	\$2.69	\$1.09	\$1.95	\$3.43
Management fees per professional	\$4.19	\$1.73	\$3.43	\$5.20
Total revenue per professional	\$6.87	\$2.76	\$5.68	\$8.56

Buyout Firm Characteristics (144 funds)				
Present Value of	Mean	25%	Median	75%
Carry per \$100	\$5.41	\$4.98	\$5.35	\$5.93
Variable revenue per \$100	\$7.54	\$6.29	\$7.46	\$8.46
Management fees per \$100	\$10.35	\$8.77	\$10.34	\$11.65
Fixed revenue per \$100	\$12.22	\$10.11	\$11.78	\$14.02
Total revenue per \$100	\$19.76	\$16.49	\$19.36	\$22.56
Carry per partner	\$10.27	\$3.38	\$6.27	\$12.73
Variable revenue per partner	\$14.21	\$4.25	\$8.94	\$17.94
Management fees per partner	\$18.47	\$6.85	\$12.93	\$24.33
Fixed revenue per partner	\$21.70	\$7.15	\$14.63	\$27.35
Total revenue per partner	\$35.93	\$11.38	\$24.07	\$46.57
Carry per professional	\$3.54	\$1.27	\$2.32	\$3.80
Variable revenue per professional	\$4.92	\$1.94	\$3.31	\$5.69
Management fees per professional	\$6.52	\$2.74	\$4.67	\$7.41
Fixed revenue per professional	\$7.66	\$3.39	\$5.25	\$8.77
Total revenue per professional	\$12.58	\$5.21	\$8.56	\$14.72

Source: Metrick and Yasuda, "The Economics of Private Equity Funds."

EXHIBIT 3

Present Value of Partner Revenue

Present Value of:	Mean of 94 Venture Capital Funds	Mean of 144 Buyout Funds
Carry per \$100 invested (\$)	8.98	5.41
Fees per \$100 (\$)	14.80	11.91
Total revenue per \$100 (\$)	23.78	17.37
Fund Size (\$ millions)	322.00	1,238.00

Source: Calculations based on Metrick and Yasuda, "The Economics of Private Equity Funds."

EXHIBIT 4

Limited Partnership Composition, 2005

Item	All Industries	Construction and Manufacturing	Retail and Wholesale Trade	Securities, commodity contracts and other financial investments	Funds, Trusts, and other Financial Vehicles	Real Estate and Rental and Leasing
Number of Partnership.....	2,763,625	226,981	189,976	219,171	42,499	1,295,948
Number of Partners.....	16,211,908	747,614	734,234	2,916,021	381,051	6,460,956
Total Assets.....	13,734,256,305	692,146,826	230,873,076	6,493,379,458	896,854,569	3,100,977,800
Total Income.....	3,553,589,456	999,701,295	766,156,493	219,930,480	8,858,762	184,803,494
Net Short-Term Capital Gain.....	42,563,416	171,017	15,005	34,040,461	3,334,016	3,729,917
Net Long-Term Capital Gain.....	277,651,703	3,866,355	672,712	171,818,522	27,454,702	45,049,435
Portfolio Income Distributed directly to Partners.....	535,267,067	7,895,565	1,869,981	328,110,297	56,278,458	72,134,260
Long-Term Capital Gain as % of Total Capital Gain.....	86.7%	95.8%	97.8%	83.5%	89.2%	92.4%
% Portfolio Income Coming from Long-Term Capital Gains.....	51.9%	49.0%	36.0%	52.4%	48.8%	62.5%
% Portfolio Income Taxed as Ordinary Income.....	48.1%	51.0%	64.0%	47.6%	51.2%	37.5%

Item	Professional, Scientific and Technical Services	Health Care, Education and Social Assistance	Arts, Entertainment, and Recreation	Accommodation and Food Services	Agriculture, Forestry, Fishing, Hunting and Mining	Others
Number of Partnerships.....	170,245	70,544	49,267	96,004	155,810	247,180
Number of Partners.....	611,046	328,770	332,198	388,076	974,783	2,337,159
Total Assets.....	131,302,194	82,518,305	65,870,456	169,544,802	283,733,118	1,587,055,701
Total Income.....	279,567,822	142,702,225	44,000,084	128,039,831	117,463,376	662,365,594
Net Short-Term Capital Gain.....	243,123	-2,007	-82,194	22,743	319,256	772,079
Net Long-Term Capital Gain.....	3,223,857	996,173	1,103,483	1,094,689	3,002,256	19,369,519
Portfolio Income Distributed directly to Partners.....	6,326,423	1,377,854	1,327,363	1,726,318	9,458,809	48,761,739
Long-Term Capital Gain as % of Total Capital Gain.....	93.0%	100.2%	108.0%	98.0%	90.4%	96.2%
% Portfolio Income Coming from Long-Term Capital Gains.....	51.0%	72.3%	83.1%	63.4%	31.7%	39.7%
% Portfolio Income Taxed as Ordinary Income.....	49.0%	27.7%	16.9%	36.6%	68.3%	60.3%

Note: Money amounts are in thousands of dollars.

Source: IRS Statistics of Income Division, Fall SOI Bulletin, September 2007.

like stock, bonds, private equity, venture capital, hedge funds, and trusts.

Partnerships are used in many other sectors as well, from healthcare to hotels, restaurants, and manufacturing, as seen in Exhibit 5.

Real estate activities dominate the number of partnerships, accounting for 46% of the total number—but many other sectors are represented, including Retail and wholesale trade; Construction and manufacturing; Agriculture, forestry, fishing, hunting, and mining; Hotels and food service; Arts, entertainment and recreation; Health care, education and social assistance; and Professional, scientific, and technical services.

More than 16.2 million people were partners in a limited partnership agreement in 2005. Almost half of them, 40% or 6.5 million people, were in real estate partnerships.

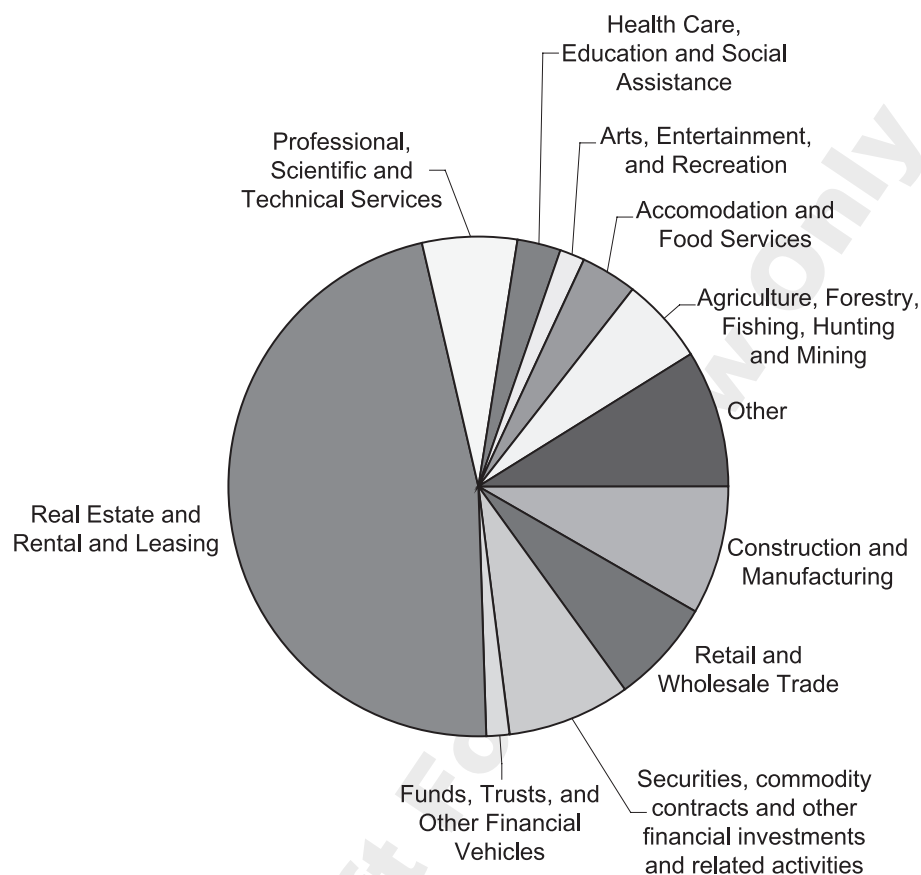
As shown in Exhibit 6, investment partnerships for the purpose of owning securities and financial assets are the largest component of total partnership assets, accounting for

\$6.5 trillion, or 46% of total assets. \$3.1 trillion (23%) in real estate assets makes up the second largest category.

The large share of financial assets relative to real estate and other hard assets reflects the trends in U.S. financial markets since 1981. Tax cuts on capital income and the sustained systematic decline in interest rates in an environment of subdued inflation caused investors to move a sizeable portion of their portfolios out of commodities, real estate, and other inflation hedge assets and into stocks, bonds, and mutual funds. This was the source of the quarter-century bull market the U.S. has enjoyed over this time. More recently, the reduction in dividend and capital gains rates in 2003 significantly increased the value of U.S. assets by raising their after-tax returns to investors. America's deep capital markets, the massive \$55.9 trillion net worth⁹ of American households, and flexible financing methods are important drivers in innovation and entrepreneurial activities, which support growth and job creation.

EXHIBIT 5

Number of Partnerships, 2005



Source: IRS Statistics of Income Division, Fall SOI Bulletin, September 2007.

In 2005, partnerships collected \$42.6 billion in short-term capital gains (see Exhibit 7A). More than three-quarters (79%) of short-term capital gains were collected by partnerships investing in securities with just 8% coming from funds, trusts, and other financial vehicles. Hedge fund gains are almost entirely short-term capital gains, which are taxed at ordinary income rates. Industry sources report that hedge funds turn over 35% of their securities each quarter, or 82.2% in less than one year.¹⁰ The implied mix of 82% short-term capital gains and 18% long-term capital gains would produce an average tax rate of 31.4% on total capital gains for hedge funds.

Securities partnerships make up the largest share of long-term capital gains (Exhibit 7B). Together with funds, trusts, and other finance vehicles, they make up 63% of total long-term capital gains collected by partnerships. This category is where we find most private

equity partnerships, including leveraged-buyouts, mezzanine financing, growth financing, and venture capital. All make investments they intend to hold over a number of years. Real estate partnerships are also responsible for a large share of long-term capital gains for the same reason—they own long-term assets.

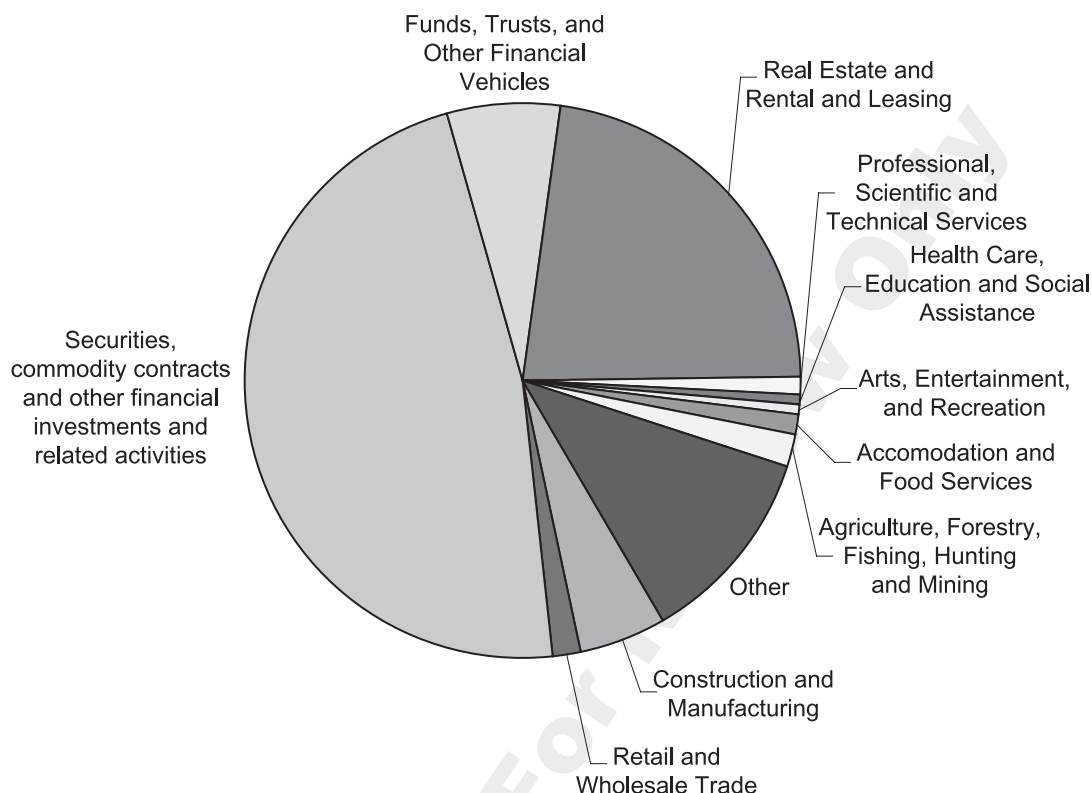
In 2005, the partners of limited partnership agreements collected \$535 billion in portfolio income, 62% of which was contributed by securities partnerships (Exhibit 8). Funds, trusts and other financial vehicles and Real Estate made up 11% and 14% of total portfolio income, respectively.

PROPOSED TAX INCREASES

On June 22, 2007, Representative Sander Levin, along with Representatives Charles Rangel and Barney

EXHIBIT 6

Total Assets of All Partnerships, 2005



Source: IRS Statistics of Income Division, Fall SOI Bulletin, September 2007.

Frank and a dozen other members of the House of Representatives, introduced H.R. 2834 to address “Investment Management Services Taxation,”¹¹ which could have a large potential impact on the economy and capital markets. The legislation would add a new Section 710 to the IRS Code of 1986, reclassifying the carried interest of an investment services partnership interest (ISPI) from capital gains to ordinary income tax treatment. It would also more than double tax rates on carried interest earned by general partners of investment partnerships—as well as on investment funds created as limited liability companies who choose to be taxed as partnerships—from the current long-term capital gains rate of 15% to the 35% ordinary income tax rate. Additionally, H.R. 2834 would limit the amount of losses available to managers of the partnerships; a net loss would be treated as an ordinary loss.

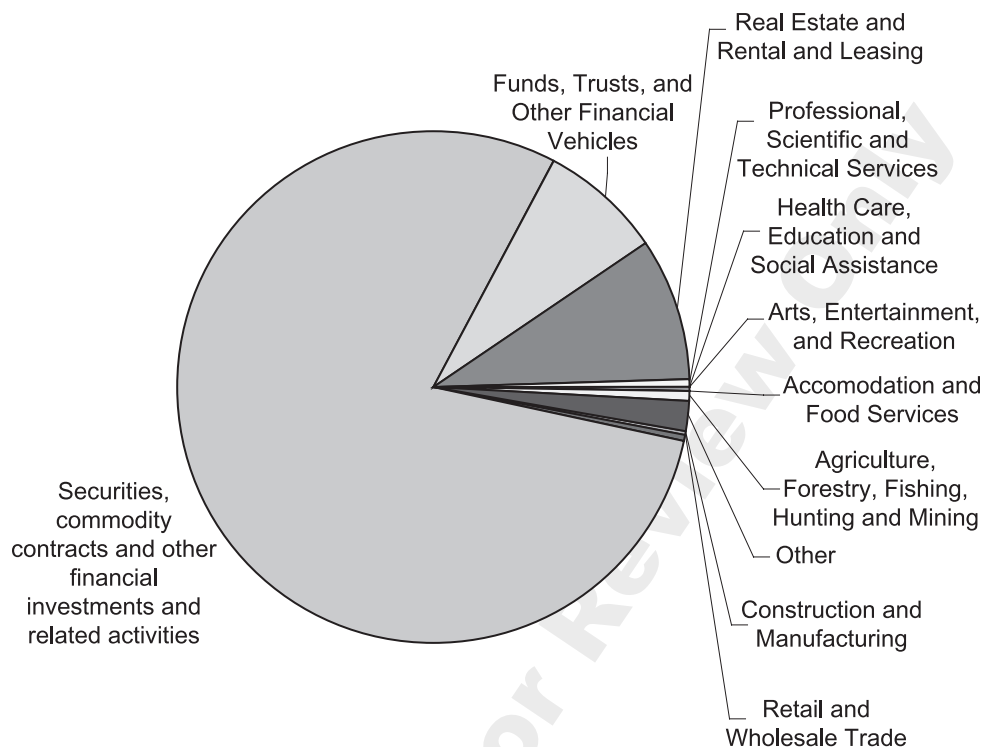
In the bill’s accompanying fact sheet, the bill’s sponsors state the tax increase will apply to “any investment

management firm without regard to the type of assets, whether they are financial assets or real estate.”¹² In addition to private equity funds, venture capital funds, and hedge funds, they will affect all investment partnerships including both real estate investment trusts (REITs) and publicly traded partnerships.

Alarmingly, House Committee on Ways and Means Chairman Charles Rangel announced that the tax increase may be applied retroactively to partnership agreements signed many years in the past, stating that “due to the potential erosion of our tax revenues in this case, my historic opposition to retroactive tax legislation may not apply.”¹³ This bill is such a stark departure from long-accepted tax principles that one law firm, in a communication to their clients and friends, stated: “This bill, if enacted, would have broad sweeping effects on the structure of investment funds and would represent a sea change in the private investment funds industry.”¹⁴

EXHIBIT 7A

Net Short-Term Capital Gain of All Partnerships, 2005



Source: IRS Statistics of Income Division, Fall SOI Bulletin, September 2007.

On October 25, Chairman Rangel of the House Committee on Ways and Means proposed a tax bill that the *New York Times* described as “a massive overhaul of the American tax system with serious implications for the private equity and hedge funds industries.”¹⁵

Then, on November 1, 2007, the House Committee on Ways and Means passed H.R. 3996, an \$81 billion tax package billed as the “Temporary Tax Relief Act of 2007,” on a 22–13 party-line vote. This bill contained a provision to tax all general partner income, including the long-term capital gains component, as ordinary income—which, according to their calculus, would raise \$25.6 billion in tax revenues over 10 years. Treasury Secretary Henry M. Paulson Jr. has said that the White House opposes the plan, asserting in a statement that it “would dramatically raise taxes in ways that in my judgment would hinder America’s ability to compete in the global economy.”¹⁶

The Senate Committee on Finance held three hearings on the subject of carried interest; the first on July 11,¹⁷ the second on July 31, and the third on

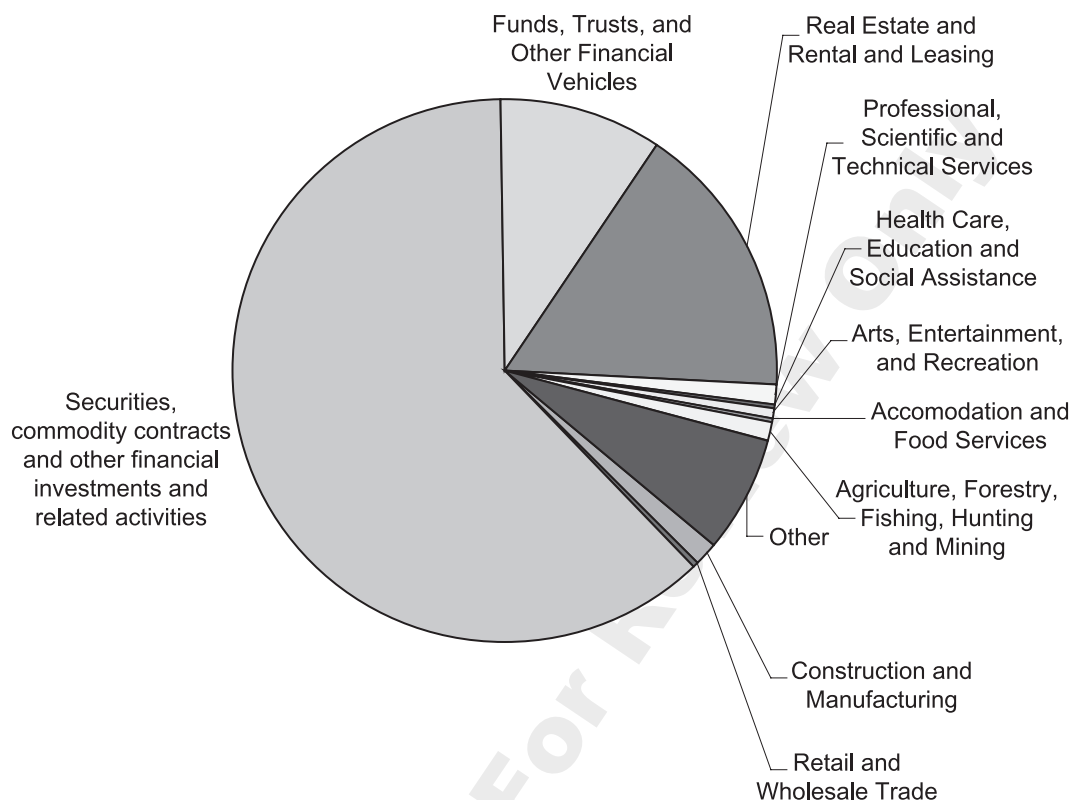
September 6.¹⁸ Senator Baucus, in his opening statement at the first hearing, stated the concern that “Some hedge fund managers and private equity managers are taking home more than \$100 million a year in what is called ‘carried interest income.’ And much of that income is taxed at the long-term capital gains rate of 15%.”¹⁹ The question arises, he continued, “are some people of great wealth merely taking advantage of the tax code to pay less than their full and proper share?”²⁰

Later in his testimony, Senator Baucus again refers to hedge funds, which “now manage nearly \$2 trillion in assets.”²¹ But hedge funds generally hold securities for very short times and pay ordinary income tax rates on short-term capital gains income, which makes up the bulk of their profits and carried interest.²² The rhetorical value of his statement is obvious—hedge fund managers are not paying their fair share of taxes. But the facts are clear; hedge funds are a minor factor in the issue of taxing long-term capital gains as carried interest.

Senator Baucus lay down a set of ground rules for the discussion that suggests he is fully aware of the

EXHIBIT 7 B

Net Long-Term Capital Gain of All Partnerships, 2005



Source: IRS Statistics of Income Division, Fall SOI Bulletin, September 2007.

critical importance of investment and capital formation for the American economy:

No matter what we may ultimately decide to do, we will in no way wish to change the interests of the limited partners. [...] Entrepreneurs create new jobs. We do not want to stifle the mother of invention. [...] We want to ensure that our entrepreneurial system continues to function well. We want to ensure that people are free to continue to create wealth.²³

Senator Grassley, in his statement, echoes many of the same ideas by stating what the inquiry and any proposal that it may produce is “not about”:

This bill [is not] an attack on capital formation [or] a tax increase on a single industry. [...] Not about raising taxes on capital income. [...]

Not an attack on the investor class. [...] Not a revenue grab from private equity firms or hedge funds. [...] Not about well-settled tax policy principles regarding capital assets, or the propriety of current law capital gains rates.²⁴

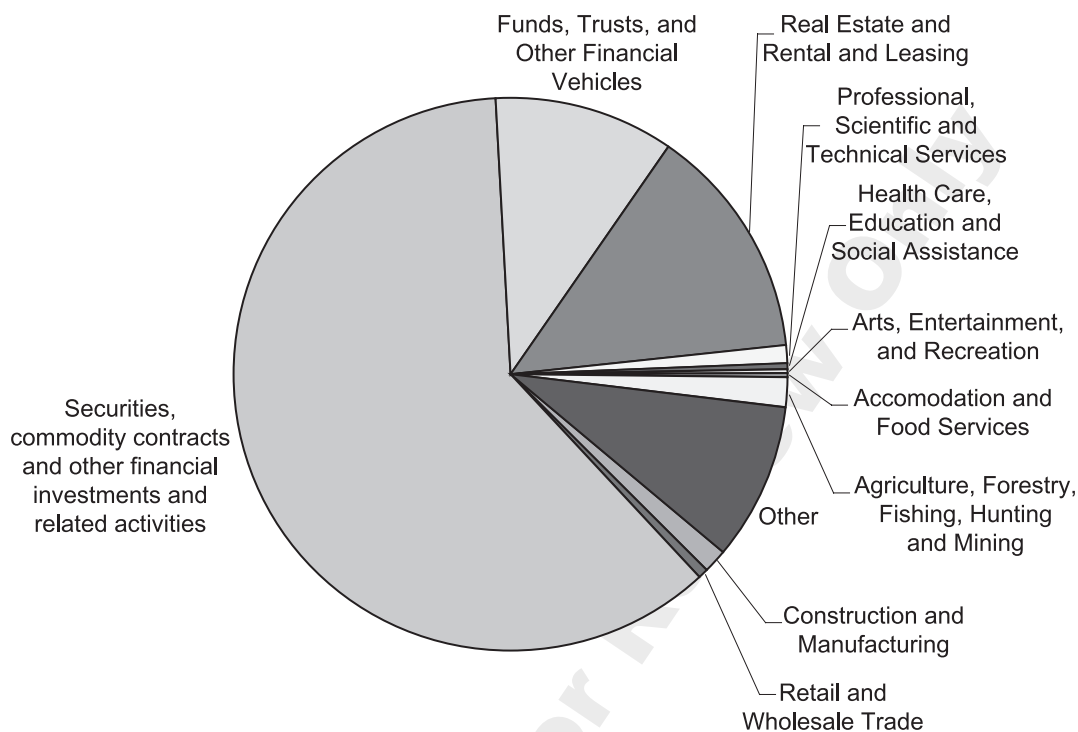
Senator Grassley reminds us that “keeping taxes low on investment returns is sound tax policy.” And later, that “lower taxes on capital gains and corporations can help American businesses compete in the global economy.”²⁵

These are important and worthy principles. It is the conclusion of this report, however, that the proposal to increase tax rates on America’s partnerships would violate every one of them.

The durability, flexibility, and tax treatment of the partnership as the dominant vehicle for undertaking new business and investment ventures is the cornerstone

EXHIBIT 8

Portfolio Income Distributed to Partners of All Partnerships, 2005



Source: IRS Statistics of Income Division, Fall SOI Bulletin, September 2007.

of the American business and investment model. The partnership is in no small measure responsible for the innovation, entrepreneurial activity and growth that have made U.S. capital markets and the U.S. economy the envy of every country in the world. We must be cautious if we want to remain the preeminent country in the global economy.

WHO WILL BEAR THE BURDEN OF THE TAX?

To the extent new revenues are generated by the tax increase it is important to ask who will pay them. The comments in Senator Baucus and Senator Grassley's statements suggest that the higher tax rates they propose can be crafted to fall solely on the (wealthy) shoulders of private equity sponsors without reducing the returns of the pension funds and their retirees or the university endowments and their students and without any negative effects on capital formation or entrepreneurial activity. Unfortunately, that is not how economics work.

Every undergraduate student learns in their first semester of Economics 101 that the incidence of a tax depends on the elasticity, or price sensitivity, of the buyers and sellers—in this case the limited partners and general partners—not on who is taxed. In this case, general partners will pay through lower after-tax gains, limited partners will pay through higher partnership costs and lower returns, beneficiaries will pay through lower pension benefits, and owners and managers of operating companies will pay through lower values for the companies they are working to build.

As Steve Forbes pointed out, “raising taxes on private equity doesn't just harm fund managers or investors—it also harms the companies that need private equity investments to bring their innovations to market, which, in turn, makes our entire economy less competitive.”²⁶

Higher tax rates also harm the limited partners who have massive amounts of their beneficiaries' money at stake. In 2006, the 20 largest pension funds invested in private equity represented 10.5 million retirees, scattered

across the country including plans from California, New York, Texas, Florida, New Jersey, Ohio, Pennsylvania and Michigan. Put together, these 10.5 million beneficiaries hold private equity investments that add up to \$111 billion. The 20 largest corporate pension plans in 2006, representing 3.8 million members and including AT&T, DaimlerChrysler, Boeing, GE, and TIAA-CREF, have a collective investment of \$44 billion in private equity funds.²⁷

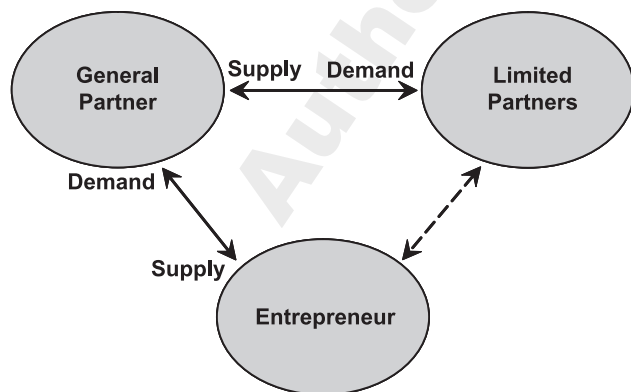
HOW WOULD A TAX AFFECT THE INVESTMENT MARKET?

Economic theory tells us that, irrespective of who pays the statutory burden of a tax, the true incidence of the tax will be shared among all of the participants in the economic activity based on the character of their market positions.

There are three players in the private equity market, as illustrated in Exhibit 9. The general partner is the sponsor; the limited partner supplies the capital; the entrepreneur on Main Street provides the business they are financing. All are affected by a tax increase.

The impact of the proposed tax increases will be determined by the relationships among the general partner, the limited partners, and the owner and managers of the business. First, we will discuss the impact on the general partner–limited partner relationship in the market for raising capital. Second, we will consider the supply–demand balance between the entrepreneur and general partner, respectively, whose impacts on the economy are arguably more important.

EXHIBIT 9
Dynamics of the Investment Market



The Market for Capital: The General Partner and Limited Partners

First, let's look at the market for raising capital to do private equity investments by focusing on the relationship between the general partners and the limited partners.

The general partner and limited partners make up a market where limited partners demand services provided by the general partner—sourcing and doing deals, and investing and monitoring the LPs' money in investment projects alongside their own. The GP is the supplier in this market. The relevant price—the terms of compensation in the partnership agreement—and the volume of activity are determined by market forces as shown in Exhibit 10 below.

The market equilibrium, represented by P_0 , is the “2 and 20” structure used by most investment funds today. This equilibrium is disturbed by a change in tax rates.

The GP's supply curve represents all the points at which the GP receives just enough compensation to make it worthwhile for him to provide a given quantity of services. When a tax is imposed on GP services, the GP's after-tax price has decreased by the amount of the tax and its supply curve must shift up to compensate.

The upward shift in the GP supply curve by the amount of the tax, however, does not mean that the GP gets to pass along the entire amount of the tax to the LP. The equilibrium price rises but not by the full amount of the tax. The result is a higher price and lower quantity than before the tax increase. General partners have a reduction in after-tax pay; limited partners face an increase in fees; and the size and number of funds raised will decrease.

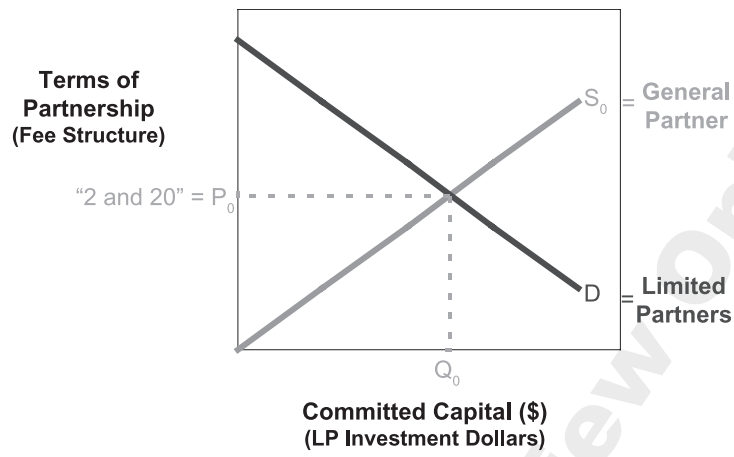
Who Pays the Tax?

When a tax is levied, the law dictates which party is legally responsible for paying the tax, known as the *statutory incidence* of the tax. But market forces dictate the *economic incidence* of the tax. The difference between the statutory incidence and economic incidence of the tax is referred to as tax shifting, and can be substantial.

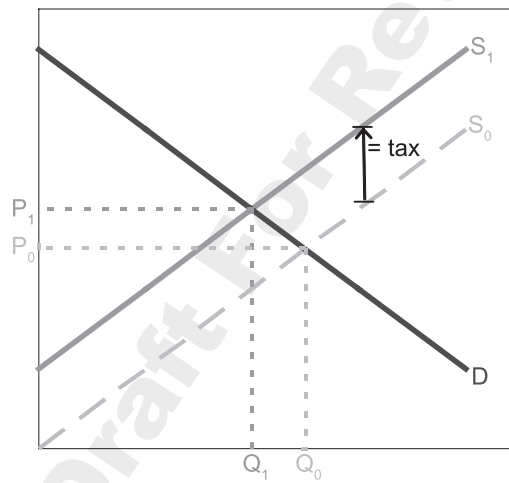
This is a universally-accepted economic principle found in any microeconomics textbook. In their textbook, *Microeconomics*, Katz and Rosen²⁸ describe the impact of tax shifting:

EXHIBIT 10

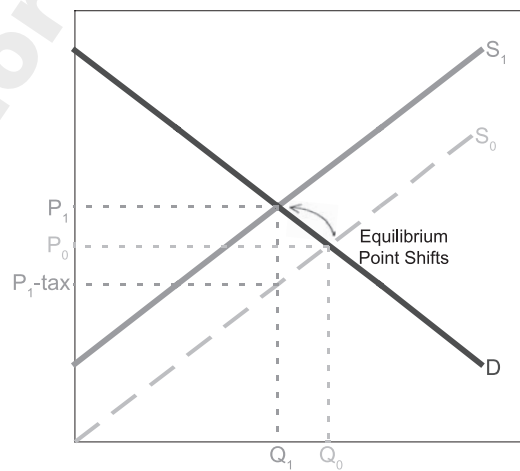
A. The GP-LP Investment Market



B. Higher Carried Interest Tax Rates



C. Market Impact



The statutory incidence of a tax tells us nothing of the economic incidence of the tax. It is irrelevant whether the tax collector (figuratively) stands next to the consumer and takes \$3 every time he or she buys a gallon of wine, or stands next to the seller and collects \$3 every time he or she sells a gallon [...] what matters is the size of the wedge that the tax introduces between the price paid by consumers and the price received by producers. It does not matter from which side the wedge is introduced. (p. ??)

It is thus not who the government decides is responsible for paying the tax but rather how the tax affects income distribution that makes a real impact on both the general partner and the limited partners.

If we know the properties (slopes or elasticities) of the supply and demand curves we can calculate the exact economic incidence of a tax.²⁹ But in the absence of such direct estimates, we are limited to qualitative statements about outcomes.

At the new equilibrium point, tax revenues equal the price of the GP's services multiplied by the amount of committed capital. These can be represented by the

area of the large shaded box in Exhibit 11,³⁰ since the vertical distance between the supply curves equals the amount of the tax.

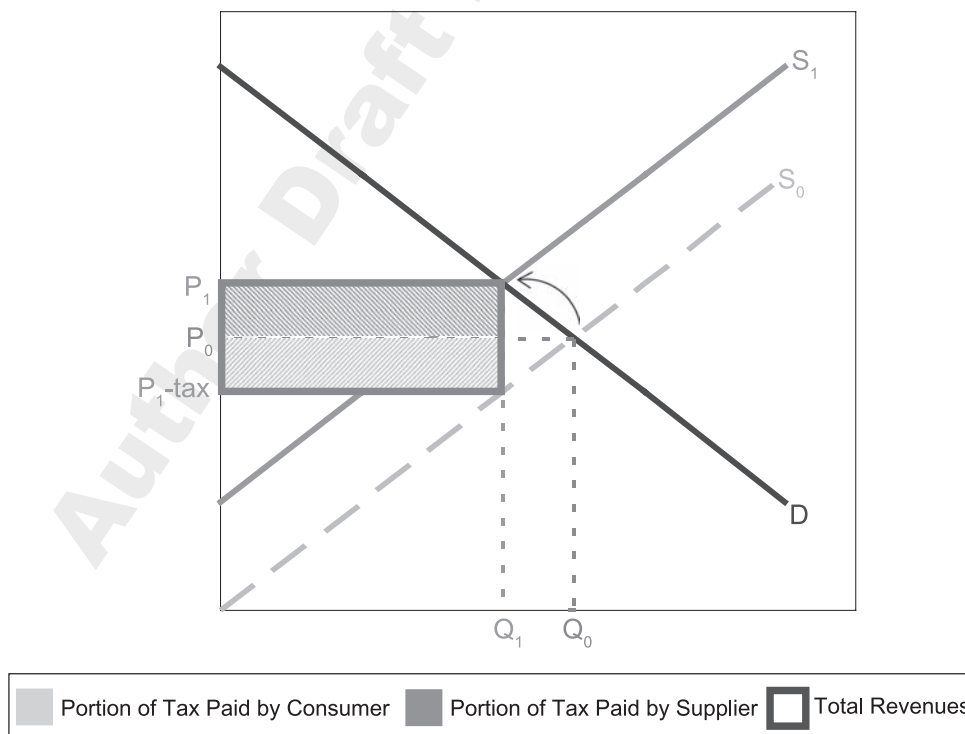
The total tax revenues rectangle described above can be broken down further into the taxes falling on each party by dividing the rectangle horizontally at the original equilibrium price P_0 . The consumer, in this case the limited partners, bear the cost of the shaded area above P_0 . The supplier, in this case the general partner, bears the cost of the tax in the shaded area below P_0 .

The distribution of the burden of the tax increase depends on each party's sensitivity to changes in price, i.e., on the slopes of their supply and demand functions.³¹ In all but the most extreme cases, in which one of the two curves is either perfectly inelastic/vertical or perfectly elastic/horizontal, the tax will be divided between producer and consumer.

SUMMARY AND CONCLUSION

Using language of closing a "tax loophole," members of Congress have proposed legislation that would significantly increase tax rates on capital deployed in

EXHIBIT 11 Breakdown of Tax Revenue Contributions



long-term investments in the United States. They are making a big mistake. Those who would raise tax rates risk undermining America's preeminent position in the world as a leader in invention, innovation, entrepreneurial activities, and growth. Selectively raising tax rates on the long-term capital gains of limited partnerships will drive capital offshore, reduce the productivity of American workers, and damage the ability of U.S. companies to compete in global markets. It will cost American jobs and reduce American incomes. In today's global economy, countries have to compete for the capital they need to grow. Raising tax rates on long-term capital gains of U.S. partnerships would hang a "not welcome here" sign on our door.

Meanwhile, foreign governments are waiting eagerly. They have learned that ample supplies of capital are the key to creating the rising incomes and economic growth that their people are demanding. They are becoming more capital-friendly every day, changing their tax and regulatory policies to reduce risk and increase returns for foreign investors who bring capital to their countries. They are waiting for us to make a mistake that would drive our capital offshore and into their welcoming arms. Raising tax rates on long-term capital gains for America's partnerships is just the mistake they have been waiting for.

As I write this final section, I am attending a financial forum in Beijing where high-ranking Chinese officials are working hard to convince major private equity, venture capital, real estate and energy investors from the U.S., Europe and the Gulf Region to relocate their offices, investment professionals and capital to China in order to fuel China's growth and create jobs for China's growing work force.

In the long run, the country with the most capital wins. America cannot afford to lose its source of capital. We should think twice before we give capital owners a reason to move their capital offshore.

ENDNOTES

¹See "The Rangel Tax Bill: The Reaction," *The New York Times* (October 25, 2007), <http://dealbook.blogs.nytimes.com/2007/10/25/the-rangel-tax-bill-the-reaction>.

²See <http://nationaljournal.com/pubs/congressdaily/>.

³See "The Rangel Tax Bill: The Reaction."

⁴The Executive Summary and full report are available for download at <http://www.uschamber.com/ccmc/default.htm?n=tb>.

⁵Federal Reserve, *Flow of Funds Accounts of the United States: Flows and Outstandings*, p. 67.

⁶Federal Reserve, *Flow of Funds Accounts of the United States: Flows and Outstandings*, p. 116, Table B.100.e, "Balance Sheets of Households and Nonprofit Organizations with Equity Detail"; Figures are for the end of 2006.

⁷David A. Weisbach, "The Taxation of Carried Interests in Private Equity Partnerships," working paper 2007, p. 39.

⁸Andrew Metrick and Ayako Yasuda, "The Economics of Private Equity Funds," *Swedish Institute for Financial Research Conference on the Economics of the Private Equity Market* (2007).

⁹Federal Reserve, *Flow of Funds Accounts of the United States: Flows and Outstandings*, p. 116; figure is for year-end 2006.

¹⁰Ed Easterling, "Hedge Funds: Myths and Facts," Crestmont Research (April 10, 2007).

¹¹Committee on Ways and Means, Press Release, "Levin, Democrats Introduce Legislation to End Carried Interest Tax Advantage" (June 22, 2007).

¹²S. Levin, "Levin and Democrats Introduce Legislation to End Carried Interest Tax Advantage," (Washington, DC: U.S. House of Representatives, June 22, 2007).

¹³House Committee on Ways and Means, "Rangel Applauds Senate Legislation on Publicly Traded Partnerships," (June 14, 2007): <http://waysandmeans.house.gov/news.asp?FormMode=release&id=525&keywords=rangel+applauds>.

¹⁴Proskauer Rose, "Congress Takes Formal Steps to Tax Carried Interest as Ordinary Income" (June 26, 2007): http://www.proskauer.com/news_publications/client_alerts/content/2007_06_26.

¹⁵See "The Rangel Tax Bill: The Reaction."

¹⁶See "The Rangel Tax Bill: The Reaction."

¹⁷E. Solomon, *Senate Finance Committee Hearing on Carried Interest I* (Washington, DC: U.S. Senate, July 11, 2007).

¹⁸Chuck Grassley, *Senate Finance Committee Hearing: Carried Interest II* (Washington, DC: U.S. Senate, July 31, 2007).

¹⁹Max Baucus, *Carried Interest I, Senate Finance Committee* (2007).

²⁰By "taking advantage of the tax code to code to pay less than their full and proper share," Senator Baucus means simply following current law when calculating their taxes.

²¹See Note 19.

²²See Easterling, "Hedge Funds: Myths and Facts." Hedge fund industry data suggest that hedge funds turn over roughly 35% of their portfolios every quarter, or 82% per year, which suggests that more than 80% of hedge fund profits and carried interest payments take the form of short-term capital gains, which are taxed at ordinary income rates.

²³See Note 19.

²⁴See Note 18.

²⁵See Note 18.

²⁶Steve Forbes, "Private Equity, Public Benefits," *The Wall Street Journal* (July 25, 2007): <http://online.wsj.com/article/SB118532670875877067.html>.

²⁷Private Equity Council, "Public Value: A Primer on Private Equity" (2007).

²⁸Michael L. Katz and Harvey S. Rosen, *Microeconomics*, 3rd ed. (New York: McGraw-Hill/Irwin, 1998).

²⁹Solving for the economic incidence of a tax on supply and demand curves of known equations can be executed as follows: Given demand and supply functions such that Demand = $P_d = 100 - 0.5Q_d$ and Supply = $P_s = 10 + 0.5Q_s$, we can solve to find the preliminary equilibrium point by setting the curves equal to one another such that $100 - 0.5Q_d = 10 + 0.5Q_s$, yielding the solution $Q = 90$ and $P = 55$. Now if we impose a tax on the supplier of \$6, the supplier's effective price is reduced by 6 and the supply curve shifts vertically upward by the amount of the tax to compensate, yielding a new supply curve: $P_s - 6 = 10 + 0.5Q_s$ or $P_s = 10 + 0.5Q_s$. If we now solve for the new equilibrium point by setting this new supply equation equal to the original demand function, such that $16 + 0.5Q_s = 100 - 0.5Q_d$, we find a new equilibrium solution of $Q = 84$ and $P = 58$. Since the consumer always pays the equilibrium price, the new price paid is \$58, which is only \$3 above the original equilibrium price of \$55.

The producer's effective price, however, is still \$6 less than the equilibrium price, so the producer now only receives \$52 per unit sold, \$3 below the original equilibrium price of \$55. Thus for each unit sold, both the consumer and the supplier are down an additional \$3, showing that in this case the tax is split equally between them while total quantity of goods sold is decreased from 90 to 84. The total amount of tax collected from this ordeal is equal to the amount of the tax multiplied by the new price, or $(6)(84) = \$504$ where the supplier and consumers' contribution are each $(3)(84) = \$252$, or exactly half of the total tax revenues. This example can be found in the textbook by *Teresa Bradley and Paul Patton, Essential Mathematics for Economics and Business*, 2nd Edition (New York: Wiley, 2002).

³⁰The points defining the rectangle are thus $(0, 0)$; $(0, P_1)$; (Q_1, P_1) ; and $(P_1 - \text{tax}, Q_1)$.

³¹The fraction of the tax paid by the consumer is given by the equation $[|m_d| / (|m_d| + |m_s|)]$, and the fraction of the tax paid by the supplier is given by the equation $[|m_s| / (|m_s| + |m_d|)]$ where m_d and m_s are the slopes of the demand and supply functions, respectively. For proof of these formulas, see *Teresa Bradley and Paul Patton, Essential Mathematics for Economics and Business*, 2nd ed. (New York: Wiley, 2002).

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