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Senators Defend “Carried Interest” Loophole for Investment Fund Managers in the Name of the Poor, Minorities, Small Businesses and Cancer Patients!

There are many reasons why House Speaker Nancy Pelosi had great difficulty in getting members of her chamber to approve H.R. 4213, the jobs and “extenders” bill that was approved last week only after it was severely weakened by conservative Democrats. One problem all along was that many members of the Senate expressed reservations about a provision in the bill to clamp down on an unfair loophole for investment fund managers.¹ Some House members were hesitant to vote for a bill that might not pass in the Senate.

The Senators, for their part, went home for the Memorial Day recess without acting on this bill, which resulted in the expiration of unemployment insurance and health benefits for out-of-work families. While Senators are in their home states during recess, they will hopefully hear from their constituents that this is no time to protect a loophole for multi-millionaires while ordinary families are struggling with unemployment, the home mortgage crisis, and cuts in state and local public services.

“Carried interest” is a portion of profits promised to certain people who manage investment funds. The “carried interest” loophole allows these fund managers to pretend that some of this compensation is actually capital gains, which is taxed at a top rate of 15 percent and not subject to payroll taxes, whereas wage compensation is generally taxed at a top rate of 35 percent and is always subject to payroll taxes. The end result is that these investment managers (who sometimes earn hundreds of millions of dollars in a year) can pay taxes at lower rates than their secretaries.

In an earlier report, we explained that Congress’s intention in creating a lower income tax rate for capital gains was to encourage people to invest their money, and that it makes no sense to allow this tax preference to apply to those who are managing other people’s money. Our earlier report also addressed some of the convoluted arguments that have traditionally been made to defend the loophole.²

Now the investment fund managers and their lobbyists have put forth new, and even more ridiculous, arguments. They seem willing to say anything — no matter how preposterous — to justify the subsidy that the rest of us provide to them through the tax code.

¹For a general description of the three types of tax loophole-closing provisions in H.R. 4213, see Citizens for Tax Justice, “The American Jobs and Closing Tax Loopholes Act of 2010 (a.k.a. the “Extenders” Bill) Would Boost the Economy and Improve Tax Fairness,” May 21, 2010. <http://www.ctj.org/pdf/extenders2010.pdf>

²Citizens for Tax Justice, “Will the ‘Carried Interest’ Loophole Finally Be Closed?” May 12, 2010. <http://ctj.org/pdf/carriedinterest2010.pdf>

Outrageous Arguments Made in Defense of the Carried Interest Loophole

1. Taxing carried interest as capital gains helps low-income neighborhoods.

This is one of the most ludicrous arguments that some Senate staffers have apparently accepted from real estate lobbyists. It goes something like this. First, taxing investment fund managers at the low capital gains rate (instead of the ordinary income tax rates that everyone else pays on their compensation) is good because it encourages risk-taking by investors. Why risky investments are good is never explained.³ This argument also ignores the fact that the people putting up the money are completely unaffected whether this loophole exists or not. (Closing this loophole will only affect the carried interest paid to a person in return for managing someone else's money.)

The second part of this argument is that risky real estate investments are investments in low-income areas. Building condos or shopping centers in wealthy neighborhoods is not risky, the argument goes, but building these things in poor, under-developed neighborhoods is risky. The people who put together these deals therefore need to be taxed at a lower rate so that they'll have an incentive to provide this service (beyond the enormous compensation they receive for doing so).

In other words, their argument is that helping low-income neighborhoods does not require lower taxes for the teachers, police officers, or the construction workers who build these communities everyday, and it doesn't even require lower taxes for the people who actually put up the money to invest in these communities. It requires, more than any of this, lower taxes for the people who manage the money being invested — no matter how many millions of dollars they earn.

It would probably be impossible to preserve the carried interest loophole only to the extent that it represents returns from investments in under-developed areas. Apparently this particular argument is an argument for preserving the loophole for *all* types of investments. And even if one believes that this loophole encourages risky investment, the term "risky investments" probably includes everything from newly engineered motors to the next ebook reader. There's no guarantee that even a fraction of this investment helps low-income neighborhoods.

Let's assume, for the sake of argument, that you really do believe that the tax code can be used effectively to encourage investments in low-income communities. Does that mean that carried interest needs to be taxed at lower rates than other compensation? Of course not. There are other ways in which we use the tax code to subsidize this sort of local economic development. We spend around \$6 billion a year on Low-Income Housing Credits. We spend over a billion dollars combined each year on New Markets Tax Credits and Empowerment

³The current economic crisis was precipitated, at least in part, by investments in risky assets like derivatives and inflated real estate properties, and yet investment fund managers cling to the notion that the tax code should encourage risk-taking.

Zones, which shower tax breaks and other benefits on those who invest in economically under-developed areas.

If one wants to use the tax code to help low-income areas, it's surely more logical to use these types of measures, rather than allowing investment fund managers to pay taxes on part of their compensation at lower rates than everyone else.

2. Taxing carried interest as capital gains helps minorities.

This argument has been put forward by Robert Johnson, founder and chairman of RLJ Companies and founder and former chairman of the cable television network BET.⁴ It's an assertion that is not backed up by any supporting evidence or even much logic.

Johnson says that minority firms that run investment funds need to attract the brightest minority investment whizzes, and won't be able to do so if these whizzes have to pay income taxes at ordinary income rates. This is really a variation on the broader argument made by the industry that the potential compensation — which can run into the hundreds of millions of dollars — simply isn't enough incentive for investment managers to provide their services unless it's topped off with a huge tax break.

Any argument claiming that the brightest minds will avoid work as investment fund managers needs to explain what they will do with their time instead. If the loophole is closed, that merely means that an investment fund manager who receives carried interest will be taxed at the same ordinary income tax rates as investment bankers or other highly paid people. There is no reason to believe that other types of work will suddenly seem more attractive after this loophole is closed.

More importantly, Johnson offers no evidence at all that a disproportionate number of investment fund managers are minorities. The percentage of investment managers who are minorities could be 15 percent, or 5 percent, or 0.01 percent or 0.001 percent. Johnson doesn't say because apparently no one knows. Maintaining a loophole that unfairly enriches multi-millionaires because some unknown number of them may be minorities would be illogical and bizarre.

Johnson also writes that “[f]or the most part, minority firms invest their funds in minority businesses and other businesses located in urban communities.” Even if this is true, Johnson offers no evidence that a disproportionate amount of the total investments made by managers receiving carried interest are investments in minority businesses and urban businesses. His argument boils down to an assertion that *all* investment fund managers should pay taxes at lower rates than everyone else because *some* undefined number of them direct investments into minority businesses.

⁴Robert L. Johnson, ‘Statement by Robert L. Johnson Opposing Carried Interest Tax as Proposed in Financial Reform Regulation,’ May 24, 2010.
<http://www.rljcompanies.com/phpages/wp-content/uploads/2010/05/Statement-by-Robert-L.-Johnson-Opposing-Carried-Interest-Tax-as-Proposed-in-Financial-Reform-Legislation.pdf>

This argument can safely be written off as another episode in Johnson's pursuit of his own self-interest disguised as concern about minorities.⁵

3. Taxing carried interest as ordinary income helps small business entrepreneurs.

The president of the Real Estate Roundtable, a lobbying group for the industry, claims that closing this loophole will affect an entrepreneur who wants to buy a house and rehabilitate it with financial backing from a few friends. The entrepreneur might be paid with a share of the profits from reselling the rehabbed house, even though he put little or no money into its purchase. The real estate lobby says that his share of the profits that do not represent a return on money he invested himself (his "carried interest") would be taxed as ordinary income if this loophole is closed.

As an example of the typical person who might be affected by the closing of this loophole, this is ridiculous. First of all, a person who is actually doing the physical work of rehabbing a house probably does not even fall into the category of persons affected by the current proposal, which only applies to people who are managing, acquiring and disposing of assets or advising people about such transactions, or arranging the financing for them. It's not clear that the entrepreneur rehabbing a house in the example could even be affected.

Second, if this entrepreneur was rehabbing houses for a living, the houses would actually be considered inventory (rather than capital assets) and any profits made upon their resale would already be taxed as ordinary income under current law.

In other words, this argument is merely another attempt to defend a loophole for wealthy individuals managing investments and putting together real estate deals by painting the loophole as a break for the little guy.

4. Taxing carried interest as capital gains helps cancer patients.

There are several types of investment fund managers who benefit from the carried interest loophole, and the most revered among them seem to be the venture capital fund managers. They argue that, unlike private equity fund managers who buy companies, fire employees and then sell off the pieces, venture capitalists direct investments into start-up companies that are creating jobs and new technologies. This may be true to a large extent, but it does nothing to explain why venture capital fund managers should pay taxes at lower rates than their secretaries.

A letter defending the loophole, apparently drafted and distributed by lobbyists for venture capital fund managers, has been signed by 28 researchers and academics claiming that closing the loophole will "discourage the very type of long term, high risk investment and

⁵Jonathan Chait, "Paint It Black: Robert Johnson, W's Favorite Race Baiter," *The New Republic*, September 3, 2001. <http://www.tnr.com/article/politics/paint-it-black>

commitment required to take our best discoveries to the next level.”⁶

“Consider the revolutionary application of nanotechnology to the treatment of cancer,” the letter pleads. “Many of the most exciting new products and medicines will not be developed without the long term commitment of venture capital.”

Even if it’s true that tax breaks for capital investments are needed to develop new health products and medicines, the assertion that this depends on lower tax rates for the people *managing* these investments is outrageous.

The claim is that a tax break — not for researchers, not for the people investing their money in new technologies, but for the people managing that money — is necessary for life-saving technological breakthroughs.

The researchers who signed the letter in support of the carried-interest loophole seem to be claiming that if the people managing investments in technology have to pay taxes on their compensation at the same rates as everyone else (the same as the actual researchers!), they will not provide their services, and the result will be less investment in new technologies. What else these venture capital fund managers would choose to do with their time is never made clear. Remember that any other job they do will result in compensation that is taxed as ordinary income, just as their carried interest would after this loophole is closed. So it’s not obvious that venture capital fund managers would suddenly find some other pursuit more appealing just because they lost this tax break.

Unless the venture capitalists and other investment fund managers respond with an Ayn Rand-style mass departure from the workforce, it seems unlikely that closing the carried interest loophole will have any effect on what they do, much less on the development of life-saving technologies.

Conclusion

The arguments made by investment fund managers in defense of the carried interest tax loophole are outlandish. The only question left is why exactly Senators and their staffs are willing to parrot these arguments. Surely, the persuasiveness of these arguments is not the reason, because they fail to meet a basic threshold for reasonableness even by Congressional standards. For most observers, the only possible reason is the oldest one — money.

In other words, the Senate is in danger of creating a very unflattering impression of itself as motivated by the campaign contributions of investment fund managers. What makes this impression particularly damaging is that the Senate’s unwillingness to close this loophole has held up a bill to provide jobs and relief for struggling Americans during a difficult time.

When Senators have turned a blind eye to any logical assessment of the costs and benefits of a policy, there is only one thing left that can possibly sway them, and that’s the voices of their own constituents. We hope those voices are heard soon.

⁶Letter in opposition to carried interest measure, May 26, 2010.
http://www.nvca.org/index.php?option=com_docman&task=doc_download&gid=605