Statement for the Record
U.S. Chamber of Commerce

ON: FAIR AND EQUITABLE TAX POLICY FOR AMERICA'S WORKING FAMILIES

TO: THE COMMITTEE ON WAYS AND MEANS

DATE: SEPTEMBER 6, 2007

The Chamber's mission is to advance human progress through an economic,
political and social system based on individual freedom,
incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce, the world's largest business federation representing more than three million businesses and organizations of every size, sector, and region, is pleased to have the opportunity to express its views on the proposal to increase the tax rate on the general partner's share of a limited partnership's profits, known as carried interest, from the long-term capital gains rate of 15 percent to ordinary income tax rates of up to 35 percent.

The Chamber opposes this change. Advocates of this tax increase have sold the increase as targeting a few wealthy hedge fund managers; however, it stands to impact over 15.6 million individuals that are invested in 2.5 million partnerships. Carried interest is a core element of partnership finance in every sector of the U.S. economy engaged in capital formation, including real estate, private equity, hedge funds, healthcare, and retail. Raising the cost of doing business with these entities would make the capital markets less efficient at a time when the U.S. is facing fierce international tax competition.

This changes would undo decades of established tax law and lead to wholesale alterations in the structure of partnership agreements including loan-purchase arrangements and shifting general partner costs to investors and portfolio companies.

The incidence of a tax increase on carried interest would be spread across all the players in the partnership—general partners through lower after-tax gains, limited partners and their beneficiaries through higher partnership costs and lower returns, and owners and employees of portfolio companies as lower business valuations.

Selectively raising tax rates on the long-term capital gains of limited partnerships will drive capital offshore and reduce the productivity of American workers and the ability of U.S. companies to compete in global markets. In the long term, 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. Reducing partnership returns by raising tax rates would encourage investors to put their money elsewhere.

Background

The Chamber recently commissioned a study by economist Dr. John Rutledge on the use of partnerships and carried interest throughout the entire economy. Key findings of the study are summarized below. The full report can be found on the U.S. Chamber's website, www.uschamber.com/publications/reports.

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, in which each partner contributes their 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, short-term capital gains or long-term capital gains—that the partnership receives.

Since its inception, the partnership structure has been a resounding success, giving American investors and entrepreneurs the tools to create and grow businesses, build shopping centers, build hospitals, explore for oil and gas, found new technology companies, and finance mergers and acquisitions. In 2004, more than 15.6 million Americans were partners in 2.5 million partnerships investing $11.6 trillion through the partnership structure.[1] The assets held by partnerships grew from over $2 trillion in 1993 to $11.6 trillion in 2004, providing capital for the growth of the U.S. economy during that period. The partnership structure is, in no small measure, responsible for the innovation, entrepreneurial activity and growth that have made the U.S. capital market and economy the envy of every country in the world.

When creating and structuring partnerships that have a life of 5-10 years, investors work hard to make sure that the interests of the various partners are aligned to avoid potential conflicts later. Limited Partners may put up 90-99 percent of the financial capital but lack the intangible entrepreneurial assets to carry out a successful project, typically agree to carve out a portion—usually 20 percent—of the ultimate gains of a project for the general partner, who may contribute only 1-10 percent of the financial capital, in recognition of the fact that the reputation, network, know-how and other intangible assets of the general partner are extremely valuable. To further align their interests, 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—carried on the partnerships 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 percent of total committed capital per year—as compensation for the work of managing the partnership's activities. Such management fees are treated as ordinary income and taxed at ordinary income tax rates. According to a recent study by Andrew Metrick and Ayako Yasuda of the Wharton School, management fees for a typical private equity fund make up 60-67 percent of the total value received by general partners, with the remaining 33-40 percent comprised of carried interest.[2]

Under well-established tax principles, all partnership income is passed through to the individuals making up the partnerships *based on the character of the income received*. To the degree the partnership receives fees or interest payments, all partners—general partners and Limited Partners—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 the Internal Revenue Service, fees and short-term capital gains income, which are taxed at ordinary income rates (up to 35 percent), accounted for 49.8 percent of total partnership income. The remaining 50.2 percent of partnership income consisted of long-term capital gains tax at 15 percent. A weighted average of the two tells us that the blended average tax rate paid by partners in 2004 was 25 percent.[3]

[1] Internal Revenue Service, 2007, Data Book 2006, (United States Department of the Treasury, Washington, D.C.).
[2] Metrick, Andrew, and Ayako Yasuda, 2007, The Economics of Private Equity Funds.
[3] Internal Revenue Service, 2007. The weighted average calculated as [(49.8)(.35)+(50.2)(.15)]/100=24.96%.

Review of Academic Literature

Over the past 30 years there has grown a vast academic literature on partnerships in general and private equity partnerships in particular. Although there are many different opinions on various aspects of the private equity markets, the vast majority of research agrees on several key points:

First, private equity is a large and extremely important part of the US economy that has played an irreplaceable role in the restructuring of American companies over the last 25 years into today's strong global competitors.

Second, private equity arises partly in response to a market failure in the public markets, known as the "Jensen hypothesis,"[4] in which some entrenched managers of public companies fail to look after the interests of their shareholders. The stronger governance and tighter control exercised by private equity investors combined with the closely aligned interests of the private equity investors and the managers of their portfolio companies through partnership agreements work to correct this problem.

Third, private equity is a major and growing source of expansion capital for family-owned "middle market" companies that are too small or otherwise unsuited for the public markets. These small companies are the backbone of the American economy, accounting for more than half of GDP and virtually all employment growth.

Fourth, private equity sponsors and the network of operating resources they bring to portfolio companies significantly improve the productivity, profitability, asset management, and growth of the companies manage. According to Steven Kaplan, Professor at the University of Chicago School of Business and one of the leading experts in the area, "the academic evidence for the positive productivity effects of private equity is unequivocal."[5]

Fifth, private equity in the form of venture capital invested in computers, industrial, energy, retail, distribution, software, healthcare and consumer products has had an extraordinary record in creating new businesses, new technologies, new business models, and new jobs. According to *Venture Impact*, a study prepared by Global Insight (2007), venture-backed companies like Intel, Microsoft, Medtronic, Apple, Google, Home Depot, Starbucks, and eBay accounted for $2.3 trillion of revenue, 17.6 percent of GDP, and 10.4 million private sector jobs in 2006. Venture-backed companies grow faster, are more profitable, and hire more people than the overall economy.

Sixth, and finally, private equity in the form of real estate partnerships has dramatically increased the availability and lowered the cost of capital to build homes, shopping centers, office buildings, and hospitals for American families and businesses. In *Emerging Trends in Real Estate* (Urban Land Institute (2007)), the study reports that in 2006, investors provided $4.3 trillion in capital to the U.S. real estate sector, including $3.2 trillion in debt capital and $1.1 trillion in equity capital. Of the equity capital, the bulk was provided through partnerships by private investors ($451 billion), pension funds ($162 billion), foreign investors ($55 billion), life insurance companies ($30

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[4] Jensen, M.C., 1993, The modern industrial revolution, exit, and the failure of internal control systems, *Journal of Finance* 48, 865–880.

[5] The Wall Street Journal, 2007, Trading Shots: Taxing Private Equity, (The Wall Street Journal).

billion), private financial institutions ($5.1 billion), REITs ($315 billion), and public untraded funds ($37.4 billion).[6]

Below is a detailed review of several key articles written on this topic:

1. *Cumming, Siegel, and Wright (2007)*[7]

In an extraordinarily thorough review article in the September 2007 issue of the *Journal of Corporate Finance*, Cumming et al. conclude that "there is a general consensus that across different methodologies, measures, and time periods, regarding a key stylized fact: [leveraged buyouts] (LBOs) and especially, [management buyouts] (MBOs), enhance performance and have a salient effect on work practices. More generally, the findings of the productivity studies are consistent with recent theoretical and empirical evidence, Jovanovic and Rousseau (2002) suggesting that corporate takeovers result in the reallocation of a firm's resources to more efficient uses and to better managers."

2. *Kaplan (1989)*[8]

In a classic article, Kaplan examines a sample group of 76 large management buyouts of public companies from 1980 to 1986, presenting evidence for long-term changes in operating results for these companies. Kaplan found that in the three years following the buyout, the sample companies experienced increases in operating income, decreases in capital expenditures, and increases in net cash flow. Consistent with these documented operating changes, the mean and median increases in market value (adjusted for market returns) were 96 percent and 77 percent over the period from two months before the buyout announcement to the post-buyout sale. Kaplan provides evidence that the operating changes and value increases are due to improved incentives as opposed to layoffs, managerial exploitation of shareholders via inside information or wealth transfer from employees to investors.

3. *Wright, Wilson and Robbie (1996)*[9]

The authors examine the longevity and longer-term effects of smaller buyouts. The evidence presented shows that the majority of these companies remain as independent buy-outs for at least eight years after the transaction, and that entrepreneurial actions concerning both restructuring and product innovation are important parts of entrepreneurs' strategies over a ten year period or more. Wright, Wilson and Robbie also provide an analysis of the financial performance and productivity of these companies using a large sample of buyouts and non-buyouts. Their analysis shows that buy-outs significantly outperformed a matched sample of non-buyouts, especially from year 3 onwards. Regression analysis showed a productivity differential of 9 percent on average from the

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[6] Miller, Jonathan D., 2006. *Emerging Trends in Real Estate* (ULI-the Urban Land Institute, Washington, D.C.). p. 21.
[7] Cumming, Douglas, Donald S. Siegel, and Mike Wright, 2007, Private equity, leveraged buyouts and governance, *Journal of Corporate Finance* 13, 439-460.
[8] Kaplan, S.N., 1989a, The effects of management buyouts on operating performance and value, *Journal of Financial Economics* 24, 217–254.
[9] Wright, M., N. Wilson, and K. Robbie, 1996, The longer term effects of management-led buyouts, *Journal of Entrepreneurial and Small Business Finance* 5, 213–234.

second year after the buyout onwards. Companies which remained buyouts for ten or more years experienced substantial changes in their senior management team, and were also found to undertake significant product development and market-based strategic actions.

4. *Nikoskelainen and Wright (2007)*[10]

The authors use a data set comprising 321 exited buyouts in the United Kingdom from 1995 to 2004 to investigate the realized value increase in exited leveraged buyouts (LBO). Nikoskelainen and Wright test Michael C. Jensen's (1993) free cash flow theory, showing that value increase and return characteristics of LBOs are related to the associated corporate governance mechanisms, most notably managerial equity holdings. They also show that return characteristics and the likelihood of a positive return are related to the size of the target company and to any acquisitions executed during the holding period.

5. *Renneboog, Simon, and Wright (2007)*[11]

This paper examines the magnitude and sources of the expected shareholder gains in United Kingdom Public-to-Private (PTP) transactions from 1997 to 2003. They show that pre-transaction public shareholders receive a premium of 40 percent. They test the sources of value creation from the delisting and find that the main sources of value are undervaluation of the target firm in the public market, increased interest deduction and tax savings and better alignment of owner-manager incentives.

6. *Jensen (1989)*[12]

Jensen argues against the 1980's protest and backlash from business leaders and government officials calling for regulatory and legislative restrictions against privatization (takeovers, corporate breakups, divisional spin-offs, leveraged buyouts and going-private transactions). He believes that this trend from public to private ownership represents organizational innovation and should be encouraged by policy. Jensen explains that there is a conflict in public corporations between owners and managers of assets known as the "agency problem," particularly in distribution of free cash flow. He argues that weak public company management in the mid 1960s and 1970s triggered the privatizations of the 1980s. He sees LBO firms as bringing a new model of general management that increases productivity because private companies are managed to maximize long-term value rather than quarterly earnings. He argues that private equity revitalizes the corporate sector by creating more nimble enterprises. Jensen further asserts that it is important that the general partners of LBO partnerships take their compensation on back-end profits rather than front-end fees because it provides strong incentives to do good deals, not just to do deals.

[10] Nikoskelainen, Erkki, and Mike Wright, 2007, The impact of corporate governance mechanisms on value increase in leveraged buyouts, *Journal of Corporate Finance* 13, 511-537.
[11] Renneboog, Luc, Tomas Simons, and Mike Wright, ibid. Why do public firms go private in the UK? The impact of private equity investors, incentive realignment and undervaluation, 591-628.
[12] Jensen, M., 1989, The eclipse of the public corporation, *Harvard Business Review* 67, 61–74.

7. *Jensen (1993)*[13]

Jensen describes the problems that accompany the "modern Industrial Revolution" of the past 20 years, citing that "finance has failed to provide firms with an effective mechanism to achieve efficient corporate investment." He explains that large corporations today do not follow the rules of modern capital-budgeting procedures, most specifically succumbing to agency problems that misalign managerial and firm interests—damaging managers' incentives to maximize firm value instead of personal gain. The classic structure of private equity buyouts helps to realign incentives through increased managerial equity holding, increased monitoring via commitment to service debt, and the active involvement of investors whose ultimate returns depend on the firm's value upon exit. Jensen provides a framework for analyzing expected longevity and improved performance in the long-run, arguing that financial sponsor involvement in companies that have previously been wasting free cash flow and under-performing can permanently improve the company's performance through improved organization and practices.

8. *Knoll (2007)*[14]

Knoll presents the first academic analysis to quantify the tax benefit to private equity managers of the current treatment of carried interests and the additional tax that the Treasury would collect if current tax treatment were changed in accord with recent proposed legislation. He points out that it is misleading to look at one party in isolation because private equity investments involve several parties including general partner, limited partner, and portfolio company owners and managers who are joined by negotiated business agreements. Knoll uses a method for estimating tax impacts that was developed 25 years ago by Merton Miller and Myron Scholes (1982). Using the Miller-Scholes methodology, he estimates the tax implications of raising tax rates on carried interest for all parties in the private equity transaction.

The fund's investment capital comes from its limited partners—wealthy individuals, charitable foundations with large endowments, pension funds, and corporations, and insurance companies. Each limited partners has a different tax status. Using estimates of the composition of limited partners, Knoll calculates estimates of net tax revenue gain from the proposed tax increase.

Knoll estimates, based on assumed $200 billion of annual limited partner investments and with no change in the composition of the partnerships or structure of the fund agreements, that the change in tax treatment as a combination of ordinary income tax rates and accelerating taxation of corporate entities would generate an additional $2 to $3 billion per year. He notes, however, that it is highly likely that the structure of private equity funds will change in response to the tax treatment revisions, shifting some portion of the burden of increased taxes to limited partners and to the portfolio companies. Assuming that companies are generating taxable profits, and can use the additional expense deduction, shifting carried interest to portfolio companies would virtually cancel out any additional taxes paid by the general partners, with the result that increasing carried interest tax rates would generate little or no net increase in tax collections.

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[13] Jensen, M.C., 1993, The modern industrial revolution, exit, and the failure of internal control systems, *Journal of Finance* 48, 865–880.
[14] Knoll, Michael S., 2007, The taxation of private equity carried interests: Estimating the revenue effects of taxing profit Interests as ordinary income, Social Science Research Electronic Paper Collection (Philadelphia, PA).

9. Fleischer (2006)[15]

Fleischer proposes a "cost-of-capital" approach under which the general partners of investment partnerships with more than $25 million in capital under management would be allocated an annual cost-of-capital charge (e.g. 6 percent of the 20 percent profits interest times the total capital under management) as ordinary income. The limited partners would then be able to deduct the corresponding amount (or would capitalize the expense, as appropriate). Fleischer argues that this tax treatment more closely reflects the economics of the arrangement, explaining "in the typical fund, the general partner effectively receives a non-recourse, interest-free compensatory loan of 20 percent of the capital in the fund, but the foregone interest is not taxed currently as ordinary income."

Fleischer claims that his cost-of-capital approach also provides a reasonable compromise on the character of income issue: "as when an entrepreneur takes a below market salary and pours her efforts back into the business as 'sweat equity,' the appreciation in the value of a private equity fund reflects a mix of labor income and investment income. A cost-of-capital approach disaggregates these two elements, allowing service partners to receive the same capital gains preference that they would receive on other investments, but no more."

10. Weisbach (2007)[16]

Weisbach argues that the arguments behind the Levin bill (H.R. 2834 in the 110th Congress) are misplaced for two reasons: 1) the labor involved in private equity investment is no different than the labor that is intrinsically involved in any investment activity, and should be treated no differently; and 2) even if there were good reasons for taxing carried interest as ordinary income, the tax changes would be "complex and avoidable, imposing costs on all involved without raising any significant revenue."

To support his first point, he compares private equity investment to purchasing stock through a margin account. In both situations, investors combine their capital with that of third parties, and labor effort is requires to make the investment. The only difference between the two scenarios is that private equity funds issue limited partnership interests as a means of financing their investment instead of margin debt. Weisbach argues that there are no valid reasons to change the way that these sponsors are taxed simply because they have chosen a different method of financing their activities or because they use a partnership.

The problem of complexity and avoidance that Weisbach describes is independent of the issue of what is appropriate according to tax law, and is concerned mostly with practicality. In order to change the tax treatment of carried interest as proposed, one would first have to define carried interests. In addition, if that were accomplished satisfactorily, fund managers would have little problem avoiding the bulk of these new taxes by acquiring non-recourse loans from limited partners.

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[15] Fleischer, Victor, 2006, Two and Twenty: Partnership Profits in Hedge Funds, Venture Capital Funds and Private Equity Funds, Colloquium on Tax Policy and Public Finance (NYU School of Law).
[16] Weisbach, David A., 2007, The Taxation of Carried Interests in Private Equity Partnerships.

Weisbach concludes that the decision of private equity fund managers to use limited partnerships instead of debt to finance their investments does not warrant such a significant change in tax law; and that even if it did, the small increases in tax revenues (after investors have avoided the bulk of the impact of the tax rate increase with simple changes in financing structure) would not outweigh the difficulties and costs that the new laws would present.

11. Abrams (2007)[17]

Abrams discusses current issues surrounding carried interest tax changes, concluding that while current tax law was drafted largely out of administrative convenience, it is in fact a fairly good compromise between the many conceptual and practical difficulties of fashioning a proper tax treatment for investment activities. He argues that while surely some portion of the returns could be considered compensation for services, it is not valid to classify all of the carried interest received by the general partner as compensation since a large part of carried interest is in fact the risky return on a capital investment and should qualify for capital gain treatment.

Abrams considers Fleischer's (2006) proposed cost-of-capital approach as a compromise, arguing that though much of the logic is sound, the proposal has very little effect on tax revenues since with every cost-of-capital charge the general partner pays, the limited partners are allowed a corresponding deduction, except for non-profit tax-exempt entities for whom the deduction holds no value. Because of the small impact this system would have on tax revenues, Abrams suggests that even if Fleischer's approach were the correct one, the transaction cost of changing current tax law is greater than the ultimate benefits of such a change, due largely to undesirable complexity and avoidance issues.

12. Fenn and Liang (1995)[18]

This thorough review of the history and structure of private equity and venture capital was published as a staff study of the Federal Reserve Board. The report traces the historical positive role regulatory and tax changes have played in fueling investment activity through the widespread adoption of limited partnerships as the dominant form of organizing private equity ventures.

Fenn and Liang describe the rise of the partnership as the most effective structure for dealing with issues of information and incentive structure between the general partner, institutional investors, and portfolio companies. Fenn and Liang emphasize that the expansion of the private equity market has increased access to outside equity capital for both classic start-up companies and established private companies.

Relevant to the current proposed regulatory and tax changes, Fenn and Liang describe the abrupt slowing of venture capital investment in the late 1960s and early 1970s due to a shortage of qualified entrepreneurs, a sharp increase in the capital gains tax rate, and a change in tax treatment of employee stock options. These changes not only discouraged investments in start-ups but drove

[17] Abrams, Howard E., 2007, Taxation of Carried Interests, Tax Notes.
[18] Fenn, George W., Nellie Liang, and Stephen Prowse, 1995, The Economics of the Private Equity Market, Staff Series (Board of Governors of the Federal Reserve System, Washington D.C.).

fund managers to shift to other strategies for private equity investing. The result, they note, was an increase in leveraged buy-outs of larger, more established companies and very little investment in new ventures.

Public concern about the scarcity of capital for new ventures prompted another round of regulatory changes in the late 1970s, changing the guidelines for public pension fund investing to include private equity and venture capital investments. The initial impact of these changes was to reinvigorate the new-issues market; its long-run impact has been to encourage pension fund investments in private equity partnerships. The evolution of the limited partnership in combination with favorable regulatory and tax changes led to early notable start-up successes such as Apple Computer, Intel, and Federal Express.

Conclusion

Since its inception, the partnership structure has been a resounding success, giving American investors and entrepreneurs the tools to create and grow businesses, build shopping centers, build hospitals, explore for oil and gas, found new technology companies, and finance mergers and acquisitions. In 2004, more than 15.6 million Americans were partners in 2.5 million partnerships investing $11.6 trillion using the partnership structure.

Increasing tax rates on long-term capital gains income designated as a general partner's carried interest would alter the long-accepted tax principle that partnership income flows through to the partners who pay tax based on the character of the income received by the partnership. If a group of financial investors came together to form a partnership with no general partner to engage in exactly the same investment activities, 100 percent of the profits from the partnership would be taxed at long-term capital gains rates. The partnership structure simply assigns a slice of those capital gains to the general partner to induce them to contribute their intangible assets—brand, reputation, deal flow network, and experience—to the venture. The fact that limited partners do so willingly, through arms-length negotiations with general partners, serves as a measure of the value that a good general partner brings to the table.

The incidence of a tax increase on carried interest would not hit just the fund managers but would be spread across all the players in the partnership—general partners through lower after-tax gains, limited partners and their beneficiaries through higher partnership costs and lower returns, and owners and employees of operating companies as lower business valuations.

U.S.-based companies are facing fierce international tax competition. In today's global economy, countries have to compete for the capital they need to grow. Increasing carried interest taxes would disrupt long-standing business practices in U.S. capital markets and risk undermining America's preeminent position in the world as a leader in invention, innovation, entrepreneurial activities, and growth. Higher tax rates would reduce the amount of long-term capital available to the U.S. economy and undermine investment, innovation, entrepreneurial activity, and productivity.