

## Myths and Facts about Private Equity Fund Managers — and the Tax Loophole They Enjoy

Congressman Sander Levin (D-Mich.) has introduced a bill (H.R. 2834) in the House of Representatives to eliminate a tax loophole that allows private equity fund managers to pay taxes on their compensation at a much lower rate than other working people have to pay.

Most of us who earn an income from work are subject to federal income taxes at progressive rates, starting at 10 percent and going up to 35 percent for the very wealthiest. Private equity fund managers are at the top of this wealthy group, but nevertheless pay only 15 percent — the special low capital gains tax rate — on almost all of their compensation. This form of wages, called “carried interest,” can run into the hundreds of millions or even in excess of a billion dollars a year for individual fund managers.

How do we know that “carried interest” is compensation, and not capital gain? There are three reasons:

**1. The fund managers don’t invest their own money.** Instead, in exchange for their financial expertise, they simply get a share of the profits on what the fund’s investors put up. If, on the other hand, the fund loses money, the managers can walk away without any cost.

**2. So “carried interest” is much like executive stock options.** When corporate executives get stock options, it gives them the right to buy their companies’ stock at a fixed price. If the stock goes up in value, the executives can cash in the options and pocket the difference. If the stock doesn’t go up or declines, then the executives get nothing. But they never have a loss. And when the stock does well, the executives pay both income taxes at the regular rates and payroll taxes (usually just the 2.9% Medicare tax) on their earnings.

**3. Private equity managers (sometimes) even admit that “carried interest” is compensation.** In a filing with the Securities and Exchange Commission in connection with taking its management partnership public, the Blackstone Group, a leading private equity firm, had this to say about its activities (in order to avoid regulation under the Investment Act of 1940):

“We believe that we are engaged primarily in the business of providing asset management and financial advisory services and not in the business of investing, reinvesting or trading in securities.

“We also believe that **the primary source of income from each of our businesses is properly characterized as income earned in exchange for the provision of services.**

“We hold ourselves out as an asset management and financial advisory firm and do not propose to engage primarily in the business of investing, reinvesting or trading in securities.”

It therefore seems straightforward that the loophole allowing the fund managers to benefit from the capital gains tax rate serves no legitimate purpose. Nonetheless, several myths about the nature of this loophole have been promoted recently by the private equity industry to confuse the debate on this issue.

**Myth: Private equity fund managers are being targeted merely because they are successful and that bothers many people who are not successful.**

**Fact: Private equity fund managers pay taxes on their earnings at a lower rate than middle-class people, and this unintended loophole in the tax law is simply unfair to ordinary Americans.**

If an unmarried receptionist working for a private equity firm earns \$42,000 a year, the top federal marginal tax rate that applies to his income is 25 percent. This is on top of the 15.3 percent he pays in payroll taxes on all of his income. The fund managers he works for, however, pay only the 15 percent “capital gains” rate on the “carried interest” they receive as compensation for managing other people’s money.

It is simply wrong, and an insult to middle-class people working to attain the American Dream, that they have to send a higher percentage of their income to Washington than a billionaire fund manager does. Warren Buffet recently made this point publicly. Extremely successful Americans should follow his lead and admit that they should pay their fair share to support the country that made their spectacular wealth possible.

**Myth: Congress is picking out one class of people for higher taxes merely because they make a lot of money and Congress wants to take it.**

**Fact: Congress just wants the fund managers to pay federal income taxes under the regular income tax rates like everyone else.**

Congress is focusing on these fund managers because they are exploiting a tax break that is supposed to benefit investors, even though they’re not investing their own money. H.R. 2834 would not change the 15 percent tax rate for people who really have invested money and received income in the form of capital gains. In cases in which private equity fund managers really do contribute some of their own money to the funds they manage, this bill would allow their actual capital gains to be taxed at the capital gains rate of 15 percent.

**Myth: Subjecting the fund managers’ compensation to ordinary income tax rates will mean they have less incentive to manage investments well.**

**Fact: Private equity fund managers can earn hundreds of millions, even a billion dollars in compensation, so even if they were taxed at a 35% income tax rate and a 2.9% payroll tax rate, there would be ample incentive for them to work hard.**

Some private equity fund managers earn hundreds of millions of dollars or more in compensation. It’s hard to believe fund managers would stop working in response to this

reform. Other extremely wealthy people who earn their income through work (think of CEOs and major league athletes) are willing to work hard even though they pay regular tax rates on their income.

**Myth: Taxing private equity fund managers at ordinary income tax rates will hurt pensioners because some pension money is invested in private equity.**

**Fact: This bill does not tax pension funds, or the returns on money in pension funds, in any way.**

The private equity industry has tried to create the impression that public employee pensions will be damaged by this reform, resulting in financial hardship for teachers, police officers, firefighters and other public employees during their retirement.

Several experts from the pension industry have flatly stated that it's "ridiculous" and "ludicrous" to think H.R. 2834 will harm pensioners. This bill closes a tax loophole for those who manage private equity funds. As already stated, it's extremely unlikely that they will stop trying to manage the funds well, given the enormous compensation and incentives that will still exist.

Representatives of public employees, such as the American Federation of State, County and Municipal Employees and the AFL-CIO, have endorsed this bill.

**Myth: A more limited bill being considered in the Senate (which only affects those few private equity firms that are publicly traded partnerships) is more reasonable. The House bill, on the other hand, "goes too far."**

**Fact: The House bill actually could go a lot further. It could be amended to ensure that fund managers don't use accounting tricks to avoid this reform.**

The current Senate private-equity bill is so limited that even its chief sponsors have expressed interest in supporting the House approach, too.

And the House bill could certainly be improved so that it really achieves its goal. If fund managers' compensation is subject to ordinary income tax rates, they might try to get around this reform, at least in part. For example, one strategy would have the real investors "loan" the managers 20 percent of the capital to be invested in the fund. This wouldn't convert all the profits into capital gains, but it could convert a portion. The House bill should be amended to ban such accounting gimmicks. But even if H.R. 2834 is enacted as currently written, it would be a major improvement over current law.