CTJ

Citizens for Tax Justice

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Congress Should Stop Subsidizing Millionaires Through the Tax Code

On November 1, the House Ways and Means Committee approved a bill (H.R. 3996) that would close the tax loophole for "carried interest" earned by buyout-fund managers. Closing this unwarranted loophole will raise $25 billion over ten years, offsetting half the cost of providing AMT relief for 2007.

The Carried Interest Provision Is a Subsidy for Fund Managers, Paid for by the Rest of Us

All taxpayers, whether middle-class or wealthy, are subsidizing the compensation of these fund managers, who can earn hundreds of millions of dollars a year. Warren Buffet, among others, has argued that it is totally unfair for these fund managers to pay taxes at a lower rate than middle-class taxpayers like the people who answer their phones and deliver their mail.

Eliminating the Carried Interest Loophole Has No Effect on the Taxation of Capital Gains

"Carried interest" is the share of profits that investors pay to their fund managers to compensate them for managing the investors' money. But fund managers have been allowed to pretend that this compensation represents profits on money they have invested themselves, thus entitling them to pay taxes at the low capital gains rate of 15 percent rather than the regular rate of 35 percent that other highly compensated workers pay. (If fund managers actually invest their own money, the bill would still treat the returns as capital gains.)

Eliminating this Tax Loophole Will Have No Effect on Realtors

Some have argued that because real estate development deals sometimes incorporate carried interest, the entire real estate industry will suffer if this tax subsidy is eliminated. This is untrue. The legislation would affect people who are providing investment advice and who are paid for such services with a share of profits (if any) connected to real estate.

But other people in the real estate industry, such as realtors, are already paying federal income taxes at the regular tax rates. In other words, realtors, just like other taxpayers, don't benefit from the carried interest loophole. Instead, they are subsidizing those who do.

Congress Should NOT Carve Out Exceptions that Would Keep the Loophole for Some Sectors

Lobbyists from some sectors affected by this legislation have argued that their industries should be exempt from the proposed reform. For example, venture capital fund managers say they should be allowed to keep using the loophole because venture capital is a good thing.

But as a matter of basic fairness, why should middle-income taxpayers subsidize the millions that are earned by venture capital fund managers or anyone else? If it is unfair for the managers of buyout funds to pay a lower tax rate than their secretaries, how could it be acceptable for managers of venture capital funds to pay a lower rate than their secretaries?

In any event, closing the carried interest loophole won't increase taxes on investments in venture capital. It will only affect those who are managing the investments, by taxing their compensation at the same rates as other well-compensated workers.

Closing the Carried Interest Tax Loophole Will Have No Effect on Pensions

The buyout industry has also tried to argue that the pensions that invest in buyout (a.k.a. "private equity") funds will be harmed by closing the fund managers' loophole, because the fund managers will allegedly no longer have an incentive to work hard or will raise their fees. But as several experts from the pension industry have flatly stated, it's "ridiculous" and "ludicrous" to think this measure will harm pensioners.

This bill does not change the tax treatment of the money that pensions invest in private equity or other types of funds. It merely closes a tax loophole for those who manage the funds. Given the enormous compensation that managers receive, it's hard to imagine that they'll lose their incentive to work if they have to pay taxes like other highly-paid workers. As for them charging higher fees, well, if they could charge more they'd be doing so already. In this regard, it's also worth noting that fees did not decline when the capital gains tax rate was reduced in 1997 and 2003.

The American People Will NOT View This Measure as a "Tax Hike"

The Service Employees International Union (SEIU) sponsored a nationwide poll conducted between June 28 and July 1, 2007, on issues pertaining to the buyout industry. The poll found that 78 percent of respondents would support a proposal to "[t]ax the profits going to private equity managers at the same rate as ordinary income, rather than at the lower rates at which capital gains are taxed." Only 15 percent opposed this proposal. The American people, it seems, understand that closing this loophole is a simple matter of fairness. Congress should understand that, too.